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

APRIL 30 TO MAY 12, 1936

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REVENUE ACT, 1936

THURSDAY, APRIL 30, 1936

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

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

Present: Senators Harrison (chairman), King, George, Walsh, Barkley, Connally, Bailey, Clark, Black, Gerry, Guffey, Couzens, Keyes, La Follette, Metcalf, Hastings, and Capper.

The CHAIRMAN. The committee will come to order. Mr. Secretary, we will begin at these public hearings our consideration of this bill that was passed yesterday by an overwhelming vote in the House, and we would like you to make a statement, and say to the committee whatever you desire.

STATEMENT OF HON. HENRY MORGENTHAU, JR., SECRETARY OF THE TREASURY

Mr. MORGENTHAU. Mr. Chairman: I welcome the opportunity to appear and discuss with you the tax proposals contained in the President's message to the Congress of March 3, and to present the Treasury's viewpoint.

As Secretary of the Treasury, I feel a special responsibility to do all in my power to maintain the integrity of the President's Budget of January 3, 1936; and therefore to urge that the supplemental revenues made necessary by the developments of the past few months be provided.

The Treasury has been able to borrow readily the amounts necessary to finance the recovery program and has been able to obtain these loans at steadily decreasing interest rates. The continuance of this satisfactory situation, however, will depend upon scrupulous adherence to an orderly program looking to a balance of the Federal Budget just as soon as the needs and abilities of our people make that possible and therefore upon a steady reduction in the public debt.

In his Budget message of January 3, 1936, the President made this statement:

"If the Congress enacts legislation at the coming session which will impose additional charges upon the Treasury, for which provision is not already made in this Budget, I strongly urge that additional taxes be provided to cover such charges. It is important as we emerge from the depression that no new activities be added to the Govern-

ment unless provision is made for additional revenue to meet their cost."

At another point in the same message the President said:

"It is pertinent to repeat here a statement appearing in the Summation of the 1936 Budget: 'Estimates of receipts contemplate continued collection of processing taxes. If the attack which has been made upon this act is sustained, we will have to face the problem of financing existing contracts for benefit payments out of some form of new taxes.'"

On the very day that the President's Budget message was read to the Congress the Supreme Court of the United States rendered a decision holding the Agricultural Adjustment Act unconstitutional. Since that date the Congress has enacted, over the President's veto, the Adjusted Compensation Payment Act of 1936, which requires payment, beginning on June 15, of the entire amounts, which were to be due in 1945 and thereafter, on the veterans' adjusted-service certificates. The additional cost of making those payments this year, when distributed over the next 9 years, comes to approximately $120,000,000 a year. The Congress has provided for carrying on a continuing program of conservation of the Nation's agricultural resources which will result in expenditures of approximately $500,000,000 a year.

Thus to conform to the Government's financial program, as set forth in the President's Budget message, we shall need to provide additional continuing revenue of $620,000,000 annually to meet those expenditures. We shall also have to find means of recouping approximately $517,000,000 of revenue sacrificed in the current fiscal year because of the invalidation of the Agricultural Adjustment Act.

The President in outlining those needs suggested three sources of revenue which could be made available for the purpose. One of those suggestions was for processing taxes on agricultural products at lower rates and distributed over a broader base than the similar taxes under the Agricultural Adjustment Act. Another was for a special form of income tax, described as a "windfall" tax, on the unjust enrichment accruing to some corporations and individuals as a result of their escape from the payment of processing taxes. The amount of the processing taxes due prior to January 6 which had thus escaped was approximately $237,000,000.

The third program, and the one of major importance, was for a revision of our system of corporation taxes. It was proposed by the President that the three existing forms of corporate taxes be repealed. Those include the capital-stock tax, the excess-profits tax, and the corporate income tax. The President proposed that there be substituted for those taxes a tax upon that portion of corporate income which is not currently distributed to stockholders in dividends and that at the same time the present exemption from the normal income tax of 4 percent of dividends received by individuals from corporations be repealed.

The status of the President's proposals today is that the House has passed a bill to give effect to two of them. The House bill is estimated by the Treasury to yield additional revenue as follows: (*a*) Net continuing revenue of $623,000,000 yearly from a tax on corporate earnings, and (*b*) net temporary revenue of $180,000,000

from an unjust enrichment tax and temporary extension of the capital-stock tax, divided as follows:

From the unjust enrichment tax, $100,000,000; from the extension of the capital stock tax for 1 year at one-half of the present rate, $80,000,000.

The bill thus fully provides the $620,000,000 needed to take care of the permanent agricultural program and the annual financing of the payment of the soldiers' bonus. It also provides for the first year of a 3-year program for recouping the loss of $517,000,000 of processing taxes lost during the fiscal year 1936. However, it does not provide any temporary revenues for the 2 succeeding years to make up the balance of $337,000,000 of temporary revenues desired.

The estimated yield of $623,000,000 from the tax on corporate earnings is the amount of additional revenue to be derived from the application of the rates and schedules in the House bill to corporate income for the present calendar year, 1936. It must be recognized that the choice of an income tax as the means for raising additional revenue necessarily involves a delay in realization of increased receipts. Receipts from taxes on corporate incomes for the calendar year 1936 will be collected in the main during the calendar year 1937 and will be divided between the 2 fiscal years, the fiscal year 1937, ending June 30, 1937, and the fiscal year 1938. The net additional revenue to be expected from the application of the corporate income tax is estimated to be $310,000,000 in the fiscal year 1937. The full additional annual revenue would be collected in the fiscal year 1938.

Senator KING. Do I understand you, Mr. Secretary, that next year, 1937, for the calendar year this tax will only bring in three hundred and some odd millions?

Mr. MORGENTHAU. Between January 1, 1937, and June 30, 1937, this tax will produce $310,000,000 additional revenue.

The House bill follows the President's suggestions in providing for the repeal of the corporation income tax, the capital-stock tax, and the excess-profits tax and by making dividends received by individuals subject to the normal tax of 4 percent. In place of the repealed taxes it substitutes a new form of tax on corporate income with rates based on the percentage retained by the corporation. The estimated annual yield of $623,000,000 is the amount by which it is expected taxes paid by corporations and individuals under the proposed plan will exceed the yield of corporate and individual taxes under the present law. That covers that point.

It is to be noted that the bill as passed by the House of Representatives, while failing, according to our estimates, to raise temporary revenues for a 3-year period in the full amount sought by the President, utilizes but two of his three suggestions. The third was for the enactment of processing taxes on a broader base but with lower rates than were in effect under the Agricultural Adjustment Act. I call this potential source of additional revenue to your attention again. I feel sure that the Department of Agriculture stands ready to supply any information you may desires on this subject.

Turning from the revenue aspects of the House bill, in which the Treasury is primarily interested, let us consider also the two suggestions made by the President, to which the House bill gives effect, from the standpoint of equity in our tax system.

As to the proposed unjust enrichment tax, I think there is little that need be said. I have not heard the justice of this tax very seriously questioned. There is no doubt whatever that the avoidance of payment of processing taxes accrued prior to January 6 has resulted in unjust gains to a limited number of persons and corporations. It would be grossly unfair to the persons and corporations who paid their processing taxes as due up to the time of the Supreme Court's decision and it would be unfair to the American consumer, who ultimately bore the major burden of the taxes, not to reduce this unjust enrichment as much as we can by taxation.

I take it for granted that an unjust enrichment or "windfall" tax will be enacted by the Congress. I assume, too, that you will give most serious consideration to the matter of the deficiency in the temporary revenue for a 3-year period expected from the House bill as compared with the President's estimates of the need. I turn, therefore, to the proposed tax on corporate income.

The principle of taxation according to ability to pay is now well established, not merely by having been written by amendment into the Constitution of the United States and supported by 20 years of application in our tax structure, but by the undoubted and unquestioned endorsement and support of the citizens of this Nation. Through successive changes in our tax laws, however, we have departed most seriously from a consistent and just application of the principle. Under the existing law we apply the principle to individual incomes, whether they are obtained from interest, rents, or salaries, from the profits of individual business enterprise or from partnership undertakings. We do not apply it to profits gained from corporate enterprise, except in a manner which taxes some citizens at unfairly high rates and gives to others the opportunity to avoid taxation on a wholesale scale.

Where a corporation makes approximately full distribution of its current earnings, the stockholder under present law first bears the burden of three different corporation taxes—the capital-stock tax, the excess-profits tax, and the corporate-income tax; second, he is required to pay surtaxes on the dividends paid to him. This stockholder thus pays what is in effect a normal tax of about 15 or 16 percent as compared to a normal tax of 4 percent paid by the individual who derives his income from other sources. On the other hand, the present law permits stockholders of large incomes to avoid the payment of surtaxes which may run to rates as high as 75 percent on their share of corporate earnings which are not distributed as dividends.

What are the dimensions of tax avoidance with which we are dealing? A few simple figures tell the story. It has been estimated by the Treasury Department that under the present tax law the income tax liability of corporations on the basis of 1936 earnings would approximate 964 millions. The Department has also estimated that under the present law more than 4½ billion dollars of corporation income in the calendar year 1936 will be withheld from stockholders and that if this income were fully distributed to the individual owners of the stock represented in those corporations, the resultant yield in additional individual income taxes would be about $1,300,000,000.

With tax avoidance occurring on the scale indicated by the figures I have cited, I do not see how any increase in individual income tax

rates or other general and continuing taxation could be justified until this leak in our tax system is stopped.

Whatever may be the debatable considerations that may enter into the preparation of particular schedules, it will be well to bear in mind at all times that this is purely and simply a proposal to put all taxes on business profits essentially on the same equitable basis; to give no advantages and to impose no penalties upon corporation stockholders that are not given to and imposed upon the individual taxpayer who alone or as a partner derives his income from business profits.

In closing let me say this: I sincerely hope that this committee will report to the Senate a bill giving effect, as fully as possible, to the President's recommendations of the amount of additional revenue needed to supply the deficiencies created since the Budget message of January 3.

The CHAIRMAN. Mr. Secretary, in title IV of the House bill, it provides for refunds of certain processing taxes. Were these taken into consideration and into account in the estimate of $517,000,000 of temporary revenues needed?

Mr. MORGENTHAU. No; they were not. I have a short explanation of that.

They were not taken into consideration because it was impossible for us to determine at that time all the possible liabilities that might occur as the result of the invalidation of the Triple-A Act. Not all of these questions are yet settled. For instance, we may still have to consider other claims for refunds arising under section 21d of the amendment to the Agricultural Adjustment Act passed at the last session. But the Ways and Means Committee, which inserted the refund provisions in the present bill, regards these particular refunds as fulfilling a moral obligation of the Government, and I agree. We estimate that they will amount to $43,000,000. If we add this to the $517,000,000 the amount to be raised in 3 years is $560,000,000, and if we deduct the $180,000,000 of temporary revenue in the House bill the remainder to be raised for the following 2 years is $380,000,000, or $190,000,000 for each of the 2 years.

The CHAIRMAN. Are there any questions of the Secretary?

Senator KING. Mr. Secretary, in determining the amount required, did you take into consideration the large appropriations which will perhaps be $1,200,000,000 for the Army and the Navy for the next year, and approximately $1,000,000,000 for flood relief and rivers and harbors?

Mr. MORGENTHAU. Senator King——

Senator KING (interposing). Pardon me. And $1,500,000,000 or possibly $2,000,000,000 for relief to be expended by Mr. Hopkins or by Mr. Ickes, or both?

Mr. MORGENTHAU. Well, to answer your question, the Budget picture as it is today—whatever time it is—is just where it was approximately, and it may be a little bit off—but approximately as when it was sent up by the President to Congress, with two exceptions. One is due to the decision of the courts on the A. A. A., and the other is due to the soldiers' bonus.

When the President sent up his message, he forecast a deficit for the coming fiscal year of $1,098,000,000, and he pointed out that if the Congress would appropriate up to $2,136,000,000 for relief, that

the deficit for the coming year would not be in excess of the deficit for the previous year. He did ask for $1,500,000,000, so if you take $1,098,000,000—let us call it a billion and one—plus the billion and a half, you get the approximate picture for the next year.

But I would like to give you the exact figures. I have it prepared to give you, if I may.

The Budget deficit for 1936 was $3,234,500,000 on January 3. That is the way the President forecast it. To this you have to add the $495,100,000, adjusted expenditures due to the A. A. A. decisions, and you get the figure of $3,729,600,000. For purposes as near as anybody can estimate, to this year's deficit we add the total of the veterans' bonus which goes out on June 15. We always take the top figure in the Treasury; we have to. We have to assume it is all going to go out. If it all goes out, we add $2,237,000,000, or total estimated deficit for 1936 of $5,966,600,000. That is the way it stands.

For the fiscal year 1937, the President's estimated deficit of $1,098,000,000, he asked for $1,500,000,000, which gives you $2,598,000,000.

You have to adjust expenditures due to the A. A. A. on account of the Court's decision, you have to add $524,000,000, from which you deduct $490,000,000, which is the increased estimates in the present bill; so you get from that $34,000,000. Then we have the $43,000,000 which we have just talked about, an increase for next year which has not been accounted for, of $77,000,000, or to bring the estimated deficit for 1937 to $2,675,000,000.

To read that again—putting the bonus in, making adjustment for the A. A. A. which is the only difference, adding $1,500,000,000 for relief, we forecast for this year a deficit of $5,966,000,000, and for the next year, $2,675,000,000.

Deficits for fiscal years 1936 and 1937 based upon estimates contained in the 1937 budget submitted to the Congress on Jan. 3, 1936, adjusted because of the A. A. A. decisions, passage of the Adjusted Compensation Act, and on the basis of the pending tax bill

Fiscal year 1936:		
Budget deficit		$3,234,500,000
Adjusted expenditures due to A. A. A. decision		495,100,000
		3,729,600,000
Add: Veterans' bonds to be issued		2,237,000,000
Total estimated deficit, fiscal year 1936, assuming veterans' bonds all to be issued this fiscal year		5,966,600,000
Fiscal year 1937:		
Budget deficit		1,098,400,000
Add: Relief appropriation pending		1,500,000,000
		2,598,400,000
Adjust expenditures due to A. A. A. decision	$524,300,000	
Deduct estimated revenue in pending bill	490,000,000	
	34,300,000	
Add: Refunds of taxes provided for in pending tax bill	43,000,000	77,300,000
Adjusted deficit for fiscal year 1937		2,675,700,000

To refresh your memory, the gross deficit in 1934 was $3,989,000,000; for 1935 $3,575,000,000; the estimate for this year is $5,966,000,000, and 1937 $2,675,000,000.

So that if it were not for the soldiers' bonus, 1934, 1935, 1936, and 1937 each year we would have a declining deficit.

Senator BARKLEY. Of course, that estimated deficit for 1937 will be reduced by whatever amount the ex-service men decline to accept in cash and continue to carry their bonds.

Mr. MORGENTHAU. The amount of cash we will have to raise and pay out in the immediate future will be reduced by that amount, it is true.

Senator BARKLEY. I realize that in making your estimates, you have to take into account the possibility of all of them cashing them.

Mr. MORGENTHAU. The top figure.

Senator BARKLEY. But we all know that that will not be the figure that will actually be necessary.

Mr. MORGENTHAU. That is true.

Senator BARKLEY. But for bookkeeping purposes, you have to assume it.

Mr. MORGENTHAU. For good, sound financing purposes, we would rather play safe.

The CHAIRMAN. As a matter of fact, if it had not been for the Court's decision and the passing of the Adjusted Compensation Certificate legislation, we would not have been called upon to pass a tax bill at this session of Congress.

Mr. MORGENTHAU. That is true.

Senator KING. But you would still have a deficit?

Mr. MORGENTHAU. Yes, sir; and the President pointed out exactly what the deficits are, and I may say that his estimates for receipts had been running within 1 percent of what he estimated, and his expenditures have constantly run under his estimates.

Senator HASTINGS. Mr. Secretary, if what the chairman says is true, and you agree that it is true, that there would have been no necessity for any tax bill at all except for the Supreme Court's decision upon the A. A. A., why did you not content yourself with raising sufficient money to pay that debt and quit there? That obligation?

Mr. MORGENTHAU. I do not quite understand, Senator.

Senator HASTINGS. I understand you to say that it would not have been necessary to have had a tax bill except for the Supreme Court's decision declaring the A. A. A. void.

Senator BARKLEY. And the bonus.

The CHAIRMAN. I added to it "and the bonus."

Senator HASTINGS. I understood the chairman to say that if it had not been for the Supreme Court's decision, there would have been no tax bill necessary, and I understood you to agree to it. Now, I understand that is not so.

The CHAIRMAN. I stated, the Supreme Court's action, together with the passage of the act for adjusted-service certificates.

Senator HASTINGS. I did not so understand it.

Mr. MORGENTHAU. The President is on record to that effect; that he would ask for no new taxes.

Senator HASTINGS. I did not understand it.

Mr. MORGENTHAU. I would like to point out that the President is on record that he would have asked for no new taxes this year unless the Congress passed legislation which was not included in the Budget.

Senator HASTINGS. He was also on record last year, as I recall it.

Mr. MORGENTHAU. If he was, he kept his word.

Senator HASTINGS. He did ask for taxes last year.

Mr. MORGENTHAU. There is nothing stated in his Budget message of the year previous, as far as I know.

Senator HASTINGS. Not in his Budget message, but in his Message to the Congress in 1935, you will find a statement to the effect that he was not anticipating asking the Congress to add any new taxes to the present rate.

Mr. MORGENTHAU. If you do not mind, I would like to refresh my memory on that.

Senator HASTINGS. I think you will find I am correct.

Mr. MORGENTHAU. Because as far as I know, in every statement that the President has made on his Budget and fiscal matters, he has absolutely kept his word.

Senator COUZENS. I ask you, Mr. Secretary, have you made any estimates of what the increased revenue would be due to increased business, if the taxes were to remain in status quo?

Mr. MORGENTHAU. Senator Couzens, we cannot forecast beyond the fiscal year of 1937. We have been rash enough each year to do that, and as I say, we have come within 1 percent, but the forecast beyond 1937 would really be taking too much upon us.

Senator COUZENS. Well, assume that we only consider the calendar year 1936, have you any estimates about the increased revenue, what the increased revenue would be on the present law due to increased business?

Mr. MORGENTHAU. That is included. Our forecast for both the calendar year 1936 and the fiscal year 1936—we are operating on that now, and our estimates show that our revenue to date for both the fiscal and the calendar year are running about 1 percent in excess of our estimates.

Senator COUZENS. What were they? Do you remember?

Senator LA FOLLETTE. In other words, if I understand you, Mr. Secretary, when you made the estimates, you took into account as a factor, whatever the actuaries decided to allow for improved business conditions?

Mr. MORGENTHAU. We did, and as I say, I am rather proud of the work of the technical men in that respect, because the receipts are running just about 1 percent in excess when we have taken into account a healthy increase in business for this year.

The CHAIRMAN. Do you recall in recent history where any Secretary of the Treasury has come so close to the estimates and revenues as was done last year?

Mr. MORGENTHAU. No; and here is the record if you would like it.

The CHAIRMAN. It is my opinion that no one has come so close. Will you agree with my statement on that?

Mr. MORGENTHAU. Yes; I will; I am glad to agree to it.

As a matter of fact, in 1931, they missed the estimates by 15 percent. In 1932, they missed it by 7 percent. In 1933 they missed it by 13 percent. In 1934, they missed it by 5 percent.

The first forecast, for 1935, which I made, the revenue is 4.6 percent over what we estimated; and this year—again I am responsible—we are running about 1 percent in excess of our estimates.

Senator KING. The chairman wants you to state that the Democrats are better prophets than the Republicans.

The CHAIRMAN. I do not want to get any partisanship into this discussion.

[Laughter.]

Senator HASTINGS. Mr. Secretary, will you go over those again and see whether they were underestimated or overestimated?

Mr. MORGENTHAU. I will be very glad to, Senator Hastings. This sheet that I have here says, "Comparison of actual and estimated income tax receipts, fiscal year 1931 to 1936, inclusive, daily Treasury statement basis."

In 1931, whoever was Secretary of the Treasury, estimated——

Senator BLACK. Who was that; do you recall?

Mr. MORGENTHAU. I guess it must have been Mr. Mellon.

[Laughter.]

The then Secretary of the Treasury estimated receipts of $2,190,000,000, and the actual receipt of $1,860,000,000, or 15.1 percent less than the estimate.

Senator HASTINGS. Is that true all the way down?

Mr. MORGENTHAU. I will be glad to continue.

Senator HASTINGS. Just answer my question.

Mr. MORGENTHAU. It runs from 15 percent to 5 percent off.

Senator HASTINGS. And they were less?

Mr. MORGENTHAU. They always were less. And in 1935, which is the first year that I had a chance to forecast, our revenues exceeded 4.6 percent, and this year they are running about 1 percent in excess of estimates. I mean, after I came in in the fall of 1933, and I am responsible for 1935 and 1936 calendar years; in those 2 years, they were the first 2 years, going back to 1931, that the revenue has exceeded the estimates.

Senator HASTINGS. I am glad this administration was correct in some estimates.

Mr. MORGENTHAU. Well, sir, they have been correct on all of their estimates.

Senator HASTINGS. Including balancing the Budget?

Mr. MORGENTHAU. We have done everything on a fiscal financial basis that we have said. As I pointed out before, Senator Hastings, our revenues have exceeded estimates and our estimates for expenditures every year have been under.

Senator KING. May I say that I hope that my friend from Delaware will not blame the President for the eccentricities of Congress.

Senator HASTINGS. I won't blame him for anything.

The CHAIRMAN. You may have forgotten, Mr. Secretary, but some of us recall that when Mr. Mills was Secretary of the Treasury, he revised his estimates three times in 6 months, and then he was wrong in a greater amount than you.

If that is all, thank you very much, Mr. Secretary.

Senator COUZENS. I would like to ask the Secretary a few questions. It appears that the gift tax was estimated in 1936 as $60,000,000, and the actual collection up to date was $154,751,457. I am wondering to what extent if at all you contemplate that that will affect the high surtax brackets.

Mr. MORGENTHAU. Mr. McLeod will answer that. If you will, please?

Mr. McLEOD. We have considered that in our estimate. We have made adjustments for that in our estimates by reason of the smaller number of individuals in the high surtax brackets, as closely as we could, meaning that there has been a shift downward to some extent from the high surtax brackets to the lower.

Senator COUZENS. But you do not recall the amount in dollars and cents?

Mr. LEOD. No; I do not have that.

The CHAIRMAN. Are there any other questions?

(No response.)

(The Secretary retires.)

The CHAIRMAN. Before we proceed. The Secretary has gone, has he not?

Mr. HELVERING. Yes, sir; he has.

The CHAIRMAN. I wanted to make this request at this time. I was going to request him, and so I request through his experts, that the Secretary do this. It seems to some of us—I was conferring with Senator La Follette, and I know that he and I are of this opinion—this House bill is rather complicated. I think they have done a magnificent job, but in order to get at the same results on the amount of taxes to be raised through this change in policy of assessing the stockholder instead of the corporation, if you could not work out some plan that would simplify the matter, and instead of having four columns as are included in this bill, if you could not get it down to one column, so that the layman might work out the proposition.

I can appreciate that it had to be written, probably, this way, because you have your instructions from the Ways and Means Committee, and I offer no criticism; but if we can work out a simplified form, it would be much better; and I understood that over there it was their desire to give some relief to the smaller corporations, more than to the larger corporations, and that is why the bracket was fixed under $10,000 adjusted net income and over $10,000 adjusted net income.

It will be recalled that in some of the prior bills that we have passed, in order to help the smaller corporations we exempted $1,000 and $2,000 and $3,000. I think we got up that far. Now, it would seem to some of us that if you had one column and could work it out by exempting, say, up to $25,000 adjusted net income, or $1,000, or maybe $2,000, that we would get the same results that the House was trying to get at and that it would simplify the scheme.

So that what I was going to ask the Secretary, and I request it of you gentlemen, is to work out your estimates to see whether or not that can be done and submit it to the committee, and to give us an estimate on the proposition of putting up to $20,000, and then up to $25,000, adjusted net income, and to give off $1,000, and to except $2,000. Make it on those two bases, to see whether or not we might get the same results in revenue as are obtained by the bill.

If you can do that, you will greatly simplify this matter.

Senator LA FOLLETTE. And, Mr. Chairman, may I ask for one further thing to be considered? I am entirely in sympathy with what the chairman has said about simplifying the bill. Another thing I would like to have worked out to be submitted for the consideration of the committee is to work out a schedule putting the tax on the amount retained instead of having to have the schedule IIA,

with the interpolator, which so much fun has been poked at. As I understand it, schedules can be worked out which will result in exactly or approximately the same amount of tax being paid; but if they are worked out in percentages on the retention of earnings, we can get rid of this interpolator and make the tax readily understandable to anybody that reads it. I would like to have that submitted also, just for the consideration of the committee.

The CHAIRMAN. In that connection, may I ask you, Mr. Commissioner, if the fact that the House, the last day when they had the bill up for consideration, under the 5-minute rule, amended the law so as to make the dividends payable in the taxable year, instead of as originally drawn, did not eliminate one difficulty to enable you to do just what Senator La Follette has requested you to do, and to work it out on the retained surplus instead of what is paid out.

Now, you may proceed, Mr. Helvering.

STATEMENT OF GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, TREASURY DEPARTMENT

Mr. HELVERING. I have a short statement.

The Secretary of the Treasury has just presented to you an analysis of the additional revenue needs of the Federal Government, as outlined in the President's supplementary Budget message of March 3, and the extent to which those needs are met by the bill passed by the House of Representatives. Having appeared before the Ways and Means Committee, I am glad to place myself at the disposal of this committee for any assistance I may render. As a preliminary I desire to make a few general statements as to the President's proposal and the House bill.

The first thing to which I should like to call your attention is the fact that in the last analysis none of the three sources of additional revenues suggested by the President involves new taxation. One of them—the "windfall" tax, so-called—is designed only to recoup, for the Treasury and the public, taxes that were actually paid by numerous business firms and by consumers generally, but which became part of private, rather than of the public, revenues. Another—the proposed tax on corporate earnings, coupled with the repeal of the existing corporate-income, capital-stock, and excess-profits taxes—is designed only to make effective the present schedules of income-tax rates applicable to individual incomes, by reducing the opportunities for tax avoidance and tax evasion. The third was for the enactment of processing taxes on a broader base, but with lower rates, than those that were in effect under the Agricultural Adjustment Act. The suggested processing taxes, therefore, would only replace the similar taxes previously in force and, moreover, are proposed for only a temporary period.

The CHAIRMAN. How much do you expect to get under the present regulation? About $517,000,000 over a period of 3 years?

Mr. HELVERING. The schedules of the Agricultural Department presented to the Ways and Means Committee would raise approximately $208,000,000 in a year.

Senator CLARK. By processing tax?

Mr. HELVERING. By processing tax; yes.

The CHAIRMAN. Which was not accepted by the committee?

Mr. HELVERING. No. I might say in that connection, that those were rates much lower. For instance, the wheat rate under the old schedule was 30 cents. Under the new proposal by the Agricultural Department it was 5 cents.

The CHAIRMAN. So they were greatly reduced as to the amount of processing tax?

Mr. HELVERING. About 20 percent average of the old rates.

The CHAIRMAN. And the base was broadened by taking in other commodities?

Senator KING. Upon which to impose the processing tax?

The CHAIRMAN. Yes. You may proceed, Mr. Commissioner.

Mr. HELVERING. The President's suggestion to obtain additional permanent revenue was for an improvement in our method of corporate income taxation. In essence, as I have already indicated, this proposal does not seek to impose any new taxes or any higher rates of taxes. On the contrary, its effect would be to lower taxes for a great many, perhaps the majority of our corporations in number; and to lower them also for a very large proportion of corporation stockholders.

Senator KING. I should like to make an inquiry. As a matter of fact, out of the three-hundred-and-some-odd-thousand corporations in the United States, less than half have ever paid any taxes at all; is that not true?

Mr. HELVERING. There are some 500,000 corporations in the United States, and the number that were in the small brackets—Mr. McLeod can tell you better.

Mr. MCLEOD. In the small brackets, under the bill as proposed by the House, about 214,000 were under $10,000; 43,000 had net incomes above $10,000.

The CHAIRMAN. Mr. McLeod will be the next witness that will be before us, and he can go into that phase.

Mr. HELVERING. A great number of those corporations did not pay.

Senator KING. A majority of the corporations in the United States do not pay any taxes at all.

Mr. HELVERING. No; I do not think a majority. I think a majority of them do pay taxes, but quite a number of them in the small brackets.

The fundamental objective of this proposal is to increase the Federal revenues by plugging up a major source of tax avoidance and tax evasion now existing, and thereby greatly to increase the fairness and balance of the Federal income-tax structure as a whole.

Senator KING. Could you say that it is an avoidance or evasion if corporations have reserved what they regard as legitimate against days of adversity or to meet contingencies or for the purpose of expansion?

Mr. HELVERING. I did not mean to use these terms with any criminal intent on their part, but it is just a chance to do it, and do it legally, under the present law.

The President's proposal, the principles of which are incorporated in the House bill, is no new development. It has received the attention and support of students of taxation from the earliest days of income taxation in the United States. Its principles were incorporated in our first income-tax law, 1862–71, when Congress provided that the gains and profits of corporations should be included in the annual taxable gains, profit, or income of any person entitled to

them, whether divided or undivided. Shortly before and while the Revenue Act of 1921 was under consideration, a proposal identical in principle with the President's suggestion received the support of many representatives of organized business, Members of Congress, and the Treasury Department. The principle was recommended by Secretary of the Treasury Houston in his annual report for the year 1920. In somewhat modified form, it was incorporated in a bill passed by the Senate in 1924.

The CHAIRMAN. Do you quote that part of Secretary Houston's report in your statement?

Mr. HELVERING. Do you wish it incorporated?

The CHAIRMAN. If you have not, I wish you would incorporate in your remarks that part of Secretary Houston's recommendation which deals with that phase.

(The matter referred to follows:)

EXTRACT FROM THE ANNUAL REPORT OF THE SECRETARY OF THE TREASURY FOR THE FISCAL YEAR 1920 (PP. 39–43)

The excess-profits tax, however, must be replaced, not merely repealed, and I believe that it should be replaced in large part by some form of corporation profits tax. This conclusion is based not only upon the Government's need for revenue but upon grounds of equality and justice. So long as taxpayers other than corporations are subject to a progressive income tax rising now to over 70 percent, corporation profits should not be allowed to escape with a single tax of only 10 percent. Individuals (and partnerships in effect) pay normal taxes and surtaxes upon all net income, whether spent, saved, or retained in the business of the taxpayer. Corporations pay only normal tax on such income, although their stockholders pay in addition surtaxes on the profits of the corporation which are distributed as dividends. But no surtaxes are paid on or with respect to the profits not distributed. It seems plain, therefore, that when the excess-profits tax is repealed some equivalent or compensatory tax should be placed upon the corporation in lieu of the surtax upon reinvested income paid by other taxpayers. Unless this be done, a heavy premium would be given to the corporate form of business. If, for example, three equal partners in a business invest capital of $2,000,000 and make net profits of $600,000, draw out $75,000 as salary and $75,000 as profits, leaving $450,000 in the business, these partners would together pay income taxes of approximately $279,570. But if they should incorporate the business, the total income and capital-stock taxes on the corporation and its three stockholders would, in case the excess-profits tax were repealed, be only $75,865.

One partial substitute for the excess-profits tax would be a tax on the undistributed profits of corporations as nearly as possible equal to the surtax imposed upon the saved income of the individual. If individuals doing business in partnership pay 20 percent on undistributed profits, individuals doing business through the medium of the corporation should pay 20 percent. This plan could be applied in many different ways: (1) The distributed profits of the corporation could be substituted for the so-called excess-profits credit of the excess-profits tax and the remaining or taxable profits be taxed at 20 percent; or (2) a 20 percent tax on undistributed profits could be applied as a corporation surtax under title II of the revenue act; or (3) corporations could in form be subjected to the same progressive surtaxes as individuals—a proposal which would prove very advantageous to all corporations with small incomes—with a proviso that the total surtax should never exceed an amount equal to 20 percent of the undistributed profits. None of these plans presents any grave administrative difficulty or involves any particular complexity of operation.

If an undistributed profits tax be adopted, it should contain provisions expressly recognizing the various devices by which many corporations find it possible to distribute statutory "dividends", while actually retaining the profits in the business. The object should be to subject stock holders of corporations to the same tax burdens imposed upon the members of a partnership, and any procedure which facilitates the attainment of this object should be welcome. The stockholders of any corporation should be permitted, for example, by a

unanimous vote to elect to be taxed as the members of a partnership or as the stockholders of a personal-service corporation are now taxed under existing law. It would be advisable seriously to consider the propriety of requiring every corporation, 95 percent or more of the stock of which is held by one individual, to be treated as a partnership or personal-service corporation. This would go far toward solving the problem whose solution is now vainly sought in section 220 of the revenue act of 1918.

The object of these suggestions is to establish so far as possible an exact equivalence between the taxation of corporation stockholders and other taxpayers. The undistributed-profits tax appears to be one practical means of obtaining approximate equality of treatment. This is not only to satisfy a theoretical sense of justice. It is, I believe, the course of practical wisdom. At some points the revenue law as now formulated discriminates unjustifiably against the individual in favor of the corporation. At others it discriminates unduly against corporations in favor of the individual.

These indiscriminations operate to force many business enterprises into forms of organization not intrinsically the best suited to their needs. Furthermore, the most troublesome problem of income taxation is the same in case of both corporations and unincorporated taxpayers, i. e., the repressive effects of heavy rates when applied to income which is saved and reinvested. That and many other problems of personal and corporation income taxation will best be decided when linked together. We are now taxing reinvested income of individuals at rates which may exceed 70 percent. The error of this treatment appears plainly when we attempt to apply such rates in the case of corporations. It would be unthinkable to tax the saved income of corporations at 70 percent. On the other hand the stockholders of corporations are forced to pay through the corporation a higher normal tax than individuals. They receive no credit against this normal tax for the personal exemptions, and—under existing law—profits which have paid both the corporation income tax and the heavy excess-profits tax are again subjected, when distributed as dividends to stockholders, to surtaxes rising in some cases to 65 percent. In the latter instances the discrimination is against the corporation and its stockholders. Like treatment should prove in the long run the surest means of obtaining just and wholesome treatment. Separate treatment will in the long run conduce to corporation baiting. If corporations insist upon different treatment, they are in the long run likely to receive worse treatment. The next revision of the tax law should place the income tax upon an enduring foundation of sound principle. Lasting solutions and not temporary makeshifts should be sought.

The tax on undistributed profits has certain obvious disadvantages, as, in fact, have all tax proposals. It is widely opposed because it would, in form, fall on reinvested profits, although the personal-income tax falls also on reinvested profits. It is believed also by many honest and able men that, notwithstanding the fact that it would reduce the tax burden upon corporations, it would tend to cause an undue dissemination of corporation profits and subject directors of corporations to a strong temptation to pay out as dividends profits actually needed in extending or maintaining the business itself.

If, in the opinion of the Congress, these or other difficulties make the undistributed-profits tax unavailable, the excess-profits tax might be replaced, in part at least, by a compensatory corporation tax, or "corporation surtax," at a flat rate. Such a tax, at any practicable rate, cannot be made the equivalent of the individual or personal surtaxes on reinvested income. It would leave the corporation tax less burdensome than the personal tax on some business concerns and more burdensome than the personal tax on others. The undistributed-profits plan would tax income saved by corporations at the maximum rate paid by individuals on saved income, while leaving the corporation an option to distribute the profits—either constructively or actually—and thus subject such profits to taxation in the hands of the stockholders. But the "corporation surtax" has the great merit of simplicity, and such a tax has recently been adopted in the United Kingdom for precisely the purposes here set forth; that is, to secure from corporations some contribution in lieu of the surtax collected from individuals on reinvested income. The discussion of this tax by the chancellor of the exchequer in his financial statement of April 19, 1920, is enlightening, and it is quoted in part below. The italics are mine:

CORPORATION-PROFITS TAX

I propose therefore to introduce this year a new tax which, for the time being, will be levied concurrently with the excess-profits duty, but which, either in the form in which I propose it or in an amended form, may in the future prove a substitute for it. The character of the new tax, a permanent tax, has been the subject of most anxious consideration by the Government and myself and, as I have previously mentioned, I think, in the House last year, I sent out a mission to Canada and the United States to investigate and to study the schemes of profits taxation in force in those countries, and to see whether we could derive any lessons of use to us from their practice and experience. The results of the inquiry and of independent investigation in this country have not served to remove the difficulties which presented themselves to our first consideration of the proposal for a taxation of profits in excess of a certain return upon invested capital, and have not enabled us to see our way to adjust such a tax to existing business conditions and customs in this country. We therefore abandoned the idea of creating a tax on profits in excess of a fixed standard and we propose to have recourse to a different measure. I may describe our proposal as a corporation tax levied at the rate of 1 shilling in the pound on the profits and income of concerns, with limited liability, engaged in trade or similar transactions. This tax will run concurrently with excess-profits duty until that duty is repealed. Where a concern is liable to both taxes, any excess-profits duty payable will be treated as a working expense in arriving at the profits for the purpose of the new tax. Both excess-profits duty and corporation tax will be deducted before the assessment of profits for income tax, and to prevent the new tax constituting too severe a burden on the ordinary shareholder of existing concerns in which there are large issues of debenture and preference shares, where a considerable proportion of the profit has to be allocated to the payment of interest and fixed dividends thereon, we propose that in no case shall the duty exceed 2 shillings to the pound on the profits which remain after the payment of such interest and dividends on existing issues of debentures and preference shares. I would remind the committee that under the provisions of the excess-profits duty prosperous concerns with a large pre-war profit standard may escape liability for the tax because their present profits, though high, are not in excess of their standard, and, at any rate, they pay a tax on what all of us think an unduly low scale. Incidentally, the new tax will do something to correct this anomaly. But I justify it on much broader grounds. Companies incorporated with a limited liability enjoy privileges and conveniences by virtue of the law for which they may be asked to pay some acknowledgment. But, more than that, partners in a private partnership pay supertax not merely on the profits which they divide, but also on the undivided profits which they place to reserve. No such charge falls upon the undivided profits of limited liability companies. The corporation tax is justified by this distinction of the existing law in favor of such corporations, and it may be regarded as a composition in lieu of the liability to supertax.

A flat corporation surtax of adequate rate could probably be substituted for the excess-profits tax without serious loss in revenue. Whether any loss would result by the substitution of an undistributed-profits tax is problematical. The shrinkage in the tax collected from corporations as the result of distributed profits would be partially counterbalanced by an increase in the taxation of the stockholders of the corporations involved. Furthermore, the yield of the excess-profits tax is declining and may decline rapidly in the near future. Two hundred million dollars is probably a maximum allowance for the loss of revenue that would result in 1922 if the excess-profits tax were replaced (as of Jan. 1 1921) by an undistributed-profits tax of 20 percent. New taxes capable of yielding approximately this amount should be selected from the additional taxes suggested below or from other sources in case the undistributed-profits tax is adopted.

Senator KING. And likewise that provision of the 1924 act which you think incorporates its principle; at any rate, if not in all respects, this provision is with respect to the taxation of undistributed profits.

Senator LA FOLLETTE. I did not understand the Commissioner to say that it became incorporated in a law. He said it passed the Senate in 1924.

(The matter referred to follows:)

EXTRACT FROM H. R. 6715, SIXTY-EIGHTH CONGRESS, FIRST SESSION, IN THE SENATE OF THE UNITED STATES (PAGES 85-93)

SHAREHOLDERS TAXED AS PARTNERS

SEC. 228. (a) The shareholders of any corporation which is subject to the tax imposed by subdivision (a) or (b) of section 230 shall, if they all agree thereto in respect of any taxable year of the corporation, be taxed in the same manner as the members of a partnership. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to such corporation and the shareholders thereof. If all the shareholders are so taxed, the corporation shall be exempt from tax under section 230 for such taxable year.

(b) For the purposes of this section amounts distributed by such corporation during its taxable year shall be accounted for by the distributees; and any portion of the surtax net income (as defined in subdivision (c) of section 230) remaining undistributed at the close of its taxable year shall be accounted for by the shareholders of such corporation at the close of its taxable year in proportion to their respective shares.

(c) Any undistributed portion of the surtax net income (as defined in subdivision (c) of section 230) which is taxed to the shareholders under this section shall, when distributed, be exempt from tax to the distributees.

SEC. 230. (a) In lieu of the tax imposed by section 230 of the Revenue Act of 1921, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a normal tax of 9 per centum of the amount of the net income in excess of the credits provided in sections 236 and 263.

(b) In addition to the normal tax imposed by subdivision (a) of this section, there shall be levied, collected, and paid upon the surtax net income (as defined in subdivision (c) of this section) of every corporation a surtax equal to the following percentage of the undistributed net income as defined in subdivision (c) of this section:

One-fourth of 1 per centum, if the undistributed net income is more than 10 per centum, but not more than 11 per centum, of the surtax net income;

(This surtax increased one-fourth per centum for each 1 per centum increase in the percentage of undistributed net income up to 5 per centum on undistributed net income of 29-30 per centum. For the interval between 30 and 40 per centum, the surtax rate rose one-half per centum for each 1 per centum increase in the undistributed net income percentage, reaching 10 per centum on undistributed net income of 39-40 per centum; from 40 to 50 per centum, the surtax rose 1 per centum for each 1 per centum, reaching 20 per centum on 50 per centum, and from 50 per centum on the surtax rose 2 per centum for each 1 per centum increase in the undistributed net income percentage, reaching 40 per centum on all undistributed net income over 59 per centum of the surtax net income.)

(c) For the purposes of subdivision (b) of this section—

(1) The term "surtax net income" means the net income as defined in section 232, increased by the amount of the deduction allowed under paragraph (6) of subdivision (a) of section 234;

(2) The term "undistributed net income" means the amount by which the surtax net income exceeds the sum of (1) the amount of the tax imposed by subdivision (a) of this section for the taxable year, plus (2) the amount of cash dividends paid during the twelve months preceding the 15th day of the third month following the close of the taxable year, plus (3) amounts retained to replace capital losses sustained after the enactment of this Act, plus (4) amounts retained in compliance with law and the distribution of which is prohibited by law, plus (5) $10,000;

(3) The term "cash dividends" includes dividends paid in interest-bearing scrip, if subject to tax in the hands of the distributees to the same extent as a dividend paid in cash.

Mr. HELVERING. Yes. It did not pass the Congress.

The CHAIRMAN. That is a good idea. Put it in that it passed the Senate. We had a great deal of respect for the Senate in 1924.

Mr. HELVERING. When corporations distribute their earnings to their stockholders, the dividends are subject to the surtax rates incorporated in our income-tax law. When corporate earnings are not so distributed, the individual stockholders, while enjoying the benefit of those earnings in the form of the increased worth of their securities, are enabled to avoid all payment of surtaxes thereon.

Senator HASTINGS. Right there, Mr. Commissioner, How can he enjoy these earnings in the form of increased worth?

Mr. HELVERING. If they can be put in the reserve of the corporations, in the surplus, they therefore increase the value of the stock outstanding.

Senator HASTINGS. You say "while enjoying the benefit of those earnings in the form of the increased worth of their securities." The increased worth of the securities is of no particular good to them unless they sell them and realize on them.

Mr. HELVERING. No.

Senator HASTINGS. Then he pays the tax, does he not?

Mr. HELVERING. Oh, yes.

Senator KING. It seems to me, if I may be pardoned, Senator, that it is an advantage to have your securities increasing in value from year to year, though you do not have the increased value distributed.

Senator LA FOLLETTE. Furthermore, if he sells, he only pays the capital gain and he does not pay the surtax.

Mr. HELVERING. I am referring to the payment of the surtax this year. The corporation of course, on these surpluses can make loans or advances on the market. Outside of their legitimate business, they can do a considerable business that way.

The CHAIRMAN. Is it not a fact that a dividend-paying stock is classified as a little better than one that does not pay dividends?

Mr. HELVERING. I think it should have a higher sales value; yes.

Senator KING. And intrinsically, too, perhaps.

Mr. HELVERING. The Federal Government is thereby deprived of substantial amounts of revenue; and great inequalities in the treatment of different kinds of income, and in the treatment of incorporated as opposed to stockholders and so made to bear their fair share of taxation under the individual income surtaxes, should be subject to corporation income taxes at rates which, on the average, would compensate the Federal Government for the loss in surtax revenue.

Their loss, as the Secretary has indicated, is of very great dimensions. The Treasury estimates that, if the present corporation income, capital stock, and excess profits taxes were repealed, and all corporation earnings during the calendar year 1936 were currently distributed, the income of individuals would be increased by more than 4½ billions of which approximately $4,000,000,000 would be taxable.

Senator HASTINGS. Let me inquire whether you have made any study as to what would have been the result if you take that back say 5 years, 1935, 1934, 1932, 1931, and the years back to 1929, would that show that continued increase in surplus?

Mr. HELVERING. In this amount, you mean?

Senator HASTINGS. Yes, or approximately that amount.

Mr. HELVERING. Oh, no. The Treasury has estimates for those years, which will be placed in the hearings as to those amounts during those years.

(The matter referred to follows:)

Compiled net profit, reinvested current earnings, and ratio of reinvested current earnings to compiled net profit, 1923–33—corporations reporting net income

Year	Compiled net profit	Reinvested current earnings [1]	Ratio of reinvested current earnings to compiled net profit
			Percent
1923	$9,329,000,000	$4,571,000,000	49.0
1924	8,692,000,000	3,815,000,000	43.9
1925	10,963,000,000	4,976,000,000	45.4
1926	11,315,000,000	4,555,000,000	40.3
1927	10,694,000,000	3,776,000,000	35.3
1928	12,701,000,000	4,932,000,000	38.8
1929	14,374,000,000	5,239,000,000	36.7
1930	8,543,000,000	938,000,000	11.0
1931	4,753,000,000	481,000,000	10.1
1932	2,738,000,000	132,000,000	4.8
1933	3,580,000,000	778,000,000	21.7
Average			30.7

[1] Obtained by deducting from compiled net profit the Federal income taxes paid and cash dividends paid.

Senator KING. Mr. Commissioner, for my own information, I would like to know how you can reach any sort of definite and accurate conclusions as to what tax would be obtained if all or approximately all the dividends had been distributed, unless you know the brackets into which would fall the tax to be paid by the distributees, and by that you would have to know the number of millions of taxpayers and the brackets into which they would fall, because obviously many of these taxpayers to whom dividends would be distributed, would fall in that class where they pay no tax at all.

Mr. HELVERING. Of course, Senator, we depend entirely upon the estimates made by the statisticians, and they have estimated these figures which I am now reading. I am depending on them for those estimates.

The CHAIRMAN. It will show in the chart.

Mr. HAAS. Mr. McLeod could very probably give the fundamental basis upon which they base the whole estimate of their work. In other words, a similar basis that a life insurance actuary would use to base his estimates. We have something which we think is just as substantial as that to start with.

Senator KING. As I understand then, the tables which you will submit will show the number of stockholders who would be the recipients of dividends and the brackets into which each one would fall?

Mr. MCLEOD. We have not indicated the exact number——

Senator GERRY [interposing]. Mr. Chairman, we cannot hear a word of this.

Mr. MCLEOD. We have not indicated in that table the exact number of individuals who would receive dividends by the brackets. We have indicated the total number of individuals and the total additional number. We do know from past years where the dividends fall by brackets, and it is somewhat similar to an actuarial table by which an actuary determines the probable length of a man's life and his premiums. He does not trace a particular individual, but he knows

from a certain group of individuals, on the average, how many will die in a certain year.

On that same basis, we know that when you have the total number of net incomes of the corporations distributed—we have the records over a period of years—we know on the average how those dividends flow through the income brackets. That is really the basis of the estimate of the additional revenues.

The CHAIRMAN. All right, Mr. Helvering. You may proceed, please.

Mr. HELVERING. About $1,448,000,000, it is estimated would go to individuals whose effective surtax liability on the additional income would be less than 16 percent.

Senator LA FOLLETTE. You refer to 16 percent there as the average of what the corporations pay now under existing law?

Mr. HELVERING. Taking that as the basis to get this table.

And some $2,567,000,000 of the additional income would go to individuals whose effective surtaxes on the additional income would be greater than 16 percent, as is illustrated in a chart I should like to put in the record.

The CHAIRMAN. We will have another demonstration made of that chart before we get through so that the public may be let in on it.

Mr. HELVERING. In consequence, the yield of the individual income tax, assuming no change in rates other than the removal of the present exemption of dividends from the normal tax, would be increased by more than $1,700,000,000 if such distribution were made.

It is estimated that more than 71 percent of the increase in taxable income would be received by individuals with net incomes of more than $25,000 a year, and that about 45 percent would be received by individuals with net incomes in excess of $100,000 a year.

This increase in revenues that would result from a full and effective application of the existing individual income tax schedules indicates the extent to which the existing law results in a loss in revenue to the Federal Government. But besides yielding substantial additional revenue to the Federal Government, the proposed method of taxation would eliminate the two main sources of inequality in our tax system.

Under our present laws, individuals and members of partnerships must pay income surtaxes on the entire amount of their earnings, whether such earnings are distributed in full, partly reinvested, or reinvested in their entirety. Corporation earnings which are reinvested escape income surtaxes for the time being and may escape them altogether or become subject to them later at much lower rates.

Senator GERRY. Have your statistics—you must have them, I presume—showing how many copartnerships there are in the country, and what the amount of their capital is, and what the amount of their earnings is.

Mr. HELVERING. Yes, sir.

Senator GERRY. You are putting those in the record, are you, so that we can see them, and that will show how much of the business is done in the country by copartnerships?

Mr. HELVERING. I might say, without being held to the exact number, I think there are 205,000 copartnerships with income of $1,158,000,000. Those incomes from those copartnerships run all the way up from small figures to over $1,000,000.

Senator GERRY. Will you please put those in the record?

Partnership returns filed for year 1935 showing net income $100,000 and above

Bracket	Number of returns	Total net income	Average net income
$100,000 to $200,000	552	$76,153,151.47	$137,966.79
$200,000 to $500,000	201	57,219,775.87	284,675.49
$500,000 to $1,000,000	57	37,809,513.68	658,815.11
Over $1,000,000	23	47,533,241.98	2,053,706.30
Total	833	218,615,682.00	256,442.60

Partnership returns filed for 1936

	Number of returns	Total net income
Under $100,000	178,419	$943,660,354.76
Over $100,000	833	218,616,689.00
Total	179,252	1,159,277,043.76
Losses	26,180	87,012,154.46
Total	205,432	1,072,264,889.30

Senator BLACK. The natural tendency of the tax as it has been has been such that by virtue of it a copartnership was compelled to pay tax on all profits while a corporation was not compelled to pay a tax on all profits, and that has been a very coercive influence in causing people to organize corporations, has it not, and would it not necessarily result in that?

Mr. HELVERING. I might say to you, Senator, that in the year 1926 the number of copartnerships and corporations were about equal. The copartnerships have gradually gone down each year and the corporations have gone up, until in this year, the past year, it has resulted in 205,000 copartnerships as against 500,000 and some corporations.

Senator BLACK. In other words, as I understand the point that you have there, if a copartnership made a million dollars of profits and there were two men in the partnership, they were compelled to pay a tax under the present law on every dollar of profit they made whether they reinvested all of it or not, but if the same two men organized a corporation out in Delaware or some other State, and they made that same million dollars of profit, they would be limited to 15 or 16 percent. That is all the tax they would have to pay, is it not? So that naturally there is a constant and strong inducement to keep from paying the 50 percent of the profits if they can get out by paying the Government 15 percent by organizing a corporation.

Mr. HELVERING. A little later on, Senator, I give an absolute example of that, computed in dollars and cents.

Senator GERRY. Is that not just saying in other words that your copartnership is treated in taxation the same as the individual?

Mr. HELVERING. Yes.

Senator GERRY. And therefore the idea, when we had the old Jones Amendment Act, was to make the corporation pay the normal tax so as to even it out? Was it not something like that, as I recall the old law?

Mr. HELVERING. I know those considerations were taken up.

Senator GERRY. And then in addition to that, they paid an additional tax besides that, and that was an attempt to even it up between the copartnership and the corporation.

Mr. HELVERING. Yes.

Senator BLACK. As I understand it then, as it came out a year or so ago, there was a gentleman said to own many million dollars worth of stock in various corporations and who paid no income tax. Now, if the corporations in which he was interested hold their increased profits, the corporations would not have paid anything either? If they put it in surplus, they would have paid 15 or 16 percent.

Mr. HELVERING. That is a flat rate.

Senator BLACK. If that had been an individual, he would have had to pay a large amount of taxes to the Federal Government.

Mr. HELVERING. I think there is no doubt about that.

Mr. BLACK. What you are seeking to bring out here is, as I understand it—just one other question. If there were small stockholders in the corporation, distributed over and around the country, who only owned a very small block of stock, who would not have had to pay 15 percent on their normal individual income, it was to their interest to have that money distributed, and so they were injured if the corporation held it and did not pay it out. That is true, is it not?

Mr. HELVERING. On the small stockholder, the tax went up.

Senator BLACK. But the men who owned the large blocks of stock in the corporation, by the millions, two or three millions, have been greatly benefited to the disadvantage of the small stockholders in the way the tax has operated?

Mr. HELVERING. We think that is the result under the present law, yes.

To consider, first, the case of current tax liability, let us take the case of a partnership composed of five equal partners and with total earnings of $500,000. The Federal Government under the present law would receive $166,770 of these earnings in individual income taxes, assuming that the partners were single men and had no other taxable income. If these same men conducted their business as a corporation and paid themselves salaries of $15,000 each, but no dividends, the Federal Government would receive a total of only $68,710 in income taxes—a difference of $98,060. Even if this corporation distributed in dividends 50 percent of its earnings under the present law, after payment of $75,000 in salaries, the Federal Government would still receive $52,385 less in taxes than it would receive if the business were conducted as a partnership.

Senator HASTINGS. Mr. Helvering, is it true if those five persons were in business as an equal partnership, that they could not take out as an expense any salaries?

Mr. HELVERING. Oh, no.

Senator HASTINGS. They have to pay on all of that?

Mr. HELVERING. That goes in just the same as though they were not in any business at all. If they take out salaries, that goes in as income, and their earnings go in on top of that, and the tax is computed just as though they were individual business men.

Senator HASTINGS. That is, if the five persons were president and vice president and managers and so forth, whatever they call them-

selves, they would not pay themselves any salary and take that out of the profits of that business?

Mr. HELVERING. You mean when they would make their return?

Senator HASTINGS. When they make their return.

Mr. HELVERING. No; they would have to include that salary as part of their return, together with all the other interests and profits and their pro-rata share.

Senator KING. But they could take out the salaries paid to the employees?

Mr. HELVERING. Oh, yes; other than the owners. Also depreciation, depletion, and all that sort of allowances under the present law.

Through withholding earnings, moreover, and paying them out only as those in control elect, a corporation is able to average the earnings and the losses of its stockholders over an indefinite period of years, and it is also able to speculate on the possibility that the Congress in some years may be induced to lower individual income-tax rates. It may retain earnings at times when the Government needs additional revenues, and pay them out when tax rates are lowered. The individual does not have these opportunities. If he had a large income in 1929, for instance, he paid in 1930 a tax based exactly on that 1929 income, in whatever brackets of taxation it might fall. If he suffered heavy losses in 1930 and 1931, he was not able to make any deduction or obtain any refund of the taxes he had already paid and for which he had already become liable on his 1929 income. If that same individual's activities had been incorporated, he need have paid individual income taxes only on that portion of his earnings that he withdrew in the form of salary and dividends during the good year to meet his current needs, and by withholding the remainder he would have been able to offset the losses that he sustained in the two succeeding years. That is one door of escape, and it is a most important one.

A second source of inequality is the opportunity enjoyed by owners of corporate businesses to reduce their income taxes by taking part of their income in the form of so-called capital gains. By withholding earnings from distribution, a corporation builds up enhanced capital values which are reflected in the worth of its stock. After a block of that stock has been held in the same ownership for a number of years, it can be sold and the resulting gains in value will be taxed at lower rates than other sources of income. As an instance, if the stock has been held for more than 10 years and then sold, only 30 percent of the resulting gain from its sale will, under the present law, be taxed as income, and if the individual's surtax rates have thus been brought as high as a bracket of 50 percent, he will pay a tax equal to only 15 percent of the whole amount of his gain. This is referring to capital gain. A few years ago, the wealthy stockholder faced only a 12½-percent tax on capital net gains.

But there is a very great number of instances in which corporate earnings have continued to pile up year after year for a far longer period than 10 years, constantly adding to the value of the estates of their individual owners, without ever having been subject to any surtax taxation, but only to the ordinary corporation income taxes at rates rarely higher than 15 percent. What this means in simple terms is the privilege of reinvesting earnings without the payment of surtaxes upon them, a privilege of very great monetary value to those

whose income reach surtax brackets higher than 15 percent. This means anyone whose surtax net income is more than $22,000 a year.

Now, the President has suggested that the Congress enact a tax measure which will produce approximately the same revenue from corporate earnings, whether they are distributed or not distributed. He suggested also the repeal of the present corporation income tax, the capital-stock tax, the excess-profits tax, and the repeal of the present exemption of dividends from the 4 percent normal income tax; all these taxes to be replaced by a tax on undistributed corporate earnings.

The Ways and Means Committee of the House has applied the principle suggested by the President in a form which expresses the tax not as a levy upon that portion of corporate income which is not distributed in the form of dividends to stockholders, but as a levy on total income. The House bill contains schedules which apply to the entire adjusted net income of a corporation, at rates graduated according to the proportion of the income which is retained by the corporation after the distribution of dividends and after payment of tax. It apparently has been thought by the House committee that this form of expression of the tax rates will more clearly represent to the corporation stockholder the tax cost of retaining any given proportion of net earnings for capital purposes.

Probably the first thing to be noticed about the rates for permanent corporation taxes in the House bill is that any corporation that distributes all of its current earnings will pay no Federal corporation taxes whatever. Such tax as applies will be paid by the individual stockholders on the same basis as all other individual income taxes are paid.

Senator KING. Supposing you have a corporation that is closely held, that has three or four or five or six stockholders, and any dividends that are paid would be paid to them, they could declare a dividend and distribute the profits during the year to themselves, and the corporation would pay no tax at all?

Mr. HELVERING. Absolutely.

Senator LA FOLLETTE. But they will pay on their individual income tax?

Senator KING. Yes; but the corporation would pay no tax.

Senator LA FOLLETTE. In paying the individual income tax they would pay more than they are paying now?

Mr. HELVERING. It is possible that there may be some corporations in the United States that would pay no corporation tax under this proposal.

Let us see what will occur in the case of corporations which do not distribute their earnings fully. Two sets of rates have been presented by the House committee, one applying to corporations with adjusted net income of $10,000 or less; the second applying to corporations with adjusted net incomes of more than $10,000, with a provision for merging the effect of these schedules on corporations with adjusted net incomes between $10,000 and $40,000. That is the same thing that the chairman was referring to awhile ago in the suggested matter that you want to have put in the record. The small income corporations, which comprise approximately 80 percent of all nonfinancial corporations, will be able to retain up to approximately 40 percent of a year's earnings for capital purposes and still pay less tax than

they pay now. Corporations with large incomes will be enabled to retain about 30 percent without paying as much in taxes as are paid under the present law.

Senator LA FOLLETTE. It is my understanding, Mr. Commissioner, that a study of the distribution of dividends over a period of approximately 10 years indicates that on the average corporations normally retain about 30 percent.

Mr. HELVERING. Yes; I think that is what the tables show over the period from 1921 to 1931. I do not know as those are the years, but it is over a 10-year period.

Senator KING. Where do you draw the line of differentiation between the small corporation and the large corporation?

Mr. HELVERING. Income of $10,000 or less is provided for in the House bill, adjusted net income of $10,000 or less, for the small corporation.

I have studied the application of these schedules to various types of corporations, large and small, and I have found that in addition to the opportunity given corporations to avoid all Federal income taxation by making full distributions of current earnings, the schedules permit very liberal additions to surplus from current earnings upon payment of taxes lower than those now in effect.

Where, then, does the increased revenue come from? It comes primarily from stockholders already enjoying large incomes who would pay higher taxes on their incomes as these incomes are increased by additional dividend distributions. It would come, in other words, primarily from those who are now able to avoid their just share of the burden of income taxation by holding income-producing property in the corporate form, and by having their corporations retain very large proportions of these earnings, subject only to the ordinary corporation income tax. It is inequitable and it is a source of great loss to the public revenues to permit the corporate form to be used by wealthy persons to avoid graduated individual income surtaxes.

As your committee is well aware, the objectors to bills providing additional revenues are always many and the advocates are usually few, because the benefit is general whereas the hurt is specific. It is natural, also, for some to advocate increasing the present corporation income-tax rate even as high as 25 percent, in lieu of the present proposal.

I might say to you gentlemen that some of the witnesses appearing before the House Ways and Means Committee were so strongly in opposition to this proposal that they even admitted they would pay 25 percent State income taxes on corporations rather than have this proposition.

Senator CONNALLY. Mr. Commissioner, the basic theory of this plan is that the Government will exact the same tax in the aggregate, whether the revenue is held in the treasury or whether it is distributed to the stockholders, because if it is distributed to the stockholders they will then pay individual income taxes, just as they do pay their income taxes now, is that correct?

Mr. HELVERING. The idea is to put all the income through the tax mill in either one form or the other.

Senator CONNALLY. In the same relative ratio?

Mr. HELVERING. Yes; and the statisticians have advised me that the rates in the retention, the rates that are retained, that are pay-

able by the corporation, are comparable to those paid by the individuals.

Senator CONNALLY. Then it becomes largely a matter of mechanics and calculation as to what the rate should be on the proportion of the income distributed and that proportion that is retained in the treasury, is that true?

Mr. HELVERING. Oh, yes. But such a substitute would victimize corporations generally, as well as heavily penalizing small stockholders, in order to enable a relatively small number of wealthy individuals to continue to use the corporate form as a means of avoiding individual surtaxes.

The bill passed by the House of Representatives was the product of very painstaking and conscientious consideration by the House Ways and Means Committee, which was assisted by officers of the Treasury Department and the experts of the Joint Committee on Internal Revenue Taxation and of the Office of the Legislative Counsel. In accordance with its desire to take full account of the practical requirements of different types of corporate business enterprises, the committee, while maintaining the principles of the President's proposal, made special provisions for special cases.

Senator WALSH. Mr. Commissioner, have the larger corporations been predisposed to set aside a larger percentage of their earnings as surpluses than the small corporations, so-called, or is there any rule that runs through these corporations?

Mr. HELVERING. No, Senator. Some very large corporations distribute almost fully. There is no general rule.

Senator WALSH. There are apt to be just as many small corporations that retain more than 30 percent of their earnings in surplus as the larger corporations?

Mr. HELVERING. Yes. I do not know whether it is in here, but the small corporation could, under the schedule as provided in the House bill, retain about 40 percent.

I have already noted that the rates of tax proposed for small-income corporations, which comprise the large majority in number of all corporations, are substantially lower than those for large-income corporations. In addition, the bill makes very liberal provision for the retirement of corporate indebtedness. It likewise makes special provision for banks and insurance companies, for corporations in receivership, for different classes of foreign corporations, for affiliated corporate entities, and so forth.

Senator HASTINGS. Mr. Commissioner, why is there special consideration for the banks?

Mr. HELVERING. Well, that was a matter of policy which the Committee on Ways and Means thought it advisable to place in the bill.

Senator HASTINGS. Was that recommended by the President?

Mr. HELVERING. It was not, as I understand it.

Senator HASTINGS. Do you see any particular reason why a special provision should be made for the banks?

Mr. HELVERING. Well, there were certain conditions that were presented to the Ways and Means Committee, and they decided, or they thought there should be some consideration.

Senator HASTINGS. I am asking for your judgment now.

Mr. HELVERING. Well, the Treasury's viewpoint about it is that the bill should be made almost universal.

Senator HASTINGS. Then it is your judgment that there is no particular reason for making a distinction, so far as banks are concerned?

Mr. HELVERING. I do not see any, Senator, when you take into consideration the amount of the exempt income that they have.

The CHAIRMAN. But you did deal the same with the banks as you dealt with the insurance companies and some other companies?

Mr. HELVERING. Yes.

The CHAIRMAN. There are certain States that compel banks to carry certain amounts of surplus, are there not?

Mr. HELVERING. Yes.

Senator BLACK. What other kind of companies? The Chairman said "banks, insurance companies and other companies."

The CHAIRMAN. Trust companies, companies in receiverships.

Mr. HELVERING. The whole idea, as I understood from the discussions in the Ways and Means Committee, was to put into a special class and give a flat rate to those companies, that could not, by virtue of their situation, like being in receivership, and things like that, come under this provision without a hardship.

Senator BLACK. Was there an exemption given to all types of insurance companies?

Mr. HELVERING. No. A 15-percent rate is given insurance companies.

Senator BLACK. Fire and life, and that is all?

Mr. HELVERING. Mutual, all sorts of insurance companies.

Senator BLACK. Then the exemption includes all kinds and types of insurance companies?

Mr. HELVERING. Well, there are some insurance companies of the mutual class that are exempt under the present law, and those are left exempt under this.

Senator BLACK. What I was getting at, does it exempt all types of insurance companies, the liability-insurance companies, fire, life, and so forth, or does it exclude from the exemption some kind of insurance companies?

Senator GEORGE. I understood it was applicable only to mutual insurance companies, other than life.

Senator CONNALLY. He is talking about the 15-percent rate.

Mr. HELVERING. The 15-percent rate applies to all insurance companies except those exempt under present law.

Senator HASTINGS. What I have in mind, take the case of an insurance company, which is the extreme case, it in the first place has to have a certain reserve set aside to make its contract a good contract, but it is engaged in business for profit, and if it makes a large sum of money why should not it be compelled to pay out its dividend just like any other business corporation, when you separate the surplus earnings from the surplus that is necessary to make the policy good?

Mr. HELVERING. Well, in the discussions in the Ways and Means Committee they have taken into consideration various requirements in the States, as required by law in those various States, on the question of reserves.

Senator HASTINGS. Well, that could certainly only be the kind of reserve that is required to make the policy good. Now I am talking about another reserve, I am talking about the reserve that grows out of the profit of the corporation. I do not see why, in the case of a bank, in the case of an insurance company, I do not see any particular

reason for making the distinction. I am just trying to find out. There may be some good reason.

Mr. HELVERING. Well, we did not recommend a change.

The CHAIRMAN. Well, Mr. Commissioner, as a matter of fact life insurance companies fall into two classes.

Mr. HELVERING. Yes, sir.

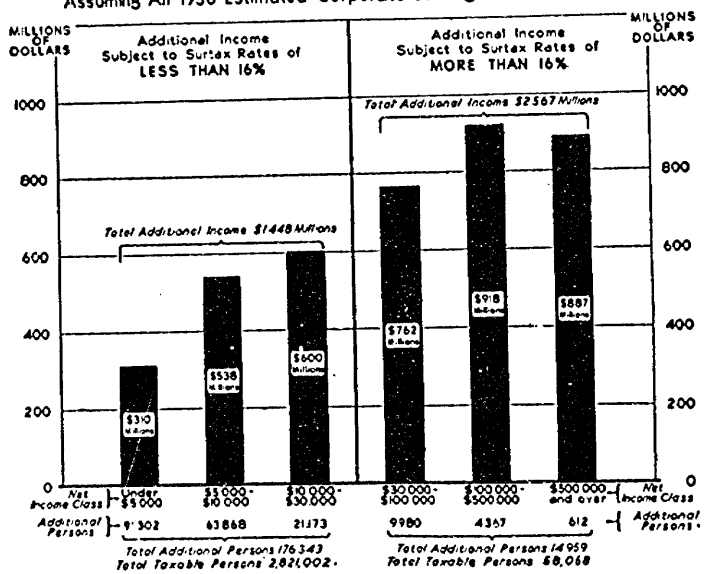
The CHAIRMAN. The stock-insurance companies and the mutuals.

Mr. HELVERING. Yes.

The CHAIRMAN. The mutuals are not taxed under this, they are taxed under another provision of the bill, is that right?

Mr. HELVERING. Yes. I feel that the House bill provides the basis for an excellent and productive revenue measure. In the first

ADDITIONS TO TAXABLE INCOMES OF INDIVIDUALS
Assuming All 1936 Estimated Corporate Earnings Were Distributed



place, it would remove great existing inequalities in the taxation of incorporated and unincorporated business, as well as in the treatment of business profits generally.

Senator CONNALLY. Mr. Commissioner, that is a point there that I think particular attention ought to be directed to. Is it not true that under the existing law the operation is really favorable to corporate incomes as against individual incomes, against individuals who might be engaged in the same business?

Mr. HELVERING. No question about it, Senator, at all.

Senator CONNALLY. In other words, the corporation pays a flat 15-percent tax, and if it holds the balance of its profits in surplus nobody pays more than 15 percent, whereas the individual who had

a comparable income might pay 20, 30, 40, or even 50 percent, is that true?

Mr. HELVERING. That is true, and also in that connection, to the small stockholder in that same corporation the 15 percent is a penalty.

Senator CONNALLY. The small man may not pay any income tax individually and yet he would pay 15 percent on the corporate tax, is that true?

Mr. HELVERING. Yes. In the second place, it would increase the Federal revenues by eliminating important sources of tax avoidance rather than by increasing existing tax rates or imposing new taxes.

The CHAIRMAN. Are there any questions of the Commissioner? If not, we will proceed with Mr. Haas.

Senator BLACK. Mr. Helvering, was there some question that came up in the House with reference to the profits over 6 percent made by the Federal Reserve bank? Did the Treasury Department recommend that all profits over 6 percent be taxed?

Mr. HELVERING. No, I do not think so. I think there was some discussion by some members of the committee during the hearing on that question.

Senator BLACK. Was there any provision made for that in the pending bill?

Mr. HELVERING. No. You mean profits?

Senator BLACK. Profits over 6 percent in the Federal Reserve, or placing it back into the Treasury.

Mr. HELVERING. No, there is nothing in the bill on that. I remember it was mentioned. Mr. Oliphant just advised me that in the hearings one Member of the House appeared before the committee and talked on that subject.

Senator BLACK. Did the Treasury Department take any position on it?

Mr. HELVERING. No, we did not.

The CHAIRMAN. Congressman Patman talked on that proposition.

Mr. HELVERING. Yes, I think it was Patman.

The CHAIRMAN. All right, Mr. Haas.

STATEMENT OF GEORGE C. HAAS, DIRECTOR OF RESEARCH AND STATISTICS, TREASURY DEPARTMENT

The CHAIRMAN. Mr. Haas, will you designate your position?

Mr. HAAS. My name is George C. Haas. I am Director of Research and Statistics of the Treasury Department.

I appear here at the request of the Secretary of the Treasury to discuss some of the broader economic aspects of the proposed change in our system of corporation taxes. I should like to analyze the considerations involved as objectively as possible; but I think that I can be of most service to the committee if I do this mainly by discussing each of a number of objections that have been raised, either in the House hearings or in the press, against the proposed change. There will possibly be some factors that I shall treat in lesser detail than some of the members of this committee may desire; but if this proves to be the case, I shall be glad to provide such additional data and discussion as the committee may request.

Because of the legal distinction between a corporation and its stockholders, only that part of a corporation's earnings which is

paid out in dividends is subject to our individual income taxes, even though the retained earnings add equally to the net worth of the stockholders. These withheld corporate earnings, if fully distributed, would go very largely to individuals of large incomes—individuals subject to the higher-bracket rates in our individual income-tax schedules. When retained by corporations, on the other hand, these earnings are subject to corporation income taxes of only 12½ to 15 percent. In consequence, the Federal Government is deprived of very substantial amounts of revenue which it would otherwise receive under the existing individual income-tax rates. It is estimated by the Treasury, for example, that about 45 percent of the withheld corporate earnings of the calendar year 1936 would, if distributed, go to individuals subject to income surtaxes ranging from 58 to 75 percent of the amount of this additional income.

The main objections which have been advanced against the proposed change in corporation taxes are:

(1) It is contended that small corporations will be prevented from growing into big ones and that, therefore, existing big corporations with accumulated surpluses will not face sufficient competition, hence, fostering monopoly.

(2) It is contended that all corporations, large as well as small, will be prevented from securing sufficient capital for expansion and other legitimate purposes.

(3) It is contended that capital will be driven into tax-exempt securities.

(4) It is contended that the change will prevent the creation of corporate surpluses necessary to maintain dividends, wages, employment, and business solvency through periods of depression.

Let us examine each of these objections in turn.

First. Those who foresee difficulties for the small corporation in the proposed legislation cannot have analyzed closely the schedules incorporated in the House bill. Much lower rates are provided for corporations whose net incomes are $10,000 or less than are provided for larger corporations. For example, if a small corporation——

Senator GERRY. One minute there. Is that accurate? Let me see if I understand this provision. You say here much lower rates are provided for corporations whose net incomes are $10,000 or less than provided for larger corporations.

Mr. HAAS. Corporations with a larger income.

Senator GERRY. With a larger income?

Mr. HAAS. That is right.

Senator GERRY. That is what I am driving at. What you do here, it does not make any difference how big the corporation is, it could be a billion dollar corporation, but if it earns $10,000 it pays a lesser rate?

Mr. HAAS. That is right.

Senator GERRY. That corporation may have just two stockholders and they would get the benefit?

Mr. HAAS. That is right.

Senator GERRY. For example, if a small corporation retains 10 percent of its adjusted net income, I think it paints the wrong picture, because it does not mean a small corporation necessarily, it means a corporation with a small income.

Mr. HAAS. You are right. Wherever I use the term "large" or "small" corporations in this statement, I refer to corporations with large or small incomes.

Senator GERRY. Well, this does not mean that it is a small corporation. It is a corporation with a small income.

Senator COUZENS. It means it has a small income in a small corporation.

Senator GERRY. It is a corporation with a small income. That is what I am driving at. This has nothing to do with capital, this has to do with income.

Mr. HAAS. That is right.

Senator GERRY. I think that is a very misleading statement.

Mr. HAAS. It has to do entirely with income. Much lower rates are provided for corporations whose net incomes are $10,000 or less, than are provided for larger corporations. I use that general expression in my statement. It describes the typical situation.

Senator GERRY. I know perfectly well the Treasury does not want to give the wrong impression, but I also know that it led me astray the other day when I questioned one of the experts on it. I just wanted to raise that point, of course, so it would be clear in the record, because it gives the wrong impression.

Mr. HAAS. Much lower rates are provided for corporations whose net incomes are $10,000 or less than are provided for corporations with larger incomes. For example, if a small corporation retains 10 percent of its adjusted net income, its tax will amount to 1 percent of its adjusted net income, as compared with a tax of 4 percent levied against corporations with incomes in excess of $10,000 which retain the same percentage of their adjusted net income. Similarly, with retentions of 20 percent of the adjusted net income, the tax is 3½ and 9 percent of the adjusted net income for small and large corporations, respectively. If 30 percent is retained, the small corporation pays 7½ percent, as compared with 15 percent for the larger corporation. We estimate that 83 percent in number of all corporations reporting net incomes for 1936, or 214,000 out of a total of 257,000, will have incomes of $10,000 or less. Under the provisions of the House bill, such corporations can withhold and directly reinvest in the business about 40 percent of each year's earnings without paying as much in corporate taxes as at present. This is a much greater proportion than can be reinvested by the larger corporations without the payment of a substantially higher rate of tax. Both classes of corporations could sharply reduce the present amount of their taxes by distributing a larger proportion of their current earnings. But regardless of their policies in this respect, the rate schedules give a decided advantage to the small corporations.

But, as you all know, the capital funds available for profitable corporations, whether large or small, are not limited to the amounts that they can save directly from earnings. Corporations that desire additional capital for expansion or other purposes can obtain such capital by the sale of additional shares to their own stockholders or to investors generally.

In the case of small corporations with a limited number of stockholders, it is almost as easy to pay out earnings in dividends and have all or a part of them resubscribed by the stockholders for additional shares of the corporation's stock, as to reinvest them directly. It is

merely a matter of convenience and tax economy which method shall be followed. Under the present system of income taxation both considerations have tended to favor the process of direct reinvestment, and hence the examples taken from the growth of corporations over the period during which this system has been operating have naturally shown small corporations growing into large ones by this method. The method of resubscribing dividends, however, would be equally effective.

I have already pointed out that under the proposed law small corporations would have a substantial advantage over large ones in the direct reinvestment of earnings. They would similarly enjoy two advantages in the process of growing through resubscribed earnings. In the first place, the very compactness of a small corporation permits this process to be carried on with a directness and informality which is impossible for the larger corporations. If under the present law small corporations retain their earnings through the consent and agreement of their stockholders, under the proposed plan, stockholders would be every bit as likely to use the proceeds of their dividend checks from the corporation to reinvest in additional stock.

Senator GERRY. In that case, Mr. Witness, again you are referring to this small corporation, all the way through in your argument, as a small corporation. Now under this provision it is not necessarily a small corporation, it may be a very large one. It means a corporation with small earnings?

Mr. HAAS. You are right, Mr. Senator, but, I have already indicated that in this statement. I mean size of income when I refer to "small" or "large" corporations. Moreover, as a general rule, small corporations have small incomes. It is the exception where you have large corporations with small incomes.

Senator GERRY. It does not say "small income." That is the thing that I went astray on before, that I was confused on. That is why I want to clear it up. It may be a small corporation but it has a large percentage of earnings for that corporation. Is that true?

Mr. HAAS. What I meant was that they are small corporations with small earnings.

Senator GERRY. I know what you mean now. We want to make the thing clear, so that it will not be confusing for us when we try to study the bill. What you really mean is a small corporation with small earnings.

Mr. HAAS. That is right. Thank you for the correction.

Senator LA FOLLETTE. But the principle is no different, is it, Mr. Haas? We do not tax an individual taxpayer today on his total worth, or his gross income, we tax him on his net?

Mr. HAAS. On the income it produces.

Senator LA FOLLETTE. Yes. And it is simply applying the same principle as the basis of taxation to corporations that we now apply to individuals?

Mr. HAAS. That is right.

Senator GERRY. If the Senator from Wisconsin will permit me, I agree with what he says entirely, I have no complaint with it, but what I had complained of was that the inference went out that the small corporation was necessarily getting a benefit under this requirement. Now it may or it may not, but in a great many cases it does. That is why the other day I asked for statistics, for example, on the number of stockholders that came under this group, and I think the

Treasury was going to try and find them for me and bring them up. That is why I wanted to know how many this affects, and whether it really does affect a great many corporations.

Senator CONNALLY. Mr. Haas, wherever you say "small corporation" in this statement you mean a corporation with a small income?

Mr. HAAS. That is right.

Senator LA FOLLETTE. As I understand it, as a general rule it is a fact that corporations with a small income are likely to be small corporations. As I understand it, the figures show that 67 corporations in 1933 had about one-third of the total corporate income of the country.

Senator CONNALLY. After all, under this bill it is immaterial whether it is big or little, it is the income that is material, whether the income is big or little is a factor. When you say a small corporation you mean a corporation with a small income?

Mr. HAAS. The basis for classification is income. If you once classify them as large or small on that criterion you can call them large or small, once you have made yourself clear.

Senator GERRY. I am just trying to clarify this thing.

The CHAIRMAN. As a matter of fact, as the result of improved economic conditions in the country, there are not many large companies or corporations that are not making a pretty fair earning, isn't that true?

Mr. HAAS. Corporate earnings, Mr. Chairman, have recovered in a very remarkable way. For instance, in the calendar year 1935 corporate earnings increased more than 40 percent. In the last quarter of 1935 the percentage increase over the same quarter of the year previous was about 117 percent. There have been very remarkable increases in corporate earnings recently.

Senator LA FOLLETTE. Is it not a fact that a reliable index indicates that a group of 1,307 corporations in 1935 increased their earnings 32 percent above those for 1934?

Mr. HAAS. The increase in the group you mention amounted to 42 percent, Senator La Follette.

Senator LA FOLLETTE. And that a group of 161 representative corporations showed an increase of 69 percent?

Mr. HAAS. I believe that the increase there was 41 percent.

Senator LA FOLLETTE. Is it not a fact that these 161 corporations showed that the profits during the last quarter of 1935 were 117 percent higher than the profits for the last quarter of 1934?

Mr. HAAS. That is correct, Senator. I think those are Standard Statistics figures.

Senator GERRY. You haven't got any statistics yet, you are trying to get them for me?

Mr. HAAS. Yes.

Senator GERRY. How many corporations will this affect? How many stockholders will this affect? I think we have the number of corporations.

Mr. HAAS. Yes.

Senator GERRY. We haven't got the number of stockholders, is that it?

Mr. HAAS. We are working on that. That is a very difficult problem, because one man may own 10 shares of this, 10 shares of something else, and so forth, and he might be counted 10 times.

Senator LA FOLLETTE. As I understand, Mr. Haas, the number of stockholders cannot be furnished, the fact that you cannot furnish those figures is not a basis for questioning the reliability of your estimates as to the distribution of corporate income if it is paid out of the corporations and into the hands of individual taxpayers?

Mr. HAAS. You are absolutely correct, Senator.

Senator LA FOLLETTE. In other words, you have sufficient actuarial samples so that you are willing to stake the revenue of the Government on the proposition that those samples and estimates are correct, and as a general rule the distribution will work out as you estimate?

Mr. HAAS. That is correct.

Senator GERRY. Of course the Senator from Wisconsin is going to address himself to one point, which is the total revenue. What I was trying to get at is the basis of the special exemption.

Mr. HAAS. How many people are involved?

Senator GERRY. Yes; and on what it was based. Just a general idea.

Mr. HAAS. I think we can get you what you want.

(Table referred to appears at end of Mr. Haas' statement.)

Senator GERRY. I just want a general idea.

Senator BLACK. Mr. Haas, as I read your statement here this morning, what you are simply pointing out is the mechanics. The stockholders of the small corporation would have an advantage of resubscribing. The mechanics would have to be utilized by the subscribers of the large corporation. I do not see where this refers at all to the man of means. What you are referring to here is making an argument to reply to another argument that the small corporations would be injured by reason of the failure to be able to bring about a resubscription. You are pointing out that a small corporation, irrespective of income, which has nothing to do with it, would not be handicapped or harrassed in any manner because the small corporation can much more easily bring about a resubscription of the stock?

Mr. HAAS. That is right.

The CHAIRMAN. You may proceed.

Senator GEORGE. Mr. Haas, before you proceed, in enumerating the objection here I note that you do not refer to one that has been suggested. I think, in certain quarters, at least it occurs to me, the difficulty that may arise out of the small holder of stock in the corporation being insistent, his insistence that there be no retentions, whether the corporation be large or small, no reserve set up. Have you given consideration to that objection? I refer particularly to the shareholder who might be described as a speculative shareholder. That does not tie into the corporation on the basis of investment so much, as he is simply speculating in stocks. The holder of a relatively small amount of stock of course would constantly agitate, constantly insist on a complete distribution of the earnings regardless of the condition of the corporation. It is easily imaginable, of course, that he would pay little, if any, tax, even if his entire share was distributed, whereas if there were withheld in the corporation any particular amount of money he would pay his proportionate share through the corporate tax.

In other words, the objection is simply this: There is the tendency in this bill to transfer management and control in the corporation

from the majority of the officers and directors to a troublesome minority, particularly speculative purchasers of stock. That seems to me to be an objection that might well be considered, and I am making the suggestion to you now so you may think it over, so that you may express some view on it by tomorrow morning.

Mr. HAAS. I will be very glad to do that. Shall I proceed?

Senator LA FOLLETTE. I would just like to interject a general observation that the experience in management of corporations does not seem to indicate that minority stockholders have much to say about the policy of the corporation.

Senator GEORGE. But they would have under this program much to say about it.

The CHAIRMAN. This matter is so important that I think you had better proceed in the morning. The committee will take a recess until 10 o'clock tomorrow morning.

(Whereupon, at 12 noon, the committee recessed until tomorrow, Friday, May 1, 1936, at 10 a. m.)

REVENUE ACT, 1936

FRIDAY, MAY 1, 1936

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

The committee met, pursuant to adjournment, at 10 a. m., 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, Guffey, Keyes, La Follette, Hastings, and Capper.

The CHAIRMAN. The committee will be in order. All right, Mr. Haas, you may continue from where you left off yesterday.

STATEMENT OF GEORGE C. HAAS, DIRECTOR OF RESEARCH AND STATISTICS, TREASURY DEPARTMENT—Resumed

Mr. HAAS. On page 4, I think I will start at the beginning of the paragraph, although I read part of that paragraph yesterday.

I have already pointed out that under the proposed law small corporations—I might say again, with regard to small corporations, that by small corporations I mean corporations with small incomes. Over short periods of time a corporation with large assets may have a small income, but over any substantial period the value of the assets is based upon income, and what I am concerned with, and what affects my conclusions, is the general picture, even though there may be an exception now and then.

Senator KING. Then you do not draw the line at $10,000?

Mr. HAAS. I draw it at $10,000. I mean small-income corporations, but the fact that there are some corporations with large assets that may have a small income during some period does not affect any of my conclusions.

Senator KING. There are many corporations with capital stock and assets probably of $1,000,000 or more, but with a heavy liability, and would have no income at all. I have known of many such corporations. In what category would you place them?

Mr. HAAS. The great bulk of them fit within my definition. A corporation that has assets which it carries at a large value on its balance sheet but which produce no income will have to write them down eventually and so become a small corporation even as defined by value of assets, regardless of the fact that it may own half a county, if, for example, it is in the real-estate or livestock business. In other words, from an economic point of view the size of a corporation over any

period is determined by its income—that is, its present income and its anticipated future income. Income is, in the final analysis, the basis for all valuations of capital.

Senator KING. I know of many corporations where the capital stock actually paid in in cash is several million dollars and there has been no income in the past 3 years.

Mr. HAAS. That is right.

Senator KING. What category would you place those in?

Mr. HAAS. I say, for the purpose of my conclusion, it does not make any difference at all about where they are placed. They both fall within my definition. A small corporation is one with a small income.

I would say further in regard to your inquiry, Senator, if that corporation, after a few years, still had no income, the assets would have to be written down. The fact that it still had large assets and no current income would mean it anticipated large income in the future.

I have already pointed out that under the proposed law small corporations would have a substantial advantage over large ones in the direct reinvestment of earnings. They would similarly enjoy two advantages in the process of growing through resubscribed earnings. In the first place, the very compactness of a small corporation permits this process to be carried on with a directness and informality which is impossible for the larger corporations. If under the present law small corporations retain their earnings through the consent and agreement of their stockholders, under the proposed plan, stockholders would be every bit as likely to use the proceeds of their dividend checks from the corporation to reinvest in additional stock. The whole operation of declaring the year's profit as dividends and resubscribing all or a portion of such dividends to additional shares of the corporation's stock, either pro rata or in such proportions as might be mutually agreeable to the shareholders, could be completed in the course of a short stockholders' meeting.

The other advantage which small corporations, in general, would have over large ones would be in the absolute amount of money which would be available to be resubscribed. It is a good general rule that the principal stockholders in small, struggling, and newly established corporations are men of much smaller total incomes than the principal stockholders in large, prosperous, and well-established corporations. If, therefore, such principal stockholders subscribe back to the corporation for additional shares all or part of their dividend receipts, less the income tax thereupon, the proportion of the gross dividend receipts subscribed back by them will be much greater in the case of the average small corporation than in the case of the average large one. The great importance of the difference which exists because of the differing individual income-tax rates upon different income classes can best be seen when it is noted that while dividends which fall in the bracket between $10,000 and $12,000 of stockholders' individual incomes will be reduced by only 11 percent, or less than the present corporation taxes, by reason of the individual income tax, the dividends which fall in the income-tax bracket between $100,000 and $150,000 will be reduced by a 62 percent individual income tax. In other words, a greater proportion of the earnings of small corporations will be available for reinvestment,

when paid out to their stockholders, than of large corporations. I submit that this differential will give smaller corporations a chance to catch up upon their larger rivals which they never have had under any previous tax legislation.

I think I have made it clear that small corporations would be given special advantages as compared with large corporations under the proposed change in our corporation taxes. I now turn to the second objection that has been raised that the proposed change would prevent larger, as well as smaller, corporations from obtaining sufficient capital for expansion, because the proposed schedules of taxes are graduated according to the percentage of corporate earnings withheld from stockholders for reinvestment in the business.

The first answer to this contention is that the schedules already allow, besides the very liberal deductions from taxable income for depreciations, depletion, bad debts and the like, the withholding by the corporation of 30 to 40 percent of each year's current earnings upon payment of taxes less than the amounts payable under the existing law. For medium-sized and larger corporations, moreover, free access to the organized capital markets offers abundant opportunities to all profitable corporations for such additional capital funds as they may require.

Senator KING. Are you quite certain about that? You take a mining company, the investment market is not, as a rule, open to it, because it is so much of a gamble.

Mr. HAAS. Where do they get their money, Senator?

Senator KING. They get it out of the people who want to invest in it.

Mr. HAAS. Those who have sufficiently speculative temperament to go into a risky enterprise.

Senator KING. Those who want to make the investment. They do not borrow it, they have to get it from their own assets.

Mr. HAAS. Because the industry is one that involves a high degree of risk. It is a little more difficult to market their stock, because you have to select those people who are willing to go into an enterprise of that sort. Their capital market is somewhat more limited than other types of business with less risk. I think that is the only difference.

Senator KING. I know of an organization that proposed to invest over $100,000 for the sinking of a shaft in a mining company. It was a gamble. If they got the ore they would be repaid otherwise they would not be repaid. If they got the ore then they would have to pay an enormous dividend the first year, because if they got the ore it would be in bulk and it would be very profitable. So the threat of this bill has prevented the consummation of this plan. I merely call your attention to that form of investment which has done so much for the mining resources in the West, as well as the petroleum interests and the coal interests.

Mr. HAAS. I do not see what effect, Senator, this bill has on the decision which they might make. You have to reach a certain type of capital market because you have a certain type of risk, but I will be glad to come back to that.

Senator HASTINGS. Before you leave that, just above, in that same paragraph you are quite certain of your figure when you say, "The

withholding by the corporation of 30 to 40 percent of each year's current earnings upon payment of taxes less than the amounts payable under the existing law."

Mr. HAAS. I think it figures out fractionally less, does it not, Mr. McLeod?

Mr. MCLEOD. That is correct.

Senator HASTINGS. All right.

Mr. HAAS. For many decades, growing and successful corporations have been able to call upon their stockholders and others for additional capital funds through the offering of rights to the stockholders to subscribe for additional securities. Through the issuance of such rights, any medium sized or large corporation whose stock is traded in the securities markets may obtain the reinvestment in its business of capital equal to all or any desired proportion of the current earnings that have been distributed in dividends; and, if need be, more.

Let me illustrate: Let us assume a corporation that desired to reinvest in its business its entire earnings of $5 a share, but that, nevertheless, decided to pay out the whole amount in dividends in order to avoid all corporate taxation under the proposed law. Such a corporation could easily obtain the reinvestment in its business of this $5 per share by offering to its stockholders rights to purchase additional capital stock well below prevailing market prices. The rights themselves would constitute a valuable marketable instrument which could be sold in the open market by any shareholder who was not disposed to reinvest his dividend check. It is equally apparent, of course, that the amount of money which can be obtained in this way is by no means limited to the amount of the earnings of the corporation, but that any reasonable increase in total capitalization can be effected by this means.

Senator HASTINGS. Mr. Haas, may I inquire whether that would apply to the listed stocks, that argument?

Mr. HAAS. You mean listed on any exchange?

Senator HASTINGS. Yes.

Mr. HAAS. Not exclusively. The fact that they are listed would facilitate it, because listing tends to give a stock a marketability which an unlisted stock does not have, although many corporations with stocks traded over the counter would not have any difficulty in doing it.

Senator HASTINGS. Do you happen to know whether it would be necessary for such a corporation to get authority from the Securities Commission before it could offer these rights to the stockholders?

Mr. HAAS. I do not know what that regulation is under.

Senator HASTINGS. What I had in mind was: Suppose a corporation had been losing money for 3 or 4 years, and then suddenly had a good year and paid it all out to its stockholders and tried to persuade them to reinvest it, I should suppose the Securities Commission would have something to say about whether that proposal should be made.

Senator KING. I do not think there is any question about that.

Mr. HAAS. I do not think so, Senator, if they made no misrepresentation and laid all the facts on the table. I am not positive about that.

The CHAIRMAN. If there is any question about it it can be written into the law.

Mr. HAAS. That is right.

Senator BARKLEY. All the law requires is that the issuing of securities must be accompanied by a truthful statement as to the reason for issuing them. The Exchange Commission does not exercise the right of deciding whether the stock shall be issued or whether the capitalization should be increased. Of course, the same is true as to the exchange.

Mr. HAAS. Shall I proceed?

The CHAIRMAN. Yes.

Mr. HAAS. During the period between 1921 and 1930, inclusive, the American Telephone & Telegraph Co. paid regular dividends at the rate of $9 per share, the dividends aggregating about $854,000,000 during the 10 years. But, during this same 10-year period, the corporation offered rights to purchase additional stock to its stockholders in 1921, 1922, 1924, 1926, 1928, and 1930, and in the aggregate raised about $950,000,000 of capital from its stockholders through the sale of such additional stock to them, or about $100,000,000 more than the aggregate dividends paid to them during the period.

Senator HASTINGS. Do you happen to know whether the same company has made any such offer since 1930?

Mr. HAAS. I do not believe so. I am not familiar in detail with their business, but they probably did not have any requirement for expansion since that time. We went into the very deep depression at that time.

Senator HASTINGS. I am wondering whether there is anything significant about that.

Mr. HAAS. I do not think they would have any difficulty today, if they needed the money.

Senator HASTINGS. I am wondering whether there is anything significant in the fact that that was done during the prosperous years and none of it was done during the depression.

Mr. HAAS. Well, Senator, I think it is a very significant fact. It is difficult to increase the investment in a business by plowing earnings back unless there are some. The only time you can do that is when you are making money. There is no choice.

Senator HASTINGS. Does not your argument rather prove that your way of getting the funds back into the company in the form of a surplus can happen only in prosperous years and it does not apply to depression years?

Mr. HAAS. In general I would say that is correct, and I would also say that the only time in which you can plow back earnings in a concern is during periods when earnings are being made, and that is during prosperous periods.

Senator HASTINGS. Do you know whether the A. T. & T. have continued their regular dividends of $9 per share since 1930?

Mr. HAAS. I think they have.

Senator HASTINGS. Do you happen to know whether they took it out of earnings or out of surplus, or a combination of the two?

Mr. HAAS. I do not know offhand.

Senator BARKLEY. The report released by the A. T. & T. 3 or 4 days ago shows the earnings in 1935, I think, were the largest since 1930.

The CHAIRMAN. Suppose in that connection we put in the record the last report of the A. T. & T. so you can answer these questions.

Mr. HAAS. That is fine. I shall do so. [An extract from the annual report of the American Telephone and Telegraph Co. for 1935 is appended to Mr. Haas' statement.]

Senator HASTINGS. The last report would not necessarily show it, because that is the prosperous year of 1935.

Senator BARKLEY. I am glad to hear you admit that.

Mr. HAAS. The Travelers' Insurance Co. of Hartford, Conn., by successive offerings of rights to shareholders to subscribe to new stock at par in 1908, 1910, 1913, 1916, 1920, 1923, 1925, 1926, 1928, and 1929, multiplied its outstanding amount of capital stock 20 times, from $1,000,000 to $20,000,000.

Senator HASTINGS. Mr. Chairman, it seems to me that is an illustration showing that it is unreasonable to exempt insurance companies like that who have made that amount of money in the operation of their business.

Mr. HAAS. It may be objected that the issue of such rights is open only to extremely large corporations or that the practice of issuing them is infrequent. Neither of these objections is true. Using figures compiled by the Commercial and Financial Chronicle, the Bureau of Business Research of the University of Illinois estimated that more than 3,000,000,000 of capital was raised by corporations in 1929 through the offerings of securities to their stockholders. In discussing such stock offerings Dewing, in his Financial Policy of Corporations, a standard work on this subject, says: "They occurred almost as frequently in 1922 and 1923 as they did in 1928 and 1929."

The April 6, 1936, bulletin of the Standard Statistics Co. lists a number of corporations, medium-sized as well as large, that are now raising additional capital funds by the sale of securities to their stockholders. These companies include the Union Bag & Paper Co., the Foster-Wheeler Corporation, the Kalamazoo Stove Co., the Atlantic Refining Co., the Standard Tool Co., the Great Northern Railway Co., the Ferro Enamel Corporation, and the Kinner Airplane & Motor Co. Other corporations that have raised capital through the sale of additional securities to their stockholders during the past several months include the Edward G. Budd Manufacturing Co., the Edison Electric Illuminating Co. of Boston, the Glidden Co., the Granite City Steel Co., the Ludlum Steel Co., Spiegel May Stern Co., and the Holland Furnace Co.

Senator BARKLEY. Let me ask you, Mr. Haas, what effect does this process have on the value of securities? For instance, if a corporation plows its earnings back into plant, there is no increase in the outstanding stock, it just uses its money and retains it from the stockholders; then if it pays it out in dividends and issues additional stock equivalent to the amount that would be plowed in out of earnings, they increase their outstanding stock to that extent; what effect would that have, if any, on the value of the stock?

Mr. HAAS. It has the same effect as a stock dividend; but from the point of view of the stockholder, judging the market value of the stock, other factors must be considered.

Senator BARKLEY. Yes.

Mr. HAAS. When the earnings are left in the corporation, the stock reflects those earnings, because it means a gross investment

which belongs to stockholders. If you pass the same earnings out to the stockholders in dividends, the market tends to value those same earnings higher than if they were left in. Now, through stock rights, if the stockholders just turn the earnings back to the corporation again, my offhand opinion would be that the stock, or that the earnings, would tend to be valued higher than if the earnings were left in the corporation.

In addition to that, the earnings per share of the corporation would increase by the decrease in taxation. In other words, for a large corporation, or on the average for all corporations, present corporation taxes amount to about 16 percent, so you could conceivably have a 16-percent increase in earnings per share.

Senator BAILEY. In your opinion, would the stockholders value the stock more highly in the corporation which declared all of its surplus than they would the stock of a corporation that had the surplus?

Mr. HAAS. I would say that earnings paid out as dividends would be valued higher than earnings retained.

Senator BAILEY. How long would it pay out dividends after it dropped the surplus?

Mr. HAAS. In this bill, Mr. Senator, when we use the word "surplus", we confine it to this meaning: That it means current earnings. If a corporation pays out its current earnings and, because of its fiscal policy, regardless of this bill decides that each year, in order to grow and expand, it has an outlook for a profitable investment of capital of 10 percent, say, in a year——

Senator BAILEY. That might be true in the case of a corporation that had a fair value, but that is not true in the case of a corporation that does not have a surplus, or has a very small surplus. Is it your contention it would be good business for it to accumulate a surplus and fail to pay it out in dividends?

Mr. HAAS. I would say that whether or not it is a good fiscal policy of the corporation to accumulate a surplus would hinge upon this question: Does it need more capital to reinvest in the business?

Senator BAILEY. I would not stop at that point. You may not need more capital to reinvest, but your surplus is an asset to the corporation; it enhances its credit, it relieves it of the necessity of going to the bankers, it has its own money to operate. Is it your theory to cut off the surplus?

Mr. HAAS. No, Mr. Senator. The bill provides for the accumulation of reasonable surpluses. But it is important to point out that surplus is a part of the stockholders' equity in a corporation, capital stock representing the other part. Surplus is on the liability side of the balance sheet, and you cannot spend that to help you in any instance.

Senator BAILEY. You mean to say you cannot use the surplus in a corporation?

Mr. HAAS. Whether you can use it or not depends on what it is invested in.

Senator BAILEY. Wait one minute. Let us talk plainly about it. You can use it, and do use it, by spending it. The surplus does not remain in the corporation doing nothing.

Mr. HAAS. I see what you are driving at, Mr. Senator. I will try to make myself clear. A surplus accumulated out of earnings just means that earnings have been reinvested in the business—new capital has gone into the business. The surplus itself appears on the liability side of the balance sheet. It belongs to whoever owns the assets. Now, if the surplus, which is $100,000, say, is invested in a steel plant, it is of some aid to the business, it has certain significance to the business, but it cannot be spent. However, if it is put into Government bonds, if there is a sort of an investment pool, then you have a liquid fund which you can call on. But just the mere fact that you have a surplus on your balance sheet does not indicate, without looking over to see what the condition of your assets is, whether one corporation is in a better shape to weather the depression or other emergency than another. For example, take a corporation that each year, instead of leaving its earnings in surplus, wrote them up into capital and carried a large proportion of its assets in a liquid condition, and another corporation that let the surplus account increase, but said, "We will put it into the plant. We will make 25 percent by putting it into the plant instead of putting it into Government bonds", and they put it into plant and they had a big surplus, but the assets representing that surplus were in a condition in which they were nonliquid and of no help to them in an emergency.

Senator BAILEY. You say "nonliquid" if it was an investment in machinery, for instance. To go back to my question, would that enhance the value of the stock in the hands of a stockholder or not?

Mr. HAAS. To an expert analyst, not necessarily. To the general public there seems to be some magic in the term "surplus." To an expert analyst I would say "no." He does as I attempted to do, he looks over to see what happened to this surplus.

Senator BARKLEY. As a matter of fact, surplus does not always mean cash in bank?

Mr. HAAS. No.

Senator BARKLEY. And as a matter of fact most people who invest money in stocks do it for the purpose of getting a return in cash.

Mr. HAAS. That is right.

Senator BARKLEY. If a corporation plowed its earnings back into the business always and the stockholders got no dividend, they might, after a while, lose interest in the stock unless the stock was very closely held within a few hands, like some companies that we know of which never pay out any dividends, because for different reasons they either plow it back into the business or set it aside as a surplus anyway, but if a corporation over a long period of years plowed all of its earnings back into business and paid out no dividends it might have a little difficulty selling that stock to the public—is that not right?

Mr. HAAS. That is right.

Senator BARKLEY. While the existence of a surplus is no doubt a valuable asset, superficially speaking, it does not appeal to the average stockholder who invests money in order to get a return only—isn't that right?

Mr. HAAS. That is right.

Senator BARKLEY. The two things might offset each other in determining the public price of a stock which was sold on the exchanges.

Senator KING. May I interrupt right there? Is it not a fact, Mr. Haas, that many persons prefer to join in a policy not to distribute the earnings but to plow them back into the business in order to have it expand, and they regard the increase in value of the stock as more important than the dividend?

Mr. HAAS. The stockholders in the high-income brackets are very much interested in this now because for every dollar directly reinvested by the corporation they save as much as 75 cents in taxes.

Senator BARKLEY. Is not that true largely among corporations where the stock is owned by a very few people and where they are indifferent to dividends, where they have got plenty of money on the outside and they do not have to depend on the dividends of that particular stock for a living?

Mr. HAAS. That is right.

Senator BARKLEY. That does not apply to the great mass of stockholders, however.

Mr. HAAS. That is right.

The CHAIRMAN. Mr. Haas, in that connection, supposing you have a closely owned corporation that has piled up enormous surpluses, like the Aluminum Corporation, or like others that I might call, a stockholder is not particularly anxious to get the dividend because it would go into the higher prices—in that case is 42.5 percent as a maximum rate high enough to penalize those people or to force distribution of dividends? For instance, they might have to pay 75 percent if they owned a great bulk of the stock, and they would pay 42.5 percent by leaving it in there as a surplus. Would not they, as a choice between the two propositions, leave it in the corporation and pay 42.5 percent rather than distribute?

Mr. HAAS. That question, Mr. Senator, was discussed in the Ways and Means Committee somewhat along those lines. There is a provision in the bill in regard to that. Mr. Kent could probably discuss that provision.

Mr. KENT. Section 102, but this section as drawn does not apply to corporations like the Aluminum Company.

Mr. HAAS. Mr. Kent, would you mind discussing that?

Senator BAILEY. As I get your view now, the stockholder's sense of value of his stock, upon the accumulation of the surplus by a corporation, is based upon magic and not upon reality? It is not reality; it is magic?

Mr. HAAS. The surplus is just a part of the stockholder's equity expressed in another account.

Senator BAILEY. The stockholder's equity is not magic?

Mr. HAAS. No.

Senator BAILEY. The equity is a reality, is it not?

Mr. HAAS. Yes.

Senator GEORGE. Mr. Haas, let me ask you one question. You give no significance at all to the surplus shown in the bank statement?

Senator BAILEY. That is the magic.

Mr. HAAS. Suppose you are a stockholder and you look at the accounts, what is your equity in the concern? You look at the capital account and the surplus account, the two of them together; suppose the bank just increased their capitalization the day before yesterday? That is the point I am trying to make.

Senator BAILEY. How do you increase capitalization?

Mr. HAAS. By declaring stock dividends to the stockholders.

Senator BAILEY. By issuing stockholders' certificates equal to the surplus?

Mr. HAAS. Yes.

Senator BAILEY. But that would be magic.

Mr. HAAS. No; I should say the situation stayed just the same. Some people, laymen, might think, "Well, it would be better to have a surplus in there."

Senator CONNALLY. Mr. Haas, let me ask you a question. You differentiated a while ago between the value of the stock on the market, between those that paid a cash dividend out of current revenues and those that accumulated it. Now, is not this the reason for that? People buying stock, if they get a little cash dividend out of the current revenues, if they get that right now, that, to their mind, is worth a little more than an expectancy of a dividend which is not distributed, which may be dissipated, may be lost, they might make a bad investment and lose a lot of it, if he gets it right now it gives him an enhanced value of the certificate; is that not true?

Mr. HAAS. That is right.

Senator CONNALLY. Is not that the differentiation?

Mr. HAAS. That is the main differentiation.

Senator HASTINGS. Mr. Haas, I would like to know whether or not you made any estimate along the line of an illustration that I want to make. Take a $2,000,000 corporation over a period of 10 years, and suppose it earned 10 percent of $200,000 for 5 years, but paid none of it out to its stockholders, it would then have accumulated $1,000,000, and it paid to the Government each year $32,000 in taxes; now, suppose at the end of 5 years it increases its plant, whatever its business is, by using all of the million-dollar surplus, it will then have $3,000,000 capital investment; isn't that true?

Mr. HAAS. What did they do with the surplus over the 5 years that they earned it?

Senator HASTINGS. They just kept it.

Mr. HAAS. Just kept it in cash?

Senator HASTINGS. Yes.

Mr. HAAS. You mean in liquid securities that they could sell to buy the plant?

Senator HASTINGS. Yes. My figures may not be exactly correct. Suppose at the end of 5 years it spent the million dollars by purchasing new material, giving labor to a lot of people, or what not; it increased the value of its plant by $3,000,000, and it continues to earn 10 percent, so its earnings have been increased, then, from $200,000 to $300,000; its taxes under the present rate will then increase from $32,000 to $48,000, an increase of $16,000.

Mr. HAAS. Yes.

Senator HASTINGS. I was wondering whether, over a period of 10 years, the first 5 during which time they were accumulating this dividend and the next 5 when they were making dividends at the same rate, I was wondering, from the Government's point of view, which would give the Government the most money, under the new plan or under the old plan.

I am not expecting you to answer that right off, because that is a more or less complicated question. I think it would be very helpful if you could take some such illustration as that and see just where we would land. Of course, I assume you would have to take into account the question whether the owners of that corporation were in the higher bracket or the lower bracket, which would, I suppose, make a difficult problem.

Mr. HAAS. Yes. I could put an illustration in the record along the lines that you have suggested. You have to make some assumptions with regard to stockholders. [Illustration referred to is attached to end of statement.]

Senator HASTINGS. I suppose that is true.

Mr. HAAS. You would have to make some assumption as to the period in which this took place. Shall we say 10 years previous to this date?

Senator HASTINGS. I am assuming a period of 10 years when the profits were just the same, 10 percent on the investment during the whole 10 years, the first 5 years 10 percent on 2 million and the next 5 years 10 percent on the increase, which would be a million, less the taxes that had been paid.

The CHAIRMAN. And following that question will you put in the record several examples?

Mr. HAAS. All right.

The CHAIRMAN. Are there any other questions?

Senator BARKLEY. In that connection, while you are off your manuscript, somebody has scattered a good deal of misinformation; a good deal of misinformation has been broadcast about this bill. I am getting a lot of letters complaining because it taxes existing surpluses that have been created over the past. Of course, it does not, and I do not know who started that story; but I would like it to be put into the record, and for the press to carry, that this bill does not touch at all existing surpluses that have been created in the past.

Mr. HAAS. That is right. The bill concerns itself only with current earnings.

Senator LA FOLLETTE. On the other hand, Senator, some people are criticizing the bill because they contend it is going to give a competitive advantage to corporations that have accumulated surpluses.

Senator BARKLEY. Well, that may be.

Senator GEORGE. Mr. Haas, may I say for myself it would be far more helpful if you concede, as I think you must concede, in the light of all the business experience, that reasonable surpluses and a reasonable accumulation of surpluses was necessary, and this bill does not make impossible the accumulation of reasonable surpluses to take care of the ordinary affairs of the corporate organization.

Mr. HAAS. I agree with you perfectly, but what I was trying to explain are the different concepts of this term "surplus."

Senator GEORGE. Oh, yes.

Mr. HAAS. Now, Senator, I agree with you perfectly, because I know you are talking about the accumulation of assets—or call it surplus, if you will—which are in such shape that you can utilize them if a contingency arises; but those assets may be expressed just as well in the capital account as in a separate account, I mean the cap-

ital-stock account. Surplus is a capital account. It is just a technical matter which I was trying to explain.

Senator GEORGE. It might be expressed in different ways, but, as a matter of practical business experience, it is a far different thing to actually have a surplus and rely upon your ability to induce stockholders to buy back, to exercise their rights, from going into the market and selling your own securities.

Mr. HAAS. It shows, Mr. Senator, if the account is kept intact, that over a period this company has grown out of earnings, and that has something to do with its credit.

Senator GEORGE. Undoubtedly it has something to do with the credit. You do not need to argue that fact. I know the surplus is not necessary. If this bill does not make the accumulation of a reasonable surplus possible without an undue burden, we think it would be far better to forego it, but I hope that this program may eliminate in a large measure the accumulation of an unreasonable amount of surplus. It just seems to me you ought to start with the premise and make a case on the theory that this does permit a reasonable surplus.

Senator LA FOLLETTE. As a matter of fact, as I understand it, if a corporation accumulates 30 percent, on which some testimony was given in executive session to the effect that that was a normal, average amount of accumulation over a 10-year period, they will pay less tax on that than they now pay under the existing law.

The CHAIRMAN. That is for corporations over $10,000, and for corporations under $10,000 it was 40 percent.

Mr. HAAS. That is right.

The CHAIRMAN. Anyway, that is a criticism that was first hurled at the suggestion by the so-called business people, that there ought to be a cushion, and the House has answered that by presenting a cushion. What they want is reasonable cushion.

Mr. HAAS. That is right.

Senator KING. Do you have that in this bill?

Mr. HAAS. Yes. The reason I discuss as much as I do the relation between capital and surplus is this—that many corporations realize that many people look at the surplus account without examining it further. I say it has little significance unless you examine the assets. They often start a new corporation out with a surplus; it is born with a surplus.

Senator KING. Is not that to take care of some contingency that may arise?

Mr. HAAS. Some State laws make it almost imperative to do that.

Senator KING. You know some businesses encounter lean years more frequently than others. You cannot standardize business.

Mr. HAAS. That is right.

Senator KING. I have in mind a mining corporation in my State. It was wisely managed. It anticipated lean years. The ore deposit in one section gave out and they had to explore. If they did not have a reserve they could not have gone to work, and they would have had to throw their men out of employment. In this particular mine they had reserves of several hundred thousand dollars. When the depression came, instead of discharging their men they kept them at work. They made no money. They exhausted all of their re-

serves; and then, because their credit had been good, they borrowed $500,000 more; and they saved the city, saved the town, saved hundreds of families. Other corporations that did not have those reserves had to close down. You would not want to adopt a policy that would preclude the cushion or the establishment of a reserve to meet contingencies of that kind, would you?

Mr. HAAS. No; the point I was making is that under this bill a corporation would have every facility to reinvest in their business and create a surplus account if it wants to do that. My other discussion as to the relationship between capital and surplus accounts is to show there is no difference between them.

Senator KING. Is it not a wrong assumption that reserves are kept by many corporations only for the purpose of evading taxes? Is it not a fact that they keep those reserves in order to meet contingencies and to take care of labor and to avoid an economic collapse in their respective communities? I know that is true with respect to mining companies and others that have many reverses.

Mr. HAAS. I am coming to that.

Senator BARKLEY. Let us take the case of a corporation that makes net earnings of $100,000 a year, and it decides to distribute half of it; and that decision is wholly within the province of that corporation; now, if it keeps half of it in its treasury, then it pays the tax under this bill in whatever bracket it falls; that tax is paid; and then the corporation could take the balance of $50,000 that it kept after paying the tax and put it all in surplus; isn't that true?

Mr. HAAS. That is right. It could do it that way, and it could go out in the market and get new funds and put them in also.

Senator BARKLEY. Oh, yes.

Senator HASTINGS. Will you not follow that little further and find out just what would be left?

Senator BARKLEY. It would be necessary to make a calculation on the bracket in which that $50,000 would come, which, I think, is set out in the table in the bill itself.

Senator CONNALLY. Mr. Haas, let me ask you a question. In answering Senator George you said you agreed with him; and I do, too, that it is desirable that corporations accumulate reasonable surpluses.

Mr. HAAS. Reserves, I think Senator George means.

Senator CONNALLY. Reserves?

Mr. HAAS. Yes.

Senator CONNALLY. In other words, a fund over and above the capital account, the ordinary capitalization, for any need that might arise.

Mr. HAAS. Yes.

Senator CONNALLY. On the other hand, is it not economically unsound and undesirable, from a social point of view, to have them retain all their surplus, to have the corporation just pile it up and not distribute its dividends and bringing more and more assets within the control of a single entity; is not that harmful to the general welfare, and is not that economically unsound from a broad, liberal standpoint?

Mr. HAAS. I think it is; and I will make a statement to that effect later on.

Senator CONNALLY. How is that?

Mr. HAAS. I agree with you, Senator, that it is economically unsound.

The CHAIRMAN. All right, proceed then, Mr. Haas.

Mr. HAAS. In addition to the funds which may thus be raised by all profitable corporations, large and small, through the offering of new stock to their stockholders, large corporations, in particular, will continue to possess, as they always have, access to the organized capital markets for the direct flotation of securities to persons other than their existing security holders, and so will be able to raise such additional funds as they may need through the offering of stocks and bonds for public subscription.

Nevertheless, there are some who argue as if capital funds obtained by direct reinvestment of earnings, and therefore credited to an account called surplus, have a special magic about them that makes them more valuable to a corporation than capital funds obtained through other means. Thus it is contended that corporations with large accumulated surpluses will be in a stronger competitive position than corporations with smaller or no surpluses. This contention does not stand examination. As the members of this committee are well aware, the item of surplus occurs on the liability side of a corporation's balance sheet and does not necessarily represent cash or marketable securities or inventories or any other type of liquid asset. In many cases a corporation is born with a surplus as a result of the expedient of undervaluing its capital stock on its books and calling the rest of its paid-in capital "surplus." In other words the surplus is the result of giving a large and sometimes fictitious value to such intangible assets as goodwill or patent rights.

Senator BARKLEY. It says "in other cases." You do not mean "in other words"?

Mr. HAAS. "In other cases"; yes. In other cases the surplus is the result of giving a large and sometimes fictitious value to such intangible assets as goodwill or patent rights. In no case, in my opinion, can it be stated that a corporation with an accumulated book surplus is in a better competitive position than another corporation with equal assets and similar liabilities and equally good management that has no book surplus. I am using "surplus" here not in the sense of meaning a reserve. It is a liability on the other side of the balance sheet.

It would thus appear that no corporation, large or small, offering the opportunity of a reasonable profit to capital is more likely to be checked in its legitimate desire for expansion under the proposed than under the present system of corporation taxation.

These considerations apply no less to corporations engaged in fluctuating industries than they do to corporations engaged in stable industries. A corporation in an unstable industry will have the same opportunity that it enjoys now of accumulating capital funds during periods of prosperity, through the sale of securities to its stockholders and others, and of using these funds in such ways as it sees fit as a buffer against periods of depression, and it will also have the opportunity to add from 30 to 40 percent of each year's earnings directly to its surplus account, without paying as much in taxes as it does now.

Senator BAILEY. That is your theory right there, is it not, that the corporation will undertake to expand through the sale of securities to the stockholders rather than buying new property?

Mr. HAAS. I would say it can do that if it wishes. It can plow back earnings in small corporations to the extent of 40 percent of its annual earnings and pay a little less tax than it pays now.

Senator BAILEY. You do not say here that it can do it; you say it would have the same opportunity that it enjoys now. The difficulty is finding a purchaser for the stock.

Mr. HAAS. That is right, if the stockholders themselves prefer cash.

Senator BAILEY. The other is getting profits out of your annual income, your operations. Now, which is easier when you come to expand?

Mr. HAAS. I do not think there is any question, if you hold back all your earnings it is just a matter of a bookkeeping entry. Even if you issue rights for a large corporation that has access to the capital markets, there is a little more work involved.

Senator BAILEY. The problem is one of expanding the operations of a corporation. You suggest the way to do that is to go out on the market and sell stock at whatever price you can get for the stock, you suggest that that is a feasible plan?

Mr. HAAS. That is a feasible plan.

Senator BAILEY. Whereas, under the present system, the general practice is, after you get your corporation going, to plow back a certain proportion of your profit. You explained it in that way. That is not any better way than the way of going out in the market and selling capital stock?

Mr. HAAS. That is not the way in which I put it.

Senator BAILEY. Well, read that paragraph then and see if it is not.

Senator BARKLEY. What you say is they have the same opportunity to do either under this bill that they have now.

Mr. HAAS. That is right.

Senator BARKLEY. The only difference being that the amount plowed back might be affected by the amount of tax they pay, depending on the amount they refuse to distribute to their stockholders.

Mr. HAAS. It does not prohibit them from increasing in size. These avenues are open to them.

Senator BAILEY. That depends altogether on whether you could sell the stock or not. It is rather difficult now to sell the stock.

Mr. HAAS. Well, without discussing that, I would like to give several illustrations of companies which are actually now, at this moment, issuing stock rights.

Senator BAILEY. Well, stock rights are an entirely different thing from the selling of stock.

Mr. HAAS. To the extent that there may be some coercion in them.

Senator BAILEY. This is a matter of selling stock. Take your present situation. As a matter of fact, very little stock by way of addition to the present stock of the corporation is being sold at the present time. Is there any activity in the sale of stock for new corporations?

Mr. HAAS. Is not this what you are saying as to that activity, Mr. Senator, that you give back the earnings to the stockholders

that own the corporation? I mean they are the ones who are the owners, and you ask them, "Will you put it back in the company?" They say, "No." Then is not that the answer? They own the company. If on the other hand the management of the company said, "We are going to hold it whether you like it or not", that is a different proposition.

Senator BAILEY. If that is the answer, then your whole theory falls down, because your theory is the corporation owns the earnings and it is not declaring them to the stockholders in dividends, but if the stockholders own and control the corporation, then to be sure they would get that interest. I do not think you can predicate your conclusion upon that premise. You have got to either argue one way or the other.

Mr. HAAS. I believe that both arguments are relevant to this subject.

Senator BAILEY. You use one premise and you reach a conclusion in one case that you can do that and in another case that you cannot do that.

Mr. HAAS. I am not attempting to argue. I am trying to present some economic facts and state my opinion on them in order to make them clear to the committee.

Senator BAILEY. I am not arguing with you, but you make some very flat statements here for this record, and I wanted to test you on the validity and soundness of your statements. I am not engaging in any argument. It just occurred to me that that statement is not correct. You make the statement [reading]:

> A corporation in an unstable industry will have the same opportunity that it enjoys now of accumulating capital funds during periods of prosperity, through the sale of securities to its stockholders and others, and of using these funds in such ways as it sees fit as a buffer against periods of depression.

You predicate the whole principle on the capacity of the corporation to sell stock rather than the capacity to save a certain amount from its earnings as a buffer. Now, I am telling you that the corporations in this country have not been in a position to sell any new stock since 1930.

Mr. HAAS. True. Most of them during the depression could not sell stock, and many of them could not plow back earnings, either.

Senator BAILEY. What would have happened to them if they had not had big surpluses to distribute? I understand the Department of Commerce stated that they distributed $27,000,000,000 since 1930 over and above their earnings. What would happen if they did not have those surpluses?

Mr. HAAS. Senator, I challenge that statement. I do not challenge the Department of Commerce figures, but I challenge the use which has been made of the figures. I am coming to that a little later on in my statement. They are not prevented from doing the same thing because of the change we are proposing in the law. I say they still have the opportunity to build up adequate reserves.

Senator BARKLEY. You are not advocating in the sentence that has been read here that corporations pay out all their dividends and then obtain additional funds by the sale of rights of stock; all you say is they can do that if they want to.

Mr. HAAS. That is right. Thank you, Mr. Senator. I do not take any position as to the fiscal policy of corporations, as to how much

they should distribute, or anything like that. All I am saying is that this bill, if it is put into law, gives them a certain choice.

Senator BAILEY. Is it not your suggestion that insofar as its capacity to accumulate surpluses may be impaired by this legislation, that it get new investments by selling new stock; is not that your argument?

Mr. HAAS. My argument is that a small corporation under the bill, if it wants to plow back earnings, can plow back 40 percent and pay somewhat less than it pays now; and a large corporation, if it wants to use that method to increase its investment in the business, can plow back 30 percent. It also has the other channels open to secure new capital for its business. The fact that a company is growing rapidly and increasing its surplus does not always give it this reserve that you are talking about. During the depression we found many companies that had grown like mushrooms, but had no real reserves although they had large surpluses. Their assets were not in a liquid form.

Senator BAILEY. Of course, that is very elementary. Surpluses are not always cash.

Mr. HAAS. That is right.

Senator BAILEY. I am not disputing that. Some of them are cash and some of them are other sources of credit.

Mr. HAAS. That is right.

Senator BAILEY. And credit is cash.

Senator HASTINGS. That statement you just made about them being able to obtain 30 percent, and so forth, as a surplus, I find that to be correct, but this is true, is it not, that in order for a corporation that has earnings of a million dollars and wants to retain 30 percent of it, or $300,000 of it, has to pay 50 percent of the amount it retained, or $150,000? So that while your statement on that 30 percent is correct, the truth is that they pay 50 percent of what they retain in the case of earnings of a million dollars?

Mr. HAAS. That is true, but that is the same situation now. If you want to change your taxation base you get a different percent. You have the same proposition now under the existing income-tax law. I shall insert a table in the record showing the tax under the present law as a percent of income transferred to surplus. [Table referred to appears at the end of Mr. Haas' statement.]

Senator HASTINGS. I am only making the statement for the purpose of clarifying the record.

Mr. HAAS. Yes.

Senator HASTINGS. The general statement that you can retain 30 percent and only pay 15-percent tax is correct.

Mr. HAAS. Yes.

Senator HASTINGS. I want the record to show that you actually pay 50 percent on the amount that you retain.

Senator LA FOLLETTE. On the other hand, it can be stated in another way, that you reduce the amount of dividend by the tax, not the amount of surplus that is retained.

Senator CONNALLY. In other words, you keep $300,000, then you pay $150,000, and the other $550,000 would go into dividends. You simply reduce the amount distributed in dividends by the amount of tax. You would still have the $300,000 in the surplus.

Mr. HAAS. That is right.

Senator CONNALLY. You would still retain the $300,000 surplus, you would pay the tax out of the remainder, and the balance would go to the dividends; is that correct?

Mr. HAAS. That is correct, and even under the present law you could take the 16 percent on the amount you would retain and you would get a higher figure too.

Senator HASTINGS. That stockholder is entitled to get that in order for the company to maintain what has been described as a normal surplus. Of whatever is retained the Government is taking half of it. I say the stockholders are entitled to get it.

Mr. HAAS. I do not think that is true.

Senator LA FOLLETTE. I do not think that is a statement of fact.

The CHAIRMAN. The Government is taking no more than it took before.

Mr. HAAS. That is right.

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

Mr. HAAS. It is argued by some that stockholders may be reluctant or even unwilling to reinvest in any given enterprise any large fraction of the earnings distributed to them in dividends. But this argument assumes that corporate managements may justly reinvest earnings in a particular enterprise against the desire of the stockholders. In the last analysis, however, the earnings of a corporation belong to its stockholders; and stockholders are entitled to exercise a choice, which, under the present corporate practices they do not always possess, with respect to the disposition of these earnings. Insofar as one effect of the proposed change will be to encourage corporate managements to obtain the consent of their stockholders for capital expansion, and to give to stockholders, the real owners of the corporation, a greater control over the disposition of their earnings, this effect is altogether desirable.

Senator BAILEY. Let me stop you there. You say [reading]:

> It is argued by some that stockholders may be reluctant or even unwilling to reinvest in any given enterprise any large fraction of the earnings distributed to them in dividends.

The theory of this bill is that we squeeze dividends out into the hands of the stockholders in order that they may fall into the higher brackets of the income tax.

Mr. HAAS. That is not the theory, Mr. Senator. The theory of this bill is that there is certain income which comes via or through the corporate form of doing business which is not now subjected to the same rate of taxation as income that flows from individual businesses or partnerships, and we now set up rates so that if corporations retain their incomes we get the same revenue as if they distributed them. We are not telling them what to do with their incomes.

Senator BAILEY. But you are telling me now that you do not contemplate raising the tax on incomes to holders of shares of stock, having them report those incomes in their returns and tax them in higher brackets? That is not at all in contemplation?

Mr. HAAS. No; I would say——

Senator BAILEY (interrupting). You do not intend to do anything on that. Now, if you do not do anything in regard to that, how would you raise $610,000,000?

Mr. HAAS. No; I do not think you understand me, Senator.

Senator BAILEY. Of course that is the purpose. We have had charts exhibited to us showing exactly how that works under each bracket.

Mr. HAAS. Yes; I had something to do with the construction of those charts.

Senator BAILEY. They will not have any large proportion of their earnings to invest; they will pay them to the Government in taxes.

Senator CONNALLY. Mr. Haas, in connection with that let me ask you a question. Is it not true that under the present tax law there is a premium or inducement for corporations to hold the surpluses and thereby pay a lesser rate of tax ultimately than they would if it was distributed, and is not the theory of this bill to say to the corporation, "Now, we do not care whether you keep it in surplus or not, that is up to you, but if you keep it in surplus, or if you pay it out, the Government will tax it at the same relative rate"?

Mr. HAAS. That is right.

Senator CONNALLY. Leaving it entirely optional with the corporation, because, after all, it belongs to the stockholders; they could put it in the right-hand pocket or the left-hand pocket, but we will not permit them to do the Houdini act and switch it from one pocket to the other and therefore getting a reduced rate of taxation and the Government losing that amount of money. The present tax structure gives a preference to the corporation over the individual engaged in the same business.

Mr. HAAS. That is right.

Senator CONNALLY. Because the individual may pay a 50-percent surtax and the corporation in the same line of business will pay 15 percent.

Mr. HAAS. Yes. Also the man with a small income is penalized if he enters a corporate business, because he pays a 16-percent tax, whereas under the individual income tax he may pay no tax, or some tax less than 16 percent.

Senator BAILEY. Have you seen the chart showing what portion would go to small incomes and what portion would go to larger incomes?

Mr. HAAS. My staff developed those charts.

Senator BAILEY. You are perfectly familiar with the charts?

Mr. HAAS. Yes.

Senator BARKLEY. It is not the concern of this bill to squeeze money out of the corporation treasury into the hands of stockholders, but it is the purpose of this bill that, whether it is squeezed or not, it shall pay a tax?

Mr. HAAS. That is right.

Senator BARKLEY. And if somebody who has not been getting a high rate of dividend gets a larger dividend because of the preference of the corporation to pay it out rather than pay a tax on it, to increase that dividend lifts that man up into the higher tax bracket and he will pay more tax. Nobody disputes that, nobody is trying to conceal that.

Senator LA FOLLETTE. As I understand it, the preparation of these charts was based on 100 percent distribution of dividends, and it simply throws one aspect on the situation, namely, where the increase would fall in case 100 percent distribution took place. That data

has been prepared for the consideration of this committee and it is not to be used as a predicate for the statement that the objective of the bill is to force 100 percent distribution.

Mr. HAAS. That is right, Mr. Senator.

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

Senator BAILEY. That is one point. When it gets into a certain bracket, I will not undertake to say which one, 50 percent of that would go for taxes, 50 percent of the income to the stockholders.

Senator CONNALLY. Of that which is retained.

Senator BAILEY. Fifty percent will be paid in taxes under certain brackets.

Mr. HAAS. If you repeat any percentage you might wish, I will have one of the people with me give you the corresponding one.

Senator BAILEY. Now, that being true, 50 percent of it certainly would not be available to reinvest, because it goes to the Government.

Mr. HAAS. You are stating that if the dividends go out and are paid to people and the Government takes out a larger proportion of that, to the extent that the Government takes it out or gets more revenue, to that extent there will be less money for those individuals to reinvest in the business.

Senator BAILEY. It would not be a question of the stockholders being reluctant, it would be a question of the stockholders not having the power to reinvest the money because the money has gone into taxes.

Mr. HAAS. Only in the case of stockholders in the upper brackets. Stockholders with small incomes would have more to invest.

Senator BLACK. Mr. Haas, that is also true if an individual made a profit and he came in the 50-percent bracket.

Mr. HAAS. That is true.

Senator BLACK. In reality, as I understand what you said, you understood it to be the main purpose of this bill to require the group that owned a large proportion of stock in corporations, where they made a profit in a certain year, to pay a tax the same as though they were not favored by owning that large block of stock in the corporation.

Mr. HAAS. That is right.

Senator BLACK. If I understand it, it is your theory that if a man happens to be fortunate enough to make huge profits in a corporation, he should have taxes imposed upon him the same as any other individual who might not be fortunate enough to own that large block of stock?

Mr. HAAS. Yes; and the ones with a small income, by the same token, would have more money to invest in the particular business as the result.

Senator BLACK. Because by the control being exercised by a small group, as we know it is exercised in every large corporation in America, and sometimes only three men might pass on 100,000 stockholders' rights, under that system that has been operating, that group that controls the large number of stockholders can withhold the stock and pay a 15-percent tax even on the profit of the very small investor, while the larger investor might escape the 50-percent tax which other unfortunate citizens would pay who did not happen to be interested in that corporation by owning a large block of stock?

Mr. HAAS. That is right.

Senator CONNALLY. Let me ask you this in regard to your talk about the big stockholders wanting to hold it in the corporation and the little fellows clamoring for dividends under the present system, is it not true under this bill that the corporation would have the greatest liberty, and the stockholders likewise, because when the matter of arriving at how much they would retain as a surplus came up no consideration would actuate them except the absolute business necessity of the corporation, because there would be no reason to hold it, the tax would be the same, and therefore the only reason they would enter into the decision as to how much they would retain as a surplus would be the absolutely economic needs of that corporation?

Mr. HAAS. That is right.

Senator CONNALLY. They will keep just as much as they need. They will distribute all that they do not need. Isn't that the real test as to the accumulation of any surplus?

Mr. HAAS. That is right.

Senator KING. I assume, Mr. Haas, that the purpose of this bill is to increase taxes which are to come from corporations or from stockholders of corporations.

Mr. HAAS. The purpose of the bill, to be absolutely correct, is to increase revenue, and the revenue is coming either from corporations or from stockholders of corporations. The present law permits a tax avoidance, if it is assumed that all income should be taxed equally from whatever source derived.

Senator KING. I am not arguing that. I say this bill is for the purpose of increasing the revenue of the Government, and it is supposed to get that money from corporations and from stockholders of corporations.

Mr. HAAS. That is right.

Senator KING. So it will impose an additional burden, whether rightfully or wrongfully I am not concerned with at the moment, upon corporations and stockholders.

Mr. HAAS. Not necessarily; the corporation may pay no tax at all. It means that some of the stockholders of the corporation will be taxed more and some will be taxed less.

Senator KING. At any rate, the aggregate taxes collected will be approximately $600,000,000.

Mr. HAAS. Yes; more than they were before.

Senator KING. And you will take that amount from stockholders, or corporations, or both.

Mr. HAAS. That is correct; that is the aggregate addition, and it comes about in this way—that some people will be taxed more and some people will be taxed less, but the burden will be more equitably distributed than before.

The CHAIRMAN. All right; proceed, Mr. Haas.

Mr. HAAS. I turn now to a third objection that has received considerable publicity.

Senator WALSH. Mr. Chairman, I note the third objection merely deals with the claim made that this bill, if enacted into law, will drive individuals with large incomes into buying tax-exempt securities. That is not a major feature of this bill, and I suggest it be put into the record and the witness turn to part IV to save time.

The CHAIRMAN. I think that is a good suggestion. If there are any questions to be asked about that, we can call on him to answer those questions.

Senator WALSH. I suggest having that printed in the record and have the witness go to part IV, which is more important.

Senator LONERGAN. If the witness is in a position to speak for the Treasury Department, I would like to ask him a question on that subject.

Mr. HAAS. What is the question?

Senator LONERGAN. What is the attitude of the Treasury Department on the discontinuance of the tax-exempt securities?

Mr. HAAS. The Secretary prepared a statement on that, and he has made recommendations against the continuance of it. I would be glad to put his statement in the record with regard to that.

Senator LONERGAN. I would like to know, because I prepared and filed with the Senate on January 16, 1934, a report on this question of tax-exempt securities, and nothing has been done about it. My understanding has been that the Treasury Department desired that no action be taken on that on account of the issues that we authorized from time to time.

Mr. HAAS. I should be glad to put the Secretary's statement in the record.

[The statement referred to appears at the end of Mr. Haas' testimony.]

Senator LONERGAN. I wish you would.

Senator KING. Senator, do you refer to securities issued by State and other political subdivisions or only the Federal securities?

Senator LONERGAN. The Federal securities.

(Part III of Mr. Haas' statement, referred to above, follows:)

I turn now to a third objection that has received considerable publicity. It is contended by some that if the proposed bill should result in a much larger distribution of corporate earnings, it will simply drive individuals of large incomes into tax-exempt securities in order that they might avoid the individual income surtaxes on their additional dividends; and hence it is contended that the Government will not get the revenues that the Treasury anticipates from the new measure.

On its real merits, this argument would hardly warrant extended discussion for certain obvious reasons.

In the first place, the aggregate amount of tax-exempt income available constitutes only a small fraction of the total amount of corporate income.

In the second place, the larger part of it already goes to individuals subject to the higher surtax rates, who, therefore, would possess little motive for selling their tax-exempt securities to others. In the third place, further increases in the amount of tax-exempt income, made available by new issues of tax-exempt securities, are not likely to be substantial. It is obvious, moreover, that wealthy individuals who sought to convert their large stock holdings into tax-exempt securities would, in the first place, face the necessity of paying substantial taxes on the capital gains realized by the sale of their present holdings. It is also obvious that large stock holdings give their possessors certain advantages other than dividend income, such as generous salaries and immediate economic power, that they would hesitate to sacrifice. It is likewise clear that any sudden and great enlargement of the demand for tax-exempt securities would go far to drive up their prices and drive down their yields to a point that would counterbalance all or most of the tax advantage of such securities.

Although the real merits of this objection hardly justify more than the remarks that I have just made, I propose, nevertheless, to go into the matter a little more fully because of the great amount of misconception that exists respecting the possibilities of greatly increasing this avenue of tax avoidance.

In the first place, refuge from income taxation by means of tax-exempt securities is very definitely limited by the amount of tax-exempt securities available and by the rates of interest that they pay. The largest source of tax-exempt-security income is that derived from the obligations of States, counties, cities, and so forth. The net aggregate amount of such tax-exempt securities has not changed materially during the past 5 years. On June 30, 1931, the net principal amount outstanding, as estimated in the 1935 annual report of the Secretary of the Treasury, was approximately $17,500,000,000, and on June 30, 1935, approximately $16,900,000,000. In other words, between these two dates a decrease has actually taken place in the net principal amount of tax-exempt State, county, and municipal obligations. Further, it does not appear that the volume of tax-exempt securities will be increased in the near future at a rate anything like the rate of increase during the twenties.

The Federal Government is not now issuing any long-term obligations exempt from surtaxes. In fact, during the present administration the 3½-percent first Liberty Loan bonds and certain pre-war-bond issues the interest on which was exempt from surtaxes have been refunded in part by bonds lacking the surtax-exemption privilege. The only fully tax-exempt obligation that the Federal Government is issuing to the public at the present time are short-term bills and notes.

The tax-exempt income made available by these issues, however, is far less than their principal amount would suggest. The Treasury has been borrowing at a cost of about one-tenth of 1 percent per annum on Treasury bills of 9 months' maturity, and at 1½ to 1⅝ percent per annum on 5-year notes. Moreover, much the greater part of the Treasury's bill and note issues are purchased by financial and and other corporations which derive no benefit from the fact that the interest on these short-term securities is exempt from surtaxes, since corporations are not subject to surtaxes in any event. That is, whereas the interest on the short-term Treasury notes held by an individual might be exempted from a surtax bracket rate as high as 70 or 75 percent, in the hands of a corporation the exemption is limited to the rate of the corporation income tax, the maximum of which is 15¾ percent in the case of consolidated railroad returns. Further, the tax exemption that corporations enjoy on the income derived from Federal obligations does not apply to the dividends based upon this tax-exempt income when the latter are distributed to the stockholders.

In the last Treasury financing, that of March 15, 1936, holders of maturing notes were offered the option of exchanging these notes for either 1½-percent 5-year Treasury notes, fully tax exempt from normal and surtaxes, or 2¾-percent 12- to 15-year Treasury bonds exempt only from normal taxes but not from surtaxes. Ninety-one and two-tenths percent of all the exchange subscriptions were made for the Treasury bonds, the interest on which is subject to surtaxes, and only 8.8 percent were made for the fully tax-exempt Treasury notes.

I would like to emphasize again that it is tax-exempt income rather than the principal amount of tax-exempt securities that is important. And I would like to point out in this connection that the declining trend of interest rates on State, county, and municipal debts, as well as on Federal obligations, is operating very powerfully to reduce the amount of tax-exempt income. The average coupon rate of interest on outstanding State and municipal bonds is estimated at about 4½ percent. A reduction of only one-half of 1 percent in the average coupon rate would be roughly equivalent to a reduction of 1,900 million dollars in the principal amount of the tax-exempt debt outstanding, so far as tax-exempt income is concerned. As against the present average coupon rate of about 4½ percent on the outstanding State and municipal obligations, it is striking to note that the interest rates on 10 typical new offerings of State and municipal bonds during the first 3 months of 1936, as listed in the appended table, run from 2¼ to 4 percent. If the present trend of interest rates continues, or even if only the present level is maintained, we can reasonably expect a reduction in the total amount of tax-exempt income as a result of the refunding of State and municipal obligations on a lower interest basis.

A fuller distribution of corporate earnings will not create a new situation so far as investment in tax-exempt securities is concerned. The existing individual income-tax rates have already fostered a considerable concentration of tax-exempt securities in the hands of individuals subject to high surtaxes, and it should be borne in mind that a further loss of revenue to the Federal Government from this source could only be caused by a transfer of such securities from

individuals and institutions subject to relatively low tax rates to individuals in higher surtax brackets. The practical possibilities for such further transfers are therefore limited, both because of the existing concentration and because a large volume of institutional holdings of tax exempts will be retained for their preeminent safety and liquidity.

Mr. HAAS. Fourth. Finally, I should like to direct attention in some detail to the matter of corporate reserves and corporate surpluses, the importance of which has been greatly emphasized by critics of the President's plan and of the House bill. There has been a great deal of unfounded and misleading criticism of the President's proposal as incorporated in the House bill on the ground that the enactment of the measure would prevent the accumulation of corporate reserves needed for the maintenance of solvency and of employment during depressions. There are several sets of observations that I shall make on this point.

In the first place, the bill very definitely allows as lawful deductions, before arriving at taxable income, the usual reserves for depreciation, depletion, and bad debts. During the 5 years 1926 to 1930, inclusive, corporations in the aggregate deducted more than $24,000,000,000 on these accounts before arriving at statutory net income or deficit for tax purposes. During the 3 succeeding years, 1931 to 1933, inclusive, they deducted more than $15,000,000,000 additional on these accounts, making a total for the 8 years of more than $39,000,000,000. These deductible reserves from taxable income, which have been approximating $5,000,000,000 a year, will be allowed under the House bill as under the present law.

Further, beyond those deductible reserves, the House bill clearly permits the retention by small corporations of approximately 40 percent of each year's current earnings and by large corporations of approximately 30 percent of each year's current earnings as additions to corporate surpluses upon payment of taxes lower in both cases than those that would be paid under the present law.

Despite these facts and the further fact that corporations will remain perfectly free to call upon their stockholders and the capital markets generally for any additional capital that they may require, the proposed change in our system of corporate taxation has been called a tax on thrift and a tax that would prevent the accumulation of needed corporate reserves. In this connection certain critics have attempted to use and to play upon a widespread misapprehension of the nature of corporate surpluses. The implication of their remarks is that corporate surpluses consist of pools of liquid assets, cash and the like, which corporations keep available for use in emergencies. As I have noted before, "surplus" appears on the liability side, not the asset side, of a corporation's balance sheet, and very frequently represents fixed assets such as plant, machinery, or intangible assets such as "good will", patent rights, and so forth, none of which can be "spent" to meet depression needs or to repair damages caused by a flood, or any other emergency. It is not the size of a bookkeeping figure called surplus that determines the ability of a corporation to meet a depression or other contingency, but rather the amount of the total assets of the corporation compared with its obligations, and most particularly the proportion of its assets which it keeps in liquid form. The proposed measure would have no influence whatever upon the form in which a corporation might decide to

keep its assets, nor does it limit the total amount of capital that a corporation may acquire. When a corporation withholds current earnings from its stockholders it is obtaining new capital from them, though often without their express consent, no less than when the stockholders employ portions of their dividends to purchase additional securities of the corporation.

There are some who, though admitting the inequities of the existing system of corporation taxes, nevertheless defend it on the ground that the corporate surpluses that are thus built up free from surtaxes serve a public function by enabling corporations to maintain employment at a higher level than would otherwise be possible in periods of depression. Now, the most obvious fact bearing on this argument is that it simply did not work, as I shall show in detail shortly, when in 1929 the greatest depression this country has ever experienced came upon us. Not only do we now know that the corporate surpluses accumulated in the twenties were not used to any great extent, in the aggregate, to maintain employment during the depression but we also have some ground for suspecting that the accumulation of these very corporate surpluses assisted materially in causing the depression. Thus, it has been argued by very respectable economic authority that among the causes of the depression was starving of consumption through the withdrawal of a too large proportion of our funds for corporate capital expenditure. Is it not quite possible that in many instances, important in the aggregate, overexpansion of plant capacity was stimulated by a desire of the controlling stockholders in corporations to reinvest earnings for the purpose of avoiding the taxes that they would have paid if earnings were distributed? It is also held by many that one of the vicious influences contributing to the great stock-market boom of the late twenties was the piling up of corporate surpluses. Stock-market speculation, which had already been stimulated by the mere piling up of such surpluses, was further stimulated by the volume of surplus funds poured into brokers' loans by corporations.

But let us examine specifically the contention that these accumulated surpluses were actually used during the depression to maintain employment, dividends, and other payments. Large figures are frequently cited to represent the aggregate losses of corporations during the depression. Either by direct statement or by implication the contention is made that these losses represent the amounts which corporations have had to pay out, in excess of their receipts, to workers, suppliers of materials, bondholders, and the like; and that only their previously accumulated surpluses allowed them to do this without bankruptcy.

We have been at pains to examine the matter a little further on the basis of the actual income-tax returns filed by corporations, and we find that the figures reported each year to the Bureau of Internal Revenue are strikingly at variance with this contention or belief. Let me cite you some of the facts that I shall present in greater detail in tables attached to this statement:

First. If we consolidate the income accounts of all corporations for each of the 3 years, 1931–33, inclusive, we find that they reported an aggregate net deficit for this 3-year period, after taxes, of 6.6 billion dollars. We also find, however, that this aggregate net deficit was arrived at after deducting some 11.2 billion dollars for deprecia-

tion, some 761 million dollars for depletion, some 3.7 billion dollars for bad debts, and some 5.1 billion dollars for loss on the sale of capital assets; deduction which, in the main, do not represent current cash outlays making for employment, dividends, and so forth. In other words, the aggregate net income of corporations before these valuation deductions, in the worst depression in history, was a little more than 14 billion dollars, and their cash dividends a little more than 13 billion dollars. For corporations as a whole, dividends, wages, and other payments, came out of current receipts, primarily, and not from accumulated "liquid surpluses." The book surpluses of corporations were indeed reduced, but they were reduced in the aggregate, not by actual cash disbursements, but by the writing-down of assets on the books of the corporations.

It may well be objected that these figures may be deceptive because they include financial as well as nonfinancial corporations. But the figures for nonfinancial corporations alone, which include all of our manufacturing, mining, merchandising, and similar business corporations, tell the same story. Nonfinancial corporations reported a net aggregate deficit after taxes for the 3 years, 1931–33, inclusive, of 3.9 billion dollars. Their net income before valuation deductions, however, amounted to 11.1 billion dollars, and the dividends paid to 10.6 billion dollars. It is obvious that the previously accumulated surpluses of nonfinancial corporations, while reduced by valuation deductions, did not represent liquid resources that were drawn upon, in the aggregate, to pay wages or dividends. The cash and investments of all nonfinancial corporations submitting balance sheets amounted to 32.7 billion dollars at the end of 1929; at the end of 1933 they amounted to 33.5 billion dollars.

Senator BLACK. Liquid assets?

Mr. HAAS. Liquid assets, mainly.

Even if we confine our attention to deficit nonfinancial corporations—that is, nonfinancial corporations reporting no statutory net income—we find that valuation deductions, rather than cash-operating losses, accounted for the largest part of their aggregate net losses during the depression. During the 3 years, 1931–33, inclusive, the aggregate net losses after taxes of those nonfinancial corporations that reported no net income amounted to 12.1 billion dollars; but 9.5 billion dollars of this aggregate deficit, or 78 percent, represented valuation deductions, primarily, rather than cash operating disbursements in excess of cash receipts. It should be borne in mind, moreover, that a corporation is included in the deficit group only in those years in which it reports no net income; so that the figures that I have just cited *include* the losses of all corporations during their worst years of the depression, and *do not include* their net income, if any, in other years of the depression.

The figures that I have cited were obtained from the income-tax returns actually filed by corporations with the Bureau of Internal Revenue. It should be pointed out that there were other deductions in the book "surplus" of corporations besides those allowed for income-tax purposes, and some of these represented cash outlays. I want to make it clear also that the figures that I have presented for all corporations, for all nonfinancial corporations, and for deficit nonfinancial corporations only, are aggregate figures and are subject to the limitations of all aggregate and composite data. They are not

necessarily representative of the experience or practices of any particular corporation. It is also true that in many cases corporations employed a portion of the receipts charged off as valuation items for necessary replacements of plant and machinery. Finally, I should point out that most corporations are permitted to exercise a liberal range of discretion in the valuation of their assets on their own books and for their own purposes. Many of them revalue their assets upward during periods of prosperity, thereby creating direct additions to their surplus accounts, independently of their current income. Similarly, in periods of depression many corporations make large write-downs in the valuation of their assets on their own books, and they make corresponding reductions in their book surplus accounts.

Although the accounting methods of corporations vary considerably, such variations do not affect the income and deficit figures that I have presented, because the regulations of the Bureau of Internal Revenue, as well as the statutes, lay down substantially uniform rules for the determination of taxable and nontaxable income. The Bureau also receives balance-sheet data in connection with corporation income-tax returns. Only a limited use can be made of these balance-sheet data, because, in contrast to the uniform rules for the determination of taxable income, the Bureau has not prescribed detailed uniform regulations for balance-sheet data. It should also be said that our statistics of income are not strictly comparable from year to year, because of changes in law, in affiliations for consolidated returns, and other factors.

Nevertheless, these limitations of the data obtained from corporation income-tax returns do not impair the general conclusions that I have drawn respecting the character of corporation deficits during the depression and the uses made, such as they were, of the accumulated corporate surpluses. It must be emphasized, in contradiction to certain misleading statements that have gained considerable currency, that reductions in book surpluses arising in the fashion that I have outlined do not represent funds paid out to employ labor, to purchase materials, or to pay interest or dividends.

In general, then, the figures reported to the Bureau of Internal Revenue clearly indicate, first, that for corporations, as a whole, valuation deductions greatly exceeded the aggregate net losses reported during the depression; second, that valuation deductions, rather than net cash outlays, account for the largest part of the losses reported even by deficit nonfinancial corporations; and third, that corporate surpluses in the aggregate have not been drawn down in fact to maintain employment, dividend payments, and other disbursements during the depression.

In conclusion, I should like to state my conviction that the economic arguments advanced in opposition to the proposed change in corporate taxation rest very largely upon misapprehension and misinterpretation of the facts. While certain of these arguments may appear plausible to some at first blush, they do not withstand analysis. In my opinion, the proposed change in our system of corporate taxation is one that, in addition to its productivity from a revenue standpoint, would improve the character of our economic organization as a whole.

(The tables referred to appear at the end of Mr. Haas' statement.)

Senator BAILEY. Will you tell me how much the write-down was in the case you were discussing, the write-down of capital assets of corporations?

Mr. HAAS. The figures are given in the tables attached to my statement.

Senator BAILEY. It sums up to $15,000,000,000. I was running through your figures. You do not sum them up. Assume that there was a write-down of 10 billions of dollars in corporate structures in this country for the last 3 or 4 years, nevertheless they remained solvent and continued to go on. That is true, is it not?

Mr. HAAS. That is right.

Senator BAILEY. They could not remain solvent after the write-down, except for the fact that they made the write-down out of accumulated surplus. You could not write it out of capital structure; you have to write it out of surplus.

Mr. HAAS. You can write the capital down as well as the other.

Senator BAILEY. No; if you write down the capital of a corporation, it becomes insolvent, and anybody can close it up. That is statutory. That is not a question of fact; that is a question of law.

Mr. HAAS. Well, I am not making any argument that you should not have any surpluses. I have not made that argument during this hearing.

Senator BAILEY. The write-down is not valuable to the commerce of this country insofar as it affects the employment of people. It is not sustained by the argument. I will agree you have got some good facts; but, after all, the write-down occurred because all values went down.

Mr. HAAS. The plant still stayed there.

Senator BAILEY. All values went down.

Mr. HAAS. That is right.

Senator BAILEY. Now, this write-down occurred without impairing the capital or making the corporations insolvent, and therefore they continued to operate. Suppose they had had no surplus, then the write-down would have broken every one of them and you would have this country filled with receiverships. That is the point.

Mr. HAAS. I am not trying to make a point as to how a corporation should organize its capital structure.

Senator BAILEY. I am not either.

Mr. HAAS. Whether they can withstand the situation that you pointed out is largely contingent upon the nature of their assets.

Senator BAILEY. Just tell me how they would have withstood the write-down of $11,000,000 in 3 years if they did not have a surplus to be able to write it down. They would have certainly become insolvent.

Mr. HAAS. The point is, Mr. Senator, that I have never, throughout the testimony, tried to put up any case against not building up surpluses. I have tried to prove that they did not provide employment for labor or do these other things claimed for them.

Senator BAILEY. It kept millions of people employed, it kept the industries going and they employed the labor.

Mr. HAAS. No; I do not think so.

Senator BAILEY. The ability to withstand the write-down prevented the corporation from going into receivership. The law is

very simple. If the capital stock of a corporation is impaired then a stockholder can bring an action for receivership.

Mr. HAAS. That is a legal point, but it is my understanding that except in special statutory cases, such as those of banks or insurance companies, a corporation can cure this situation by reducing the stated value of its capital.

Senator HASTINGS. Mr. Haas, you have made some definite statements here in the last paragraph, or next to the last, in which you say [reading]:

> First, if we consolidate the income accounts of all corporations for each of the 3 years, 1931-33, inclusive, we find that they reported an aggregate net deficit for this 3-year period, after taxes, of 6.6 billion dollars.

Did not you have the figures before you when you dictated that statement?

Mr. HAAS. Those are figures from the income account. Senator Bailey was asking for figures from the balance-sheet account. Those figures are in there in the table in the back.

Senator HASTINGS. All right.

Senator CONNALLY. Mr. Haas, let me ask you one question. Suppose there were not any corporations at all and that we were doing business as individuals grouped together and pooled our assets in these corporations; is it not the theory of this bill, if that had been the case, that we would be getting now the same amount of money as we propose to get under this bill?

Mr. HAAS. In other words, if there was no corporate form of business and they were all operating as partners and nothing else?

Senator CONNALLY. If everybody under the present law was operating as partnerships or as individuals and we were taxing them under the existing tax rates we would be getting just as much money—approximately the same amount of money as we propose to get under this bill?

Mr. HAAS. Yes, sir.

Senator CONNALLY. The theory of this bill is that we are not going to allow the device of a corporation to prevent the Government from getting what it would otherwise get if there was not a corporation?

Mr. HAAS. Exactly, Mr. Senator.

Senator HASTINGS. Just a minute. These tables you indicate are from 1931 to 1933. I suppose that is inclusive?

Mr. HAAS. We thought that was the worst period.

Senator HASTINGS. Why did not you include 1934?

Mr. HAAS. We would be glad to put in 1934 but the data are not yet available.

Senator BLACK. I want to find out if you have any statement which you have compiled with reference to write-downs, as to the amounts of dividends that are paid by the companies during that period compared with the other things and the other items. Have you compiled those figures?

Mr. HAAS. Most of those data are included in the tables appended to my statement and I will add a schedule showing interest payments of all corporations.

(Tables referred to appear at end of Mr. Haas' statement.)

Senator BLACK. Would there be much difficulty in getting it, so that we could find out the amount of it?

Mr. HAAS. No, it will be relatively easy.

Senator LONERGAN. Mr. Haas, may I ask a question?

Mr. HAAS. Yes, Senator.

Senator LONERGAN. Say corporation "A" owns all of the stock in corporation "B", except the shares to qualify the directors, and corporation "B" pays 15-percent corporate tax, the balance is turned into the treasury of corporation "A", would corporation "A" under this bill be allowed the deduction of 15 percent?

Mr. HAAS. Mr. Turney will answer that.

Mr. TURNEY. What is the question?

Senator LONERGAN. Corporation "A" owns all of the stock in corporation "B", except the shares that are necessary to qualify the directorship; corporation "B" pays 15-percent corporate tax, turning over 85 percent to corporation "A." Will corporation "A" again be obliged to pay 15 percent on that 85 percent that it receives from its subsidiary?

Mr. TURNEY. You mean under the proposed bill?

Senator LONERGAN. Yes, sir.

Mr. TURNEY. It depends on whether or not corporation "A" declares that out in dividends to its stockholders. If corporation "B" retains 30 percent and pays 15-percent tax, the tax of corporation "A" on the 55 percent it receives will depend on the percentage that it distributes to its stockholders. If it distributes 100 percent, it will not pay any tax. If it in turn retained 80 percent, it will pay a 15-percent tax.

Senator LONERGAN. Notwithstanding the fact that the ownership is the same and that corporation "B" pays 15 percent?

Mr. TURNEY. That is right.

Senator LONERGAN. Now, would not that be a double taxation on that 85 percent?

Mr. TURNEY. Well, of course, we have to apply the tax to each corporation, in order to prevent the holding of the entire income in one corporation in the chain and in order to get the money into the hands in individual stockholders.

Senator LONERGAN. Yes; but if the corporations are so closely alike in the nature of their business and the parent organization regards the subsidiary as a necessity to enable it to carry on, that is the case I have in mind.

Mr. TURNEY. If the subsidiary declares all its income in dividends, the subsidiary will not pay any tax. The double taxation only occurs when you have a retention of income in both corporations.

Senator LONERGAN. You mean that could be avoided by having the subsidiary turn over all of its earnings to the parent corporation?

Mr. TURNEY. Yes, sir; the corporate tax under the bill is based on the percentage of corporate income retained. If we compare the tax on an operating corporation owned by individuals, assuming a given income and amount of retained earnings, with the tax on an enterprise consisting of an operating company owned by a holding company which is owned by individuals, assuming the same income and the same total retention in one or both of the corporations, we may find two taxes, but the total amount of tax will not be more, and may be less, than in the first case.

Senator LONERGAN. Thank you.

The CHAIRMAN. Thank you very much, Mr. Haas.

(The exhibits referred to in Mr. Haas' statement follow):

Typical new municipal bond issues, January to March 1936

Borrower	Amount	Coupon	Average maturity	Average yield[1]
		Percent	*Years*	*Percent*
State of California	$5,000,000	2½	9½	2.49
State of Mississippi	1,500,000	2½	4½	2.16
State of South Dakota	2,195,000	3	11	3.27
Buffalo, N. Y	1,500,000	3.30	10	3.29
Danville, Va	1,515,000	3½	17½	3.23
Detroit, Mich	1,988,000	4	9½	3.80
Easton, Pa	2,750,000	2½	17½	2.65
Houston, Tex	2,102,000	3	15½	2.98
Los Angeles, Calif	4,000,000	3½	12½	3.35
San Francisco, Calif	2,700,000	4	9½	2.48

[1] To original (wholesale) purchaser.

Net income, valuation deductions, and cash dividends paid, for all corporations, 1931–35

[In millions of dollars]

Year	Net income after taxes[1]	Depreciation	Depletion	Bad debts	Loss on sale of capital assets	Total valuation deductions	Net income before valuation deductions	Cash dividends	Valuation deductions as percentage of net deficit
All corporations:									
1931	−$1,176	$4,008	$268	$1,183	$1,793	$7,156	$5,980	$6,131	$609
1932	−4,115	3,669	247	1,313	1,706	6,958	2,843	3,886	169
1933	−1,353	3,496	243	1,369	1,896	6,977	5,624	3,127	493
Total	−6,644	11,193	761	3,715	5,403	20,791	14,147	13,164	313
Corporations with net income:									
1931	4,858	1,746	78	343	154	2,321	6,674	5,572	.....
1932	2,453	1,210	83	286	111	1,640	4,092	3,270	.....
1933	3,157	1,542	85	333	171	2,131	5,288	2,356	.....
Total	9,962	4,498	246	913	436	6,092	16,054	8,578	.....
Corporations with no net income:									
1931	−5,539	2,267	190	840	1,649	4,936	−603	2,279	87
1932	−6,567	2,453	164	1,077	1,594	5,318	−1,249	1,565	81
1933	−4,510	1,954	162	916	1,515	4,547	37	743	101
Total	−16,606	6,694	516	2,833	4,658	14,791	−1,905	4,586	89

[1] Statutory net income less Federal income taxes, plus dividends and tax-exempt interest received.

Net income, valuation deductions, and cash dividends paid for all nonfinancial corporations, 1931–33

[In millions of dollars]

Year	Net income after taxes[1]	Depreciation	Depletion	Bad debts	Loss on sale of capital assets	Total valuation deductions	Net income before valuation deductions	Cash dividends	Valuation deductions as percentage of net deficit
All nonfinancial corporations:									
1931	−631	3,652	263	696	614	5,227	4,576	4,935	808
1932	−2,976	3,393	245	753	600	4,990	2,014	2,120	168
1933	−247	3,205	244	720	616	4,785	4,538	2,552	1,837
Total	−3,874	10,250	754	2,168	1,830	15,002	11,128	10,567	387
Nonfinancial corporations with net income:									
1931	3,515	1,613	77	241	100	2,031	5,546	3,271	.....
1932	1,997	1,143	83	188	61	1,475	3,472	2,068	.....
1933	2,740	1,492	84	300	104	1,980	4,720	2,158	.....
Total	8,252	4,248	244	729	265	5,486	13,738	7,497	.....
Nonfinancial corporations with no net income:									
1931	−4,165	2,039	188	454	514	3,195	−970	1,524	77
1932	−4,974	2,250	162	564	539	3,515	−1,459	1,051	71
1933	−2,986	1,713	161	420	512	2,806	−180	395	94
Total	−12,125	6,002	511	1,438	1,565	9,516	−2,609	2,970	73

[1] Statutory net income less Federal income taxes, plus dividends and tax-exempt interest received.

Interest paid by all corporations, and by all nonfinancial corporations, 1931–33, inclusive

	All corporations	Nonfinancial corporations
All returns:		
1931	$4,492,000,000	$2,727,000,000
1932	4,043,000,000	2,650,000,000
1933	3,511,000,000	2,448,000,000
Total	12,046,000,000	7,845,000,000
Returns showing net income:		
1931	1,499,000,000	954,000,000
1932	863,000,000	678,000,000
1933	889,000,000	765,000,000
Total	3,251,000,000	2,397,000,000
Returns showing no net income:		
1931	2,993,000,000	1,783,000,000
1932	3,150,000,000	1,987,000,000
1933	2,622,000,000	1,683,000,000
Total	8,795,000,000	5,452,000,000

Estimated number of individuals and distribution of individual net income by net income classes, calendar year 1936

Net income classes (thousand dollars)	Number of individuals				
	Taxable under present law	Additional taxable[1]	Nontaxable under present law	Additional nontaxable[1]	Grand total
1-2	873,000	15,772	11,812,226	44,000	12,248,000
2-3	438,000	21,208	1,110,794	44,000	1,614,000
3-4	472,000	24,830	461,170	32,000	990,000
4-5	317,000	26,494	147,506	21,000	512,000
5-10	365,711	63,868			429,579
10-25	163,959	12,203			176,162
25-50	40,351	15,233			55,583
50-100	13,544	3,717			17,261
100-150	2,103	2,876			4,979
150-300	1,398	705			2,103
300-500	375	786			1,161
500-1,000	212	400			612
1,000 and over	86	212			298
Total	2,687,768	191,302	13,031,698	141,000	16,051,768

Net income classes (thousand dollars)	Net income (in millions of dollars)				
	Taxable under present law	Additional taxable[1]	Nontaxable under present law	Additional nontaxable[1]	Grand total
1-2	1,379	20	16,968	66	18,443
2-3	1,215	57	2,778	110	4,160
3-4	1,787	94	1,614	112	3,607
4-5	1,550	129	666	95	2,440
5-10	2,499	538			3,037
10-25	2,445	306			2,751
25-50	1,371	675			2,046
50-100	913	381			1,294
100-150	252	365			617
150-300	282	236			518
300-500	140	317			457
500-1,000	143	280			423
1,000 and over	185	607			792
Total	14,161	[2] 4,015	22,026	[2] 383	40,785

[1] Assuming that all corporate earnings were distributed.
[2] Exclusive of $370,000,000, the estimated additional amount which would be distributed to tax-exempt institutions, etc.

Extract from the Annual Report of the American Telephone & Telegraph Co. for 1935

Bell System Financial Statements

The Bell System financial statements which follow on pages 14 to 18, inclusive, consolidate the accounts of the American Telephone & Telegraph Co. and those of 23 associated telephone companies listed below:

Bell Telephone Co. of Nevada.
The Bell Telephone Co. of Pennsylvania.
The Chesapeake & Potomac Telephone Co.
The Chesapeake & Potomac Telephone Co. of Baltimore City.
The Chesapeake & Potomac Telephone Co. of Virginia.
The Chesapeake & Potomac Telephone Co. of West Virginia.
The Cincinnati & Suburban Bell Telephone Co.
The Diamond State Telephone Co.
Illinois Bell Telephone Co.
Indiana Bell Telephone Co.
Michigan Bell Telephone Co.
The Mountain States Telephone & Telegraph Co.
New England Telephone & Telegraph Co.

New Jersey Bell Telephone Co.
New York Telephone Co.
Northwestern Bell Telephone Co.
The Ohio Bell Telephone Co.
The Pacific Telephone & Telegraph Co.
Southern Bell Telephone & Telegraph Co.
Southern California Telephone Co.
The Southern New England Telephone Co.
Southwestern Bell Telephone Co.
Wisconsin Telephone Co.

All but four of these companies are controlled directly by the American Telephone & Telegraph Co. through ownership of a majority of their voting stock. (See p. 27.) The Bell Telephone Co. of Nevada and Southern California Telephone Co. are controlled indirectly, all of their stock being held by the Pacific Telephone & Telegraph Co. The Home Telephone & Telegraph Co. of Spokane, one of the group formerly consolidated, was merged with the Pacific Telephone & Telegraph Co. as of December 1, 1935. In view of their close relationship to other Bell System companies, the Cincinnati & Suburban Bell Telephone Co. and the Southern New England Telephone Co., in which the American Telephone & Telegraph Co. owns less than a majority of voting stock, have for many years been treated as parts of the Bell System and their accounts included in the Bell System figures.

Since January 1, 1913, all Bell System telephone companies have maintained their accounts in accordance with the uniform system of accounts prescribed for telephone companies by the Interstate Commerce Commission and continued in effect during 1935 by the Federal Communications Commission. In accordance with the rules prescribed in the system of accounts, telephone plant is carried in the accounts, with certain exceptions specified in the rules, at cost to the accounting company.

The consolidated income statement excludes (with minor exceptions) all intercompany items such as interest, dividends, and license-contract payments, which constitute income receipts to one company in the consolidated group and income disbursements to another company in that group. The consolidated balance sheet excludes, for the 24 companies in the consolidated group, intercompany receivables and payables and intercompany security holdings. The latter comprise mainly investments of the American Telephone & Telegraph Co. in the securities of the associated telephone companies. The American Co. carries these securities at their cost to it, which is about $57,000,000 in excess of their par value, and this excess has been extinguished from the consolidated balance sheet with a corresponding reduction in unappropriated surplus. Telephone plant is included in the consolidated balance sheet in the aggregate amount at which it appears on the respective books of the 24 companies consolidated.

Investments in stocks of companies (not consolidated) controlled directly or indirectly by Bell System companies, such as the Western Electric Co., Inc., the Tri-State Telephone & Telegraph Co., Bell Telephone Laboratories, Inc., and 195 Broadway Corporation, are shown on the consolidated balance sheet under "Investment in controlled companies" at the amount of the Bell System's equity in their capital stock and surplus. Dividends and interest received from such companies, and the Bell System's proportionate interest in their earnings or deficits for the year (after dividends) are included in the consolidated income statement under "Other earnings—net."

Consolidated balance sheet

[Consolidating the accounts of the American Telephone & Telegraph Co. and its 23 associated telephone companies]

ASSETS

	Dec. 31, 1935	Dec. 31, 1934
Telephone plant. Plant and equipment for furnishing service; comprising land and buildings, rights-of-way, poles, wire, cable, underground conduit, switchboards, telephones, office furniture, vehicles, tools, construction work in progress, etc. Includes also on Dec. 31, 1935, organization and franchise costs, $1,915,833, and undistributed cost of property, $8,321,103.	$4,266,684,160	$4,248,184,253

Consolidated balance sheet—Continued

ASSETS—Continued

	Dec. 31, 1935	Dec. 31, 1934
Investments in controlled companies (not consolidated):		
Stocks	$208,713,100	$208,816,934
Comprises equity of Bell system in capital stock and surplus of these companies.		
Bonds, notes, and advances	23,162,026	23,461,294
Other investments:		
Stocks	37,254,973	37,487,074
Includes investment in the Bell Telephone Co. of Canada of $18,854,783.		
Bonds, notes, and advances	14,469,372	13,715,453
Miscellaneous investments	27,332,221	22,939,803
Principally real estate including about $16,000,000 of land and buildings retired from telephone plant and held for sale.		
Sinking and other reserved funds:		
Sinking funds—cash and securities	3,993,117	3,985,753
Deposit for redemption of bonds	44,000,000	
Cash deposited with trustee for series A bonds of Southwestern Bell Telephone Co., called for redemption on Feb. 1, 1936.		
Current assets:		
Cash and deposits	55,659,774	47,728,342
Temporary cash investments	[1] 212,160,526	207,597,962
Includes on Dec. 31, 1935, U. S. Government obligations $209,975,096, and tax anticipation warrants $1,904,184.		
Current receivables	91,640,280	88,061,896
Interest and dividends receivable, working advances, amounts due for service, etc., less reserves for uncollectible accounts.		
Material and supplies	48,869,839	49,742,663
Deferred debits:		
Discount on funded debt	10,837,293	14,350,628
Prepayments of rents, taxes, directory expenses, etc	9,384,838	6,832,715
Other deferred debits	5,264,843	4,355,018
Debit items, the final disposition of which had not been determined at close of year.		
Total assets	5,059,352,366	4,977,054,656

LIABILITIES [2]

Capital stock (par value outstanding held directly by public):		
Common stock:		
American Telephone & Telegraph Co	$1,866,227,500	$1,866,227,500
Associated telephone companies	131,979,143	132,942,743
Preferred stock, associated telephone companies	97,937,600	97,937,600
Premiums on stock, American Telephone & Telegraph Co	268,749,078	268,749,078
Amount received in excess of par value.		
Stock installments, American Telephone & Telegraph Co	4,330,337	9,078,813
Amount received under employees' stock plan on stock subscriptions not yet completed or canceled. (This plan was discontinued as to new subscriptions in 1933.)		
Long-term debt (see p. 19):		
American Telephone & Telegraph Co	453,902,713	454,434,613
Associated telephone companies [3]	[3] 634,474,740	584,340,072
Current and accrued liabilities:		
Current liabilities	64,801,429	67,461,124
Bills for supplies, services, etc.; liability in respect of customers' deposits, prepayments, and advance billing for service; provision for refunds due subscribers under rate orders; and (for 1935) provision for premium payable on series A bonds of Southwestern Bell Telephone Co. called for redemption on Feb. 1, 1936.		
Accrued liabilities not due	116,535,624	113,134,913
Taxes, interest, dividends, and rents payable after the close of the year.		
Deferred credits	3,491,134	3,462,014
Credit items, the final disposition of which had not been determined at close of year.		
Reserves for depreciation of plant and equipment	1,061,102,083	967,712,984
Provision to meet loss of investment in depreciable plant upon its ultimate retirement from service.		
Other reserves	1,618,919	1,631,378
Provision for pending accident cases and for the ultimate retirement of leaseholds, franchises, etc.		

[1] Market value, Dec. 31, 1935, $212,962,000.
[2] Statement as to certain contingent liabilities appears in note (e) on p. —.
[3] Includes $43,836,800 Southwestern Bell Telephone Co. series A bonds called for redemption on Feb. 1 1936, see also note (i) p. —.

Consolidated balance sheet—Continued

LIABILITIES—Continued

	Dec. 31, 1935	Dec. 31, 1934
Equity in consolidated surplus—reserved and unappropriated—attaching to common stock of associated telephone companies held directly by public	$3,914,411	$9,621,640
Equity of American Telephone & Telegraph Co. in consolidated surplus:		
Surplus reserved	86,043,049	80,213,792
Comprised at Dec. 31, 1935, provision of $66,205,949 against general contingencies, etc. (including $64,654,444 reserved by American Telephone & Telegraph Co.); $16,731,008 against the contingency of refunds by Bell System companies of exchange and toll revenues collected; and $3,016,092 to extinguish as of Feb. 1, 1936, the unamortized discount on series A bonds of Southwestern Bell Telephone Co. called for redemption.		
Unappropriated surplus (see p. 17)	268,943,306	271,056,224
Total liabilities	5,059,352,366	4,977,064,656

Consolidated income statement

[Consolidating the accounts of the American Telephone & Telegraph Co. and its 23 associated telephone companies]

	Year 1935 (c)	Year 1934 (c)
Operating revenues:		
Local-service revenues (c)	$640,993,436	$607,676,275
Revenues from local exchange service.		
Toll service revenues	273,453,256	258,691,363
Revenues from long distance and local toll service.		
Miscellaneous revenues	23,724,799	21,177,809
Revenues derived from directory advertising, rents, and miscellaneous sources.		
Less uncollectible operating revenues (c)	3,830,619	3,012,808
Provision made during year for revenues which may be uncollectible.		
Total operating revenues (d)	934,370,872	884,532,439
Operating expenses:		
Current maintenance (c)	175,469,287	172,804,235
Cost of inspection, repairs, and rearrangements required to keep the plant and equipment in good operating condition, representing 4.2 percent of the cost of the average plant in service during 1935.		
Depreciation expense (c)	171,681,516	163,474,643
Provision to meet loss of investment when depreciable property is retired from service, based on rates of depreciation designed to spread this loss of investment uniformly over the service life of the property. Depreciation expense during 1935 represented 4.3 percent of the cost of the average depreciable plant in service.		
Traffic expenses	131,839,788	128,047,316
Costs incurred in the handling of messages, principally operators' wages.		
Commercial expenses	74,541,595	71,573,365
Costs incurred in business relations with customers; pay station commissions; also the cost of directories, sales activities, advertising, etc.		
General and miscellaneous expenses:		
General administration, including cost of development and research	21,879,163	21,503,471
Accounting and treasury departments	33,868,909	32,223,926
Provision for employees' service pensions	11,320,412	11,321,217
Employees' sickness, accident, death, and other benefits	6,880,785	6,378,700
Other general expenses	(e)13,932,795	7,004,318
Less expenses charged construction	2,171,444	3,814,079
Operating rents	13,186,209	13,436,143
Rents paid for the use of buildings, poles, conduits, and other facilities.		
Total operating expenses	651,429,009	616,052,355

Consolidated income statement—Continued

	Year 1935 (c)	Year 1934 (c)
Taxes (c) Provision for federal, state and local taxes.	$93,923,952	$89,453,361
Operating earnings	187,017,911	178,994,813
Other earnings—net:		
Dividends from controlled companies	2,600,609	3,125,535
Proportionate interest in earnings or deficits (after dividends) of controlled companies [1]	2,450,954	[2] 7,990,818
Dividends from noncontrolled companies	2,098,325	1,969,805
Interest revenues, and miscellaneous earnings, net	5,743,793	5,815,450
Total net earnings	199,911,551	182,513,780
Interest deductions (c) Interest charges, including amortization of discount on funded debt and taxes payable under bond indentures.	53,373,527	57,003,914
Net income	147,539,054	125,351,786
Dividends on preferred stock of associated telephone companies held directly by public	6,425,085	6,425,085
Net income applicable to common stock of associated telephone companies held directly by public	8,319,187	7,759,147
Net income applicable to American Telephone & Telegraph Co. stock	132,794,782	111,167,554
Number of shares of American Telephone & Telegraph Co. stock outstanding during the year	18,662,275	18,662,275
Earnings per share on American Telephone & Telegraph Co. stock	$7.11	$5.96

[1] Includes for 1935 $2,606,081, proportionate interest in earnings, and for 1934 $7,687,955, proportionate interest in deficit, of Western Electric Co. This company paid no dividends during these years.
[2] Italics denote deficit.

Changes during 1935 in American Telephone & Telegraph Co.'s equity in consolidated unappropriated surplus

Balance—Dec. 31, 1934		$321,056,224
Additions:		
Net income applicable to American Telephone & Telegraph Co. stock	132,794,782	
Transfer from surplus reserved upon settlements of rate litigation	3,693,124	
Miscellaneous additions	602,492	
Total		137,090,398
Deductions:		
Dividends on American Telephone & Telegraph Co. stock	167,960,475	
Transfers to surplus reserved:		
Provision against contingency of refunds in pending rate cases, and other miscellaneous contingencies	6,534,797	
Provision against extinguishment of unamortized discount on bonds called for redemption on Feb. 1, 1936	3,016,092	
Premiums payable on bonds called for redemption on Feb. 1, 1936	2,441,830	
Premiums paid on bonds redeemed	2,655,400	
Unamortized discount extinguished upon redemption of bonds	2,542,886	
Miscellaneous deductions	4,031,836	
Total		189,203,316
Balance Dec. 31, 1935		268,943,306

C. A. Heiss, *Comptroller.*

EXPLANATORY NOTES RELATING TO CONSOLIDATED BALANCE SHEET AND INCOME STATEMENT

(a) As of Dec. 31, 1935, certain of the associated telephone companies had contingent liabilities to make refunds, including interest thereon, in the event of adverse decisions in court cases involving charges for telephone service of some $20,000,000, which had been collected within the period 1924 to 1935, inclusive and taken up in the accounts pending final adjudication. Against these contingencies, there has been set aside by these companies in surplus reserved, the amount of $16,799,628. The American Telephone & Telegraph Co. is surety on bonds executed by the Ohio Bell Telephone Co. in the amount of $17,112,069 to guarantee such rate refunds, if any, as may finally be required of that company. The American Telephone & Telegraph Co. was released on Jan. 1, 1936, from its suretyship on a bond of $3,000,000 executed by the Southwestern Bell Telephone Co. to guarantee such rate refunds as might be required in connection with the San Antonio, Tex., rate case, the case having been closed.

The consolidated financial statements contain no specific provision in respect of the following contingencies.

(1) A guarantee covering payment of notes in the amount of $3,056,194, secured by collateral, undertaken by the New Jersey Bell Telephone Co.

(2) A tax claim made by the city of New York upon the American Telephone & Telegraph Co., as to which tax the company denies liability. (See p. 23.)

(b) Two important items of refinancing occurred during the year 1935:

(1) The Illinois Bell Telephone Co. sold in October $45,000,000 first and refunding mortgage 3½ percent bonds, series B, at 100½ percent, applying the proceeds with other company funds to the retirement at 103 percent of its $43,726,200 series A 5 percent bonds which were called for redemption on Dec. 1.

(2) The Southwestern Bell Telephone Co. sold in December $44,000,000 first and refunding mortgage 3½ percent bonds, series B, at 100½ percent (and has since the end of the year sold an additional $1,000,000 of these bonds at the same price). The net proceeds of these sales will be applied with other company funds to the retirement on Feb. 1, 1936, of $48,286,000 series A bonds at 105 percent. Since these transactions had not been completed at the close of 1935 their effect is not fully reflected in the consolidated balance sheet.

This refinancing reduces Bell System funded debt by about $7,500,000 and annual interest charges by $1,728,140. Taking into account income taxes and amortization of the premium on the bonds retired, the annual saving will amount to approximately $1,100,000 of which $218,000 will represent a saving through the use of treasury funds.

(c) The consolidated income statements for 1934 and 1935 reflect adjustments in the accounts made in connection with settlements during these years of pending rate litigation. The settlements were those of the Illinois Bell Telephone Co. in the Chicago rate case and the Chesapeake & Potomac Telephone Co. in the Washington, D. C., rate case (both of which were referred to in the 1934 annual report); and that of the Southwestern Bell Telephone Co. in the San Antonio, Tex., rate case, which settlement involved a refund approximately $729,000. The combined effect of these adjustments was to increase certain accounts, and decrease others, as follows:

	Year 1935	Year 1934
Local service revenues	[1] $615,178	[1] $14,914,059
Uncollectible operating revenues	[1] 99,000	[1] 995,000
Depreciation expense	[1] 1,226,178	[1] 15,943,059
Taxes	[2] 103,000	[2] 574,905
Interest deductions	[1] 491,635	[1] 4,806,738

[1] Indicates increase.
[2] Indicates decrease.

(The net effect of these adjustments was to decrease net income by $114,365 in 1935 and by $4,203,833 in 1934.)

(d) Operating revenues for 1935 include for certain of the companies consolidated a total amount not exceeding $4,000,000 subject to possible refund in the event of adverse decisions in pending rate cases. (See note (c) above.)

(e) Due to the adoption of a revised method of distributing engineering costs, the 1935 figure for other general expenses includes such costs in the amount of approximately $5,972,000; in 1934 similar costs were distributed principally to maintenance and construction accounts.

COMPARISON OF FEDERAL REVENUES, UNDER PRESENT LAW AND UNDER HOUSE BILL, THAT WOULD BE DERIVED FROM THE HYPOTHETICAL CORPORATION DESCRIBED BY SENATOR HASTINGS (p. 39 OF HEARINGS)

I. A corporation earns 10 percent annually on $2,000,000 over a period of 5 years, retaining all the earnings in cash. At the end of the fifth year it invests its accumulated earnings of the previous 5 years in additional plant, and for the ensuing 5 years it earns 10 percent annually on the augmented investment, retaining in cash all such earnings. What would be the aggregate amount of Federal revenues derived during the 10-year period under the present law?

During the first 5 years the corporation taxes would approximate 16 percent of the annual income, or $32,000 a year. During the second 5 years the corporation would earn 10 percent, not only on its original capital of $2,000,000 but on the additional reinvested earnings of $840,000 ($1,000,000 less $160,000 for 5 years' taxes). Hence, during the second 5 years it would pay approximately $45,440 in corporation taxes annually. For the 10-year period, therefore, the Federal Government would obtain $387,200 from the earnings of this corporation under the present law. (The stockholders, having received no dividends, would pay no individual income taxes on the corporation's earnings.)

II. Under the House bill, if the corporation distributed all of its earnings during the first 5-year period, it would pay no Federal tax whatever. But its stockholders, if they represent a cross section of stockholders generally, would be subject to individual income taxes on the distributed earnings, amounting to about 33⅓ percent in the aggregate. (This is the average rate which would be paid on corporate earnings if all estimated 1936 corporate earnings were distributed.) Thus the Federal Government would receive approximately $335,000 during the first 5-year period; and if no part of the dividend payments were used to subscribe for additional capital in the corporation, the Federal Government would receive an additional $335,000 during the second 5-year period. This total of $670,000 may be compared with the $387,200 of Federal revenues that would be derived under the existing law.

III. To make the examples comparable, however, it is proper to assume that under the House bill, no less than under existing law, the corporation could profitably employ additional capital. If, therefore, at the end of the first 5 years the corporation successfully invited its stockholders to resubscribe for additional capital stock an amount equal to all of the dividend distributions of the previous 5 years, less the average amount of individual income taxes thereon, the capital of the corporation would be increased by approximately $665,000 to a total capital of $2,665,000. Annual earnings thereon at the rate of 10 percent would amount to $266,500. If the corporation distributed all of these earnings to stockholders, it would pay no corporation taxes. But the stockholders would pay individual income taxes, on the same basis as that noted above, amounting to $446,387 for the second 5-year period, making total Federal revenues for the 10-year period $781,387, as compared with $387,200 under the present law.

Present Federal corporation taxes as percent of income transferred to surplus

Transferred to surplus	Federal corporation taxes [1]	Dividends paid	Taxes as percent of amount transferred to surplus
Percent of statutory net income	*Percent of statutory net income*	*Percent of statutory net income*	*Percent of statutory net income*
4	16	80	400.0
9	16	75	177.8
14	16	70	114.3
19	16	65	84.2
24	16	60	66.7
29	16	55	55.2
34	16	50	47.1
39	16	45	41.0
44	16	40	36.4
49	16	35	32.7
54	16	30	29.6
59	16	25	27.1
64	16	20	25.0
69	16	15	23.2
74	16	10	21.6
79	16	5	20.3
84	16	0	19.0

[1] Rough average of total corporation income, capital stock, and excess-profits taxes.

STATEMENT PREPARED BY SECRETARY MORGENTHAU FOR THE JUDICIARY COMMITTEE OF THE HOUSE OF REPRESENTATIVES ON THE SUBJECT OF TAX-EXEMPT SECURITIES, FEBRUARY 19, 1935

The Treasury Department favors as a permanent policy the elimination of the exemption from Federal taxation now accorded to Federal, State, and municipal securities, insofar as future issues of such securities are concerned.

I consider it very important that when the exemption is eliminated it should be eliminated not only in respect to future issues of Federal securities, but in respect to future issues of State and municipal securities as well. The enactment of legislation requiring Federal obligations to be issued in the future on

a fully taxable basis, in competition with wholly tax-exempt securities originating elsewhere, would be likely to react unfavorably on the market for Federal securities, to increase the cost of the Government's borrowing, and to complicate our financing operations.

I am advised that a constitutional amendment would be required to enable the Federal Government to tax State and municipal securities. In my judgment, such an amendment should be drawn on a reciprocal basis; the States should be permitted to tax Federal securities and the Federal Government to tax State and municipal securities. I favor such an amendment.

STATEMENT OF FRANKLIN SPENCER EDMONDS, PHILADELPHIA, PA., REPRESENTING THE PHILADELPHIA CHAMBER OF COMMERCE

The CHAIRMAN. Mr. Edmonds, as I understand it, you represent the Philadelphia Chamber of Commerce?

Mr. EDMONDS. That is right, sir.

The CHAIRMAN. All right, you may proceed.

Mr. EDMONDS. Mr. Chairman and members of the committee, the Philadelphia Chamber of Commerce has about 2,000 members representing manufacturers, wholesalers, retailers, tradesmen of all kinds in Philadelphia. We have had for several years a committee on taxation and public expenditures, of which I have been chairman during that whole period, composed of about 45 members. We have made a study of the taxing problems from the point of view of Philadelphia. We have gathered data and we have prepared a report, sir, which we will be glad to deliver to each member of the committee. That report, on its reverse side, contains the names of the members of the committee, so you can see the businesses in which they are engaged. (See data at close of Mr. Edmonds testimony.)

Senator CONNALLY. May I interrupt you there for one question?

Mr. EDMONDS. Yes.

Senator CONNALLY. Has the State of Pennsylvania still on its statute books an act exempting manufacturers from tax?

Mr. EDMONDS. You mean the capital-stock tax?

Senator CONNALLY. I am talking about the State law.

Mr. EDMONDS. No; it has not.

Senator CONNALLY. Do you not have a law in Pennsylvania that exempts manufacturers from tax?

Mr. EDMONDS. We had a law in Pennsylvania for 40 years which exempted capital engaged in manufacturing from the capital-stock tax. That law was changed in 1935, for a 2-year period, so they could have a basis for unemployment-relief taxes. Now, in 1937, when that change expires, I cannot tell what will happen then.

Senator CONNALLY. But still the manufacturers in Pennsylvania have an advantage today over most of the manufacturers throughout the United States?

Mr. EDMONDS. Not today.

Senator CONNALLY. Not in this temporary period of 2 years?

Mr. EDMONDS. There was a period when Pennsylvania favored manufacturers, and I hope it will favor them again. I see no objection to that point of view.

Senator CONNALLY. I am not arguing that. I just wanted to know whether that is not the fact.

Senator KING. However, the assets were taxable?

Mr. EDMONDS. Yes; the real estate and everything was taxable, but when it came to the capital invested in manufacturing it was exempt from that one tax, the capital-stock tax; not at all from the corporation net income tax.

Now, I would like to say, Mr. Chairman, that our committee has considered this bill with very great care, and we would like to present some thoughts to you with reference to it which are hostile to the new portion of the bill, and I want to give you very frankly the reasons for it, which will be more elaborated on in the printed memorandum.

In the first place we regard this bill as fiscally, from the point of view of the Government, an unsound piece of legislation. Why? Because today the Government is relying very largely upon income taxes, but you have an income-tax law which gives you wide variations in the return to the Government. Now, your income-tax law is different from that of Great Britain in that particular. I have certain figures here which I obtained from my friend, Mr. Parker, whom we regard as the most accurate statistician on this subject in the United States.

The CHAIRMAN. And the committee so regards him, too.

Mr. EDMONDS. That is fine, sir. In the 13 years up to and including 1935 the United States collected $21,994,000,000 from income taxes. That is the Federal Government. Great Britain collected $20,662,000,000. The average annual income tax in the United States was $1,692,000,000, and in Great Britain $1,590,000,000.

Now, notice the variations in that same 13-year period. Our lowest income was $747,00,000, in 1933, and our highest was $2,410,000,000, in 1930. In other words, the disparity between the lowest and the highest amounts to 223 percent. That is the variation in the ups and downs that you get from income taxation.

Now, what was it in Great Britain? Their lowest in that period was $1,412,000,000, in 1935, and their highest was $1,936,000,000, in 1923. Their variation from lowest to highest is 37 percent, and ours is 223 percent.

Senator CONNALLY. In other words, you favor our adoption of the British system?

Mr. EDMONDS. Give me just a moment on that, Senator. I want to explain where that variation is. Our income-tax law has a variable feature in it and their law does not have that feature in it. They tax income, the annual recurrent gains, what the average man thinks of as income; we tax income, including capital gains and losses, and it is the capital gains and losses which caused all the trouble in these variations in income tax.

Senator BARKLEY. Are you referring to the corporate tax or the individual tax?

Mr. EDMONDS. This is both. This is all of the income taxes in this period.

The CHAIRMAN. In other words, you advocate the elimination of the income-tax law?

Mr. EDMONDS. No, sir; I haven't gotten that far, because that is not before the committee. So you have this variable factor that swings your income up and swings your income down. In certain

periods you have a feast and at certain other periods you have famine. I say that is bad fiscally.

Now, you propose to add another feature, namely, by encouraging the distribution of the profits, all the profits, or a very large proportion of the profits. In the good years you will swing up higher and in the bad years you go down lower.

Senator CONNALLY. Do you advocate lessening the tax in times of prosperity and making it higher in periods of hard times?

Mr. EDMONDS. I advocate a taxing system which will give you a more stable basis. That is what I think business requires. I think this business of going up and down by 223 percent in 2 years is absurd. When you have the feast, which encourages overspending on the part of the Government, they have got the money, and when you have got the famine, that is when the people are hard up, then you have got to levy a lot of new taxes in order to make up the deficit. That is not good fiscal organization.

Senator BARKLEY. In order to have a general level of taxes, so it will be the same in depression times as in times of prosperity, you have got to increase the rate in famines and lower it in feasts.

Mr. EDMONDS. To some degree. They have done it in England. In this particular period we know the English are increasing the income tax. Then also you have lowered certain forms of taxation which are just as stable as the English taxes. Take your tobacco tax. The tobacco tax is the best tax from the point of stability that you have got on the statute books, and it is the lowest tax in the percentage of cost to collect. That is a very remarkable feature.

Senator BARKLEY. That is the only wartime tax that has never been reduced in times of war.

Mr. EDMONDS. It has lived in times of peace as well as in times of war. I think the tobacco tax has been on ever since the Civil War.

The CHAIRMAN. Pennsylvania does not raise much tobacco, does it?

Mr. EDMONDS. Oh, yes; we do, Senator. I beg your pardon. Your fondness is for cigarettes, and mine is for cigars. We raise cigar tobacco, sir.

The CHAIRMAN. You raise a lot of tobacco for these stogies.

Mr. EDMONDS. Whatever they are they are good and they give comfort to the people.

Senator BAILEY. Let me say on behalf of the South Carolina farmers that we do not think the tax is equitable. The United States Government gets $1.09 a pound, and the farmer has great difficulty in getting twenty. The farmer works all the year to produce the tobacco and the Government does nothing except passing laws.

Senator KING. The witness says "equable" not "equitable."

Mr. EDMONDS. I mean equable; I mean stable. From the point of view of the Government that makes a good tax; that is, a good fiscal tax.

Senator BARKLEY. That will result in putting the tobacco growers in the stable, because the price he gets for it does not compare with the price that the Government gets.

Mr. EDMONDS. I am sorry I brought up the illustration. Now I will get back to my point. We have a situation in which you force out net earnings into diverse use at a more rapid rate than the necessities of business would require. You would have in 1929 and 1930 a very

much higher return from the income tax than you have now, and you would have in 1933 and 1934 a very much lower return than you have now, and the result would be that you would accent the difference from the top of the hill to the pit of the valley. That is a bad arrangement.

Senator BAILEY. Can you put up a good argument for having a different rate of taxes on the income of an individual from that of a corporation?

Mr. EDMONDS. I think, sir, that I can set up a good argument. Will you save that question for a moment or two?

Now, I say that is bad fiscally, and I hope I have made my point perfectly clear, namely, you would have no increased tax on dividends at the time when you were having a feast, and you would have an increased tax on dividends just at the time when you are having a famine, and that would result in just the same kind of fiscal chaos that there has been in this country for the last 8 years.

Senator BARKLEY. What effect would the increase in rate famine have on intensifying the famine?

Mr. EDMONDS. It would certainly intensify the famine. What I mean to say is the country is just on the point of recovery, and instead of permitting the corporations to use the money, you make them pay the taxes.

Senator CONNALLY. Are you advocating that we keep the present tax law?

Mr. EDMONDS. I am advocating that you leave it alone, on the ground that it is too complicated to work under the proposed statute.

Senator CONNALLY. You say you want to leave it alone like it is now?

Mr. EDMONDS. You mean the present tax law?

Senator CONNALLY. Yes.

Mr. EDMONDS. If you are asking me the question as to whether I stand for the present tax law, I say "No." I have a reputation in taxing matters, and I am sure some of the tax laws that we have had in the past have not been the laws that we should have had.

Senator CONNALLY. A minute ago you said you would want to leave it alone.

Mr. EDMONDS. I say, leave this tax alone.

Senator CONNALLY. Your argument a while ago was that this tax had resulted in high taxes during periods of prosperity and high income and in periods of depression of low income.

Mr. EDMONDS. I am sorry, Senator, I did not make myself clear. I say this: That you have at present one variable factor that gives you a feast or famine, and you propose to add to that a second variable factor which will accent the feast and accent the famine. That is the reason I am opposed to the second factor. I would like to pass to the first factor, but I recognize that subject is not before you at the present time.

Senator CONNALLY. You are against both factors, so far as you have seen them?

Mr. EDMONDS. I am against both factors on general principles of common sense. If an Englishman puts in a £5 piece for a horse

race and wins a hundred pounds, that is his good luck; the Government takes nothing out of it.

We have made an artificial definition of income in our laws by adding this question of capital gains and losses, and by adding capital gains and losses we have gotten ourselves into an unfortunate fiscal position in which we have this feast and famine; but I recognize that this is 1936, and you gentlemen have a practical problem before. When the time comes that you will deal with that problem, I hope you will invite me to come down, because I shall be very glad to come down.

Now, on this second proposition, I think forcing out the corporate net earnings into dividends, in my judgment, is very bad, from the point of view of the investor, because it will interfere with the regularity which should characterize an investment.

Now, you have had figures presented to you. I have here certain figures for the Allied Chemical, the American Telephone & Telegraph, the General Electric, United States Steel, Westinghouse Electric & Manufacturing.

One of the Senators asked the question about the American Telephone & Telegraph. For 1935 the net income was $182,000,000. Cash dividends on common and preferred stock, $167,000,000. Now, all of those corporations, in a 10-year period, have maintained dividends. The United States Steel and Westinghouse reduced their dividends somewhat, but they have paid some dividends. All of those corporations for the last 5 years were paying out more in dividends than they were getting in net earnings, but they tried to maintain regularity. When they were accumulating the peak they would be paying heavier taxes, and consequently they would not have the funds with which to make their dividend regularly. I insist, from the point of view of the government that wants regularity of income and the point of view of the investor who wants regularity of return, it is better to let those corporations smooth out the peaks and precipices themselves, and do it on a basis that will give them a regularity of return.

I had these figures put in my hands a moment ago by the president of a corporation who is in this room today. Net loss over a 4-year period prior to 1933, $1,000,000. Profits, 1933, $26,000. Profits, 1934, $40,000. Profits, 1935, $100,000. That is $160,000 of profit made possible by increased sales. This is a retail store. But in order to carry on that business with the increased sales they had to increase their inventory by $100,000. That was the development of new lines. They had to increase their accounts receivable by $75,000. That was in order to carry the new accounts. They had to make improvements in the store and in the delivery service of $15,000. So to get that 3 years' profit required an outlay of $190,000 from their working capital. In other words, they had to borrow money as well as use all their profits.

Now, that is the condition of many businesses today. I have in mind particularly the small business. They have the idea that they will eventually grow and grow. Many of you gentlemen have practiced law, and you have seen in your practice cases of small businesses, how the man works, saves, and plows the money back, and

eventually gets the big business. It seems to me the opportunity to do that sort of thing ought still be left to the people of America without putting too high a tax on them, if they are willing to go through the sacrifices that are necessary to build up the business.

Now, my second point is that this up-and-down business is bad for the investor, and it would be bad in the long run for the character of the American people. It is better to have these corporations with a surplus that will give a regularity of dividend and a regularity of return, even though they accumulate a surplus in order to carry it on, rather than taking it away from them in taxes.

The CHAIRMAN. You haven't the figures there of the Gulf Refining Co., have you?

Mr. EDMONDS. No; I have not, sir.

The CHAIRMAN. Have you the figures there of the Aluminum Co.?

Mr. EDMONDS. No.

The CHAIRMAN. You do not know how much in the way of dividends they paid out in the last 10 years?

Mr. EDMONDS. I have no knowledge of the Aluminum Co. I have seen a reference to it in the House at some time.

Senator BAILEY. I think I saw in the paper, in the New York Times, a few weeks ago, that on last year's earnings they paid about $8 a share.

Mr. EDMONDS. I think, Senator, you ought to consider this: If you attempt to make laws for the United States with the view of catching one or two particular corporations, you will make foolish laws.

The CHAIRMAN. We are not trying to catch just some of the corporations; we are trying to make uniform laws, so that certain institutions will not allow all their earnings to be piled up to the disadvantage and inequalities of the entire situation.

Mr. EDMONDS. You made some amendment a year ago, or 2 years ago, to the taxing bill, with reference to personal holding companies and companies that expand their surplus. It seems to me that those methods that you already have are what you ought to use for exceptional cases rather than change the law for us all.

I have here an article from the New York Times by Henry Hazlit, who has some figures that I think are pertinent, and I will supply it for the record. I will not read it for the particular years.

The CHAIRMAN. You may put that in the record.

(The article referred to is as follows:)

DRIVING OUT SURPLUSES

Perhaps the main argument put forward in favor of the proposed drastic tax on corporation surpluses is that billions of dollars are not paid out in dividends at present and hence escape the Federal tax collector. These surpluses actually do pay a tax as part of the net income of the corporations, but it is alleged that if they were paid out in dividends the Government could collect a far higher average rate on them as part of personal incomes. That there are individual corporations formed or conducted for the purpose of lowering the tax rate which very wealthy individuals would otherwise have to pay is doubtless true. The revenue laws, however, already provide penalties where corporations are used for the purpose of tax evasion. Whatever the Treasury may gain in a single year by "driving out the surpluses", its probable gains over a series of years would be much more dubious.

Nothing could make this clearer than the table compiled from Treasury Department reports by the National City Bank in its March bulletin. Below is a simplified form of the table showing the taxes paid, net earnings, and dividends of all manufacturing corporations in the United States for the years 1921 to 1933:

Year	Taxes paid	Net income after taxes	Dividends paid
1921	$793,000,000	[1] $473,000,000	$1,216,000,000
1922	863,000,000	2,251,000,000	1,308,000,000
1923	986,000,000	3,089,000,000	1,761,000,000
1924	937,000,000	2,334,000,000	1,651,000,000
1925	1,077,000,000	3,154,000,000	1,908,000,000
1926	1,139,000,000	3,134,000,000	2,119,000,000
1927	1,065,000,000	2,580,000,000	2,226,000,000
1928	1,118,000,000	3,066,000,000	2,507,000,000
1929	1,161,000,000	3,962,000,000	2,575,000,000
1930	952,000,000	801,000,000	2,613,000,000
1931	731,000,000	[1] 998,000,000	1,894,000,000
1932	647,000,000	[1] 1,906,000,000	1,115,000,000
1933	552,000,000	[1] 2,000,000	1,009,000,000
Average	948,000,000	1,630,000,000	1,838,000,000

[1] Deficit.

The following facts emerge from this table: For every dollar that these corporations paid to their shareholders for the use and risk of capital, about 52 cents was paid in taxes to the Federal and local governments. The shareholders, in addition, later paid income surtaxes on the dividends they received. What is more significant from the standpoint of the proposed tax, these corporations actually paid out over this period of 13 years a higher annual average sum than their net earnings. While net earnings regularly exceeded dividends for the 8 years from 1922 to 1929, in the next 4 years dividends paid out of accumulated surpluses greatly exceeded current earnings.

Wholly apart from the social effects of the proposed tax on surpluses in aggravating the violence of the business cycle and in retarding the rate of industrial growth, one may ask whether it is not short-sighted, even as a Government fiscal policy. Over a period of 13 years manufacturing corporations, taken as a whole, actually did pay out in dividends even more than their full statutory net income in that period. It was fortunate for the Treasury that they paid it out as they did. If they had paid out everything in the years from 1922 to 1929, there would have been a much more greatly shrunken volume of dividends during the depression to tax in personal incomes than there actually was. The new policy, if adopted, would tend to increase the violence of the fluctuations in the Federal Government's income, making dividends higher than otherwise, whether other tax sources were higher and lower than otherwise, when other tax sources were lower.

Mr. EDMONDS. Here is the average. They paid 948 millions in taxes, and their net income, after taxes, the average, was $1,630,000,000. The dividends they paid were $1,838,000,000. In that period their average shows something like $200,000,000 per year distributed more than their net earnings in that period, and that shows how the tendency is to equalize the feast-and-famine proposition by wisely managed corporations.

Senator BAILEY. And to maintain the constant buying power.

Mr. EDMONDS. Yes; to maintain the constant buying power and employment. Let me speak on the third proposition.

Senator BARKLEY. Let me ask you a question first.

Mr. EDMONDS. Here is my third point: I want to ask you gentlemen if you have considered fully the relationship of this kind of tax to unemployment. I understand the tax bills are designed to raise reve-

nue. That ought to be their primary object, and their primary object must be their most important object.

The CHAIRMAN. That is so stated in the bill.

Mr. EDMONDS. Every thinking man must give consideration to the fact that in this country there are millions out of work. How are these millions going to be put back to work again?

I am very glad to say personally I have my own philosophy on the subject. While I haven't introduced myself to you at the beginning of my address, I will say that I was chairman of the Pennsylvania Tax Commission from 1924 to 1927. That is not a commission like the one that Mr. Stone presides over in Mississippi, it was not administered to increase the revenue from taxes, it was to reduce the revenue, like I said to the chairman of the Ways and Means Committee. I was on the uniformity and reciprocity committee of the State Tax Association. I was president of the National Tax Association in 1932 and 1933. So at any rate I have given some little thought on this subject.

It is my very clear feeling that we would go out of the depression only by encouraging new industries. It is the new industries that must take up the slack of unemployment. How can they do that? In our report we give you a special illustration of the Budd Co. of Philadelphia. Edward B. Budd is a man who is a genius in dealing with metals. He started 30 years ago making automobile tops, and he has a pretty large business along that line. For the last 5 or 6 years he has paid no dividend. They have spent 6 years in experimenting with stainless steel. They did not invent stainless steel, but they did fabricate it, and they were the first company that was able to fabricate it. They spent a million and a half of their accumulated net earnings in trying to solve that problem. And what have they done? They have given a new industry to the United States today. Those zephyr trains on the western plains, for which the order is coming in now, is one of the things that they are fabricating this stainless steel for. The Federal Government has required some of this stainless steel fabrication for the superstructure of the war vessels. Mr. Budd tells me that he has put into that development 600 men employees who were not employed a year ago. He has orders that will increase employment possibly to 1,100 before the end of the calendar year.

Now, frankly, that is the way in which you get out of the depressions. Remember that every one of those 1,100 is probably, in Mr. Budd's case, the head of a family.

Remember also what Colonel Ayres proved so conclusively in his figures—that every time you give employment to a thousand men in the productive line you give employment to about 900 more in the servicing lines that are made necessary for the thousand that are employed in that special position. The consequence is that when it gives an additional employment to 1,100 men you have practically 2,000 men that are removed from the relief rolls at once.

Now, frankly, it seems to me that the United States ought to encourage those new industries, and I want to say that there is no factor that has done so much for developing new ideas as the research departments that have been built up in the corporations

with their surpluses. That, in my mind, is the great feature, so far as the life's blood of our Nation is concerned.

We do not continue in this country in a static way. We are a dynamic people. We advance. If a man does anything this year in one way, he wants to do it better next year, whether it is automobile, railroad, textile manufacture, or whatever it may be. It is that improvement that requires capital.

Now, how are you going to provide the capital if the whole pressure of the Government is put upon having net incomes paid out as rapidly as possible?

Now, I submit to you, gentlemen, that from the point of view of the Nation, looking at it from the point of view of getting ourselves out of the situation that we are in now, I say that any possible encouragement that is given to this experimentation is the thing that will evenually lead us into the list of new occupations that will take up our slack. I could tell you a lot more about that if you would like to hear it.

Senator BARKLEY. I have no doubt of your sincerity and your earnestness in what you said. I appreciate it. You made some very interesting statements about what we ought not to do in order to raise this additional revenue which we must have. Have you any suggestion as to what we ought to do in order to raise it?

Mr. EDMONDS. I will tell you very frankly what you ought to do, sir. You want to raise $700,000,000. Cut down expenses by $700,000,000 and you are in just the same position. That is the only answer business can make to you. We say in here that the Federal Government ought to devote itself to its ordinary program. That, I imagine, would be $4,000,000,000, and it ought to provide money for unemployment relief, because the State and the local government cannot take hold of it in this magnitude at the present time. Let us say that would be $5,000,000,000, maybe 5½ billion if you include the C. C. C. camps. If you cut down the expense of 5½ billion dollars, business would be only too glad to sit down with you, because then we would be on a stable basis.

Senator BARKLEY. This additional income is made necessary because of the passage of the bonus bill, which is now an accomplished fact, and because of the decision of the Supreme Court in nullifying the processing tax as a part of the agricultural program.

Mr. EDMONDS. In other words, it is made necessary by the legislation of Congress.

Senator BARKLEY. Well, the legislation was necessary because we could not have a genuine prosperity in this country unless agriculture shares in it, and although for 10 years you have been boasting of artificial prosperity in other classes, everybody knows the condition of the farmer had been growing more serious all the time.

Mr. EDMONDS. If you will make a bargain with me—I will say if you will not put on me the sins of my party, I will not put on you the sins of your party.

Senator BARKLEY. I am not putting on you the sins of any party.

Mr. EDMONDS. You talked of my 10 years' boast.

Senator BARKLEY. I am speaking to you not in an individual way. It was the boast of business in the whole country. They are opposed to any legislation that is designed artificially to remedy a situation

that was created artificially. Now, whether we were wise in the passage of the Agricultural Adjustment Act or not, it increased the farmers' income over $3,000,000,000 a year. It enabled him to begin paying his debts and to buy some of the things that your factories produce. You may or may not agree with that program, but it was adopted, and it is the only one that has been adopted in 20 years that worked, although the Supreme Court held it unconstitutional, which they did way back in 1890, when we passed an income-tax law, and which they have done some 65 times since the Government was organized in 1787. So there is nothing peculiar about the fact that the Supreme Court declared that particular law unconstitutional and declared one or two others unconstitutional.

Mr. EDMONDS. Don't forget that for the income tax we amended the Constitution. Why do not you amend the Constitution for the A. A. A.?

Senator BARKLEY. We haven't had time. I do not know that it is necessary. Personally, I hope it will not be necessary; but we are talking about a condition now produced by the effort of the American Congress to stimulate agriculture and to stimulate industry, too. You will admit that it was an artificial stimulation, but it was an artificial condition that brought about the necessity for stimulation.

Now, we have got this condition here. We have got to get some money. The question is: Where are we going to get it? If you have got any idea as to where we are going to get it, I would like to have it. It is not an answer to say that we must pay the expenses of agricultural benefits that are already imposed on the Government by reducing the expenses in some other branch of the Government in the amount of some seven or eight million dollars.

Mr. EDMONDS. I was giving you an answer that our committee gives out, and it says very frankly that it is the demand of business that you save this money by cutting down expenses. Now, let me give you my personal answer. I think we are tied to the cross, and it is a very sad condition that we are in. I think that you gentlemen have sometimes lost sight of the fact that you are not supposed to be the heavy money spending end of the Government. Ordinarily the Federal Government used to spend about 3½ billion dollars, and the State and local governments spent 8 billion dollars. In place of that I think you have got the Federal Government spending about 8 billion dollars. What is the result of that? You are gradually impoverishing the assets on which local governments are going to support themselves.

Senator BARKLEY. We have to do that, because the local governments came to Washington and laid their burdens on the doorstep of Uncle Sam. They said, "We have exhausted our resources, we have exhausted our taxing ability. We cannot borrow any money." Therefore, Uncle Sam had to assume the burden. We had to assume it or allow millions of people to starve or freeze. We did not assume the burden because we want to do it. I would be glad to get out from under it tomorrow, so far as the whole program of Uncle Sam is concerned, if we could do it, but we cannot.

Mr. EDMONDS. I am willing to agree that no man will put his head in the noose willingly.

The CHAIRMAN. Your time has expired, but if you want to extend it by adding anything else you may do so.

Senator GEORGE. I want to ask one question with reference to the bill. Assuming that under this bill a corporation may accumulate reserves, on the aggregate, of approximately 30 percent of their annual net earnings without a corporate-tax outlay, which is more than under existing law, what have you to say on that point?

Mr. EDMONDS. My point is it loses sight altogether of the corporations that ought to accumulate all their earnings.

Senator GEORGE. I understand that you take the position they should be allowed to accumulate all their earnings.

Mr. EDMONDS. Yes.

Senator GEORGE. On the average, would that not give you a fair, healthy corporate structure?

Mr. EDMONDS. I do not think, personally, that it would. I think it would be an encouragement to established business that has its surplus before January 1, 1936, and it would be a terrible discouragement to the young man who is starting out in business with little capital.

Senator GEORGE. We cannot go back and remedy that.

Mr. EDMONDS. You cannot tax him back, but you can lift the young man out by putting him in such a position that he only pays as much as competitive businesses do.

Senator GEORGE. The point I am asking you, would you say, as a student of the subject, with practical experience and dealing with practical affairs, would you say that the leeway there, the possibility of retaining approximately 30 percent of the annual earnings, would not give a necessary reserve to the prudent corporation, assuming the policy of setting aside such part of it as might be necessary?

Mr. EDMONDS. No, Senator. Let me give you an illustration. I incorporated 6 months ago a hardware business for $10,000. Practically all the stock is owned by a man who started in business 10 years ago. He is saving up the surplus. He is buying a house for himself and he wants to separate his corporate investment from his personal investment. That man will have to plow all of his earnings into that business for at least 5 or 10 years before it becomes a healthy business that can compete with the other businesses in the community. It is that man that you are hurting.

Senator GEORGE. I understand that. He has got some competitive disadvantage by the fact that he cannot plow all of his earnings back, but would it not develop, over a reasonable period of years, a fairly strong, healthy corporate structure? Would that not make it possible?

Mr. EDMONDS. To that question my answer is "No." I think you would discourage tremendously new business, and you would discourage the small businesses that grow into the big businesses that seem to be worthy of encouragement.

Senator LA FOLLETTE. Under the illustration you gave the fact is that under this bill that corporation would retain 40 percent, is that true?

Mr. EDMONDS. I think that is true. It is 40 or 30 percent. That, by the way, is the last point that I wanted to touch on. May I say

this, Senator, I have a very high regard for the Senate of the United States. I hope very much, when you frame a tax bill that you will frame it in understandable English. My feeling is that the bill you have got before you now does not contain understandable English for the average man. Now, I have read it, I have gone over it with my partners, and it is quite clear to me that you cannot understand it except by taking a practical illustration and working it out.

The CHAIRMAN. We hope you will understand it when we finish it.

Mr. EDMONDS. That will be fine.

Senator KING. What would you think of a proposition to increase the corporate taxes in four categories—15 percent, 16 percent, 17 percent, 18 percent in the highest, and then increase the income taxes upon individuals, increase the surtaxes from 4 to 5 percent, and then increase the surtaxes on income in the higher brackets to raise about 8 or 9 hundred millions of dollars, in comparison with the present bill?

Mr. EDMONDS. It is better than the present bill. The point of view of our chamber of commerce is you ought to cut down Government expenses; but it is better, because it is equitable under a general law, and you do not throw on the little man the burden of employing an accountant or attorney. This bill ought to be clear. It requires an accountant in computing tax matters. I am representing the chamber of commerce, which is on a little higher plane, but I say very frankly you ought to have something here so that the average man can know what you are for.

Senator BLACK. Are you an attorney?

Mr. EDMONDS. Yes; I am an attorney.

Senator BLACK. What is the name of your firm?

Mr. EDMONDS. Edmonds, Obermayer & Rebmann, in Philadelphia.

(The report referred to by Mr. Edmonds is as follows:)

REPORT OF COMMITTEE ON TAXATION AND PUBLIC EXPENDITURES

PHILADELPHIA CHAMBER OF COMMERCE,
April 15, 1936.

To the Board of Directors, Philadelphia Chamber of Commerce:

The committee on taxation and public expenditures respectfully submits the following report:

From the point of view of taxation, every citizen is subject to three authorities, viz, the Federal, State, and local governments.

During the period of the depression additional duties have been assumed by each of these governments, and as a result they have been obliged to raise additional funds, in some cases by taxation, other cases by selling bonds, and in other cases by borrowing money on short-term loans. The pressure upon each branch of government has led to the raising of money by any device that may accord with the temporary necessity of the moment, and as a result the tax system has become unstable, uncertain, and unnecessarily complicated.

At present the Federal Government is considering a new revenue measure estimated to produce from $600,000,000 to $700,000,000. The State government has announced that there will be a special meeting of the general assembly to provide additional revenue for relief. Under these circumstances it is the duty of all citizens to consider the general subject and to give their best advice to their representatives. Consequently we outline herewith the courses of action which we are prepared to recommend to our representatives in Congress and in the general assembly of the State.

1. GENERAL PRINCIPLE

It is an often-quoted general principle that ordinarily the budgets of government must be balanced and that the current yearly income must equal the current yearly outgo. In a time of economic strain it is essential that the representatives should first examine the outgo before they provide the income. On the part of the Federal Government we would like to see a careful scrutiny of expenses, eliminating every extraordinary expense on the Federal Budget except the provision for the support of the unemployed, which at the present time is too great to be provided by State or local finances exclusively. Every other form of expenditure except the ordinary program of government should be brought to a termination as speedily as possible and the Budget made up on this basis.

Until this is done the business interests of the country are compelled in self-defense to record their opposition to all new forms of taxation. When expenditures have been reduced to a minimum the business interests of the country should cooperate in suggesting methods of raising revenue to the end that budgets may be balanced and a stable fiscal condition result. But it is useless to expect these suggestions from business until the work of economy has been done or a program for its accomplishment adopted.

II. FEDERAL GOVERNMENT

There is now pending in the Congress of the United States a proposition which is expressed in the report of a subcommittee of the Committee on Ways and Means of the House of Representatives, but which at the time of the preparation of this report has not yet been reduced to the form of a bill. In principle it is proposed to abolish the Federal corporation income and capital-stock taxes and to substitute therefor a graduated tax upon the net earnings of corporations, the rate increasing with the proportion of net earnings that shall be attained after January 1, 1936, but not distributed as dividends to stockholders. It is furthermore proposed to extend the normal personal income tax so as to apply the same to the dividends which taxables receive. It is claimed that these principles will result in a reduction in the taxes paid by corporations to the Federal Government, but in an increase in the returns of the personal net income tax to so great a degree as to provide for the losses resulting from the reduction in corporation taxes, with a net additional revenue in excess of $600,000,000.

The proposal for a graduated tax on net earnings of corporations not distributed as dividends is not new. It was considered in Congress in 1921 and in later years, and it has frequently been advocated by those whose point of view has been fastened upon the relatively few corporations, some of which are more or less personally controlled and which by accumulating net earnings save to their stockholders the burden of paying personal income tax upon dividends which might otherwise be declared. It is to be noted that under existing law, sections 102 and 351 (the latter enacted in 1934), provide a present method of taxing undue coporate surpluses. The advocates of this principle contend that if an individual makes money he pays personal income tax thereon; that if a partnership makes money the partners pay income tax upon the entire amount of the profits; but that if a corporation makes money the stockholders only pay personal taxes upon so much of the earnings as may be distributed to them.

While this argument is persuasive, we are convinced that it does not meet the necessity of the American people at the present time for the following reasons:

(a) As a result of the prolonged depression the surpluses of many corporations are exhausted, and in justice to the business they should be renewed without let or hindrance from the Federal Government.

(b) While the argument that a stockholder in a corporation is in a favored position as compared with a partner or an individual has force, yet it entirely overlooks the fact that the corporation net income tax is designed to meet precisely this situation.

(c) Experience has shown that in the larger industrial corporations the accumulation of a surplus has tended toward stability in dividends, provided the average of net earnings is maintained. This stability in dividends insures a regular income to the stockholder and a stable income tax to the Government, whereas legislation encouraging corporations to distribute all or a larger part of their net earnings in dividends will inevitably result in a large dividend in a year of prosperity and a small dividend or no dividend in a year of depression,

thereby depriving the stockholder of a regular dividend, and, furthermore, promoting wide variations in governmental income.[1] The new proposal will doubtless encourage an immediate increase in dividends, which, under present conditions, will be a sign of a temporary prosperity rather than a herald of a permanent prosperity.

(*d*) The proposal loses sight altogether of the great use which has been made by many industrial corporations in the building up of business and plan through the wise use of surpluses. The experience of the Ford Motor Co., which today represents an investment out of earnings of $700,000,000 and gives employment directly to 70,000 men and indirectly to thousands additional from an original cash investment of $40,000, is an illustration of this principle. We are convinced that the way out of the depression is through the development of new ideas, and that nothing is so conducive to such a development as the wise use of corporation earnings in research, analysis, and experiment in order that new ideas may be prepared for the market. As an illustration of what can be done along this line, we refer to the example of the Budd Co. in Philadelphia, which spent more than one and one half million dollars from its surplus and 6 years in experimentation upon stainless steel before an adequate method of fabricating this product could be developed. As a result this branch of the Budd Co. is today employing 600 men who were not employed 2 years ago, and has already received orders which will require 1,100 employees in this department, this being a substantial fraction of the 6,500 men presently employed in the plant. This company affords an excellent illustration of the way in which unemployment can be relieved through the development of new ideas.

In a general way, the English promote new ideas by the sale of stock, but this plan is not in harmony with the American tradition. We believe that it would be difficult to finance new ideas in America by the sale of stock to any adequate degree. Industrially speaking, our country is dynamic and not static. We expect continuous improvements in process and ideas, and these improvements have been developed in large measure through the practice of putting back into the industry earnings of our businesses, resulting in larger plants, greater facilities, new ideas, and additional employment. It will be a sorry day for America when its Government should decide to discourage this practice.

(*e*) It is to be noted that the suggestion contained in the report of the subcommittee will not result in balancing the Budget in 1937. If the income of the corporation is not distributed as dividends until after the first of the year, it will be another year before it is reported in the income of the individual stockholder. It is apparent, therefore, that this taxing plan is not based upon any idea of bringing the Budget into prompt balance.

(*f*) There are a number of other objections to the proposed plan of taxation, such as the necessity for eliminating corporations engaged in banking and insurance where the growth in surplus is necessary in order that they may continue their service to the public, the status of corporations which have borrowed extensively during the period of the depression and are under contract to repay their debts, the status of those corporations which are required to restore depleted sinking funds or capital before they can distribute any dividends to their stockholders.

For all of these reasons we submit that the plan of taxation now under consideration before the National House of Representatives is fiscally unsound and will work an economic hardship on the American people, delaying the period of recovery which is so profoundly desired.

Under these circumstances we advise our Representatives in Congress to consider first the outgo of Government, and when a sane figure for ordinary expenditures, together with the welfare need indicated above, has been determined, then to consider the question as to how the money shall be raised; and in this effort the Philadelphia Chamber of Commerce will be glad to cooperate.

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[1] In the period of 11 years, 1923–33, inclusive, the following results are noted: (1) Allied Chemical & Dye—has paid dividends in each year, and for 2 years the dividends were in excess of the net income; (2) American Telephone & Telegraph—has paid dividends in each year, and for 4 years the dividends were in excess of the net income; (3) General Electric—has paid dividends in each year, and for 4 years the dividends were in excess of the net income; (4) United States Steel—has paid some dividends each year, and for 5 years the dividends were in excess of the net income, and for 3 of these years there was a deficit; (5) Westinghouse Electric & Manufacturing—has paid some dividends in each year, and for 5 years the dividends were in excess of the net income, and for 3 of these years there was a deficit.

III. STATE GOVERNMENT

The Governor of Pennsylvania has announced that the general assembly will meet in special session in the week of May 4, and it is understood that one of the primary needs of the session will be the provision of additional revenue for problems arising out of the spring floods and unemployment relief.

During the past 10 years the State of Pennsylvania has enacted 18 new taxes; of which 8, not including the personal income tax, which has been declared to be unconstitutional, were enacted in 1935. We recommend to the Governor and the legislators the careful consideration of the following questions:

(a) What revenue has been produced by the eight new taxes imposed in 1935, and what may fairly be expected for the biennium for which these taxes were imposed?

(b) What has been the cost of collecting this revenue?

(c) Are there any of the ordinary costs of State government which can be reduced in order to provide a fund for the unemployed? It will be recalled that the special session of 1932 reduced the Budget appropriations by a sum in excess of $18,000,000 in order to provide funds for unemployment in that year.

(d) In view of the wide disparity in the estimates emanating from informed sources, we ask the question:

What is the real need in Pennsylvania to provide for its unemployed, and is it not possible that this need can be estimated with sufficient finality and accuracy to satisfy the taxpayers?

When these questions have been adequately answered, we believe that Pennsylvania will be ready to provide the funds necessary to care for its unemployed, but until these questions are adequately answered, it will be difficult to secure the cooperation of the tax-paying public.

IV. LOCAL GOVERNMENT

We commend the city of Philadelphia upon the improvement in tax collections.

The receiver of taxes reports for the first 3 months of 1936 that total city tax collections from all sources were $17,796,581, an increase of $3,925,200 over last year. There is an increase in the collections of city taxes, school taxes, personal-property taxes and delinquent taxes. There is a small decrease in water rents.

Recent negotiations which have been pending in the United States district court suggest that it is possible that a settlement may be reached between the city of Philadelphia, the Philadelphia Rapid Transit Co., and the owners of the underliers in the transit system. It is proposed that the consideration for the purchase of the underliers shall be paid in Philadelphia bonds. In the event that these negotiations result in an issue of municipal bonds, and the payment in cash to the underliers, we recommend to the mayor and city council the advisability of authorizing an issue of serial bonds for this purpose. In 1927 the Philadelphia Chamber of Commerce appointed a special committee to consider the relative advantages of serial and sinking-fund bonds for the city, consisting of Sydney P. Clark, Frank M. Hardt, Edward Hopkinson, Jr., Walter E. Long, Roland L. Taylor, and Joseph H. Van Dorn. This committee unanimously recommended serial bonds. The chairman of this subcommittee, Mr. Clark, has prepared a memorandum which is attached to this report which indicates the practice in other American cities.

During the past 6 years there have been a number of disputes with reference to the administration of the sinking funds and the appropriations which should be made from the public treasury. We believe that the time has come to inaugurate a system of serial bonds on which the appropriation for interest and retirement will be a definite matter of computation without requiring the intervention either of expert accountants or of the courts of law.

It is to be noted that the city is under the immediate necessity of providing additional money for the sinking fund. Under the decision of the Supreme Court on January 6, 1936, the city was directed to pay forthwith to the sinking funds the sum of $7,667,015.04 for the requirements of 1935. But $1,000,000 has thus far been provided, and we recommend to city council to formulate at once a plan for this payment, and to this end to inaugurate a policy of strict economy in the municipal business.

V. CONCLUSION

We remind our representatives that it is probable that at present 20 percent of the gross income of our people is being used for the expenses of government. If we included the entire expenditures of government, including loans for current expenses, we would be obliged to say that the total outlay of government in the United States at the present time represents more than 30 percent of the gross income of the people. It is impossible to expect that business will expand so as to take up the slack in unemployment so long as this condition exists. Business needs stability in taxation in order that plans may be formed for the future, and such plans are essential in order that unemployment may be reduced to a minimum.

We present these suggestions in the strong hope that the point of view here presented may meet with the approval of our legislators and thereby pave the way for a restoration of prosperity.

Respectfully submitted.

TAXATION AND PUBLIC EXPENDITURES COMMITTEE.

Memorandum for: Philadelphia Chamber of Commerce.
Prepared by: Mr. Sydney P. Clark.

TAXATION AND PUBLIC EXPENDITURES COMMITTEE,
April 15, 1936.

The conclusions and recommendations contained in the report of the subcommittee on serial bonds of the committee on taxation and public expenditures of the Philadelphia Chamber of Commerce, dated January 1927, hold true today. We are, therefore, outlining in this memorandum the practices followed by certain municipalities in the United States and in the State of Pennsylvania, other than the city of Philadelphia, with regard to the issuance of municipal bonds in either term or serial form. For purposes of comparison throughout the United States we feel that an examination of the form of debt outstanding in each of the first 10 cities of the country will serve to indicate the general practice and trend. The first 10 cities of the United States in population are as follows: New York City, N. Y.; Chicago, Ill.; Philadelphia, Pa.; Detroit, Mich.; Los Angeles, Calif.; Cleveland, Ohio; St. Louis, Mo.; Baltimore, Md.; Boston, Mass.; and Pittsburgh, Pa.

New York City, N. Y., population 1930 census, 6,930,446

The city of New York utilizes both forms of municipal bonds—sinking fund and serial. The sinking fund, or term bonds, are known as "corporate stock" and mature within 50 years after date of issue. Corporate stock usually is issued to finance the cost of capital improvements of a revenue-producing character, such as water, rapid-transit and dock properties. Serial bonds are issued to finance capital improvements and the final serial maturity must not exceed the life of the improvement financed, and the maximum maturity in any case must not exceed 50 years. As of January 1, 1935, there was outstanding corporate stock in the amount of approximately $1,003,000,000 par value, and serial bonds in the amount of approximately $442,000,000 par value.

Chicago, Ill., population 1930 census, 3,376,438

The city of Chicago had outstanding in December 1935 approximately $208,000,000 par-value serial bonds, and approximately $32,000,000 sinking-fund bonds. The sinking-fund bonds were issued in 1933 and 1935 for refunding purposes.

Philadelphia, Pa., population 1930 census, 1,950,961

In December 1935 the city of Philadelphia had outstanding approximately $560,000,000 par-value bonds, all of the sinking-fund type.

Detroit, Mich., population 1930 census, 1,568,662

Detroit presents a special situation inasmuch as the city defaulted on its debt service in February 1933 and effected a reorganization of its debt which became operative about a year later. Briefly, the city of Detroit refunded principal amounts of bonds maturing up to July 1, 1943, into 30-year bonds bearing

the same coupon rate and callable any interest date at 100. It is to be noted, however, that as market conditions have warranted during the past 2 years the city of Detroit has called certain of the 30-year refunding bonds referred to above and replaced them with serial issues.

Los Angeles, Calif., population 1930 census, 1,238,048

In December 1935 Los Angeles had outstanding approximately $195,000,000 par value of bonds, all in serial form, with the latest maturity 40 years from date of issue.

Cleveland, Ohio, population 1930 census, 900,429

In December 1935 Cleveland had outstanding both types of municipal bonds—sinking fund and serial. All of the sinking fund, however, were issued in 1921 or prior thereto. The city has issued serial bonds since 1914 along with sinking-fund issues. However, as noted above, no sinking-fund bonds have been issued since 1921. The approximate relative par value of each type of bonds outstanding in December 1935 is as follows:

Sinking-fund bonds	$21,000,000
Serial bonds	97,000,000

St. Louis, Mo., population 1930 census, 821,960

The city of St. Louis has outstanding both types of bonds, sinking fund and serial. Until 1935 all sinking-fund bonds were dated 1923 and prior thereto. In 1935, however, the city issued approximately $2,500,000 par value of term bonds for refunding purposes. The approximate relative par value of each type of bonds outstanding in December 1935 was as follows:

Sinking-fund bonds	$3,700,000
Serial bonds	75,600,000

Baltimore, Md., population 1930 census, 804,874

In December 1935, with the exception of approximately $800,000 par value sinking-fund bonds, issued in 1933 and 1934, the city of Baltimore had outstanding approximately $58,000,000 par value term bonds, dated 1912, or prior thereto, and approximately $130,000,000 par value serial bonds.

Boston, Mass., population 1930 census, 781,188

Boston continues to utilize both types of municipal bonds, sinking fund and serial. The approximate relative par value of each type outstanding in December 1935 is shown below:

Sinking-fund bonds	$88,000,000
Serial bonds	00,000,000

It is interesting to note, however, that of the approximate par value of sinking-fund bonds outstanding, noted above, only approximately $19,000,000 par value have been issued since 1930.

Pittsburgh, Pa., population 1930 census, 669,817

In December 1935 the city of Pittsburgh proper had outstanding only serial issues. There are certain small political subdivisions which have been incorporated within the city at various times and whose bonds the city has assumed. Of these assumed bonds approximately $1,000,000 par value are of sinking-fund type and are dated 1921 and prior thereto, serial bonds of the city of Pittsburgh outstanding in December 1935 amounted to approximately $60,000,000 par value.

The first 10 cities in Pennsylvania in point of population are Philadelphia, Pittsburgh, Scranton, Erie, Reading, Allentown, Wilkes-Barre, Altoona, Harrisburg, and Johnstown. We have considered Philadelphia and Pittsburgh above in the first 10 cities in the United States, so we will eliminate them from consideration in Pennsylvania.

Scranton, Pa., population 1930 census, 143,433

All of the bond issues of the city of Scranton are in serial form.

Erie, Pa., population, 1930 census, 115,933

The city of Erie has a total of $325,000 term bonds, all issued in 1916. The balance of approximately $7,500,000 par-value bonds are all in serial form.

Reading, Pa., population, 1930 census, 115,967

The city of Reading has a total of approximately $150,000 par-value term bonds, issued in 1912 and 1913. The balance of approximately $6,750,000 par value of bonds are all in serial form.

Allentown, Pa., population, 1930 census, 92,563

The city of Allentown has approximately $2,400,000 serial bonds and approximately $2,000,000 par value of term bonds. No sinking-fund bonds have been issued by the city of Allentown subsequent to 1929.

Wilkes-Barre, Pa., population, 1930 census, 86,626

All of the outstanding bonds of the city of Wilkes-Barre are in serial form.

Altoona, Pa., population, 1930 census, 82,054

The city of Altoona has approximately $1,500,000 par value of serial bonds and approximately $3,200,000 par value of sinking-fund bonds.

Harrisburg, Pa., population, 1930 census, 80,339

All of the outstanding bonds of the city of Harrisburg are in serial form.

Johnstown, Pa., population, 1930 census, 66,993

The city of Johnstown has approximately $1,000,000 par value of term bonds, dated 1922 or prior thereto, and approximately $3,300,000 par value of serial bonds.

Without going further into the division between sinking-fund and serial bonds in other individual cities, it is true that in Pennsylvania and throughout the United States as a whole the sinking-fund issue is the exception and the serial issue the rule.

Practice of nine largest cities in the United States as to issuance of sinking-fund or serial bonds

City	Population 1930 census	Approximate number outstanding December 1935		
		Sinking fund	Serial	Percent serial
New York	6,930,446	[1] $1,693,000,000	[2] $442,000,000	20.70
Chicago	3,376,438	32,000,000	208,000,000	84.67
Philadelphia	1,950,961	560,000,000		
Los Angeles	1,238,048		(?)	100
Cleveland	900,429	21,000,000	97,000,000	82.20
St. Louis	821,960	3,700,000	75,500,000	95.09
Baltimore	804,874	58,800,000	130,000,000	68.86
Boston	781,188	88,900,000	90,000,000	50.31
Pittsburgh	669,817	[1] 1,000,000	60,000,000	98.36

[1] On small political subdivisions whose bonds the city proper has assumed. [2] All bonds.

(Detroit omitted from above list because of situation described in enclosed report.)

The above figures are subject to comments in the attached report.

Practice of eight largest cities in Pennsylvania (excluding Philadelphia and Pittsburgh) as to issuance of sinking fund or serial bonds

City	Population 1930 census	Approximate number outstanding December 1935		
		Sinking fund	Serial	Percent serial
Scranton	143,433		(1)	100
Erie	115,967	$325,000	$7,300,000	95.85
Reading	111,171	150,000	6,750,000	97.83
Allentown	92,563	2,900,000	2,430,000	45.28
Wilkes-Barre	84,626		(1)	100
Altoona	82,054	3,300,000	1,500,000	31.92
Harrisburg	80,339		(1)	100
Johnstown	66,993	1,000,000	3,300,000	76.74

[1] All bonds.

The above figures are subject to comments in the attached report.

STATEMENT OF M. L. SEIDMAN, NEW YORK CITY, CHAIRMAN, TAXATION COMMITTEE, NEW YORK BOARD OF TRADE, INC.

The CHAIRMAN. Mr. Seidman, you are chairman of the taxation committee, New York Board of Trade?

Mr. SEIDMAN. Yes, sir.

The CHAIRMAN. All right; you may proceed.

Mr. SEIDMAN. Gentleman, this bill proposes, chiefly, an undistributed profits tax on corporations. In actual fact, it is not a tax at all that is proposed, but a penalty, leveled against corporations who fail to distribute their entire net income to their stockholders.

Senator LA FOLLETTE. How can you make that statement when it is a fact that under this bill a corporation can retain 30 percent if it makes more than $10,000, if it is undistributed and pays less tax than it pays now, and the corporation that makes under $10,000 can retain 40 percent?

Mr. SEIDMAN. That is true; but inasmuch as a corporation is let go scot free if it distributes all of its income, then necessarily, to the extent that it does not distribute it is penalized. That is the extent of my statement.

Senator LA FOLLETTE. Your statement is not a correct statement concerning this bill, as I understand it.

Mr. SEIDMAN. I say if they distribute all of their income they go scot free. If they distribute all of their net income, they go scot free of tax. If they do not, they must pay as much as 42½ percent of their entire net income, or an equivalent of 73.9 percent of the net income retained.

Senator BARKLEY. If they do not distribute anything, then the stockholder goes scot free. So somebody is going scot free in any event.

Mr. SEIDMAN. If they do not distribute anything, there will be no dividends to the stockholders to be taxed.

Senator BARKLEY. Sure.

Mr. SEIDMAN. I say this, gentlemen, that charging a business 73.9 percent for the right to retain its own working capital is an outrage under any tax system and under whatever name the tax is imposed.

Senator LA FOLLETTE. You do not think, do you, that the stockholders have any right to any earnings?

Mr. SEIDMAN. I certainly do. I think it has been demonstrated this morning that stockholders have received earnings to pay a surtax on.

Senator BLACK. Do you think it is an outrage for an individual to pay 73.9 percent if he makes that much profit?

Mr. SEIDMAN. I certainly do.

Senator BLACK. So you are opposed to the income tax in the high brackets?

Mr. SEIDMAN. I think it defeats itself.

Senator LA FOLLETTE. This is one of the loopholes we want to plug up so it will not defeat itself.

Mr. SEIDMAN. Gentlemen, may I have the privilege of making my statement completely, and then I will be delighted to answer the different questions?

Senator BLACK. Did you place in the record your business?

Mr. SEIDMAN. I am a certified public accountant.

Senator BLACK. You appear in your own capacity?

Mr. SEIDMAN. I appear as the chairman of the tax committee of the New York Board of Trade, and not in my individual capacity at all.

Senator BLACK. Are you employed by them or simply representing them voluntarily?

Mr. SEIDMAN. I am chairman of their tax committee and a member of their executive committee and a member of the board of directors.

Senator BLACK. You are not employed by them?

Mr. SEIDMAN. I am not employed by them.

Senator BARKLEY. Are you a member of a firm of certified public accountants?

Mr. SEIDMAN. Yes, sir.

Senator BARKLEY. What is that firm?

Mr. SEIDMAN. Seidman & Seidman.

Gentlemen, there is just one thing definitely known about the proposed bill. It will abandon an assured revenue totaling $1,132,000,000, in exchange for something which is highly speculative and entirely conjectural in its revenue-producing possibilities.

The theory of a corporate undistributed profits tax has been discussed from time to time for many years. Never in this country, however, and seldom anywhere else, has this theory been put to the test of actual, practical experience. As against this, our present system of taxing corporate profits and dividends is one which has taken us almost a quarter of a century to evolve. It has been perfected by numerous congressional enactments, and it has been clarified by thousands of rulings and judicial interpretations. At a time like the present, when the need for revenue is so great, when we are spending so much more than what we are taking in, when business is recuperating from the worst depression in our history, and when industry is so sensitive to every disturbing influence, how can we possibly afford to gamble such a vast sum of known public revenue for what is so much an adventure into the wilderness?

Much criticism has been directed against the basic theory of the undistributed-profits tax. I believe that many of such objections can

be overcome by a carefully thought-out bill. Such a bill, however, cannot be born in haste, as, in fact, the bill before us has been. In my opinion, this subject cannot possibly be dealt with adequately by the present Congress during an election year. I will, nevertheless, direct my remarks to some of the specific provisions of the bill, on the assumption that this Congress is going to enact an undistributed-profits tax and that we might just as well get the best possible bill under the circumstances.

In directing my criticism to this proposed bill, you gentlemen may be interested to know that I am not antagonistic to the theory of an undistributed-profits tax. As a theory, there is much to commend it. But for the plan to have a chance for a successful career, it must be initiated under conditions very much more favorable than those existing today. It must also be entered into with the clear understanding that the plan is a highly experimental venture and that it will call for some very delicate adjustments in our economics in the process of shifting from one method of taxation to the other.

In any event, the plan will be doomed to failure, and to be the cause of some serious dislocations, if it attempts to penalize corporations too severely for the privilege of retaining necessary working capital and reasonable reserves. Likewise is it bound to meet with failure if tax rates imposed upon the income of individual stockholders are so high as to discourage the continuance of investment in productive enterprises. As long as tax-exempt securities are available to investors having large taxable incomes, any scheme calculated to force corporations to distribute earnings for the sole purpose of adding to the stockholders' taxable income means so much additional pressure against such investors to escape taxation altogether by converting their investments into tax-exempt securities.

Senator BARKLEY. Why do you specialize on this administration? All administrations have done that, haven't they? Why specialize on this one?

Mr. SEIDMAN. I do not think we have realized the seriousness of the tax-exempt security and the damage that it causes until very recently.

Senator BARKLEY. We cannot deal with that question now, because in all likelihood it would require constitutional amendment to tax all tax-exempt securities.

Mr. SEIDMAN. If it does, then the quicker we get it started the better.

Senator KING. Mr. Witness, I doubt very much if you are including State tax-exempt securities and other political subdivisions. I doubt very much whether the people of the States would be willing to have the Federal Government tax their securities, but the Federal Government may tax its own.

Senator BARKLEY. It now taxes them on surtax, Senator. There is already a surtax on them.

Mr. SEIDMAN. On some of them; yes. I say a move of that kind would be more convincing than almost anything else that has been said or done to reform the tax system. I think that is one of the most serious evils in the tax system.

Senator BARKLEY. I suppose it is not worth while spending time on it, but have you ever figured that if you tax all of these public

securities, like the bonds of States, counties, and cities, and the United States, which bears a low rate of interest because of their nontaxable character, that the interest rates would be raised and that the people would have to pay more interest on their public obligations? It would be the same as taking money out of one pocket and putting it into another.

Senator KING. And furthermore, the bonds would sell for less.

Mr. SEIDMAN. Gentlemen, there is no question but what that is absolutely correct, and yet I say a tax-exempt system of any kind has no place in a republic.

The CHAIRMAN. And we all very much agree with you.

Senator LONERGAN. If it will give the witness any moral support, I will say that I am in hearty accord with his views.

Mr. SEIDMAN. The maximum normal and surtax rates now total 79 percent. In addition, there is usually a substantial State income tax to be reckoned with. There is thus almost complete confiscation of income in the top brackets. The only haven for the taxpayer in that position is the tax-exempt security. It is useless to impose any such tax rates and expect to collect them to any substantial extent as long as that avenue of escape exists. The proposal to eliminate tax-exempt securities has been made to the Congress almost annually, but always it has been sidetracked. It would seem that the least that should be done in that regard is for this administration to stop pouring out additional billions of dollars in tax-exempt securities. That would be more convincing evidence of good statesmanship than almost anything else that has been said or done to reform our tax system.

For the year 1936 it is estimated that 247,000 corporations will report taxable income. Of these, some 214,000 will have net incomes of less than $10,000. The remaining 33,000 will have incomes in excess of $10,000. Thus, about 87 percent of our corporations are comparatively small enterprises. In the main, they have perhaps just about enough working capital with which to carry on, if such working capital is supplemented by the usual credit facilities of commercial banks. As to the larger businesses, their financial set-up ranges perhaps from bare insolvency to extreme liquidity.

Many of the largest and strongest of these companies have accumulated enormous liquid reserves. They are in the best possible position to avoid the payment of a penalty tax for failing to distribute all of their current income in dividends. It thus appears that under the proposed plan it is the largest and most successful companies that have the most positive assurance of going scot free of tax. At the other extreme are the corporations for whom the distribution of any part of their current income will be utterly impossible. These are the companies whose reserves have been seriously depleted by 6 years of severe operating losses. It is they who are most entitled to avoid the payment of the penalty tax but are least likely to be able to do so.

Senator GEORGE. We make some allowance here for depleted capital.

Mr. SEIDMAN. Yes, sir. I am referring to those companies at the other extreme who cannot distribute income. I have covered the companies who can distribute income.

In referring to depleted reserves, I do not necessarily mean that these companies have no surpluses. Their balance sheets might show

substantial surpluses over and above paid-in capital. But businessmen understand that a corporation's surplus, as shown by its balance sheet, is seldom represented by cash or its equivalent. Quite to the contrary, such surpluses are usually tied up in plant, equipment, and merchandise inventory.

It is a well-known fact that the only way in which some businesses can obtain additional funds is by reinvestment of their earnings. Even to the large, well-financed corporation which has managed to back its surplus by cash and liquid assets this plan will tend to discourage the draining of existing reserves. For they will know full well that such reserves cannot be rebuilt through the avenue of earnings. The freezing of such reserves is bound to have the exact opposite effect to what was intended. Instead of corporate reserves being spent, thereby creating employment for the unemployed, they will be frozen in the fear that they are not replaceable.

It is this very liquid capital that has been most severely depleted during the depression. That is the part of a company's financial structure that must be rebuilt if ever we are to be on the road to full recovery. Yet here is the very point where the undistributed profits tax will make recoupment of accumulated losses impossible, or at least so costly as to appear undesirable.

Because of the penalty against the small and underfinanced corporation, there is bound to ensue a wholesale shifting in the method of doing business from the corporate to the partnership form. There will thus be lost to the small business the advantages accruing to its larger competitors who conduct their businesses in corporate form.

There would certainly seem to be something dead wrong with our process of reasoning when we profess to fear control by "big business" and yet legislate to keep big businesses big. That is exactly what this proposed plan will do. For even the corporation with a $10,000 income will have to pay a tax equal to 42 percent of income retained. In other words, if it retains $100 of income, it will have to pay out $42 to the Government, assuming $142 is its entire income.

Senator KING. You mean net income?

Mr. SEIDMAN. Net income.

Senator GEORGE. That is where it keeps it all.

Mr. SEIDMAN. No small business can survive any such cost for its working capital. We recommend therefore that the proposed rates in order to be workable and effective be substantially reduced. Also that they be simplified into a single schedule. This can be readily accomplished by allowing smaller corporations a tax exemption on the first $2,000 of income.

I think that would simplify the whole complicated rate-schedule structure.

In the matter of taxing the stockholder, it is generally conceded that a tax on the corporation is in effect a tax on the stockholder. In that regard, Chairman Robert L. Doughton, of the House Ways and Means Committee, recently stated in part, as follows:

> The earnings withheld by corporations add no less to the wealth of the shareholder than the earnings distributed in dividends; for the reinvestment of corporate earnings becomes reflected in the stockholder's share of the net worth of the coropration and in increased earning power.

Also—

To the extent that corporations do not disburse their current earnings, the additional revenues will be obtained from higher corporation income taxes corresponding as near as may be on the average to the rates that would have been by their shareholders if corporate earnings were fully distributed.

The point he is trying to make here is we ought to tax a corporation that does not distribute at about the same average tax rate as the normal and surtax would be imposed against the individual stockholder if the distribution were in fact made.

With this as the background for the tax and the rate on undistributed profits, one would suppose that once the corporation has paid a tax equivalent in amount to both the normal and surtax rates on individuals, such tax-paid income, if thereafter distributed, would be tax free in the hands of the shareholder. How great is the shock, therefore, to find it proposed that such income be again taxed in the hands of the stockholders; and not alone for surtax purposes as heretofore, but for normal tax purposes as well.

Here is a rank inequality in taxing business profits. It certainly runs counter to one of the avowed purposes of the law which in the words of the President himself, seeks "a fairer distribution of the tax load among all the beneficial owners of business profits, whether derived from unincorporated enterprises or from incorporated businesses, and whether distributed to the real owners as earned or withheld from them."

Why is not that a proper and fair thing to do if equity is what we seek in taxing businesses alike?

Senator LONERGAN. I would like to ask a question at that point of one of the Treasury experts about the double taxation. Suppose a corporation invests part of its funds in the stock of another corporation that has already paid its tax on the earnings of the stock, the new ownership would have to pay a tax on that, would it not?

Mr. TURNEY. Those dividends received went into their net income the same as any other net income and the tax depends on what the receiving corporation does in the way of dividend payment.

Senator LONERGAN. I would like to ask the witness a question on that point. Do you regard that as double taxation? I very much regret that I did not follow you. Supposing corporation A owns stock in corporations B, C, D, E, F, and G, and down the line, 25 of them, and all of those corporations have paid to the United States Government a tax, and corporation A has invested in those securities as a means of finding a safe place to invest for the building up of reserves, my question is: Is it fair for corporation A to pay a tax on the earnings of those investments? Is that double taxation?

Mr. SEIDMAN. It certainly is if the corporations were taxed independently and then we just distributed to the upper holding company and it is taxed again.

Senator LONERGAN. Yes.

Mr. SEIDMAN. That is the worst possible form of double taxation.

Senator BLACK. Suppose a corporation makes $100,000 and it decided to keep $50,000 in reserve; it pays a tax on that $50,000, does it not?

Mr. SEIDMAN. The corporation has earned $100,000 and has retained $50,000 in reserve?

Senator BLACK. Yes.

Mr. SEIDMAN. Distributing the remaining $50,000?

Senator BLACK. I am talking about the first $50,000. Who pays the tax?

Mr. SEIDMAN. Under the plan here proposed?

Senator BLACK. Who pays the tax on that?

Mr. SEIDMAN. The answer to that question directly is the stockholder pays the total tax either directly or indirectly.

Senator BLACK. Who pays it? Out of what fund does it come?

Mr. SEIDMAN. It comes out of the corporation's assets, of course.

Senator BLACK. The first $50,000 is held in reserve, it is put into the corporate fund. Who pays the tax on the $50,000 that is distributed?

Mr. SEIDMAN. The stockholders.

Senator BLACK. Do you find any double taxation in that particular instance?

Mr. SEIDMAN. No; but you have got——

Senator BLACK (interrupting). That is the whole plan.

Mr. SEIDMAN. You have an illustration there of a corporation that has had $100,000 of its income taxed. Its entire income.

Senator BLACK. You stated that this bill provides for double taxation. The bill provides for the part of the profits reserved that the taxes are to be paid by the corporation, and for the part of the profits that is paid out by the corporation the taxes on that shall be paid by the person to whom it is distributed. Do you call that double taxation?

Mr. SEIDMAN. I said double taxation appears only at this point: Where the corporation, to simplify the example, retains all its earnings, it pays the average surtax rate for every dollar of its earnings as if it were, in fact, distributed to the stockholders, and if ever in the future that profit is distributed to stockholders they again are called upon to pay both the normal tax and the surtax. I say that is wrong; that is double taxation of the worst kind.

This double taxation of income also emphasizes the fact that several hundred million dollars of revenue estimated to be produced by this bill will come about only as a result of taxing twice income that has heretofore been taxed only once.

Why should a stockholder in a small and poorly financed corporation, having suffered his share of tax through direct payment by the corporation, be again required to pay a tax on the same income when he comes into actual possession of his share of what is left of it after the corporation has paid the tax? If such distributions are to be again subjected to tax as is proposed, why is not the shareholder at least entitled to a credit against his tax for his pro-rata share of the tax paid by the corporation on what is left of the very same income?

That is the system England has employed for many years, and, as a matter of equity and fairness, should be pursued here if income-tax laws are not to completely topple over by the very weight of their own inequities. Such a plan as is here proposed must eventually work its own destruction. The quicker that is understood, the better for all concerned.

It may be contended that such tax duplication is justified by the Government's fiscal needs. Let us then remember that no tax pro-

gram will catch up with the policy of spending $2 for every $1 taken in. But, if such revenue must be raised through the income tax, let it be raised by a broadening of the tax base, through an increase in the normal tax and a lowering of the tax exemptions, so as to directly include a large number of our people who are today paying huge taxes in disguised form, concealed in the price of the things they buy. Such a broadening of the tax base should be designed deliberately to bring home to our people the cost of our enormous Government spending which they, the people, must ultimately pay for.

May I call your attention to section 102, subdivision (e), of the proposed law, which reads as follows:

(e) *Payment of surtax on pro-rata shares.*—The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro-rata shares, whether distributed or not, of the retained net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro-rata share, be exempt from tax in the amount of the share so included.

Here is an excellent provision in connection with surtax evasion and an excellent example of how cash distributions can be made unnecessary and how tax duplication can be avoided. Why can't a similar provision be made to extend to the treatment of the undistributed profits tax? This would give to the stockholders of the corporation a simple means of being taxed individually on their pro-rata share of corporate income, without making it necessary for the corporation to actually distribute the income in cash or its equivalent. Such a provision would simplify the entire problem of distribution and would enable the vast majority of corporations to be treated as partnerships for tax purposes, and thus would more nearly accomplish equality in the taxation of business profits. Perhaps, as many as 9 out of every 10 corporations could take advantage of such a provision.

The CHAIRMAN. Have you estimated the loss to the Government by extending that as you have suggested in revenue?

Mr. SEIDMAN. I haven't estimated the loss, but I say you haven't accomplished equity; and what is more, you have aggravated the situation, you have, to some extent, a duplication of taxation in the present law. This proposal would compound the felony.

The CHAIRMAN. That would come back to the same proposition. Certain reserve held by the corporation must be tax exempt. Do you figure that whatever reserve is retained by a corporation should be tax exempt until it is distributed?

Mr. SEIDMAN. No. I say let the corporation pay the tax on that, but then label that income tax free whenever it is distributed, it is tax-free to the stockholder. That is exactly what you have done in section 102.

If all the stockholders of a corporation, in order to ease the tax burden of the company and in order to conserve its working capital, are willing to pick up every dollar of the company's income in their own tax returns and pay a tax on it at normal and surtax rates, the Government should have no complaint. That is all the Government can hope to collect from the more prosperous companies, who are in a

position to distribute all their current income and thus escape paying an undistributed-profits tax.

Several other serious defects in the bill should receive consideration. The present revenue act does not permit corporations to file consolidated returns. Yet we all know that where a business unit is conducted through two or more corporations it is the consolidated net income that is the true net income for that business. The loss of one corporation in the group must necessarily be offset against the profit of another before true income is arrived at. For many years our income-tax laws did in fact recognize this truth and permitted the filing of consolidated returns by affiliated companies. But, when our Government's fiscal needs began to overshadow the element of equity and fairness in our tax laws, the consolidated return was thrown overboard. Such an inequity may be bearable under an arrangement where a corporation is subjected to an income tax of from 12½ percent to 15 percent as is now the case, but it will certainly be intolerable under any such plan as would tax retained corporate income at rates running up as high as 73.9 percent.

The same comments could well apply to the treatment of capital losses. At present capital gains are taxable, but capital losses in excess of such gains are limited in deductibility to a $2,000 maximum. When a business is to be taxed at anything like the proposed rates on its entire net income, including capital gains, the very least to be expected is that the tax be imposed on true net income after all legitimate business losses are deducted.

For the same reasons, losses of one year should be permitted as a carry-over deduction against the profits of at least the two succeeding years. We have learned by sad experience that profits and losses have their peaks and valleys. If an extremely high rate of tax is to be imposed against profits of 1 year, it is only fair and just that the losses of the immediately preceding years be given some consideration in determining the tax liability.

Permit me also to direct your attention to section 27, subdivision (j) of the proposed law on the subject of intercorporate dividends. This provides that corporations, 80 percent or more of whose gross income is derived from dividends, shall, in figuring their undistributed-profits tax, be deprived of so much of the dividend credit as is equal to the amount of income accruing to a corporate shareholder owning 50 percent or more of the taxpayer's stock. In effect, what this means is that even if such a company distributes every dollar of its income, it may nevertheless have to pay 42½ percent of its income in undistributed-profits tax.

Imposing such a tax on the earnings of a subsidiary company within a corporate structure means certain death to the subsidiary. Last year this Congress was engaged in a desperately fought controversy over a so-called death sentence proposed against certain public-utility holding companies. Following many months of consideration and discussion of the subject, the proposal was defeated. Yet here, in this law is proposed a virtual death sentence not alone against public-utility holding companies but against all holding companies of the nature here described. The proposal comes out of a clear sky, without any notice whatsoever to these companies. It was not even mentioned when the Ways and Means Committee held its public hearings on this bill.

Presumably there are many instances in which the corporate structure can and should be simplified. Our laws in the past encouraged such complicated structures. On the other hand, there must be numerous instances in which corporate structures of this nature are necessary and invaluable in the conduct of large businesses. This is certainly true where business operations extend into many States and are thus subject to many State laws.

Senator KING. And where it extends into other countries, such as Chile and Mexico, where you cannot conduct business there as an American corporation, you have to organize a Chilean corporation and place all of your stock with the Government before you can get a charter, and you must organize a corporation in Mexico and place your stock there; so that if you and I should organize a company here, such as a mining company, and decide to branch out into Mexico and Chile, we would have to organize a company in Chile and another in Mexico; we would be the holding company, and Mexico and Chile would tax very heavily, and any dividends that would come back to the holding company, I was wondering whether there would be anything left.

Mr. SEIDMAN. There may be thousands of instances which require these subsidiary companies to be formed in a way in which they have been formed; yet we are about to put them to death.

Senator KING. They have to organize these companies in order to do business.

Mr. SEIDMAN. Of course.

Assuming, however, that the elimination of all such corporations is desirable, and that it is the Government's business to so legislate, there is surely no occasion for any such strong-arm methods as are proposed in this law. I submit that if such holding companies are to be penalized for living, they ought to at least be given a fair trial and an opportunity to justify their existence before they are summarily condemned. If they cannot do so, then and only then should they be forced to go into liquidation by a certain, reasonably far-removed date in the future.

The law is chock full of nonconstrued provisions, which are sure to cause litigation for many years to come. It has been dubbed "the most complicated piece of legislation in 50 years." Its intricacies and its controversial provisions are bound to have serious effect upon the productivity of the tax and the temper of the business community.

Simplification is possible only by further detailed study, discussion, and consideration. To enact such revolutionary changes in our tax system without ample and mature consideration is unthinkable.

Business is worried over the uncertainty produced by the constant changing of our tax laws. Changes of tremendous importance are made after much bickering and controversy, only to be again changed 6 months or a year later, often before the earlier enactments have been given a chance to prove their own worthiness. Last summer Congress and business sweated for many weeks on a tax bill. The most bitterly fought provision of that bill involved the principle of taxing corporate "bigness" as such. That provision now goes out the window for something which may suffer the same fate 6 months or a year hence.

It is the uncertainty and unreliability of our constantly changing tax laws that makes for a lag in confidence and for delay in return to business normalcy. This proposed bill embodies some of the most revolutionary changes since the enactment of the sixteenth amendment. We must be sure we are right before we make any more radical changes in our tax laws.

Thank you, gentlemen.

The CHAIRMAN. This is not the first time you have appeared before the committee in connection with tax laws, is it, Mr. Seidman?

Mr. SEIDMAN. No, Mr. Chairman; it has been my pleasure to appear here time and again.

The CHAIRMAN. Have you ever appeared before us when a tax bill was under consideration and advocated its passage?

Mr. SEIDMAN. I did not get your question, Mr. Chairman.

The CHAIRMAN. I thought your language today seemed very much like the language you have spoken before the committee when we have had other tax bills up for consideration, and I asked the question whether you have ever appeared and asked for the passage of any tax bill.

Mr. SEIDMAN. I have always tried to make constructive suggestions.

Senator BLACK. Have you ever favored any tax bill proposed here?

Mr. SEIDMAN. The New York Board of Trade——

Senator BLACK. Which one have you favored?

Mr. SEIDMAN. The New York Board of Trade has always favored a sales tax. The New York Board of Trade is for a sales tax as a means of raising revenue.

Senator BLACK. You have appeared here for how many years in connection with tax bills?

Mr. SEIDMAN. About 15 years.

Senator BLACK. Have you ever favored any bill that was proposed, and, if so, which one?

Mr. SEIDMAN. Whenever I appeared as an individual I was definitely for or against——

Senator BLACK. Have you ever appeared as an individual?

Mr. SEIDMAN. Yes, sir; perhaps as far back as 1921, in connection with the 1921 Revenue Act.

Senator BLACK. Did you favor that act?

Mr. SEIDMAN. I favored—there was a question there——

Senator BLACK. Is that one you favored?

Mr. SEIDMAN. There were many provisions that I favored.

Senator BLACK. Has there ever been a bill on which you came down here and testified in favor of; I would like to know that so that I could read the evidence.

Mr. SEIDMAN. Mr. Senator, no bill is ever presented in such form that you can favor all of it or none of it; there are provisions you are either for or against. This bill, itself, I have not criticized——

Senator BLACK. Are you in favor of the repeal of the excess-profits tax?

Mr. SEIDMAN. Yes, sir.

Senator BLACK. Were you opposed to the amendment which the Senate and House passed which attempted to plug up the loopholes?

Mr. SEIDMAN. I was in favor of it. I appeared for the New York Board of Trade——

Senator BLACK. Where did you testify in favor of it?

Mr. SEIDMAN. Four or five years ago.

Senator BLACK. Four or five years ago—you were here in 1934?

Mr. SEIDMAN. The 1932 was the Revenue Act which attempted to button up the loopholes in our tax law.

Senator BLACK. In 1934 and 1935, when the committee had its hearings, do you recall testifying against that bill?

Mr. SEIDMAN. I know I testified in favor of closing up the loopholes.

Senator BLACK. You appeared this morning favoring the idea of taxation of undistributed profits. I understood in one statement——

The CHAIRMAN. He only approved in a general way the principle and facility of the thing.

Senator KING. He approved the theory but is against the practice.

Mr. SEIDMAN. Yes.

Senator BLACK. In other words, you think you have not had time in which to work all of that out?

Mr. SEIDMAN. Yes, sir.

Senator BLACK. You think it takes more time?

Mr. SEIDMAN. Yes, sir.

Senator BLACK. Have you ever read Mr. Jeremy Bentham's Current Fallacies of Anti-Reformers?

Mr. SEIDMAN. No, sir.

Senator BLACK. I would appreciate it if you would read the speech of Mr. Noodles that appears in that discourse in an interpretation of Mr. Sydney Smith of Bentham's Fallacies. I think if you will read that you will recall some of the arguments that you have made here this morning—

I favor the philosophy and theory, but this is not the proper time.

Mr. SEIDMAN. I would appreciate reading it.

Senator BLACK. I am sure you will enjoy it.

Mr. SEIDMAN. The point, gentlemen, is not so much that this is not the time, but it will not work with tax-exempt securities and a 75-percent surtax.

Senator BLACK. You favor it, but this is not the proper time; you think we have not studied it long enough and that there are certain things that make it impossible to put it into effect?

Mr. SEIDMAN. It would be a good thing to make sure the rates are reasonable so the thing can work, but it is handicapped——

Senator BLACK. I understood you also were very fearful it would hinder the small corporations.

Mr. SEIDMAN. Yes, sir.

Senator BLACK. Do you have a list of the contributors to the association you represent and the names of the companies that your organization works for as public accountants?

Mr. SEIDMAN. Contributors to what?

Senator BLACK. To the New York Board of Trade.

Mr. SEIDMAN. You mean the membership of the association?

Senator BLACK. Are there any large companies that belong to that organization?

Mr. SEIDMAN. May I say, Mr. Senator, that the New York Board of Trade is made up of large companies and small companies.

Senator BLACK. What large companies?

Mr. SEIDMAN. The small companies predominate.

Senator BLACK. What large companies have you discussed the tax measure with which belong to it?

Mr. SEIDMAN. In the first place, I cannot——

Senator BLACK. Does the Guaranty Trust Co. belong to it?

Mr. SEIDMAN. Yes, sir.

Senator BLACK. Does the City National Bank belong to it?

Mr. SEIDMAN. Yes, sir.

Senator BLACK. The Chase National Bank?

Mr. SEIDMAN. I believe it does.

Senator BLACK. Do you know whether or not the Electric Bond & Share belongs to it?

Mr. SEIDMAN. I do not think so.

Senator BLACK. You do not think so?

Mr. SEIDMAN. No, sir.

Senator BLACK. Do you know whether or not any of its associates belong to it?

Mr. SEIDMAN. Quite likely.

Senator BLACK. Do you do work for any of the companies I have mentioned?

Mr. SEIDMAN. I do not.

Senator BLACK. Does your firm do work for them?

Mr. SEIDMAN. My firm does not.

Senator BLACK. Is it engaged in independent accounting?

Mr. SEIDMAN. Yes, sir.

Senator BLACK. And you have appeared here each time for the New York Board of Trade, and still nobody has paid you for your appearance at all?

Mr. SEIDMAN. That is correct.

Senator BLACK. In each instance?

Mr. SEIDMAN. Yes.

Senator BLACK. And you appear voluntarily as a citizen?

Mr. SEIDMAN. That is right.

Senator BLACK. What is the name of your company?

Mr. SEIDMAN. Seidman & Seidman, certified accountants.

Senator BLACK. Where is its office?

Mr. SEIDMAN. New York City, head office.

Senator BLACK. At what place?

Mr. SEIDMAN. New York City.

Senator BLACK. What place in New York City?

Mr. SEIDMAN. The street number?

Senator BLACK. Yes.

Mr. SEIDMAN. 80 Broad Street.

Senator BLACK. Is that an office building?

Mr. SEIDMAN. Yes.

Senator BLACK. What?

Mr. SEIDMAN. The Maritime Exchange Building.

Senator BLACK. What is the number?

Mr. SEIDMAN. 80 Broad Street.

Senator BLACK. What is the number of the office?

Mr. SEIDMAN. The room number?
Senator BLACK. Yes.
Mr. SEIDMAN. Two thousand six hundred.
Senator BLACK. And who else is in your firm?
Mr. SEIDMAN. Just three brothers.
Senator BLACK. Three brothers?
Mr. SEIDMAN. Yes.
Senator BLACK. Have they appeared, also? Did you appear in connection with the holding company bill?
Mr. SEIDMAN. No, sir.
Senator BLACK. You took no part in it?
Mr. SEIDMAN. No, sir.
Senator BLACK. Have you appeared in connection with any other legislation except tax legislation?
Mr. SEIDMAN. No, sir; only tax legislation.
Senator BLACK. You have appeared on that ever since 1921?
Mr. SEIDMAN. Yes, sir.
Senator BLACK. And that was the first time?
Mr. SEIDMAN. I believe so.
Senator BLACK. You have appeared at each session since then?
Mr. SEIDMAN. At most of them.
Senator BLACK. And that has been wholly on your own accord and nobody has asked you to do it?
Mr. SEIDMAN. Of course, what I have discussed here is for the committee on taxation of the New York Board of Trade.
Senator BLACK. Who else is on that committee?
Mr. SEIDMAN. Well, there is Mr. Eggleston, of Young & Co., New York.
Senator BLACK. What business are they in?
Mr. SEIDMAN. Art dealers.
Senator BLACK. Who else?
Mr. SEIDMAN. Mr. James Rowe, a retired businessman; Mr. George Semon, of the Heyden Chemical Co.; and three or four others.
Senator BLACK. Do you know the others?
Mr. SEIDMAN. Mr. Griffith, an officer of the New York Board of Trade; Mr. Blair, of the Chemical Bank.
Senator BLACK. The Chemical Bank & Trust Co.?
Mr. SEIDMAN. Of New York. I believe that is about all; there are six or seven.
Senator BLACK. You do not remember any others?
Mr. SEIDMAN. There may be one or two others.
Senator BLACK. But you do not remember them?
Mr. SEIDMAN. No.
The CHAIRMAN. Is Mr. Gilman a member?
Mr. SEIDMAN. No, sir.
The CHAIRMAN. Is Mr. Gimble?
Mr. SEIDMAN. No, sir.
The CHAIRMAN. Are Gimble Bros. members of the board of trade?
Mr. SEIDMAN. I believe they are.
The CHAIRMAN. Did you read the statement of Mr. Gimble in the papers this morning?
Mr. SEIDMAN. No, sir.
The CHAIRMAN. You should read it; it is a good statement.

Senator BARKLEY. Do you favor the sales tax as a substitute for all income tax?

Mr. SEIDMAN. No, sir; as a supplement.

The CHAIRMAN. The committee will recess until 2 o'clock.

(Whereupon, at 1:05, the committee took a recess until 2 p. m.)

AFTERNOON SESSION

The committee reconvened at 2 p. m., pursuant to the taking of the recess.

The CHAIRMAN. The committee will please come to order. Mr. Klein, I believe, is to be the next witness. Mr. Springer, do you have a word to say?

Mr. SPRINGER. Mr. Chairman, for the purpose of the record, my name is Durand W. Springer, secretary of the American Society of Certified Public Accountants, and in presenting Dr. Klein as our representative I want to say for the benefit of you who may not know it that at one time he was the tax editor of the New York Globe and professor of taxation in the City College of New York, an author of a very much read book on income taxation.

He has been president of the New York State Society of Certified Public Accountants, is senior partner of the accounting firm, Klein, Hind & Finkle, New York City, and is now acting in the capacity of chairman of our committee on Federal legislation. The report which you have before you gives the names of the committeemen on this committee and their residences.

We had a meeting of our board of directors here on Monday and Tuesday of this week, at which the points he will present were discussed and approved, so that what he will say to you will come as the result of conferences in which 22 States have been represented by the two.

I might merely add one other statement, that if we were to come to you with any desire to take advantage of a possible opportunity for profitable gain, there would be nothing better that we could do than to urge that you pass the bill as it is, because certainly it would increase the volume of practice which the independent accountants would have during the succeeding years.

Dr. Klein will now make his statement to you.

STATEMENT OF JOSEPH J. KLEIN, NEW YORK CITY, CHAIRMAN OF THE COMMITTEE ON FEDERAL LEGISLATION OF THE AMERICAN SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

The CHAIRMAN. Doctor, you have a memorandum here, and suppose we put that in the record, and that within 20 minutes you pick out the salient things you want to tell the committee, because we have a great number of witnesses here.

Dr. KLEIN. I sympathize with you, Mr. Chairman, and after the first 3 minutes whenever you feel I am not constructively useful, sound your gavel and I will quit.

The CHAIRMAN. That is all right; you just get through as quickly as you can and we will put this brief in the record.

Dr. KLEIN. First of all, I shall not say anything more about the simplicity or the complexity of this bill. You indicated, I think, Mr.

Chairman, during the course of this morning's discussion, that the bill when it finally emerges may be decidedly and fundamentally different from what it now appears to be.

The CHAIRMAN. I do not know whether I said that.

Dr. KLEIN. If not, sir, then the cruelest punishment that might be meted out to the members of this committee, and I here recall the procedure of the college of cardinals, no crueler punishment could be meted out to those who vote for the bill in its present form than placing them in cells without food until they solved a simple problem which I am prepared to submit for such purposes.

One other matter regarding simplicity I think I ought to touch upon: I think the bill has been unfairly criticized by some persons merely after a superficial reading of it, because of the presence of four tables, and reference in schedule 3 to the use of those tables for corporations with incomes between 10 and 40 thousand dollars per year.

Table 1 and table 2, as distinguished from table 1-A and 2-A, are utterly and totally useless and redundant, impractical of application, and unnecessary. I believe if those two tables were eliminated, the bill would not seem to be as formidable and foreboding as it now appears to be.

The CHAIRMAN. I made a statement calling on the experts to see whether or not they could work out something in the way of eliminating some of those tables and put it in one, if possible.

Dr. KLEIN. Some of the suggestions I will make ought to be of help to those experts, and I want to tell you there are some very commendable features in the bill, and perhaps I may list them quickly.

Little has been said by outsiders, and probably little will be said in favor of the bill but I want to go on record about seven points which I think are highly commendable.

First. The proposal to levy a flat tax on selected corporations, while I might not agree with you on those which should be selected, and especially on receivership and deficit corporations, is a move in the right direction.

Second, I commend in principle the provisions (though I think them entirely too complicated), which are intended to lighten the tax burden on corporations with prior deficits, those prohibited by binding agreements with creditors or by statute from disbursing earnings, and debt-ridden corporations which wish voluntarily to amortize their debts.

Third. Early elimination of the capital-stock and excess-profits taxes, although I raise the question whether you can afford to give up those revenues.

Fourth. Subjecting dividends to surtaxes, I think is a move in the right direction, although on the basis of equity it seems to me there should be an exemption for the recipient of the dividend equivalent to the tax on the earnings which made the dividend possible. I sometimes think this theory, which seems to be held by most, does not bear logical analysis.

Fifth. You have a dividend carry-over provision, and I think if you do finally decide to levy high rates, you ought to consider the fairness and the need of having some carry-over provision for net losses similar to that which was introduced in the 1918 act, carried through into 1921 and gradually sloughed off.

6. You have a very commendable feature with respect to the complete liquidation of corporations, and by that device or provision you make unnecessary the resort to a well-known subterfuge, and I should like you to consider the advisability of extending that into the next logical realm, partial liquidation.

7. With respect to your withholding provisions, the attempt to tax those nonresident aliens that to so great an extent escape taxation, I would suggest a flat 15-percent rate, instead of 10 percent, and I would also suggest in addition to the provisions you are not considering, a tax on profits resulting from the sale of securities.

A tremendous volume of securities are actively dealt in by nonresident alien individuals and corporations. The Securities Exchange Commission can give you those figures if you are interested in them.

I know how difficult it is in practice to ascertain the profits resulting from such sales, but it is not an insurmountably difficult task, because of imposing a flat tax as on other income applicable to foreigners, predicated on the arbitrary assumption that 25 percent of the selling price represents profit, with full opportunity to the person involved to prove what the true profit was, some unnecessary revenue losses will be avoided.

I am not prepared to say exactly how much additional revenue must be raised, but I read this morning the statement of the Secretary before this honorable body that in estimating revenue he is pessimistic and in estimating disbursement he is optimistic, which is wise budgetary procedure.

Nevertheless, I think it is lamentable that there is no evidence, intrinsic or extrinsic, so far as the deliberations of the Ways and Means Committee are concerned, that any attempt was made to ascertain whether or not estimated disbursements can be diminished.

I do not doubt at all that such investigation may have been conducted and that the question was considered, but I say it is lamentable that there is no evidence of the fact that such consideration actually occurred.

May I speak for a moment on the constitutionality of the bill before you, and I am not for a moment claiming this bill is unconstitutional in any of its major parts.

The CHAIRMAN. Doctor, are you a lawyer?

Dr. KLEIN. Yes, sir.

The CHAIRMAN. Some people who are not lawyers like to speak on constitutional questions, is the reason I ask.

Dr. KLEIN. I will not argue with anyone who claims it is constitutional. I do not know, and no modest man knows, since the recent surprises that have come to you from a place not far from this room. Even so sound a lawyer as Mr. Kent cannot be sure.

But, I say to you, just suppose by the barest, the wildest possibility that this bill turns out in its major part to be unconstitutional; what is the result? You have given up $1,132,000,000 of officially estimated income under existing levies, subject to the widest sort of adjustment by the statisticians I suppose, when they get down with their sharp pencils to refigure it, for something supposed to result in $620,000,000 additional revenue.

I have nothing to say about prophesies of this sort, optimistic or pessimistic, and I realize that history has a way of dealing with

them, but those who are charged with responsibility for enacting this legislation must know they are foregoing a tremendous positively assured income for an income which it is barely possible may turn out to be elusive.

If the Congress is intent on levying a tax on undistributed corporate earnings, there is much to be said in favor of that principle, but, as in so many other fields, the gap between theory and practice is so wide.

As the President first announced the theory, I think it sounded a responsive chord in the minds of many who publicly claim to be opposed to anything that emanates from the White House today, but the Ways and Means Committee found, as you will note, that you cannot apply that principle without modification, without adjustment, without special consideration, which accounts for the actual complexity of the bill.

If you were merely intent upon producing a bill of a few lines it could be very simple, but it would likewise be unfair. One must concede that the endeavor to modify the harshness of the original provisions as introduced added to the complexity of the measure.

It cannot be gainsaid that this proposed tax will put in a preferred position the opulent corporations, the corporations well-heeled with surpluses from past years.

This result is unavoidable, but the evil effects may be exaggerated by speakers less restrained than I.

The CHAIRMAN. Have you any constructive suggestion as to how we can regulate this so that we can get some fair amount of revenue from them?

Dr. KLEIN. I would not have the temerity to come before this body merely to criticize a measure without attempting to offer constructive suggestions.

Perhaps those suggestions so regarded by me as constructive suggestions may be worse than those before you, but at least they are sincerely offered in the desire to be helpful.

Here is a constructive suggestion: Extend the provisions of the existing law, in sections 102 and 351, retain the existing taxes, modified, as I shall later indicate, and supplement them by an experimental tax on undistributed earnings.

Try it out, and if it works, if it is constitutional, go the whole length if you are thus disposed.

Under existing section 351, as you know, corporations, personal holding companies which fail to distribute at least 80 percent of their net income, slightly adjusted, are subject to a tax that runs from 20 to 60 percent. Extend that, if you will, to the corporations that you seem to have in mind, when you refer to a handful of individuals able to control the destinies of the corporation to their own tax enrichment.

I suppose the Mellon companies would be a splendid example of the type that ought to be brought under section 351.

I should think Mr. Ford's corporation might well be brought within the purview of section 351.

Section 102 of the present law deals, as you know, with mere holding companies and mere investment companies, and with a large

category of other corporations which permit accumulation of earnings unreasonable in size. I doubt very much that the ingenuity of the present administration officials, and that splendid body of technicians who carry on in the Treasury Department, whether appointive officials come or go, cannot put teeth into sections 351 and 102. I should hate to admit their inability in that direction.

As to the experimental levy along the lines of the bill, after your net income, and after a tax on the net income, I suggest that after certain adjustments the undistributed surplus, experimentally it seems to me, might be subject to a very simple schedule of rates, say, 1 percent on the first 10 percent not distributed, 2 percent on the next 10 percent, and so on up to 10 percent on all of such undistributed net income. I submit it would work; it will yield considerable revenue, and it is very much simpler than the rates you have been asked to consider.

The CHAIRMAN. That proposition was presented to us some years ago, but the Senate would not accept it.

Dr. KLEIN. I did not get that, Mr. Chairman.

The CHAIRMAN. I say that principle was presented in a minority report when we happened to be in the minority, but our Republican brothers would not accept it.

Dr. KLEIN. You will not resent my saying that perhaps Congress, as well as the rest of us, develop.

The CHAIRMAN. I am glad to know you think we were right, then, as we are right now.

Dr. KLEIN. You may have been wrong both times and right both times, because times change.

I imagine that big businessmen, and someone today referred to the fact that businessmen might be put in quotation marks, might be happy to accept today what they rejected 3 or 4 years ago.

If you wish to retain the category or classification of corporations set forth in the bill, I suggest the following for the normal ordinary corporation without special problems: A tax of 20 percent on ordinary net income, although I suppose some clients will wish to lynch me when they read of this.

Senator KING. Net income, you mean?

Dr. KLEIN. Ordinary net income as defined in the existing law, deduction to be allowed for capital losses, both securities and capital assets, but in no event to decrease the taxable income by more than 15 percent. That would mean that the 20 percent might drop to 17 percent, but not lower.

That distributions of taxable income in the hands of individuals be also allowed as deductions—and I wish you would follow me closely in this—limited, however, to one-third of the amount of such distribution, and in no event to reduce the tax by more than 25 percent of the amount of the tax.

In other words, this would encourage distributions by corporations by persuasive, commendable, and economic methods. This would encourage payment of three-quarters of the amount of current earnings at a tax benefit to the distributing corporation.

Now, as to personal holding companies and investment holding companies, what I said a moment ago applies, and I shall not repeat myself.

Companies in bankruptcy, and those in other forms of court reorganization proceedings should be subject to a 10-percent tax, although I do not think it makes much difference in the long run whether you say 10 or 90, you will not collect much there, but it looks well, I think, to limit the rate to about 10 percent.

The CHAIRMAN. Mr. Klein, in making these suggestions, of course, you have figured out what the estimate would be in the matter of increased revenue.

Dr. KLEIN. No sarcasm, I know, is intended by your question, but it should have been, sir. Of course, I made no attempt to do so, but I have worked with tax committees long enough to know you have at your beck and call statisticians much abler than I to handle this problem, and who have figures and basic facts which are not available to me.

The CHAIRMAN. Of course, we have to look at the amount of revenue to be derived, as you know.

Dr. KLEIN. I understand. In the days of McCoy he could answer in 5 minutes, but it takes a little longer now.

There ought to be some special provision for corporations that either because of binding contract arrangements or because of statutory prohibitions cannot make distribution: Once again, 20 percent on their net income; once again a limited allowance for capital losses; and once again a similarly limited allowance for (*a*) the distribution which cannot be made under statutes; (*b*) for the distribution which cannot be made because of legal prohibition; (*c*) if you wish, for some limited amount of voluntary amortization of debt as under the present bill, but altogether limited to not more than one-fourth of the basic tax rate.

Something was said this morning by an eloquent witness about the need of encouraging business to reduce unemployment. Here I have a definite, and I hope a constructive suggestion to make.

Billions have been spent by the Government in connection with direct and indirect relief, many millions have been spent in the endeavor to decrease unemployment.

In the heavy-goods industry, while I have no figures to submit, I am quite positive that local, State, and National expenditures in this direction have not attained results which are pleasing to anybody.

My constructive suggestion, therefore, while, of course, I may be wrong, at least deals with an attempt to do something about unemployment where it is the worst today—in the heavy-goods industry.

Suppose you were to permit as a deduction from that same net-income figure to a very limited extent, and at the present time I suggest not more than for 2 fiscal years, of 50 percent of the amount distributed in the first year, and limited so far as reduction of taxes is concerned to 20 percent thereof, or one-fifth, which would be 4 percent; and for the next year also to 20 percent, but this time only with respect to 30 percent, for what is actually spent—not contracted for, but actually spent—by way of replacement and additions to plant and equipment.

I hope that no similar suggestion will have to be made for the next following year.

I now come to a specific revenue-producing proposal. I make the suggestion now in the belief that the bonus legislation, which was referred to at least twice this morning, was enacted because Congress believed there was an overwhelming demand for it.

Why should not the great public be permitted to share in the financing of the precipitated bonus? I shall not go into the philosophy of direct and indirect taxation, but I do submit that if a direct tax was ever justified it is for the support and financing of a measure that seemed to be overwhelmingly popular, and here I have some figures, Mr. Chairman, which I will submit.

The possibility of a tax on salt, which at 1 cent per pound would yield——

Senator KING. Did you say a tax on salt?

Dr. KLEIN. Yes, Senator; but I am not trying to rub it in.

Senator KING. What did that do toward precipitating the French Revolution?

Dr. KLEIN. It brought it about, I believe, so we are told. But I would sweeten it a bit with a tax on sugar.

Senator BLACK. That kind of a tax was not popular in England.

Dr. KLEIN. I am not sure, but I think Senator King's reference to the French Revolution is correct. Let me give you the figure. A tax on salt at 1 cent per pound would be $152,241,480, on the basis of the consumption in 1934. I am not surprised that you are surprised at such a figure.

The CHAIRMAN. Have you figured what part of that tax Utah would bear to the whole amount?

Dr. KLEIN. What is that, Mr. Chairman?

The CHAIRMAN. Have you figured what amount of that tax Utah would bear, as compared to the whole amount, in that salt tax?

Dr. KLEIN. I think Utah would be more interested in the sugar tax, which I will come to next.

Senator BARKLEY. If you tax salt, you will tax salt used for human consumption only?

Dr. KLEIN. Yes; the tax will be something less than the figure I gave, because of refinement. I am not much of a politician, but I think the salt tax is an ideal tax because of ease of administration, although it may be said that it was the primary cause of the French Revolution, to which reference has been made.

Senator KING. Why don't you put it on tea?

Dr. KLEIN. We will come to that later. I also do not drink tea. Because of the fact, per the Statistical Abstract for 1935, that there were less than 100 domestic corporate producers of salt, the tax could be very easily levied at the source.

To come to the next point, sugar, both that which is produced domestically, as well as that which is imported at 1 cent per pound would yield $130,000,000, and the tax could be easily collected either at the point of import, with respect to foreign sugar, and at the domestic refineries on the domestic sugar.

A tax on coffee at 5 cents per pound, according to the 1935 figures of consumption, would yield $75,000,000.

Now coming to tea, no matter how high you place the rate, you cannot get much from it. At 20 cents a pound, it would be only $19,000,000, based on the 1934 consumption.

Now, I come to a subject that Senator Hastings, I think, would be interested in. This is the question of intercorporate dividends.

The CHAIRMAN. Why would Senator Hastings be interested in it?

Dr. KLEIN. I will make that clear. In the hearings on the 1935 act, and I go by the record now, Senator Hastings refreshed the recollections of his colleagues by referring to the fact that when the so-called utility death bill was under consideration he or somebody else had stated that if you are going to compel the break up of these pyramided structures—and I hold no brief for them; they are abominations in many respects—that there ought to be some tax easing out of the situation, and, as I recall, it was in the Senate, and not on the other side of the Capitol, that section 110 was introduced, amending section 112 (b) of the 1934 act, which permitted, as I recall it, a tax-free break-up through liquidation if consummated within a 5-year period.

At this point I think I should say that the record ought to be corrected, because, without intention, misinformation was given to the committee regarding the subject now under discussion.

Under the provisions of section 27 (j) (4) of the bill before you, if a corporation distributes its income to the controlling corporation—that is, from corporation B to corporation A—and if A owns more than 50 percent of B, the distributing corporation may not reduce its tax because of that dividend distribution, and if you have a chain of corporations, there is a similar loss at each step in the process, at a diminishing percent, but eventually you do approach a figure which approaches, although you cannot reach entirely a zero balance of income left for the ultimate stockholders.

I submit, and this is what I thought Senator Hastings might be particularly interested in, that of those corporations that have availed themselves of your invitation of last year to disappear from the scene as pyramids and started to liquidate, which must take some time, of course, they ought not to be subjected to this penalty.

Certainly a corporation series or group of corporations integrated in this fashion, which takes all of its earnings and passes them rapidly through the group to the top company, which makes a distribution, all within the tax year in which it was earned, ought not to be subjected to this penalty, because, after all, even under the bill all you intend to do is to tax the earnings once, if not distributed, and I submit that the harsh result was surely not the intendment of those who drafted this provision. They worked under such pressure they really could not foresee all of the consequences, which, of course, is human.

Senator KING. Have you prepared an amendment which will obviate the evils of which you complain?

Dr. KLEIN. I am a very poor draftsman, but I would be glad to submit what I think will do so.

The CHAIRMAN. All of our draftsmen, and they are taking down notes.

Dr. KLEIN. I am sure of that. Here is something else for which my Society is not responsible, but you may welcome it. I think the Treasury as well as you will admit that as the tax burden becomes more onerous there is greater conflict between the taxgatherer and the potential taxpayer, and that accounts in some degree, if not

entirely, for the large number of American-owned foreign corporations. I have not the statistics on the number, and nobody really has. They do business without paying any tax on their profits except to the extent it is American business and it is discovered, and, strange as it may seem, upon the death of the stockholders in such corporation, you wipe the slate clean, and all of that increment of income escapes taxation.

I submit that somewhat along the line of section 112 (b) (6) of the bill you might well enough provide for the return of such American-owned foreign corporations under terms which would not make the return too onerous, and thus bring them within the control of the taxing authorities, and I make two constructive suggestions:

(1) If the corporation is broken up and the assets taken down, to subject the profit to a flat tax, and I submit 12.5 percent merely for the sake of discussion; and

(2) That where an American company is established, or is already in existence, which takes down such assets, it should be permitted to do so under the terms and conditions similar to those which you introduced in the 1935 act with respect to the liquidation of pyramided corporations.

I now come to the very last suggestion, and it is this: You will not get a perfect tax bill whether you try to do the job in a week or in a year. The measure before you now requires tremendous revamping both for administrative and for fiscal reasons, in my opinion.

I suggest that instead of trying to tinker with this law at this time, and that is all you are doing, you are not making an effort at complete revision that a joint congressional committee be appointed to study the entire subject of tax legislation, with the purpose which is more necessary today than it was 3 or 4 years ago, for more effective cooperation between the State taxing bodies and the national legislation and administration, and meanwhile, provide for emergency revenue, because, whether we like it or not, revenue must be raised. That cannot be left open, and it is nobody's fault that you are confronted with this situation.

Senator KING. Would you support the resolution I offered in the Senate some time ago to have the President of the United States confer with all of the States and have the State and Federal Government appoint a body—delegate ambassadors, or whatever you may call them—for the purpose of working out a plan as far as possible for the coordination of the State and Federal Government so that there would not be duplication in taxation as it now exists; but nothing has been done about it.

Dr. KLEIN. I am in entire accord with you on that, Senator, and I venture to say that sooner or later all will come to you on that.

Senator KING. Mr. Graves, a very able tax man of New York, and others, met here about a year ago and examined the proposition.

Dr. KLEIN. Yes; I know him very well; he is a splendid official.

Senator KING. And I thought they were going forward with the plan to bring about such a conference.

Dr. KLEIN. I cannot speak off the record, so therefore it will have to be on the record, that New York is a little timid about that, because I am sure that while it is accidental—but whenever we pool

our revenue from the States the State of Texas seems to get a larger proportionate share than New York.

Senator BLACK. May I ask whether New York sells anything to Texas on which they make a profit?

Dr. KLEIN. Yes; but they would like to sell more. You cannot get me to argue about Texas, because I have a soft spot for that State.

Senator BLACK. I understood you to say that Texas got more than New York and I wanted to know whether New York got anything in the way of profit on the things produced and sold in Texas.

Dr. KLEIN. Yes; but I think that distribution of pooled funds is likely to be on a geographical rather than on a population contributing basis.

Senator BLACK. You think it is geographical?

Dr. KLEIN. Sir, you have got me all wrong; I am really praising Texas.

Senator CONNALLY. In New York you regard Texas as one of the richest suburbs of New York City.

Dr. KLEIN. Not for plucking, if that is what you mean.

Senator CONNALLY. You have plucked them so bad that there is not much left now.

Dr. KLEIN. You cannot get me to argue against Texas because as I said I have a soft spot for that State. I am through now in a few seconds except for your questions, if you have any to ask.

My final suggestion is that as to temporary emergency revenue we should be restricted to an essential minimum to provide for the current and for the next fiscal year while this entire problem shall be investigated. Meanwhile additional emergency revenue should be sought from one or more of the following sources: Increased rates on corporate incomes and I have indicated what I think might be a fair figure; increased normal rates on individual incomes, 1 percent and surely not more than 2 percent; reduced personal exemptions somewhat above the British level; subject dividends received by individuals and to some extent by corporations, to the normal tax; assure tax from nonresident aliens and nonresident corporations; a small unit tax on one or more of the commodities I have referred to, and the chances are you will be able to select the commodities which will lend themselves to this sort of taxation much better than I.

The CHAIRMAN. Thank you very much, Mr. Klein. Your discussion has been very instructive, and we will have included in the record at this point the brief submitted by you.

(The brief referred to is as follows:)

THE AMERICAN SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS,
Washington, D. C.

MEMORANDUM PREPARED FOR SUBMISSION TO THE FINANCE COMMITTEE OF THE SENATE RE REVENUE BILL OF 1936

The revenue bill under discussion deals with a number of matters, but I intend to restrict my remarks to the income-tax features. What I am about to submit represents my views as chairman of the committee on Federal legislation of the American Society of Certified Public Accountants, views which, in the main, except where otherwise indicated or implied, are shared by the board of directors and by my fellow committeemen.

Besides criticism of selected provisions of the bill, specific and detailed constructive suggestions are offered and, in addition, there are presented for consideration specific as well as general changes and modifications and a fundamentally different approach to immediate as well as long-range revenue-law revision. All of this is arranged in 15 sections.

Respectfully submitted.

JOSEPH J. KLEIN,
Chairman, Committee on Federal Legislation, the American Society of Certified Public Accountants.

Committee on Federal legislation.—Howard C. Beck, Washington, D. C.; Howard S. Bell, Spokane, Wash.; Gilbert F. Dukes, Mobile, Ala.; James J. Fox, Boston, Mass.; Elsworth L. Fulk, Lincoln, Nebr.; Gilbert B. Geiger, Peoria, Ill.; John S. Glenn, Nashville, Tenn.; Horace P. Griffith, Philadelphia, Pa.; James E. Hammond, San Francisco, Calif.; John T. Madden, New York, N. Y.; Douglas S. Meaden, Cleveland, Ohio; Allen Redeker, Denver, Colo.; Frank A. Shallenberger, Baltimore, Md.; T. Dwight Williams, Oklahoma City, Okla.

Executive committee.—William D. Morrison, Denver, Colo.; Harry M. Jay, Memphis, Tenn.; Durand W. Springer, Washington, D. C.; William C. Heaton, Elizabeth, N. J.; Henry J. Miller, New Orleans, La.

1. ALLEGED SIMPLICITY OF THE REVENUE BILL

The President, in his message to the Congress on March 3, 1936, indicated additional revenue needs. He invited the attention of Congress to the revenue-raising possibilities of a tax on undistributed corporate income. He said of this proposal:

"Such a revision of our corporate taxes would effect great simplification in tax procedure, in corporate accounting, and in the understanding of the whole subject by the citizens of the Nation. It would constitute distinct progress in tax reform."

As a representative of the American Society of Certified Public Accountants, I am not here to discuss tax reform per se, nor whether or not the proposal constitutes real or desirable reform. I do, however, refer to the experience of the Committee on Ways and Means in its attempt to apply the apparently simple principle advocated by the administration and submit, as a representative of a group which has been familiar with principles and practices of Federal income taxation since 1909, and which has been privileged to serve both the Government and the taxpayer, that the precise proposal now under consideration by the House and by this committee is decidedly not simple.

Competent students of taxation were shocked at a first reading of the bill. In my own experience with American and foreign taxation and with national and local taxation, I know of no taxing measure that approaches the present bill in apparent as well as in actual complexity. In my opinion, the present bill cannot be made really simple. I venture the guess that if the country were ever unfortunate enough to be subjected to taxation under any such bill, as the one under consideration, whether or not the proposed "windfall tax" provision therein contained would prove fruitful of revenue, accountants and tax practitioners would find in the legislation a veritable windfall, for I doubt very much that many corporations, unless served by professional accountants and tax experts, would risk undertaking to determine the tax under the terms of the bill.

I should be the first to concede that the message of the President, in its reference to a tax on undistributed corporate income, was set forth in simple and understandable terms. The members of this committee are aware, however, through wide experience in the drafting of revenue legislation, that a precise and detailed tax measure, capable of wise, equitable, and effective administration throughout the land and under the diverse conditions and situations which exist, cannot be brief and simple if it is to avoid unintended hardship and harsh discrimination. Although we have become accustomed to complex revenue laws, all our past experience has not prepared us for what is now proposed as a substitute for existing law. But it is hardly necessary to labor the point. A few valiant voices on the other side of the Capitol have publicly acclaimed the bill under discussion as simple in composition and easy of application. I shall leave to others, less mild-mannered than the speaker, just characterization of the assertion.

There comes to mind the procedure of the College of Cardinals when a new pope is to be elected. It would be cruel and inhuman punishment to test the alleged simplicity of the proposal by inviting Congressmen who voted for the bill to apply the rate formulas to typical problems. If these Congressmen were placed in solitary confinement and deprived of food and drink until they had solved successfully one of several typical problems which I am prepared to submit, it is a safe guess that they would never again legislate on this earth.

II. A GENERAL SURVEY, WITH ESPECIAL REFERENCE TO COMMENDABLE FEATURES OF THE BILL

Aside from the complexity of the bill which, if its philosophy is to be adopted, is inevitable in the attempt to avoid undue harshness, the proposal has some commendable features which deserve praise. On the other hand, there are grave reasons why the bill should not be approved, and these I intend to present as concisely as possible in fulfillment of the desire of the American Society of Certified Public Accountants to continue its constructive aid to the legislative and administrative branches of the Government.

Among the commendable features of the bill, for procedural or substantive reasons, or for both, are:

1. A flat 15-percent tax (in lieu of the complicated levies under sec. 13) on selected corporations such as banks, insurance companies, foreign corporations not doing business in the United States, and, most especially, companies in receivership and "deficit" corporations.
2. In principle, the provisions (possibly unnecessarily complicated) which are intended to lighten the tax burden on corporations with prior deficits, those prohibited by binding agreement with creditors from disbursing earnings, and debt-ridden corporations which wish voluntarily to amortize their debts.
3. Early elimination of the capital stock and excess-profits taxes.
4. Subjecting dividends to the normal tax, despite the theoretical equity of offsetting the exact amount of corporate taxes paid prior to distribution (as was the case under the 1913 and 1916 acts) by an equivalent exemption to the recipient stockholder.
5. The dividend "carry-over" provision. (It is unfortunate, in view of the heavy taxes proposed, that a similar carry-over of net losses was not incorporated through a simplified version of sec. 204 of the 1921 act and in the spirit of the corresponding British tax procedure.)
6. Liberalization of provision dealing with the tax incident to complete liquidation; the provision should be extended to the two types of partial liquidation.
7. Extension of withholding provisions to cover dividend payment. (For myself, I suggest a flat rate of 15 percent (instead of 10 percent proposed for individuals) on income of nonresident alien individuals, corporations, partnerships, and other entities, without business activity in the United States.)

Criticism of the bill, together with constructive recommendations, will now be stated very briefly.

III. SOUND LIMITATION ON REVENUE INCREASE

While it is realized that current expenditures of the Government should be met currently, and while no competent person would advocate the meeting of operating expenses by increased deficits, at the very threshold of our inquiry as to the amount of additional revenue required, we are struck by the absence of any reference to curtailment of expenditures. Accountants have had considerable budgetary experience. In this field they have assisted governments and private industry. In their own recent domestic economy, they have also been confronted with the problem of budget balancing. Professional accountants would be chargeable with gross negligence if, in dealing with budgetary problems, they did not study and examine the disbursement phase of the budget. Accountants viewing the amount of increased taxes sought to be raised by the bill cannot withhold comment that it is lamentable that there is no evidence whatsoever that any attempt has been made to minimize the need of increased taxation through curtailment of expenditures. Although it is undesirable that the invalidization of the processing taxes and the acceleration of the bonus payment unbalanced the ordinary budget, it is submitted that Congress should endeavor to reduce current revenue needs, as far as is possible, by reduction of expenditures, and restrict additional taxes to make good that portion of the precipitated deficit which cannot be met by elimination and

reduction of expenditures. Such additional taxes should be temporary levies and should not be made a part of our permanent tax system.

IV. ALLEGED JUSTIFICATION FOR INCREASING CORPORATE TAXES

Among the reasons which I have heard advanced in justification of the proposed tax on undistributed corporate net income was one which has a popular appeal. It is that, aside from the question of additional revenue needs, the advantages and privileges of corporations, as compared with partnerships and sole proprietorships, amply justify a heavier tax; also, that, in the past, corporations have enjoyed tax benefits denied to partnerships and sole proprietorships. Let us look at the record:

From 1909 to 1913, corporations were subject to a Federal excise tax, although it was not until 1913 that individuals became subject to income tax. During 1918, corporations were subject to a combined income tax and excess-profits tax which attained a maximum of 82.4 percent; the corresponding maximum tax applicable to individuals was 77 percent. However, dividends distributed by corporations (which, as stated, might have paid a maximum of 82.4 percent) became subject to surtax in the hands of recipient stockholders up to a maximum of 65 percent, or to a combined tax of 93.81 percent. Corporations were also, of course, subject to Federal and State taxes on capital. During later years, the tax on individuals, relative to that on corporations, became higher, so that it is true that in many instances there was, and still is, tax economy in conducting business as a corporation. There is economic justification for some differentiation, because a stockholder of a corporation does not actually enjoy corporate profits until they are made available to him, as was recognized by the Supreme Court in *Eisner* v. *Macomber* (252 U. S. 189). However, merely from the viewpoint of Federal, State, and local taxation, advantages no longer exist in favor of conducting small enterprises in corporate form.

V. CONSTITUTIONALITY OF THE REVENUE BILL

Speaking for myself, may I venture to assert that it takes considerable ingenuity to formulate an unconstitutional law taxing corporations? While the constitutionality of revenue acts has never been attacked because of the presence of two redundant and almost unusable tables of rates, challenge has been based on alleged lack of required uniformity of burden, on the creation of irrebuttable presumptions, and on other grounds; other Federal legislation has also been attacked on the ground of improper delegation of authority because of conflict with the due-process clause, and because of arbitrariness and discrimination.

The members of the accounting profession do not pose as experts on constitutional construction. There are elements in the bill, however, which warrant concern about constitutionality. It is somewhat questionable whether a tax which requires the mathematical calculation which this bill imposes on the taxpayer would find support in the courts, especially if the trier of the issue attempted to calculate the tax. More important, however, I might direct your attention to that provision of the act, in section 10, which makes the Commissioner's decision final, that is, irrebuttable. I am in some doubt as to whether the courts would sustain a palpably arbitrary decision by the Commissioner when the available facts clearly negatived the correctness of his conclusion. Quite evidently, too, the tax is not measured by either gross or net income, but on a radically different basis. Also, there is manifest discrimination, possibly too arbitrary, among classes of corporations. What the attitude of the courts will be with respect to such a levy accountants are not called upon to attempt to prophesy.

I do not wish to be misunderstood; I do not claim that the bill before you is unconstitutional in any of its parts; I do venture to indicate, however, that congressional enactments much simpler in import than the one before us have been held unconstitutional by the High Court, recently and dramatically enough to be in the minds of all of us.

VI. WHY RISK THE LOSS OF APPROXIMATELY $1,000,000,000 PER ANNUM

The existing levies on corporate income are as follows:

1. The ordinary income tax, ranging from 12½ percent to 15 percent (prior thereto at 13¾ percent), which, together with the tax on a consolidated income

basis, and the surtax under sections 102 and 351, yielded $572,117,876 during the last complete fiscal year which ended June 30, 1935, and collections under which during the present fiscal year have been $125,275,922 greater than during the corresponding 9 months of the preceding year.

2. The capital-stock tax at the rate of $1.40 per $1,000 of declared valuation which, at the $1 rate imposed under the 1934 act, yielded $91,508,121 during the last complete fiscal year which ended June 30, 1936. Collections at the higher rate during the first 9 months of the current fiscal year have been $93,080,878, an increase of $3,193,172 over the corresponding period of 1935.

3. The excess-profits tax at 6 percent and 12 percent on income in excess of the amounts freed from the levy because of the capital-stock tax which, at the 5-percent rate then in effect, yielded $6,560,483 during the last complete fiscal year ended June 30, 1935. $10,000,000 was the estimated yield for the current fiscal year, per the 1935 report of the Secretary of the Treasury.

4. The surtax under section 102 for unreasonable or improper accumulation of surplus, at 25 percent and at 35 percent, and the surtax on "personal holding companies", under section 351, at rates ranging from 20 to 60 percent. The yield from these sources has not, so far as I know, been published separately, but it is undoubtedly available to the committee, as it is the estimate for the current year. This levy is retained in a limited form, as is also the surtax on "personal holding companies."

The total yield from all taxes on corporations for the last fiscal year which ended June 30, 1935, was $670,186,480; collections for the current year are running ahead of those for last year by approximately $131,000,000. (If business continues to improve, it is reasonable to expect correspondingly higher yields from the sources under discussion. Indeed, the Statistician of the Treasury has estimated that all corporate taxes for 1936, if the existing law remains unchanged, would amount to $1,132,000,000.)

In considering the revenue bill, consideration must, of course, be given to the proposal that, save for the temporary retention of the capital-stock tax at half the existing rates and the temporary retention of the excess-profits tax, reasonably assured income of over $1,000,000,000 is to be abandoned, in the belief that the complicated and novel measure under discussion will yield a permanently increased revenue of $620,000,000 per annum from the proposed levies on undistributed corporate income and from the proposed increased income tax on dividends received by individuals, which are to become subject to the normal as well as to the surtax. Fellow accountants with whom I have seriously discussed the matter, while hesitating to criticize official estimates, agree with me that it is quite impossible to exaggerate the unavoidable hazards of relying on estimates of yield from so novel a measure as the pending revenue bill.

Suppose, just suppose, that the Supreme Court were to decide that the new tax law is unconstitutional. Personally, I shall not argue with anyone who claims that the risk of such a decision is immeasurably slight, nor do I suppose that anyone of competence would unqualifiedly assert that under no circumstances is it conceivable that the High Court might find the proposed bill in its major provisions, invalid. Whether the Schechter (N. R. A.) and the Triple A (Hoosac) decisions were or were not catastrophic in their effect is quite beside the point; a final decision holding unconstitutional the proposed levy on corporations would work unthinkable injury to our national finances.

To me it seems abundantly clear that those who are charged with the responsibility of revenue raising would not early assume the constitutional risks inherent in the proposition. Fortunately, as I shall at once proceed to show, it is entirely unnecessary to assume such risks.

VII. A SHORT-SIGHTED FISCAL POLICY

Witnesses before the Ways and Means Committee have clearly indicated that the fiscal policy of corporations which resulted in the creation of surpluses during profitable years alone made possible dividend disbursements during lean years. In the teaching of economics and corporate finance, the principle of profit conservation for dividend-stabilization purposes has long been regarded as sound doctrine.

Recently, the National City Bank of New York, on the basis of Treasury statistics, showed that during the period from 1921 to 1933, while the average annual reported net income for all corporations amounted to $3,200,000,000,

dividend disbursements during the same period averaged, $3,900,000,000 per annum. More significant was the showing that during 5 of these 13 years dividends were distributed, either in the absence of net income or in amounts substantially in excess of net income. Thus, during 1930, the first full year of the depression, dividends aggregating $5,600,000,000 were paid by corporations which, during that period, reported net earnings of only $1,400,000,000. In that year, for example, the corporate income tax rate was 12 percent; without adjustment for the deficits of corporations which were taken into account in the determination of the aggregate net income, and on the assumption that the conclusions predicated on the statistical data employed do not require substantial adjustment, the Treasury would have foregone collections of over $168,000,000 had no tax been levied, as is proposed in the revenue bill, on corporations which had distributed all of their corporate earnings. At best, to waive taxes of corporations which distribute all of their current income manifestly would exempt from tax, during certain lean periods, many large companies with substantial income; to reduce the tax of dividend-paying corporations proportionately to the ratio of dividends paid to net income would similarly benefit many companies amply able to meet tax obligations.

Moreover, if Congress is to embark on the policy of taxing current corporate income on the basis of the amount retained, it should be clear that while temporary collections will be greater, during periods of business recession three evils will be superimposed on those which are inevitably associated with depressions: (*a*) The amounts distributed by corporations will be less because their reserves will be less; (*b*) dividends received will be less, the tax on these dividends will be less, and stockholders will have less to spend when spending is most necessary; (*c*) those corporations which are conducted profitably despite the business recession (and there are some) will pay no tax on their profits at a time when the Government needs income most, because of the probability that these corporations will distribute most, if not all, of their earnings.

An analysis of the normal probable effect of the proposed bill appears to justify the conclusion that it embodies a short-sighted fiscal policy—a policy which attempts to collect in taxes more than the traffic will bear, without concern for the fiscal needs of the morrow. Legislation so conceived lacks the essential qualities of statesmanship and is without vision.

VIII. INFLUENCE ON CORPORATE FINANCING AND GROWTH

If the present bill represents a permanent attitude of Congress toward corporate taxpayers, financing through bond issues will inevitably be discouraged, because it will become increasingly difficult to assure bondholders of the established mode of protection to which they are entitled. Provision restricting dividends so long as bonded obligations exist, and adoption of a policy of amortization (thus interfering with the free use of earnings for dividends on common and preferred stock) will be hindered because of the penalty on retention of earnings. And as one regards this problem one cannot be unmindful of the history of taxation here and elsewhere. A tax tends to became crystallized; the temptation to increase rates becomes irresistable; hence, whatever the evils in the proposed bill may be, such evils tend to become greater as the needs for increased revenue arises. It is for this reason, among others, that constructive criticism of the measure should be free and unrestricted.

Now, as to the growth of corporations. It is almost too manifest for argument that corporations which, in the past, have built up large surpluses will, through the inevitable effect of the tax policy incorporated in the bill, be tremendously advantaged in competition with corporations that have no surpluses or deficits and with newly created enterprises. Surely, the framers of the revenue bill could not have intended any such boon to the opulent corporation.

IX. SAFER EXPERIMENTATION

If Congress decides that it really wishes to experiment with a general tax on undistributed income, two perfectly safe alternatives are available: (1) Extension of existing sections 102 and 351; (2) Continuation of existing taxes supplemented by a minor (experimental) tax on undistributed corporate income.

(A) ***Extension of existing sections 102 and 351.***—Under section 351 of the existing law, a surtax is levied on incomes of personal holding companies.

This is in addition to the normal tax on the statutory net income of such corporations, levied at the rates applicable to ordinary corporations. The statutory net income is adjusted in the manner clearly set forth in the law, and the excess of such adjusted net income over dividends paid during the taxable year and after a 20-percent reserve and a reasonable reserve to retire indebtedness incurred prior to 1934 is subject to a graded surtax ranging from 20 percent to 60 percent.

To the extent of the validity of the criticism directed against corporate management, namely that because a few stockholders are in control, income is permitted to accumulate unreasonably and unnecessarily, the definition of personal holding company could probably be modified so as to cope with major abuses. Surely, if the criticism is predicated on the conduct of a relatively few corporations which are controlled by a handful of stockholders, that fact hardly justifies such radical change in our taxing system as is contemplated in the revenue bill.

Section 102 of the existing law deals with mere investment and holding companies, regardless of the number of stockholders, and with other ordinary business corporations which are used or availed of for the purpose of accumulating unreasonable surpluses. While it is understandable that the Treasury has experienced difficulty in enforcing the provision generally, except with respect to mere holding and investment companies, I wonder if the ingenuity of those now charged with fiscal responsibility could not suggest more effective administrative provisions than those contained in the present statute. I suggest that officials both of the Treasury and of the joint congressional committee be urged to make appropriate recommendations. For myself, I am not prepared to concede that enforcement of the principle of section 102 is impossible.

(B) *Continuation of existing taxes supplemented by a minor (experimental) tax on undistributed corporate income.*—If it is to be assumed that Congress is determined to experiment with a tax on retained corporate earnings, I suggest that the existing corporate levies be continued; that if other alternatives are not acceptable, a flat corporate income-tax rate be imposed slightly higher than the existing maximum graded rates; that the normal tax be made applicable to dividends received by individuals; that the normal tax on individuals be increased by one or at most by 2 percent, or that the specific exemptions be moderately reduced; and, in addition, that a very moderate, simple, and experimental tax be imposed on undistributed corporate income.

I suggest for discussion a tax of 1 percent on the first 10 percent of retained net income (determined by deducting from ordinary net income the applicable income tax thereon, capital losses not deductible in calculating ordinary net income, and taxable dividends disbursed during the dividend year), 2 percent on the next 10 percent with similar gradations until a maximum of 10 percent on the final 10 percent of retained net income has been reached.

There may be some question as to the constitutionality of any levy on retained net income because it is neither on gross income nor on true net income, but the chances are that such a tax levied on corporate taxpayers would survive the constitutional test. But even if the levy were eventually held unconstitutional, no great harm would ensue. On the other hand, if the levy were found to be constitutional, Congress could safely, if it so decided, later embark on a wider and more comprehensive plan of taxing undistributed net income.

X. SIMPLIFICATION OF THE REVENUE BILL

If Congress is determined on enacting a general tax on undistributed net income of corporations, simplification of the revenue bill should be sought, even at the expense of theoretical (but never completely attainable) equitableness. Why, for instance, should Congress wish to avoid "income brackets" for corporations and retain them with respect to individuals? Insofar as the revenue bill undertakes to tax ordinary business corporations, it is primarily on the basis of the retained net income, a concept which is quite different from taxable net income as it has developed under the present series of income-tax laws. That concept, however, is the basis of the surtax under sections 102 and 351. Perhaps the basis for acceptable compromise may be found in the following relative simple tentative proposals in which the suggested tax on retained net income is based on net income and specified deductions therefrom:

(1) Applicable to ordinary corporations without special problems.

(a) Deductions to be allowed for capital losses not taken into consideration in the determination of ordinary net income but in no event to decrease the ordinary net income by more than 15 percent thereof;

(b) Deductions also to be allowed for distribution of earnings taxable in the hands of individuals, limited, however, to one-third of the amount thereof, and in no event to decrease ordinary net income by more than 25 percent thereof.

If the maximum deductions are taken, the net tax will be equivalent to 12 percent of the ordinary net income; ordinary dividend distributions up to three-fourths of the amount of net earnings will be encouraged without unreasonable harshness or questionable validity or undesirable economic consequences; and the yield from taxes on individuals will be increased. Under the provisions of the revenue bill, if 75 percent of current earnings are distributed, the tax on net earnings would be about 4 percent for ordinary corporations with incomes up to $[illegible],000 and 7¾ percent for such corporations with incomes over $40,000; the corresponding tax herein proposed is 15 percent.

(2) Applicable to personal holding companies: Continue the surtax under existing section 351, with rates provided in existing section 102, and continue the existing normal tax on such corporations, or, preferably, substitute a flat tax rate.

(3) Applicable to mere investment or holding companies: Same as tax proposed for section 351 corporations above.

(4) Applicable to corporations in bankruptcy or in court reorganization proceedings: A tax of 10 percent on the ordinary net income.

(5) Applicable to corporations with statutory and/or binding legal restrictions on payment of dividends:

(a) A tax of 20 percent on ordinary net income.

(b) Deductions to be allowed for capital losses not taken into consideration in the determination of ordinary net income, but in no event to decrease the ordinary net income by more than 15 percent thereof.

(c) Deductions also to be allowed (*i*) for distributions of earnings taxable in the hands of individuals, (*ii*) to the amount of current net earnings which, pursuant to statutory requirements, cannot be distributed as dividends; and (*iii*) for the amount of current net earnings which, pursuant to binding written agreements between the taxpayer and its creditors in existence on or before March 3, 1936, cannot be distributed as dividends; the aggregate deductions hereunder limited, however, to 50 percent of the aggregate amount thereof, and in no event to decrease ordinary net income by more than 25 percent thereof. The proposed provision for including among deductions item (*ii*) accomplishes part of the evident purposes of section 14 more simply; it is also more equitable.

XI. ENCOURAGEMENT OF CAPITAL DISBURSEMENTS

It is a trite observation that in the framing of a revenue measure economic conditions should, as far as possible, be taken into consideration. Many observers agree that the continuance of the existing economic derangement is due partially to the persistent volume of unemployment, and that unemployment is most severe and distressing in the so-called heavy or durable goods industries. In the endeavor of the administration to remedy this situation during the past 2 years, among the billions disbursed for direct and indirect relief, many millions have been spent to decrease unemployment in the heavy industries. Discounting adverse and unfriendly criticism and allowing for faulty labor statistics, it is nevertheless unfortunately true that improvement in these industries appears not to have been commensurate with the amount spent by Federal, State, and local governments. I am too well aware of how history manages to ignore prophecy, whether optimistic or pessimistic, to assert without the utmost qualification that, in my opinion, democratic government is in danger unless business and industry cope successfully with this problem of unemployment. The question then becomes: How, if at all, can taxation most effectively cooperate? I offer for the consideration of the committee a proposal that disbursements for replacement of, and additions to, plant and equipment be, to a very limited extent and during a relatively brief period of time, permitted to decrease tax liability. The effect should be in line with Government policy. My tentative suggestion, primarily for consideration and discussion, is as follows: That, applicable to the taxable year 1936, disbursements made (and not merely obligations incurred) for plant and equipment replacement and additions actually installed shall be allowed as a deduction from ordinary net income to the extent of 50 percent of the amount of the disbursements, but not in excess of 20 percent of the ordinary net income; that, applicable to the taxable year 1937, such disbursements shall be allowed as a deduction to the extent of 30 percent of the amount of the disbursement, but not to exceed 20 percent of

ordinary net income. I trust that no similar provision will be necessary, desirable, or expedient for the taxable year 1936.

The suggested proposal under any given set of rates, under existing law or regardless of the type of new revenue legislation which may be enacted, would unquestionably result in decreased revenue; the estimated loss need not be provided for by increased basic tax rates or otherwise, because of the probability that improved business and increased employment in the heavy-goods industries would result in increased corporate and individual taxable incomes, and because such prospectively increased employment would at least correspondingly reduce the Government's responsibility for emergency relief.

During the past 2 years, taxpayers have been permitted deductions for depreciation at substantially lower rates than those which were allowed theretofore. The tax effect of this policy, as administered under Treasury Decision 4422, which was promulgated on February 18, 1934, is indicated in the reports of the Commissioner of Internal Revenue for 1934 and 1935. From March 15 to July 15, 1934, a total of $248,831,043 of claimed depreciation was disallowed, resulting in increased taxable income of $242,424,222 and recommended deficiency assessments of $29,889,304. For the full fiscal year 1935, the total disallowed for claimed depreciation deductions was estimated at $288,081,928, the resultant additional tax at $351,916,414, and the amount of such additional tax agreed to by taxpayers at $25,032,112. The slower depreciation write-off has undoubtedly tended to delay plant replacement. When a capital account on the books has been nearly written off, replacement reserves are correspondingly large and management is not as prone to hesitate to make replacements as when machinery still in use appears on the books at a relatively greater value. This retardation in replacement has undoubtedly had some appreciable effect on increased unemployment in the capital-goods industries. The suggestion for temporary allowance of a limited part of the cost of replacement and additions is, in addition to the other reasons advanced, predicated on the existing depreciation allowance policy.

XII. FINANCING THE ACCELERATED BONUS

The President's message advised Congress that from $120,000,000 to $160,000,000 would be required annually for the next 9 years to amortize the cost of the recent bonus legislation; in the specific recommendation $120,000,000 was the figure employed. Speaking in what follows for myself alone, I feel that it is a fair assumption that the bonus legislation was enacted because Congress believed that there was an overwhelming, popular demand therefor. It is unthinkable that Congress should wish to have the electorate know exactly how and to what extent and by whom the burden of financing the cost of the bonus legislation is borne? If a direct tax is ever justified or expedient, the financing of popular legislation would seem to provide the occasion. For this reason, I invite your attention, without recommendation, to the desirability and expediency of having the cost of the recent bonus legislation borne by popular subscription, as it were.

In this connection, I direct your attention to the fiscal possibilities of a tax on salt. Production of salt in the United States, during 1934, amounted to 7,612,074 short tons; a tax of 1 cent per pound would be equivalent to $152,241,480. Not all of the salt produced is of the table variety, of course, and the tax could be so calculated as to be equivalent to 1 cent per pound on the refined product, with the resulting tax somewhat less than the figure given. A salt tax, if levied at the point of origin, would not create substantial administrative problems because the number of domestic producers, per the statistical abstract for 1935, is less than 100.

Naturally, any commodity tax which Congress might decide to impose would avoid the constitutional pitfall which proved the undoing of the processing tax.

Primarily for the purpose of reminding you of their tax potentialities, I shall also refer to three other commodities which, at least administratively, also lend themselves to simple levies.

The domestic consumption of sugar during 1935 is given as 6,632,516 short tons. Much of this sugar is imported. If a tax of 1 cent per pound could be levied at the import point and, with respect to the domestic product, at the refinery, the yield would approximate over $130,000,000.

The import of coffee into the United States during 1935 amounted to 1,504,770,000 pounds. A tax of 5 cents per pound, administratively easy of collection as an import duty, would yield about $75,000,000.

If coffee were subject to tax, tea should also be taxable. The import of tea during 1933 amounted to 95,705,000. A tax of 10 cents per pound would yield about $9,500,000, while a tax of 20 cents per pound would yield about $19,000,000.

XIII. TREATMENT OF INTERCORPORATE DIVIDENDS

In the 1935 act, by section 102 (h), 10 percent of dividends received by a corporation from a domestic corporation was made subject to the normal tax. In the same act, by section 110, the break-up of pyramided corporate structures was encouraged by permitting tax-free liquidations over a period of 5 years. In the bill under consideration, by section 27 (j) (4), intercompany dividends are subject to maximum taxes, even though the passage of the dividend to the parent unit is expedited and the top corporation makes immediate disbursement to its stockholders. Speaking for myself and not for my committee (which was not consulted about the matter), I feel that the inevitable result could not have been intended. Punitive taxes directed against corporations frequently hurt innocent stockholders. I believe that the minimum change should exempt from the application of the subsection (1) corporate groups which are in process of statutory liquidation under section 112 (b) (6) of the bill, and (2) group intercompany dividends which are distributed to others than controlling corporations during the "dividend year" in which received. These corporate groups should not be forced to seek lawful means of escape, such as is indicated, for example, in section 27 (j) (3) of the bill.

XIV. SPECIAL PROVISION FOR AMERICAN-OWNED FOREIGN PRIVATE CORPORATIONS

It is no secret to the tax administration and to this committee that high taxes tend to drive to cover those taxpayers who can escape the tax collector. There are probably no available statistics relating to the number of Americans who formed or use foreign corporations for the primary purpose of lawfully minimizing or avoiding United States taxes. Under the existing law, upon the death of stockholders in such corporations, the slate is, in effect, wiped clean. Although I have not had an opportunity to poll my own committee on the matter, I venture to offer the suggestion that Congress might wish to permit the return of such American-owned foreign corporations under terms which would make the return not too onerous, and thus bring within tax reach funds and transactions which otherwise would continue to remain lawfully immune from American process.

Something like analogous precedent for this suggestion may perhaps be found in section 110 of the 1935 act, which appears as section 112 (b) (6) in the revenue bill. This section, as all of you, especially Senator Sterling, will recall, was intended to encourage the break-up of the pyramided corporate structure recently under criticism. My suggestion is to encourage the dissolution of American-owned foreign private corporations. Two methods suggest themselves:

(a) Liquidation of the assets to American stockholders subject to a flat tax of, say, 12½ percent of the amount of gain realized, but with no allowance for corresponding losses.

(b) Transfer of the assets to existing or to newly created domestic corporations under conditions and restrictions similar to those in section 110 of the 1935 act.

The privilege referred to should be available during a very limited period of time, say 1 year from the enactment of the governing legislation.

XV. POSTPONEMENT OF REVENUE LAW TINKERING UNTIL THOROUGH SCIENTIFIC REVISION IS POSSIBLE

I believe it must have been made abundantly clear that the bill under consideration is not an ideal revenue measure. It is equally obvious that the proposal does not pretend to be a fundamental revision of our entire scheme of taxation. Our tax laws are in need of scientific and fundamental revision. It may or may not be feasible in the process of revision to cooperate with State taxing authorities. There are those who believe, however, that much may be done to extend the existing legislative and administrative cooperation between the Nation and the States.

For all of the reasons which have been advanced I venture to recommend:

(1) That the piecemeal tinkering implicit in the revenue bill be abandoned.

(2) That temporary emergency revenue, strictly limited to an essential and irreducible minimum, be provided for the current and for the next fiscal year through one or more of the following sources: Increased rates on corporate income, increased normal rates on individual income, reduced personal exemption, subjecting dividends received by individuals to the normal tax, assured tax on nonresident aliens and corporations, a small unit tax on one or more commodities.

(3) That the Joint Congressional Committee on Taxation, or a special joint congressional committee, should be forthwith assigned to the task of studying our tax system and fiscal needs and to report its findings and recommendations by March 1, 1937.

The CHAIRMAN. The next witness listed is Mr. Satterlee, of New York City. I hear no response, and apparently he is not here.

Mr. Lane is the next witness.

STATEMENT OF E. H. LANE, THE LANE CO., INC., ALTA VISTA, VA.

The CHAIRMAN. Mr. Lane, you are from Virginia?

Mr. LANE. Yes, sir.

The CHAIRMAN. We will give you 20 minutes, Mr. Lane, and if you can get through in less time, we will appreciate it, but if you do not finish, if you will state your proposition, you may put your brief in the record.

Mr. LANE. Mr. Chairman, I guess that a businessman to come up here is taking a lot of nerve, because it seems that for the last few years it has been a sort of open season for businessmen.

We started a little business down in Virginia in 1912, and when this new tax bill was presented we began to visualize what that would have done if that had been in effect during the years of our business existence, not so much that it can go back and hurt us over those years but the fact is we have about 3,500 dealers in this country, a lot of whom have lost a good part of their working capital.

Senator BARKLEY. What is your business; you have not stated it?

Mr. LANE. I am a manufacturer of furniture, cedar chests and things of that kind.

Senator BARKLEY. Household furniture?

Mr. LANE. Yes, sir.

Senator CONNALLY. You are from Marion, Va.?

Mr. LANE. Alta Vista, Va., a small town near Lynchburg. Of these dealers we sell to, they are of varying credit, first-grade credit, who discount their bills and all such things; the second-grade credit, which is a lesser grade, and the third-grade credit, which means credit of almost any kind.

A lot of them have lost their working capital during the depression. If I was speaking from my own point of view, I would say go ahead and pass the law for the reason we have sufficient capital in our business. We have a lot of competitors who have lost their capital during the depression, and it would be that much easier for us to stay in the industry, because we can get capital from the capital market, but we have competitors that cannot get it, and they would not require enough capital to interest the general market.

We have about 1,500 dealers who we are afraid of going broke because they were so impaired in the last depression. I will say our capital position has been impaired somewhat in the last depression,

and we are worried over that, because if our dealers go broke, they will pull us down.

I have tried to prepare a little picture of what will happen to our business if this proposed tax law had been in effect during our period in business, and I can give that in a brief form, or go into detail.

The CHAIRMAN. Just give us a brief statement of it.

Senator BLACK. Is your business incorporated, or a partnership?

Mr. LANE. It is incorporated, a close corporation, with only about 75 stockholders.

Senator BARKLEY. What is the capital stock?

Mr. LANE. We have 10,000 shares no par-value stock, and our present capital is about a million dollars.

We started with a capital in the beginning of $18,000 and we added to it from time to time, until it got to about $189,000.

Between 1912 and 1915 if we had had to pay additional taxes on this business I think we would have gone broke, because we were just about a half a jump ahead of the sheriff all of the time, and under this proposed bill we would have had to pay $2,100 of taxes in that period, whereas we did not pay anything under the old tax law in effect at that time.

Senator BARKLEY. You are going back to 1912, there was not any corporation tax at all at that time?

Mr. LANE. I understand, that is correct, it was not until 1913, but the point I am trying to make, if we had had any additional taxes to pay, it might have rubbed us out.

Senator BARKLEY. If you had had that tax, you would have taken it into consideration in the profit on your commodities?

Mr. LANE. Well, Senator, I do not know how long it has been since you have been conducting a business of this kind, but if you have been, you know that it is the public that sets the prices.

We paid $1,200 taxes in that period, and the bank gave us all they could, we got every nickel we could by pledging all of the security we had, even using our accounts receivable, which is the last card a manufacturer has to get money, and by putting mortgages on our property.

We have a lot of customers who are today in the same fix.

In 1912 to 1918, which covers a greater period, our company made a profit of $35,000.

Senator HASTINGS. During the first 7 years?

Mr. LANE. Yes, sir.

Senator HASTINGS. $35,000 for the whole period of time?

Mr. LANE. Yes; and paid out approximately 10 percent of that, or some $3,000.

Senator HASTINGS. For what?

Mr. LANE. For dividends, and we paid out approximately the same amount in taxes, to be exact, $2,937 paid in taxes during that period. Under this new bill, we would have had to pay $12,500 or 35.7 percent of all of our earnings in that time.

Senator HASTINGS. You mean on the profit you made of $35,000, as you understand this bill, you would have had to that tax?

Mr. LANE. Yes, sir. I would like to say there are some provisions in this bill for companies who have fixed debts and that kind of thing, that, which I dare say, figures out better, but we do not understand how it would be.

Senator BLACK. Would you mind putting down the profit you made each year so that we could have it figured out, because if I understand the bill it would not have been that much tax.

Mr. LANE. I will be glad to put in those figures.

Senator BARKLEY. Your figures are before or after you paid the stockholders?

Mr. LANE. From 1912 to 1918 we paid out 8.6 percent of our earnings in dividends, and the taxes amounted to 8.3 percent for the same period, so that the Government got approximately as much as the stockholders did. But under this bill it would be approximately 35.7 percent paid out in taxes.

Senator BARKLEY. The tax of 35.7 percent was on the total that remained in the corporation; you did not pay a corporation tax on what you distributed to your stockholders, although they may have paid it.

The CHAIRMAN. They paid this on the profits of the corporation.

Senator BARKLEY. Back in 1913?

Senator KING. As I understand, this is 1912 to 1918.

Mr. LANE. That is correct.

Senator BLACK. Would you mind putting down the figures of the profit for each year so that we can figure that out on what you reserved? I believe you said you made $35,000 in that period.

Mr. LANE. Yes, sir; from 1912 to 1918.

Senator BLACK. Do you have it by years?

Mr. LANE. I can furnish it by years, but I haven't it here except in bulk.

Senator BLACK. Do you have your net income for each year there?

Mr. LANE. No, sir; not here. I just brought some bulk data that I thought we could use, and you would like to see.

Senator BLACK. Was it about even each year?

Mr. LANE. No, some years we had a loss and other years we made money.

Senator BLACK. You kept all of this in your business?

Mr. LANE. Yes, we kept all of that $35,000 in the business, except $8,096 paid out in dividends, and $2,937 we paid in taxes.

Senator BARKLEY. Let me see if I have that correctly. Thirty-five thousand dollars is the profit from 1912 to 1918, annually?

Mr. LANE. No; that is the total profit for the entire period, and the point that is worrying me about our accounts is that when a concern is young, trying to go ahead, it needs every bit of strength it can get, and this bill will sap the strength away from them. We have had competitors that lost a lot of money in the depression, practically lost all of their working capital.

The CHAIRMAN. How would it sap your business?

Mr. LANE. Mr. Chairman, it was taking something over one-third of the money we made, whereas it only took 8 percent in the old tax situation, and to show we are not making anything out of it we did not pay any dividends to amount to anything in that period.

The CHAIRMAN. How much are you earning now, what is your profit annually?

Mr. LANE. It fluctuates, of course. Last year, I think, according to the way the Internal Revenue Department figures it, we earned $160,000 net.

The CHAIRMAN. Did you declare any of it in dividends?

Mr. LANE. Yes, sir; we paid approximately one-third of that in dividends.

The CHAIRMAN. Do you think it would have hurt you if you had paid out 30 percent and retained 80 percent?

Mr. LANE. Mr. Chairman, I will answer this way, last year we spent about $80,000 in improvements in our plant, and this year we are planning to spend $110,000 in improvements.

We could use our reserve to increase working capital, but we would have to become static in capital, and could not grow any more, as we see it. I cannot understand this tax bill and I have had lawyers, tax experts, and everybody else try to explain it, and I cannot understand it at all.

The CHAIRMAN. Suppose five people owned this plant of yours, and it was a partnership instead of a corporation, they would have to pay on their individual incomes, would they not?

Mr. LANE. Yes, sir.

The CHAIRMAN. How do you distinguish between them? If a corporation should pay some amount, why should favoritism be shown a corporation as against an individual?

Mr. LANE. As I understand a copartnership, as a rule there are not very many partners, and they can get together and decide what they want to do for the good of the business, but we are just trustees of some property as managers of the corporation, and we have the stockholders looking to us to look after their interests, that never come to a meeting even.

The CHAIRMAN. From governmental standards why should a corporation be put under more favorable circumstances than a partnership when it comes to collecting taxes?

Mr. LANE. Mr. Chairman, I should have said, to start out, that I am just a businessman, I am not an expert like Mr. Klein, and I did not come up here to tell you what kind of taxes to put on, nor to oppose this scheme of taxation. Mr. Lawson, our vice president, knows more about taxation that I do.

The CHAIRMAN. Does it not appear to you as a layman that it is a fair thing from a governmental standpoint that a corporation should not be put in a more favorable position than an individual in paying taxes?

Mr. LANE. Yes, sir; I think so, from a layman's viewpoint.

The CHAIRMAN. That is all that is being done here.

Mr. LANE. Yes; but I wonder if it could not be accomplished without putting such a burden on the small corporation. A gentleman read this morning a list of 10 corporations who would not pay any taxes, and the stockholders would not pay any more tax than the 4 percent you are putting on the corporation dividends.

I know some tobacco corporations last year and the year before who paid out more than they earned during those years, and you are going to leave them without any taxes at all, and you understand what I am interested in is the small corporation struggling along that is looking for all that it can get to keep going.

The CHAIRMAN. We are going to give you an amount of reserve and there will be no higher tax on that than you have been heretofore paying, if you analyze that situation.

Mr. LANE. As we analyzed it, Mr. Chairman, this tax as now proposed is going to double our taxes for 3 years over what they were for 1935, on the same earnings.

Senator BLACK. Double whose taxes?

Mr. LANE. Double our corporation tax.

Senator BLACK. Not the little company, but the company as it is now.

Mr. LANE. Yes, sir.

Senator BLACK. As a matter of fact, you have figured out enough to know at the time you are talking about your company being small, it would have gotten out on a much smaller tax than the 15 percent.

Mr. LANE. No; I have not figured that out.

Senator BLACK. Yes; that would be true, and it would be better for the small corporation.

Mr. LANE. The less tax they have to pay, the longer they will survive.

Senator CONNALLY. How does your company handle the income that you expect to retain as reserve on surplus?

Mr. LANE. I think I can answer that question best by what we have done.

Senator CONNALLY. I am talking about the experience of your company.

Mr. LANE. I will give what we have done in the disposition of our earnings.

Since we have been in business, since 1912, 29.9 percent of our earnings since we started in business has been reinvested in fixed assets.

Senator CONNALLY. If you do that in the future, you will not pay any more tax than you do now, because you retain 30 percent in surplus and reserve, and you will then not pay as much as you do now.

Mr. LANE. I am not a sufficient financial expert to say, sir.

Senator CONNALLY. All right, you may go ahead.

Mr. LANE. As I say, 29.9 percent reinvested. It took 23 percent more of our earnings to increase fixed capital to take care of the production that the increase brought about. So that there is approximately 53 or 54 percent that it took of our total earnings during that period for improving conditions of the plant and increasing net working capital.

Senator CONNALLY. How much do you figure you would pay if you did that under this bill, say, if you take 50 percent of the earnings and distribute it and keep 50 percent?

Mr. LANE. I cannot answer that. I can only say the earnings last year were $160,000.

Senator BARKLEY. If you keep $80,000 and pay out $80,000 under this bill, how much would the tax be?

Senator CONNALLY. Mr. Kent, can you figure that out? While Mr. Kent is doing that, Mr. Lane, just go ahead and state what the capital of your company is.

Mr. LANE. It is approximately a million dollars.

Senator CONNALLY. And you made $160,000?

Mr. LANE. Yes, sir.

Senator CONNALLY. That is a very good profit, 16 percent.

Mr. LANE. Yes; but we have got to look back to 1932 and 1933.

Senator CONNALLY. We are out of the woods on that now.

Mr. LANE. No, I don't think so; but if so, while we are out of the woods now, we are looking for the next depression.

Senator BARKLEY. You are looking for the next depression?

Mr. LANE. Yes, sir. We paid out 31.8 percent for dividends, and I think that answers your question of awhile ago. We have paid out 32 percent in round figures of our profits in dividends since we have been in business, but mind you, 84 percent of what we have paid out has been in the last 12 years of our life, or about one-half of our entire life of 24 years

Senator BARKLEY. How many stockholders did you have when you first organized?

Mr. LANE. When we first started we had two, my father and myself.

Senator BARKLEY. As your business grew your neighbors and freinds bought stock?

Mr. LANE. Yes; we pleaded with them to help us out.

Senator BARKLEY. Your stock is not registered on the stock exchange?

Mr. LANE. No, sir; it used to be registered at Richmond, but when the Securities Exchange came on, we dropped it, so as not to be bothered with making the reports.

Senator BARKLEY. There is not much trading in your stock?

Mr. LANE. Very little.

The CHAIRMAN. Suppose you and your father had continued this business as partners when you first started, have you figured out how much tax you would have paid as individuals, as compared with what you would have to pay under this bill?

Mr. LANE. No, sir; I have not.

The CHAIRMAN. It would be a greater amount?

Mr. LANE. I presume it would be from what I have learned from copartnership arrangements. But my judgment is that could be corrected. It would seem to be it is important for a corporation to have a good start, because the point I am trying to stress is from my own experience, Mr. Chairman, how utterly necessary it is to keep every penny you can get hold of in your embryonic years as a corporation.

The CHAIRMAN. Yes; you have got to keep some money in the business, you have got to enlarge, but if it is a copartnership and they are paying taxes much higher than the corporation, and what we are trying to do is to put them on an even keel.

Mr. LANE. I think it is an unfairness that should be corrected in some may, but I am not sure the present one is the way to do it, since we calculate that in 1918 our company would have passed out of the picture if we had been compelled to pay taxes on the basis set up in this proposed bill.

Senator CONNALLY. Mr. Chairman, Mr. Kent has those figures now.

The CHAIRMAN. Will you state the result of what you have figured?

Mr. KENT. Since the corporation here was realizing a net income of $10,000 or less, if it retained 50 percent of its adjusted net income it would pay a tax at the rate of 18.5 percent; 31.5 percent under those circumstances would be distributed in dividends to the shareholders.

The CHAIRMAN. Eighteen and five-tenths percent of what was distributed.

Mr. KENT. Eighteen and five-tenths percent of its net income.

The CHAIRMAN. Its net income was how much, did you say?

Mr. KENT. Say they had $10,000 of net income, they retained $5,000 in surplus, and they would pay taxes of $1,850 and would pay out dividends of $1,500, and when they get into the higher income groups between $10,000 and $40,000, under schedule 3, there is a somewhat different rate, and after they get past $40,000 they would pay 35 percent.

Mr. LANE. We earned last year $160,000, and retained half of that; how much would the tax be on the rest?

Mr. KENT. If my arithmetic is correct, it would be about $56,000; but that does not take into account there are other means of keeping the money without paying the maximum tax.

Mr. LANE. That still leaves us where we cannot learn much about the law from the study we have been doing since the President suggested it and since we got the first report from the Ways and Means Committee.

Senator CONNALLY. This $160,000 profit you made, was that after depletion, amortization and all of that figured off?

Mr. LANE. Yes; that is net profit.

Senator CONNALLY. For income-tax purposes?

Mr. LANE. Yes, sir.

Senator HASTINGS. Was it after the taxes were paid?

Mr. LANE. After all taxes, but no dividends.

Senator HASTINGS. You did not deduct the income tax from that?

Mr. LANE. No, sir. In this connection I might say our books do not agree with the Internal Revenue Department because they do not allow us to count off taxes the depreciation we have. Our experience teaches us we have an obsolescence factor in equipment from the standpoint of style changes, of which we have had four in 24 years, but they will not recognize those things we think they should recognize.

The CHAIRMAN. Is that due to the peculiar styles of furniture?

Mr. LANE. Yes, sir; that is correct.

Senator KING. You are not making any solid furniture?

Mr. LANE. Yes, we do; but we are specialty manufacturers, making primarily cedar chests.

The CHAIRMAN. You will admit you make as good furniture as any other manufacturers?

Mr. LANE. Yes; of course.

Senator BARKLEY. You do not make any antique furniture?

Mr. LANE. Not much, but we have a set of furniture, a duplicate of the Mount Vernon furniture, but that is high-priced furniture, and we do not make any money out of it. Our cedar chests, on account of being nationally advertised, we can get a volume of production on it and can make some money on it.

The CHAIRMAN. If you want to, one of the experts on this proposition of figures will be glad to cooperate with you and tell you everything about it.

Mr. LANE. I think we have learned a lot today, gentlemen, but I want to say this: We know that twice during our business career, 1918 and 1922, if these taxes had been in effect we would have been totally insolvent, because the taxes proposed under this bill appeared

to us to be three and a half times what they would be under the old law that existed at that time.

Senator CONNALLY. If you had been a partnership instead of a corporation, you would have been "busted"?

Mr. LANE. I think so.

Senator CONNALLY. What about the individuals that are partnerships and paying the higher taxes? You have been getting off with a lower rate than you would have if you had been an individual or partnership?

Mr. LANE. They have a perfect right to organize a corporation any time they get ready.

Senator CONNALLY. Yes; that is correct.

Mr. LANE. That is what I would do; I would never operate a personal business instead of a corporation.

Senator CONNALLY. You have paid less taxes because you were not a partnership.

Mr. LANE. Yes; there was no corporation tax when we organized.

Senator BARKLEY. There are other advantages of organizing as a corporation, because you are only liable to the amount of your stock.

Mr. LANE. Yes; and we were glad from 1912 to 1922 that we were a corporation. I heard the statement this morning—that if we wanted to keep our profits in our business we could offer stock rights and things of that kind to our stockholders. That might sound like a remedy, but in between 1912 and 1922, if our stockholders had ever gotten hold of any of our earnings as profit they would have taken them and run with them; they would never put them back into the business. If I could have gotten half of mine at that time I would have said to the creditors, "You can have the rest of it."

You must understand the small corporations have no access to the capital markets when they can only get money by selling stock to friends and borrowing from the banks and things of that kind, and under this bill I don't see how a small corporation ever can get anywhere.

The CHAIRMAN. But you are pretty much out of that class now.

Mr. LANE. We just claim we are green country boys trying to make a living.

Senator HASTINGS. Would you mind telling how many shares the largest stockholder holds in that corporation?

Mr. LANE. I own the largest number—35 percent of 10,000 shares.

Senator HASTINGS. Are you engaged in any other business?

Mr. LANE. No; this keeps me plenty busy; and during the last 3 years I have been kept busier than I want to be, because we have to look after our business and watch Washington all at the same time.

Senator BARKLEY. And you do not want Washington to exercise the same supervision over you?

Senator BLACK. You say in the last 3 years you have been watching Washington?

Mr. LANE. Yes, sir.

Senator BLACK. You did not have time to watch Washington in 1932?

Mr. LANE. I have had more time than in a long while recently, and I could play golf in those years, but not the last couple of years; I haven't had time.

We talked this matter over with a concern in Lynchburg, and took his figures and projected them since he started in 1916 with the figures under this proposed tax bill. We do not claim it would have put him out of business, but at times he would have had a heavy squeeze.

In 1912 we started working 12 men, and today we work about 500, and over 400 in the plant. We figure if this tax had been applied we would have been working about 250 today—just about half as many.

If we had not had working capital in 1931, 1932, and the early part of 1933, we would have discharged half of the employees we had and cut the wages of the rest of them as much as we could and tried to make some money in those years, but we did have working capital and we kept all of our people on, except only those who dropped out of their own accord and we did not take back. We worked them short hours, sometimes 12 or 15 hours a week; we took our loss, but tried to keep those people busy. If we had not had working capital we could not have done that.

Frankly, when we projected this little expansion program last November and December which we are working out now, if I had dreamed then this new tax bill was contemplated, I would not have put on this expansion program. We just bought a machine yesterday, a big triple-drum sander from a concern in Wisconsin.

Senator CONNALLY. You bought it yesterday, when you knew about this bill?

Mr. LANE. We had the building all ready, and we had to put something in it. They told us that is the third machine they have sold in 6 months.

Senator BLACK. Did they tell you how many they sold in 1932?

Mr. LANE. I presume they did not sell any, and probably they took some back.

The CHAIRMAN. Business has improved in your line of business, however?

Mr. LANE. I think it has improved, but the capital-goods industry has not improved yet, with the exception of a few.

The CHAIRMAN. That is the general impression, that business is improving.

Mr. LANE. That is true. Frankly, I am not here throwing rocks at anybody; I have been a Democrat all of my life, but if you could get off our backs for a while, quit threatening us with all types of legislation, and let us see where we can go, we will be a lot better off. I will be so glad when you fellows adjourn, which I hope will be next month.

Senator BARKLEY. You would rather we would adjourn before we pass this tax bill?

Mr. LANE. I surely do. This new law to us seems a provision against plowing back the profits into the business. It will seriously injure the capital-goods industry, as a large percent of the business they get is the result of profits being used to expand business facilities. If this act is passed in anything like its present form, then credit should be allowed against profits used in increasing facilities, and we believe that ought to be done if it could be made workable.

Of course, you realize when you increase taxes you are transferring spending power from individuals and business to the Govern-

ment, and the more you take the less individuals and private industry can have to expend, so that we cannot be responsible for reemploying people, because we haven't anything to employ them with.

I am just giving you as a layman the businessmen's point of view, and I appreciate your attitude, because you are not treating me very rough.

We believe a good deal of the suffering of the last depression was due to income taxes. By business in the last 20 years, because history teaches us we have fat and lean years, and if we do not lay aside for the lean years while business is good in the fat years, we will be put out of business in the lean years.

If it is politically impossible to enact a sound basis of taxation from an economic standpoint and you feel it is necessary to increase the Government's revenue through taxation, then why not continue the present basis and increase the rate to the amount absolutely necessary to be raised, then we can calculate, as we already know how much reserve we have to set aside to meet those taxes.

The CHAIRMAN. Have you any idea how much we would have to increase the flat corporation tax in order to raise the money we have to raise this year?

Mr. LANE. I have not figured that out, but if your tax is, roughly, 15 percent, if you raise it to 30 you ought to double it. I don't know how much you would lose in the shuffle, because the higher you raise it the more ways will be found to evade it.

If you increase it 5 percent, you will increase it a third; then if you want to tax the surplus, or make an experimental tax like Mr. Klein suggested, I think it would be a good idea.

It seems to me unsound to try to trade a certainty for an uncertainty. You know how much revenue the present taxes will raise, and you can estimate quickly how much a certain increase in the present tax will yield. The Treasury Department can estimate what the taxes will yield on the basis of 1934.

This tax closely approaches, if it does not actually reach, confiscation.

In other words, you are under this bill eating the seed corn.

I have always thought that all of us have just learned how to make out the old returns and the law has not been radically changed enough that we cannot still have lawyers and tax experts to make out our returns, but on this new bill I have had lawyers and experts figuring it, trying to find what our tax would be on last year's income, and no two agree about it. This is the most complicated thing ever suggested in the history of the world on taxation, and I defy any man in Congress, as he goes along in the year, to figure within 25 percent of how much he will have to set aside for a commitment on this tax.

The CHAIRMAN. You could do that in December.

Mr. LANE. Yes; but the year is over, and supposing you have spent something in improvements. At the present time we can tell how much taxes we have to set aside each month.

Senator BARKLEY. You do not have to estimate the amount of taxes until the tax year has passed, and you have 3 months in which to figure it all out before you make out the return, and it is the same proposition, depreciation, depletion, bad debts and all of that is involved in the present law, so that you have to go through the same tabulation to arrive at your net income under this bill, as you do now.

You may be able to get some additional credits under this bill that you do not get now, but after you have arrived at your net income for the year, then the only question is how much you are going to distribute, and when you have decided how much you are going to distribute, then you do not have to worry about the part you distribute, you only worry about the part you keep.

Then, there is no more obligation on what you keep than there is at the present time.

Mr. LANE. I do not see as a practical business man, myself, how we could tell as we go along during the year what your tax will be.

Senator BARKLEY. You cannot do it now.

Mr. LANE. Yes; we can estimate it closely now.

Senator BARKLEY. You do not know how much the income for the year will be until the year is over?

Mr. LANE. But we can take the profit each month and multiply it by the number of months, and come very close to it.

Senator BARKLEY. You have got to arrive at your taxable income after the year has passed and you have gotten all of the credit you think you are entitled to. In the first place, you file the income tax according to what you think, then they come along and check it up, and maybe you do not agree, but finally it is settled. The complications in making out an income-tax return, it seems to me, will not be greater than they are now; and one advantage, you only pay one tax, you haven't got to worry about all of the other taxes you pay now.

Mr. LANE. As I said, we have gotten to the point where we can estimate what our taxes are for the year by multiplying by the earnings to date, and under the new bill you cannot tell until the end of the year what it will be.

Senator GEORGE. Your position is you are doing business all of the year, every day, and you are not watching for the end of the year to get to make our your tax return?

Mr. LANE. Yes; and suppose we pay quarterly, like we do, and we pay dividends; then if we haven't got money enough to pay the tax, what can we do?

The CHAIRMAN. There is a provision here that you can have them carry it over if you pay out too much.

Mr. LANE. Yes, sir.

Senator BYRD. You say you earned $160,000; suppose you invested that $160,000 in new plant, how much tax would you have to pay then?

Mr. LANE. We would have to pay as much as if we had kept the cash, as I understand it. As we go along during the year, if we need money for fixed assets, in order to make a certain style of chest and to take care of any supply of chests, we cannot determine how much money we will have for that purpose without changing our current position.

Senator BYRD. One other point, one of the last points made here, that prior to the passage of this bill a corporation may have contracted to build a plant, and in your circumstances, you had contracted to build a plant, and invested the $160,000 of your earnings for this year, then you would pay 42 percent taxes.

Mr. LANE. Yes; clearly that comes down to us this year, in that we earned $160,000 last year, and we had enough money in our working capital position to pay out $110,000 and still be reasonably comfortable during the spring season, when the business is not as much as it is in the fall, and pay for our improvements, expecting we could take all of this year's profit we needed except the 15-percent income tax and pay for the improvements and replenish our working capital position.

That is why I say if I had known this law was going to be offered I would not have made these improvements.

Senator BARKLEY. Suppose I owned a factory that has made $160,000 a year profit, as an individual, and I wanted to build a new plant, and I put that $160,000 in a new plant, I would have to pay taxes, I take it, in the $160,000 bracket, would I not?

Mr. LANE. Yes; and I tell you if this tax bill goes through, I wish you owned the plant.

Senator BARKLEY. And that bracket would be higher than you pay as a corporation?

Mr. LANE. That is true, as I understand it, but do you believe, if you are conducting a business of this size under the present conditions, you would conduct it as a copartnership?

Senator BARKLEY. No; I would not, but there are people who do.

The CHAIRMAN. Mr. Lane, you made those contracts you referred to prior to March 3 of this year?

Mr. LANE. We signed the contract January 15 of this year.

The CHAIRMAN. Then this bill helps you out on that proposition.

Mr. LANE. We did not go into it without money.

The CHAIRMAN. This is on the money you made last year.

Mr. LANE. But I cannot replenish my working capital position under that.

There is one other thought I would like to give you. We believe the principle upon which this new corporation tax law is based is absolutely unsound. In the first place, the Government takes upon itself the responsibility of conducting the business by reason of its earnings it must pay out in dividends or suffer the penalty, without at the same time assuming the responsibility for the damage such action might cause to the business in the future.

In other words, the Government assumes the prerogative of management without assuming the responsibility for results.

The CHAIRMAN. Thank you very much, Mr. Lane.

The CHAIRMAN. The next witness is Mr. Paul H. Wilson, of Worcester, Mass.

STATEMENT OF PAUL H. WILSON, REPRESENTING THE GRATON & KNIGHT CO., WORCESTER, MASS.

The CHAIRMAN. Mr. Wilson, can you get through in 15 minutes?

Mr. WILSON. Yes, sir.

The CHAIRMAN. You represent the Graton & Knight Co.?

Mr. WILSON. Yes, sir.

The CHAIRMAN. What business are they engaged in?

Mr. WILSON. The tanning of hides, fabricating hides and leather, leather belting, and leather products.

The CHAIRMAN. If you have a brief and want to put it in the record, that will be all right, and then you can point out the main points to us, if you want.

Mr. WILSON. I am secretary and comptroller of the company and have been with this company for 27 years. I have been secretary of the company since 1926.

I am appearing before this committee at my own request and on behalf of the Graton & Knight Co. The purpose of my coming here is to point out to this committee the ill effects the proposed tax law will have upon this corporation. Under the provisions of section 15, the Graton & Knight Co. will be required to pay a tax of 22½ percent on its income, which is an increase of 50 percent, which increase is an undue hardship under the present conditions.

This company was organized in 1851 and has been doing business continuously since that date. Its business, as I have said, is the tanning of hides, manufacture of leather belting and leather products.

Our present capitalization as of January 1, 1936, is as follows:

Preferred stock, 20,645.6 shares, $2,056,560; common stock, 83,229 shares, $1,037,875; surplus, paid in and earned, $711,112.40; making a total of $3,805,547.40.

Our outstanding preferred stock, consisting of 20,549.2 shares is held by 1,505 individuals, averaging 13.7 shares per person.

Our outstanding common stock, consisting of 82,977.8 shares, is held by 1,732 individuals, with an average holding of 47.9 shares. The stock of the Graton & Knight Co. is widely distributed.

In addition to the preferred stock and common stock outstanding, the company, after it was reorganized in 1926 issued bonds $1,750,000, of which $1,148,500 are still outstanding. The indentures securing the bonds provides for an annual sinking fund of $75,000.

The company at the present time employs approximately 1,200 people, does business in every State in the Union, and has a small factory in Shanghai, China, and branches in Canada, England, India, and dealer representations in other countries of the world.

The company had a very prosperous period through its entire existence up to and including the year 1919. To that time the company distributed large amounts in dividends yearly.

During the World War our company had large contracts with the United States Government for the manufacturing of war materials, such as scabbards, gun slings, holsters, and many other articles. At the request of the United States Government, we expended large sums of money during the war years in the erection of buildings and the purchase of large quantities of leather and other supplies for production of war materials. Immediately after the close of the war we had a plant capacity far in excess of our needs, and a large inventory of leather and supplies purchased primarily for war purposes.

At the end of the year 1919 we had an inventory valued at $11,001,661.98 and were indebted to banks and other parties for borrowed funds in the amount of $6,148,500. During 1919 we did not suffer financial losses, but during 1920 and 1921 heavy losses were sustained due in part to reduced sales volume, but mainly to receding prices on raw materials, most of which were purchased during the war period. In these 2 years our losses were, 1920, $2,785,000; 1921, $4,865,000; a total of $7,650,000.

Our deficit at the end of 1921 was $3,567,000. Dividends were paid during 1920, but early in 1921 dividends, after one payment, were discontinued on the common stock, and only three quarterly dividends were paid on the preferred. No dividends have been paid on the common stock since 1921. A portion of the 1921 dividends were paid in scrip.

During the years 1922 to 1925, inclusive, the company earned about $625,000, and these profits, together with the cash realized by a reduction in inventories, was used to liquidate the company's indebtedness.

In 1927 the company succeeded in putting a bond issue, the proceeds of which were used to pay off bank loans.

Senator KING (interposing). May I interrupt you at this point, Mr. Wilson? Had you redeemed the first issue of bonds, the $700,000?

Mr. WILSON. This is the same issue that I am referring to. They were issued in 1927.

Senator KING. I see.

Mr. WILSON. The terms of the indenture were very strict and rigid. In that indenture we agreed at all times to maintain a certain amount of net tangible assets. These terms, we were told, were necessary in order to sell the bonds. At the present time we are in technical default on these bonds, because of this particular section, in the amount of $370,000. We have been advised by our counsel that it would be illegal for us to pay any dividends on any stock as long as we are in default on our mortgage indenture.

Because of the terms of the mortgage indenture, the company cannot pay dividends, as its earnings are required to meet the sinking fund and other provisions of the mortgage, yet under section 15 the tax on its earnings is at the rate of 22½ percent. Under the present law the tax would be at the rate of 15 percent or less, and this increase of 50 percent on the present tax is a further burden on a corporation which is trying to keep going ahead. I believe also that this section 15 should be further clarified so that Graton & Knight Co. and other corporations in smiliar situations would be sure to obtain relief under the section.

Our bond indenture does not specifically state that we shall not pay dividends but does state that our assets shall be maintained at a certain fixed amount as long as any bonds remain outstanding and unpaid. This provision prevents the payment of dividends. A failure in the payment of sinking funds would constitute a default under the terms of the mortgage, and the rights of all stockholders would be in jeopardy.

Senator KING. Have you maintained your sinking fund since the bond issue?

Mr. WILSON. Yes, sir.

Our company is one whose earnings are seriously affected by market prices of raw materials, namely, hides. During the past 10 years we have seen some very violent fluctuations in the prices of hides. Our inventories have always been taken on the basis of cost or market, whichever is lower, and due to these wide fluctuations of high prices, our inventory losses in the past have been large. On the basis of our present inventory a difference of 1 cent per pound on

hide prices is equivalent to approximately $140,000 on our total inventory, which at present is approximately $3,000,000.

Senator KING. You mean the personal property amounts to $3,000,000?

Mr. WILSON. That is the inventory itself.

Senator KING. All of your assets?

Mr. WILSON. No, sir; all of the inventory, including hides and leather in the process of tanning. I might say, that is, on the first of the year the price of steer hides was 14¾ cents; today it is 13 cents. That reduction has wiped out practically all of our earnings for the year 1935.

The CHAIRMAN. You cannot hedge?

Mr. WILSON. It is rather risky.

The CHAIRMAN. You do not practice it.

Mr. WILSON. We do not.

We have had the unfortunate experience of having hide prices drop very suddenly at the end of the year, which has resulted in large inventory losses for us, compelling us to show losses for the 1 year, and large profits for the succeeding year, simply because we have had to price our inventories on the basis of cost or market, whichever was lower. In the year 1932, because of this condition, we showed a loss of $923,000, whereas in 1933 our profits amounted to $401,000. A large part of the profit in 1933 was due to the increase in hide prices.

The CHAIRMAN. What was it last year; did it show a profit or loss?

Mr. WILSON. Last year we showed a profit of about $211,000.

The CHAIRMAN. What was it in 1934?

Mr. WILSON. As I remember, we lost about $200,000 in the year 1934.

Senator KING. And in 1935?

Mr. WILSON. We made about $211,000, after setting up a reserve for taxes of about $40,000.

The CHAIRMAN. It has been the character of your business to fluctuate from one year to another?

Mr. WILSON. Yes, sir.

Senator KING. Is it your position it is your problem to build up your reserve rather than pay dividends?

Mr. WILSON. Yes, sir.

Senator KING. So that any tax levied upon that reserve or surplus is especially injurious in your opinion?

Mr. WILSON. We believe so.

Senator KING. And if you had a deficit you would be in greater default with respect to the obligations on your bonds?

Mr. WILSON. Yes, sir.

Senator KING. You might even be forced into bankruptcy any minute?

Mr. WILSON. Yes. We felt we were faced with such a condition in 1932.

Senator CONNALLY. But in such a year you would not have any taxes on net income?

Mr. WILSON. But we could not build up our reserve.

Senator CONNALLY. But you would not have a reserve where you had a deficit?

Mr. WILSON. For the preceding year.

Senator CONNALLY. This only deals with current income.

Mr. WILSON. But if our reserves are exhausted, we feel we must build them up in order to take care of future contingencies.

The CHAIRMAN. Do you feel you should take care of all of them out of your net earnings?

Mr. WILSON. No, sir.

The CHAIRMAN. About what percentage do you set aside when you are making a profit?

Mr. WILSON. We have never carried out any consistent policy of setting up a specified amount, but I would say about 50 percent, depending upon the size of our earnings.

The CHAIRMAN. You would not pay much more tax under this bill on a 50-percent reserve than under the present law, would you?

Mr. WILSON. My interpretation is we would pay 35 percent, if we did not get any relief.

The CHAIRMAN. If the reserve is 30 percent, you would only pay 15 percent, would you not—never mind, I do not want to go into all of that.

Mr. WILSON. The existing income-tax laws, which do not allow us to carry over losses, applying them against the profits of succeeding years, creates a hardship on the company. Increases or decreases in our inventory values do not create actual profits or losses. Profits or losses on book inventory values are book profits or losses only. Actual profits or losses accrue to the company only when the inventory is full fabricated and sold.

Due to the nature of our business, our inventory turnover is small, and to a certain extent it is impossible to avoid suffering great losses when hide prices recede.

Due to the losses which this company has suffered since 1926, due to the depression and other causes, amounting to $1,259,000, our working capital has been impaired. We believe the only possible way to get working capital to carry on will be through earnings.

During the 10 years referred to, 1926 to 1935, inclusive, with deficits or losses amounting to $1,259,000, it is interesting to note that our city, State, and Federal taxes for the same period of years amounted to $886,236.

Senator KING. You have to pay that amount of taxes in that time?

Mr. WILSON. In those 10 years, sir. The first part, from 1926 to 1929, our profits were $990,000, and from 1930 to 1935, inclusive, our losses were $2,249,000.

The management of this company adopted at the very beginning of the depression a policy of releasing no employee who has dependents, unless absolutely necessary. While the employees' hours were reduced, all of our employees through the entire depression had an income, though it was a reduced one. Our plan of curtailment during the depression was, first, the elimination of the preferred dividends; second, the reduction of executive salaries; third, the reduction of office salaries, and, fourth, the reduction of wages. Our executives' salaries were cut from 35 to 60 percent, our office em-

ployees and sales employees, 40 percent, and the factory wages, 20 percent. Our company subscribed whole-heartedly to the program of the N. R. A. and lived up to absolutely every agreement of our code. We have absolutely made no wage cuts of any nature whatsoever since the codes were discontinued. The wages of our factory employees have been restored 100 percent, the salary cuts of our office employees have been restored 50 to 75 percent, and the cuts in the executives' salaries have been restored approximately 50 percent. If it had not been for our attitude during the depression, our financial condition at the present time might have been better. With our present situation I doubt very much if we could do this again if we had another emergency like the depression.

Due to the inventory losses, which we may have in the future, and to the terms of our bond indenture and to our shortage of working capital, the proposed tax on undistributed earnings of corporations will prove a serious hardship to us. A 22½ percent tax on undistributed income as compared with the present approximately 15 percent would increase the tax payable to the Government 50 percent, as stated. We believe that such a tax would be extremely unfair to us.

Furthermore, in the event of an expansion of business whereby the company will have increased inventories and accounts receivable, the company will require all its earnings in order to have sufficient working capital to operate.

Due to the condition which the Graton & Knight Co. is in, the net earnings will be needed for working capital. Such working capital will not be in the form of cash, but in new equipment, inventories, and accounts receivable. The corporation does not have any excess cash and has no investments in securities which can be turned into cash, and is not in a position to make a cash distribution to the stockholders. The money is needed in the business.

While I represent Graton & Knight Co. alone, yet I believe there are many other corporations in a similar position to the Graton & Knight Co.

We realize that the Government must have income, and one of the principal sources of revenue is the taxation of income of corporations. However, I believe that the Graton & Knight Co. and other companies similarly situated should not have any increase in the rate of tax under these circumstances. Unless we work out from under this default our tax rate would immediately step up to 42½ percent; if we do get relief under the law, our rate would be 22½ percent, and even at that I doubt very much if we would be in a position to resume dividends.

Senator WALSH. You are not paying preferred dividends?

Mr. WILSON. No, sir.

Senator WALSH. Since what time?

Mr. WILSON. 1931.

Senator WALSH. And you are not paying any dividends on common stock since when?

Mr. WILSON. 1921.

Senator WALSH. Are you meeting interest on your bonded obligations?

Mr. WILSON. Yes, sir.

Senator WALSH. About how much a year is that?

Mr. WILSON. About $65,000 a year.

Senator WALSH. Did you say how many employees you had?

Mr. WILSON. About 1,200.

Senator BLACK. You said you had not reduced wages since N. R. A.?

Mr. WILSON. That is right.

Senator BLACK. Do your employees still work the same hours?

Mr. WILSON. No, sir. During 1933, in the middle of 1933, when the N. R. A. became effective, our business improved to the point where we could work our employees 40 hours. At the present time they are working about 36 hours.

Senator BLACK. I mean the number of hours per day; how much were the hours per day under N. R. A.?

Mr. WILSON. Eight hours a day and 5 days a week.

Senator BLACK. You still work them 8 hours a day?

Mr. WILSON. When we have the business.

Senator BLACK. You have not increased the number of hours?

Mr. WILSON. No, sir; unless we have an unusual situation——

Senator BLACK. You mean only in exceptional cases?

Mr. WILSON. Yes, sir.

Senator BLACK. Are your employees organized?

Mr. WILSON. Not that we know of.

The CHAIRMAN. You spoke of undue hardship due to the terms of your bond indenture. We will look into that phase. As expressing the views of one member of this committee, I think the provision as to contracts made before March 3 and consummated, we should change that, because if anybody has made a contract, has incurred an obligation, before March 3, whether consummated or not, if there were negotiations at that time, it ought to apply.

Senator KING. If the obligation is incurred the liability would result under the contract.

What was the beginning of the dull period in your company?

Mr. WILSON. We noticed a falling off in business in the summer of 1929.

Senator KING. You had 5 dull years?

Mr. WILSON. With the exception of 1933, when we did enjoy somewhat better business.

Senator KING. Prior to 1929 was your company indebted; did it owe any money?

Mr. WILSON. Yes, sir; previous to 1918, no.

Senator KING. 1929.

Mr. WILSON. Yes, sir; we were in debt. Our bond issue was dated March 1, 1927.

Senator KING. You ran a loss of $2,000,000 during the 5-year period; is that correct?

Mr. WILSON. Yes, sir.

Senator KING. How did you take care of that? Did you issue more bonds, or do you still owe the money?

Mr. WILSON. No, sir. We have met our sinking-fund requirements every year. We have reduced our inventories, reduced our working capital, and used the money to meet these debts and also to take care of our deficits. We have spent little or nothing on new equipment.

Senator KING. Do you know of any way that a business concern can establish a credit other than through a reserve and paying its bills when due?

Mr. WILSON. Having a reserve—not unless we have good earnings every year and we are in a position where banks might be willing to loan us money.

Mr. Chairman, I would like to add a further thought. I believe that my limited contact with the Federal income-tax law since we have had that law indicates that while it may be imperfect in some respects, still we have had that law for a great many years, and it seems to have been more or less perfected, and it seems to me rather, perhaps, too bad to pass that law up and substitute one that we do not know what it will produce. I would like to recommend the thought to the committee that we take the present tax law as it applies to corporations and individuals, leave the law as it is, and add a percentage to the tax paid by every corporation and individual in order to help the Government over the present crisis.

Senator KING. What do you think of my suggestion that—of increasing the corporate tax up to 18 percent on income over $40,000 and then increasing the income tax upon the individuals, the normal tax, from 4 percent to 5 percent, and then a gradual increase in the surtax, particularly reaching those incomes of from $20,000 to $50,000, and then on up into the higher brackets, and raise about $900,000,000 in that way, and maintain the present tax structure?

Mr. WILSON. I am not in a position to discuss the surtaxes or the higher brackets, but, as a businessman, I believe the businessman today would favor an increased tax rate. I believe that the individual paying the normal tax also should have his tax raised. I believe the tax should be passed along to everyone. Incidentally, I believe that if Congress would give the businessman encouragement of that sort and other encouragement, that the businessman would be willing and ready to go ahead and that business conditions would improve through an increase of the tax rate. I believe that the businessman should be assured that Congress pledge itself to operate or to conduct itself as economically as it possibly can in the wise expenditure of money, as I believe you will get the cooperation of the businessman. I believe the businessman today feels Congress is antagonistic to him, and I believe the majority of businessmen in this country are just as loyal citizens of the United States as any other class of citizens.

Senator WALSH. Will the experts inform us how much increase there will have to be in order to meet the amount of money required under the bill; what would be the increase in the rate of corporation tax?

Mr. KENT. If the increased amount were gotten under the corporate banks, it is estimated it would have to be about 25½ percent; that is, an increase of about 10½ percent in the present rate. There would be about $60,000,000 additional revenue for each 1 percent increase in the corporate rate. I do not have the details with respect to the increases in the individual rate.

Senator WALSH. I do not think you understand my question. You want to raise $800,000,000?

Mr. KENT. Yes.

Senator WALSH. And you want to raise it by levying a certain percentage of increase in the amount of tax being paid by corporations under the existing law; what would that percentage have to be on the average?

Mr. KENT. It would be between 25 and 30 percent, Senator. At the present time the estimates for 1936, under the present law, were about $1,100,000,000 from corporate taxes and about an equal amount from taxes on individual incomes. Now, to increase that by $600,000,000 would mean between 25 and 30 percent.

Senator WALSH. So you would have to announce to the taxpayers that their taxes would be increased 25 to 30 percent?

Mr. KENT. Yes.

Senator BLACK. Do you believe, Mr. Wilson, that profits derived by a person through his interest in a corporation's stock should be subject to any higher or lower rate of taxation than the profit derived from any other line of business?

Mr. WILSON. I am afraid I do not quite understand.

Senator BLACK. I will ask you in another way. An individual or partnership can make a profit on trading in various ways, or an individual can buy stock in a corporation and depend upon profit in the stock of the corporation. Do you believe it fair that the rate he pays on his profit on the corporation's stock should be the same as the rate he pays on the profit he receives from other lines of business endeavor?

Mr. WILSON. My offhand answer would be "yes."

Senator BLACK. If there is a system, whatever the system is, that makes some individual pay more on his profits derived from a corporation's stock than he does from other profits, and makes other individuals pay less on their profits derived from corporation's stock than is paid on profits derived from any other industry, that should be changed, should it not?

Mr. WILSON. I think so, without knowing all the conditions——

Mr. BLACK. The only condition I am speaking of is, a man may make a profit in several types of endeavor, trading as an individual, from a profession, from any line of business activity, including an investment in a corporation, or an investment in real estate as an individual. Now, as a matter of fairness, no system should be permitted to stand, should it, if it gives certain individuals an exceptional rate by reason of their investment in a corporation and a much higher rate on income from individual investment; that should not be allowed to continue?

Mr. WILSON. I do not think so.

Senator BLACK. It is wholly unjust and contrary to everything we believe equitable, is it not?

Mr. WILSON. I think so.

The CHAIRMAN. Thank you, Mr. Wilson. The next witness is Mr. R. C. Fulbright.

STATEMENT OF R. C. FULBRIGHT, REPRESENTING THE SOUTHERN PINE ASSOCIATION

The CHAIRMAN. You represent the Southern Pine Association, Mr. Fulbright?

Mr. FULBRIGHT. Yes, sir.

The CHAIRMAN. Can you finish in 20 minutes?

Mr. FULBRIGHT. I wish to go into some phases of the estimates here.

The CHAIRMAN. Try to get through as briefly as you can.

Mr. FULBRIGHT. Before going into the presentation for the Southern Pine Association I want to take a minute to mention one other matter, and that refers to the amendment made in section 115 (c) at page 108 of the committee print, part I, of the bill before you. That section deals with distributions by corporations in liquidation. It has been very widely changed by the House upon recommendation of the Treasury Department so as to provide that where there is complete liquidation of a corporation the amounts received will have the benefit of the provisions of the capital, gains and losses, section 117–a. That has been the law previous to 1934, but in 1934 this section was changed so as to eliminate corporate liquidation from the capital gains and losses provision. Now, it was so left in 1934 that it constitutes a trap in some cases to unwary taxpayers to fall into it. In other words, if a corporation liquidated and distributed its properties to its stockholders, the stockholders did not get the benefit of section 117 with respect to capital gains, whereas if the corporation sold its stock to another corporation and that other corporation liquidated it to its stockholders, they got the benefit, and they could liquidate without any profit.

We have had some correspondence from people in the chairman's State and in Louisiana who got caught in that, and the only thing we ask is that the provision be made retroactive to December 31, 1934, where there are cases where companies were caught in that trap last year.

Senator KING. Some have paid their taxes after having been caught in the trap.

Mr. FULBRIGHT. It should be made retroactive to 1934, because it has been an unjust situation and is so recognized.

Senator KING. If some have already paid we will no doubt have legitimate and equitable demands from those who have paid.

Mr. FULBRIGHT. I think so.

I wish to state that the Southern Pine Association represents the softwood industry of the South; we have numerous small corporations, a few fair-sized corporations and we also have numerous partnerships in our industry. The Southern Pine Association has not had an opportunity to pass upon the provisions of this bill, but prior to its annual meeting on March 30 there was released from Washington the first report of the subcommittee of the Committee on Ways and Means——

Senator KING. What percent of the lumber business of the South, the pine business of the South, is embraced in your organization, 10, 20, 50, or 100?

Mr. FULBRIGHT. I should say about 50 percent. There are numerous small mills and we cannot very well keep track of all of them; they move from place to place.

In that proposal there was also a proposal to tax distributions from reserve——

The CHAIRMAN. Just confine yourself to this bill, Mr. Fulbright.

Mr. FULBRIGHT. The association considered the proposal which has been eliminated by the House. I shall not discuss it.

With regard to the general scheme of taxing undistributed net income, it was fully realized that while it would result in reducing taxes to them, they went on record as not approving the general principle involved in the bill.

Now, much of the comment that I make on this bill will not be matters which have been passed on by the association, but I have been engaged in the law practice and in handling tax matters for 25 years or more, and I have listened with great interest to the presentations that have been made, and I wish to say at the outset that I do not believe there is any class of taxpayers today in this country that is demanding a tax reduction. Personally, I do not think this is the time for tax reductions. I believe we have necessarily had to undergo expenditures that make it necessary that we raise more revenue, and before I conclude I shall make some suggestions along that line, if I may.

But the more I have studied the estimates that have been presented to the Ways and Means Committee and to this committee, the more I am convinced they will not raise the revenue it is thought will be produced.

I wish to make some observations for the benefit of this committee along those lines.

Now, of course, corporate returns do not show to whom dividends are paid; likewise, individual income-tax returns do not show the corporation from which dividends are received. It is a very difficult matter from the data available to make any complete study of the subject, as the representatives of the Treasury have told you; but even if they could get complete data, from what corporations they came and to what individuals they were paid, it would still not throw much light on the question as to what individual taxpayers will receive the dividends which will be forced out of the corporations by the new legislation. It is not correct to assume that the same persons who return as income dividends from corporations under the present tax system will be the recipients of the additional dividends, for the reason that in a large percentage of the cases the additional dividends will go to individuals who do not hold any substantial amount of stock in corporations now paying dividends.

Senator KING. And under the present law will be exempt from the payment of taxes?

Mr. FULBRIGHT. Yes, sir.

We can compute what revenue will be lost, but we can only speculate as to what will be obtained. The Treasury experts estimate a loss of $1,132,000,000. This is approximately 16 percent of the estimated corporate income for 1936 and is based upon the assumption that the entire corporate income will be distributed under the new law. Of course, this is not correct, because, as the Treasury points out, a substantial part of the income may be retained at a much less rate of tax than is now paid.

The CHAIRMAN. Do those figures include the 15-percent tax?

Mr. FULBRIGHT. They estimate a total of 16 percent; that is, the 15 percent plus the guesswork taxes called excess-profits taxes.

However, assuming that all of the corporate net income will be distributed, we must also assume that practically all of it will pay 4 percent, which will leave a net loss of $844,000,000 to be compensated by surtaxes paid by individuals under the existing schedules.

In the case of corporations with small income it is admitted by the Commissioner of Internal Revenue that perhaps the majority of such corporations and a majority of the individual stockholders thereof will reap the benefit of a lower tax burden than they now sustain. According to the statistics for 1933, the latest year available to the public, approximately 15 percent of the corporate net income returned is received by corporations having less than $50,000 net income. As to these it may be said that there will generally be a substantial reduction in the combined revenue to be received from such corporations and their stockholders. In other words, none of the deficit will be made up from this class, but rather will the deficit of $844,000,000 be increased by the opportunities which are available to closely held corporations to very greatly reduce the total tax burden of the companies and their owners.

By far the most important group of corporations from the standpoint of tax revenue is the class returning a net income of $5,000,000 or more per year. In 1933 this class returned more than 30 percent of all corporate net income returned. This percentage, as well as that of the corporations having less than $50,000 income, is rather closely in line with the percentages for these classes as shown by statistics for former years. If this enormous loss is to be made up, it is obvious that we should expect that a considerable part of it should come from the class of corporations having taxable net income of $5,000,000 or more per year, particularly since they are by far the most important class.

An analysis of this class of corporations will disclose that the Government will not likely make up any part of the deficit from them and their stockholders. The reason for this is that most of the very large corporations have already built up reserves to conduct their business and follow the habitual policy of distributing nearly all of their net income from year to year. We have made an analysis of certain available data for the year 1933 and have used this because it is the latest year for which the revenue statistics are available. It will be noticed that in the presentation of the Commissioner before the House Ways and Means Committee actual figures were given only for 1933 and prior years. Round estimates were given for 1934 and subsequent years. In 1933, according to the report of the Bureau of Internal Revenue, there were 69 corporations returning a net income of $6,000,000 or over and the aggregate taxable net income returned by this class was $903,781,000, which constituted 30.29 percent of the taxable net income returned by all corporations.

Our analysis shows that instead of obtaining additional revenue from this class of corporations under the proposed bill there will be in fact an added deficit.

Senator KING. If the 69 corporations whose net income exceeded $5,000,000 constituted only 30 percent——

Mr. FULBRIGHT. Of the total income.

Senator KING. And the total is 1,000,000,000 plus——

Mr. FULBRIGHT. Yes.

Senator KING. It would seem to me there was an hiatus there somewhere.

Mr. FULBRIGHT. There are 69 corporations making returns of over $5,000,000. Their total return was $903,000,000. That constituted 30 percent of the total returned by all classes of corporations. We

have examined the annual statements of corporations as published by Poor's Compilations of Corporate Data and took all corporations with incomes above $5,000,000, and we selected 73 corporations. There were more than that number, but by combining them where we knew they would be consolidated we found there were 73. These corporations represent, perhaps, an approximation of the group on which the Bureau of Internal Revenue based its figures.

Senator KING. That would be after their income tax was paid, their corporate tax.

Mr. FULBRIGHT. Naturally, the distribution of the corporation would be, Senator.

This does not include some $20,000,000 of stock dividends.

Naturally, the income from these 73 corporations would be expected to be in excess of the taxable income figure reported by the Bureau of Internal Revenue. The range of net income, as shown in the annual statements for these corporations, was from approximately 5 to 137 million dollars, and in the aggregate total $1,115,000,000. In the year 1933, against this income, these corporations distributed $929,000,000 in dividends, or a percentage distribution of 83⅓ percent of the total net income of the corporations.

Three corporations out of this list paid no dividends at all in 1933, although in the previous years of the depression they had continued to pay dividends even though their earnings, their earning statements, reflected deficits.

It is submitted that the figures for 1933 are not abnormal or out of line with any previous years from which such a comparison might be made for the reason that by 1933 many corporations had reduced their dividend rates from previous higher rates which had applied in 1930, 1931, and 1932.

Therefore, by taking the corporate distribution in dividend percentage of 83⅓ percent and applying the schedules under the proposed Revenue Act of 1936, it can be seen that a taxable rate of slightly less than 5 percent would come into play. Five percent of $1,115,000,000 would return to the Government only $55,750,000 in taxes. Of course, under the new law it can be assumed that the distribution of $929,000,000 would be subject to added taxation in the form of the 4-percent normal tax. Therefore, $37,160,000 in additional revenue would arise from this source, or a grand total of $92,907,000 of revenue which would come to the Government from the 1936 Revenue Act in its effect on corporations of net income over $5,000,000, or approximately 40 percent less revenue than would be derived under the present rates.

The CHAIRMAN. Pardon me, Mr. Fulbright. I desire to announce that tomorrow morning we will start the hearing at 9:30; we have a great number of witnesses.

Mr. FULBRIGHT. Mr. Chairman, I apologize for taking your time, but I think this goes to the very heart of what we are doing here. The question is: Are we going to get the revenue hoped for under this bill?

Now, we have verified these figures in other ways. We took all corporations from the manual, showing $10,000,000 or more of net income over the period of the last 5 years, and we went back for each of the years. In 1933 there were 58 of those corporations and they distributed 88.4 percent of their earnings.

In 1935 there was a less percentage; there were 51 corporations last year having reported earnings of more than $10,000,000, with a total net earnings of $1,160,000,000, and they distributed $905,000,000, or something over 78 percent.

Now, apply this bill to them and the average rate of tax would be 6⅔ percent. You would have a loss of approximately 5 or 6 percent on all of that class of the large corporations by the application of the bill. It would amount to many millions of dollars.

In 1934 the distributions of the similar class of corporations was 87½ percent. Back in 1931 and 1932 the corporations earning more than $10,000,000 actually distributed more than they made. This was for the reason that those corporations had built up reserves out of which they could continue their dividend-paying policies.

I took a group of companies which I knew were outstanding companies, selected more or less at random. I took the total income and total dividends for 5 years. Those companies were the American Telephone & Telegraph Co., American Tobacco, Consolidated Edison, Corn Products, General Electric, General Motors, Pacific Gas, Public Service of New Jersey, Procter & Gamble, Reynolds Tobacco, Standard Brands, Union Pacific. They had a total income for the 5-year period of $2,552,000,000 and total dividend distributions of $2,637,000,000. There was not one of them that did not distribute more than 90 percent of its earnings for the period. I first had International Harvester included in that, but I took it out because I found, for the 5-year period, the International Harvester Co. had only earned $15,500,000 and had paid out over $54,000,000 in dividends. The International Harvester Co. kept its plant going and kept its men in employment out of what it had built up prior to that time; but I left it out of this calculation.

Senator KING. You found many companies that paid out in dividends more than their earnings?

Mr. FULBRIGHT. Numerous companies. You will find they all are companies with general stock ownership. On the other hand, we know there are companies that do not do that; they come into the small class. How are you going to make up this deficit?

It is my opinion that the estimate made by the Treasury that there will be 4½ billion dollars corporate net income for the year 1936 which would not be distributed under existing law but which would be distributed under the proposed law, is so highly speculative as to be of little or no value. This estimate is arrived at by estimating the total statutory corporate net income for 1936 will be $7,200,000,000, or more than double the actual income of corporations in 1933, which was $2,986,000,000. We may assume that this estimate is about as good a guess as we can make at this time. Personally, I am inclined to believe that it is about what is indicated under the latest available business statistics.

The CHAIRMAN. I did not understand the Treasury said that would be distributed, but that is the amount of undistributed income; they did not say it was distributed.

Mr. FULBRIGHT. I gathered that, and I may be in error; I cannot keep up with all of their figures, Senator. That is more than double the amount of income of corporations that had income in 1933. I am not criticizing that estimate, but from the analysis we have been

able to make of the reports up to date, there will certainly be a much larger income this year than last year, unless something we do not dream of now happens.

However, the assumption is made under existing law nearly $2,700,000,000 will be paid in net cash dividends, whereas in 1933 the actual figures as to net cash dividends were $2,102,000,000. The net cash dividends are arrived at by eliminating the dividends received by corporations. It will be observed that while it is estimated that the 1936 income will be considerably more than double that of 1933, on the other hand it is estimated that the net cash dividends paid will only be about 28 percent more. In other words, while the net income will jump from $2,986,000,000 to $7,200,000,000, the net cash dividends would only be increased from $2,102,000,000 to $2,700,000,000. The statistics of dividend payments by the large corporations, as available from various statistical bureaus, indicate a much larger proportion of income being paid out as dividends than revealed by the estimate of the Commissioner.

Now, taking the $7,200,000,000, we estimate in this class of small corporations, the less-than-$50,000 class, they have about 15 percent of the income, or $1,080,000,000. There will be an 8-percent loss, a $84,800,000 loss. Applying the 1933 base to those of $5,000,000 or over, constituting 70 percent of the income, there will be a loss of $129,000,000, or a total loss of $214,000,000 to add to the $844,000,000, making $1,058,000,000 to be made up out of the intervening class. We do not think it can be done.

Senator BLACK. You mean all of the corporations under the new law, as you have computed it, the Government will draw a smaller amount of tax from them and their stockholders by the new bill than by the old law?

Mr. FULBRIGHT. I think that will be conceded, Senator.

Senator BLACK. And their stockholders and they would have to pay a much smaller amount of tax?

Mr. FULBRIGHT. Much smaller.

Comparative statement of income-tax burden under present and proposed revenue acts in case of corporations with small income

(By R. C. Fulbright)

For a convenient comparison showing the effect of the proposals in H. R. 12395 six illustrations are given, in each of which it is assumed that the corporation has an adjusted net income of $20,000 and has three stockholders, i. e., Smith, owning 50 percent of the stock; Jones, owning 30 percent; and Brown, owning 20 percent. It is also assumed that the personal exemptions and deductions to which each stockholder should be entitled are exactly offset by salaries and other income.

In the first three illustrations (A, B, and C companies) the stockholders have no other taxable income than the dividends received from the corporations; whereas in the other three illustrations (X, Y, and Z companies) the stockholders have outside taxable income.

The A and X companies are situated so that they can afford to distribute all of their earnings. The B and Y companies cannot afford to distribute more than half of their earnings, while the C and Z companies can afford to distribute 70 percent of their earnings. The statements show the change in the tax burden under the proposed law and the discrimination which will arise against the less fortunate corporations.

	Stockholders	Dividends received	Under present law: Individual taxes	Under present law: Share of corporate taxes	Under present law: Total taxes	Under proposed law: Individual taxes	Under proposed law: Share of corporate taxes	Under proposed law: Total taxes
A company (distributes 100 percent of income)	Smith	$10,000	$300	$1,320	$1,620	$700	None	$700.00
	Jones	6,000	80	792	872	320	None	320.00
	Brown	4,000	None	528	528	160	None	160.00
Total		20,000	380	2,640	3,020	1,180		1,180.00
B company (distributes 50 percent of income (schedule II-A)	Smith	5,000	40	1,320	1,360	240	$1,750.00	1,990.00
	Jones	3,000	None	792	792	120	1,060.00	1,180.00
	Brown	2,000	None	528	528	80	700.00	780.00
Total		10,000	40	2,640	2,680	440	3,500.00	3,940.00
C company (distributes 70 percent of income (schedule III)	Smith	7,000	130	1,320	1,450	410	$843.75	1,253.75
	Jones	4,200	8	792	800	176	506.25	682.25
	Brown	2,800	None	528	528	112	337.50	449.50
Total		14,000	138	2,640	2,778	698	1,687.50	2,385.50

	Stockholders	Outside taxable income	Dividends received	Under present law: Individual taxes	Under present law: Share of corporate taxes	Under present law: Total taxes	Under proposed law: Individual taxes	Under proposed law: Share of corporate taxes	Under proposed law: Total taxes
X company (distributes 100 percent of income)	Smith	$10,000	$10,000	$1,680	$1,320	$2,980	$2,080	None	$2,080.00
	Jones	6,000	6,000	680	792	1,472	920	None	920.00
	Brown	4,000	4,000	340	528	868	500	None	500.00
Total		20,000	20,000	2,680	2,640	5,320	3,480		3,480.00
Y company (distributes 50 percent of income) (schedule II-A)	Smith	10,000	5,000	1,096	1,320	2,416	1,290	$1,750.00	3,040.00
	Jones	6,000	3,000	480	792	1,272	600	1,050.00	1,650.00
	Brown	4,000	2,000	340	528	768	320	700.00	1,020.00
Total		20,000	10,000	1,810	2,640	4,450	2,210	3,500.00	5,710.00
Z company (distributes 70 percent of income) (schedule III)	Smith	10,000	7,000	1,200	1,320	2,610	1,570	$843.75	2,413.75
	Jones	6,000	4,200	554	792	1,346	722	506.25	1,228.25
	Brown	4,000	2,800	280	528	808	392	337.50	729.50
Total		20,000	14,000	2,134	2,640	4,764	2,684	1,687.50	4,371.50

I want to illustrate that by a table and data that has been passed up to the members of the committee. The first page is explanatory. We have taken A, B, C companies and X, Y, Z companies, and have assumed each has an income of $20,000, an adjusted net income, we will say, of $20,000. I wish to call your attention to the different assumptions. The first is that 100 percent of the income will be distributed; the second assumption is that 50 percent will be distributed; and the third is that 70 percent will be distributed.

Now, under the present law the A company, distributed 100 percent of its dividends, and we assume here that the three stockholders there, as the explanation shows, would have enough exemptions and

deductions to take care of their outside income, their salaries, and so forth. Under the present law that corporation would be taxed $2,640; only two of the individuals would pay any tax because they would not get into the surtax brackets—that is, the third individual would not pay any tax. Under the proposed law the corporation would pay no tax and the individuals would pay only $1,180.

You can see what the reduction is.

Now, then, the B company, we will say, has to improve its plant. Some of the lumber companies have said they need money to fix up the plant in order to manufacture a better quality of lumber than they are now able to produce, or it may be indebted in such a way it cannot follow the amortization plan that I would like to refer to if I had time. They have to retain 50 percent. You will notice that corporation and its stockholders are going to pay $3,940, or more than three times as much as the fortunate corporation that did not have to hold its money to build up its plant or do anything like that.

The third example illustrates that where a 30 percent reserve is made and 70 percent of the income is distributed, there is actually some saving, as has been attested by the representatives of the Treasury Department. But in that case I wish to call your attention to the fact that those corporations will be taxed very much more than the partnerships in business doing the same amount of business and having the same net income.

There has been a lot of talk here about partnerships, and I want to tell you about the partnerships. Business of a business of any size is not conducted by partnerships. We have the statistics on that. The Commissioner sent telegrams to all of the collectors in order that he might have here for this hearing the number of partnership returns made last year. There were 205,432 of them; there were only 80 that had incomes of $500,000 or more. They used an illustration of a partnership of $500,000 income. Those partnerships were most likely professional partnerships; some of them may have been lawyers; it has been a great time for the lawyers, you know. Now, that is not all. Only 833 of the 205,000 had incomes of $100,000 or more, four-tenths of 1 percent of them. But when you take the little businesses, I tell you that this bill makes it a lot harder on the corporation than the partnership, and this exhibit proves it.

Senator BLACK. I thought you said it reduces the little business' taxes.

Mr. FULBRIGHT. It does, provided they can distribute the money. Look at page 2. In the case of the company that has to hold half of it, it shows an increase in taxes of 50 percent, and will tax it three times as much as if it were a partnership and three times as much as the more fortunate corporation which does not have to hold its money.

Now, on the third page, we have assumed that each of the stockholders had outside taxable income of $10,000, $6,000, and $4,000, respectively. Those are pretty good sizable amounts in my country, although they may be pretty small up here. They represent our best people, our business people down there. Where they distribute 100 percent of the income, the total taxes under the present law would be $5,320, and under the proposed law they would be reduced to $3,480. That may be nice, but those people are not demanding that taxes be

reduced now. All of this great mass of business concerns over the country, the meat and bread line, have any of them been sending you letters saying they want tax reduction at this time? Now, this Y company, we find the combined tax will be $5,710, or 64 percent more than the tax of the one more fortunately situated.

Senator BARKLEY. You say they have independent income?

Mr. FULBRIGHT. It is shown in the column under outside taxable income, the $10,000, $6,000, and $4,000.

It also assumes that the ordinary exemption for the family and the ordinary deductions will be offset by the salary the man receives.

Now, the Treasury says it is so easy to get around that by having them declare a dividend and then bring the money back in as added capital and points to the great privilege they have and the ease and informality with which small corporations may do this. I wonder how much experience those representatives ever had in the actual representation of corporations under the laws of some of our States. In my State of Texas, for example, before you can get authority to increase your capital stock it has to be subscribed, 50 percent paid in with money, or the equivalent of money, and checked by the secretary of state before he will grant authority to do it. If you are going to issue stock rights, you would get into something that is not recognized under our law, and preferred stock is not recognized. You have to make a contract with all of the stockholders and they will have to hire a lawyer. You are going to impose a lot of burdens on the small corporations. First, to hire a lawyer, who will have to see how he is going to work out his capital structure every time a dividend is declared, and then hire income-tax experts to see what bracket he is going to get in.

As I stated at the outset, there are a lot of our members who are going to get reduced taxes. I sent out a questionnaire and have gotten a few returns from it. I have noted a couple from the State of the chairman. One of them estimated that next year they are going to make $60,000.

The CHAIRMAN. Was that a corporation?

Mr. FULBRIGHT. Yes. They said they had a close corporation, and they could pay that out and then pay it back. But there are a lot of them that cannot do that. Another one in an adjoining county gave an estimate of their debt; they wanted to improve the plant and would only have a small income. They do not want the proposed tax. That one was indebted; the other one did not need any money. They were going along fine.

The CHAIRMAN. How is it going to be a burden if they are given special treatment?

Mr. FULBRIGHT. They are only given special treatment if they get all of the stockholders to agree they will distribute it and pay it back. That will work all right in lots of cases, but suppose a stockholder dies and a guardian is appointed to represent minor children; the court is not going to let him invest that money in a corporation under the laws of my State or yours either. There are many cases where it cannot be done. It is fine in theory, but it will work out by causing trouble in practice. There are many cases where they can have a tremendous reduction in taxes; but, on the other hand, I do not believe they are expecting a reduction in taxes.

Now, there is another provision that was in the recommendation from the Treasury but which was changed on the floor of the House. They gave the corporation a 2½-month period after the close of the year to determine how much of the income it would distribute. In the House they crossed that out.

The CHAIRMAN. Do you not think that was a proper action?

Mr. FULBRIGHT. If they are going to get the money next year; but the trouble is that there are many companies that have not the remotest idea what their net income is until they take inventory at the end of the year, and then they are able to tell what they are going to do.

Senator KING. According to the decline in their inventory or the solvency of their debtors.

Mr. FULBRIGHT. The gentleman who talked about hides showed that where the price varied 2 or 3 cents he would be in a bad fix.

Senator CONNALLY. In order to offset a decline in the value of inventories that occurs after the first of the year in determining his ability to pay taxes, the decline should be coincidental with the income?

Mr. FULBRIGHT. They would take the inventory at the beginning of the year and at the end of the year, and until the latter one is taken they have no way to tell what it is.

Senator BARKLEY. Do you not believe that any concern that is run pretty well knows what it has made in December of a year?

Mr. FULBRIGHT. In manufacturing lines, yes, sir; but in cotton, with which I am familiar, a cotton merchant does not know where he is until he gets his inventory.

Senator BARKLEY. We will take the year 1936. Now, he will take that inventory after the 1st of January. He has up to the middle of March to make out his income-tax report. Will he not have all of that inventory information before he is required to make out his income-tax report so as to offset his earnings?

Mr. FULBRIGHT. That is perfectly correct, but under the law now they would have to determine what their distribution would be before the close of the taxable year.

Senator BARKLEY. Not necessarily.

Mr. FULBRIGHT. They would if they are going to get the benefit of the schedule in the bill. They cannot get the benefit of it otherwise.

I want to say this in conclusion—pardon me, Senator, did you have another question?

Senator BARKLEY. No.

Mr. FULBRIGHT. I want to make this suggestion, gentlemen: We had a tax bill passed in 1918 that produced more revenue than any special tax bill that was ever passed. We built up a body of regulations under it and a body of court decisions, and it was fair; that was the excess-profits tax. If a corporation made excess profits upon its capital, it paid a substantial additional tax. I do not think you will find a lot of business people hollering for it, but it will produce revenue. If we are going to have this doubling up of income, $7,200,000,000 from these corporations, which the Treasury estimates, and I have no reason to believe the Treasury is not correct, I believe that we could by reenacting a tax on which we have the regulations, court decisions, and administrative methods all worked out, we could

get a very large amount of tax next year. I suggest that is an important thing for the actuaries to get busy on, rather than to launch into such a speculative thing. The Treasury says, "We are going to lose $1,132,000,000"; now, where are we going to make it up? They point out the different ways in which they can keep from paying income taxes, and believe me, they will be doing it. The lawyers and tax experts will show them how they can do it, and to the extent they can do it you are going to lack making up the $1,132,000,000, and unless you can get a more accurate statement than those which have been referred to, I do not think it is a good idea to embark on certain experiments.

Senator BLACK. Under this proposed legislation we are not likely to raise as much taxes as under existing law; is that your contention?

Mr. FULBRIGHT. I think we will raise as much, but I do not think we will get any substantial increase.

Senator BLACK. How much do you think it would be?

Mr. FULBRIGHT. I have not been able to complete my estimates, but those who pay 15 percent of the income, there will be a very large loss, and for those who pay 30 percent, there will also be a large loss, and in the intervening class there will be a gain. How much it will be I have not been able to determine, as I have not completed my computations.

Senator BLACK. Have you examined what has been submitted by the experts?

Mr. BARKLEY. I have seen everything they have offered, both in the House and here. I can say I do not see where they are going to get any $600,000,000 in addition to the loss of the $1,132,000,000. They are going to lose $200,000,000 out of the A. T. & T.; they will go scot free; they will not pay any tax, and the General Motors will not pay any tax.

Senator BLACK. How about the people who draw the dividends?

Mr. FULBRIGHT. Some members of my family have A. T. & T. stock, that is, my wife's kinfolks. Some of them have a very small income. It is not going to make a dime's difference to the Government as far as they are concerned.

Senator BLACK. How about those in the higher brackets; will it not raise them into a still higher bracket?

Mr. FULBRIGHT. The A. T. & T. will pay just what they have been——

Senator BLACK. I am talking about the stockholders of the A. T. & T. who draw dividends and who may be in one income-tax bracket, and if they draw more, it puts them in another.

Mr. FULBRIGHT. May I illustrate——

Senator BLACK. Does it, or not?

Mr. FULBRIGHT. No, sir.

Senator BLACK. It does not affect them at all?

Mr. FULBRIGHT. Not unless they have income from another corporation.

Senator BLACK. Suppose they have income from various corporations.

Mr. FULBRIGHT. May I answer the question in my own way, Senator?

Senator BLACK. Yes.

Mr. FULBRIGHT. Here is a man who has $100,000 income to start with. He gets $20,000 dividends from the A. T. & T. By virtue of this law being passed, you force some other corporation to pay dividends it did not pay before, and he gets more from them. That is where the added revenue comes; it is not because of the A. T. & T. All he pays is 4 percent normal on that, and the A. T. & T. gets out of 16 percent, a net saving of 12 percent. But by forcing another corporation to make distribution you get some money out of that, and that is where we can make it up, but I do not see how we will make it up.

Senator BLACK. Are you an accountant?

Mr. FULBRIGHT. No, sir.

Senator BLACK. Who assisted you in this?

Mr. FULBRIGHT. People in my office.

Senator BLACK. I am asking because your evidence is interesting.

Mr. FULBRIGHT. It has been worked up in my office; the junior associate in my office is responsible for most of the figures.

Senator BLACK. Are you a lawyer?

Mr. FULBRIGHT. We are, and some of us have had to learn something about accounting and statistics.

Senator CONNALLY. I know Mr. Fulbright is a very able and capable lawyer.

Senator BARKLEY. There is a difference of 64 percent in two corporations with the same income.

Mr. FULBRIGHT. It would be a great deal more than that; that is, the combined tax the corporation and the stockholders. If one corporation was in a position to distribute all of its income and its stockholders did not have any other source of income, and the other corporation could only distribute half of it, in that case the one which could not distribute but half of it would pay more than three times what the other paid.

Senator BARKLEY. That would be a very great disadvantage.

Mr. FULBRIGHT. It is a great discrimination. This law will discriminate against small corporations in favor of small partnerships, because a partnership does not have to worry about whether or not they will withhold part of it or improve its plant; but if the corporation withholds some to improve the plant, it is going to pay three times as much as the partnership in the illustration I give.

The point I am trying to make is in case of small taxpayers it creates a tremendous inequality, and we have explained this to the lumber men and it does not appeal to them as being a good policy. I might say in my section we have many small oil-development companies that have to keep their money in the company in order to keep going in competition with the great Standard companies, the Texas Co., and companies like that, and I can see it would be a tremendous discrimination against companies of that sort.

Senator BLACK. Assume a corporation owes no money and has a big surplus, and here is another corporation that owes money and has no surplus.

Mr. FULBRIGHT. One, instead of paying 16 percent of its income to the Government, will not pay anything; the other, instead of paying 16 percent of its income, may have to pay anywhere from 17 up to 42½ percent.

Senator BLACK. Is it your view this bill works to the disadvantage of all of the corporations in this country which do not have big surpluses?

Mr. FULBRIGHT. I think ultimately that would be the effect, Senator. It does not necessarily do it to start with, because you have to take into consideration the position of the stockholders and whether the stock is closely held and whether the stockholders would take advantage of the loopholes.

Senator BLACK. One has a surplus and the other has to pay earnings.

Mr. FULBRIGHT. But if one has only three stockholders and they can declare the dividends and put them back into the corporation as paid-in surplus, they would be on an equality, but if they have one stockholder who keeps it, or a guardian is appointed, as I have pointed out, they would have to have lawyers and it would not be as simple as you are led to believe.

Senator KING. Have you some tables on the copartnership showing the number and how it affects them?

Mr. FULBRIGHT. I do not have anything on that, except there were some figures put into the record before the House Ways and Means Committee, at page 428.

Senator KING. Would you call two or three farmers who work together a copartnership?

Mr. FULBRIGHT. Yes, sir.

Senator KING. Has the Department so classified them?

Mr. FULBRIGHT. It follows the common-law concept. If it is a joint-stock association it may be a partnership under State law, but subject to taxation as a corporation. Many of our lumber companies are copartnerships.

Senator KING. I wondered whether they classified in the copartnership column a couple of sheepmen who work together.

Mr. FULBRIGHT. If they engaged in that business from year to year they are a copartnership; if they expect to dispose of the sheep the next year, it would be a joint venture.

Senator KING. A couple of men who buy a grocery store and have $2,000 of stock, what is that?

Mr. FULBRIGHT. A copartnership.

Senator KING. Have you any figures showing the aggregate earnings of copartnerships measured by the gross earnings of all corporations?

Mr. FULBRIGHT. We do not have the comparative figures. The figures I referred to are for 1935, and we did not have available the other statistics. Those copartnerships include engineering firms, law firms, and service firms.

Senator KING. Not industrialists or manufacturers?

Mr. FULBRIGHT. No, sir.

Mr. CHESTEEN. We can give you the estimated corporate income for 1935, and since the tax yield is running so close to the estimate, it would indicate the estimate on income is exact enough for your purposes, and it would give you a basis for comparison.

Senator KING. I had in mind the gross earnings of partnerships and of all corporations.

Mr. FULBRIGHT. I doubt if there are a score of partnerships engaged in business in this country where they will run over $100,000 a year. There are many law firms, and things of that character where they will run in excess of that. I was rather astonished to note that only four-tenths of 1 percent of 200,000 partnerships ran into that.

The CHAIRMAN. Was that reference you gave as to the earnings in the hearings on this bill in the House?

Mr. FULBRIGHT. On this bill; it was in the report.

Senator BLACK. Suppose a stockholder in a corporation makes sufficient income so that he is in the 65 percent brackets for the year and the company declares a dividend, adding $10,000 to his income; what percentage of that $10,000 would go to the Government for taxes?

Mr. FULBRIGHT. It would be in excess of 65 percent.

Senator BLACK. In excess of 65 percent?

Mr. FULBRIGHT. Yes, sir.

Senator BLACK. If he was in the 45-percent brackets, it would be in excess of 45?

Mr. FULBRIGHT. Yes, sir.

Senator BLACK. And if he was a stockholder down in the 4-percent brackets, it would be somewhere in excess of 4 percent?

Mr. FULBRIGHT. Yes, sir.

Senator BLACK. Now, if he is paying under the present corporation tax and that profit stays in the corporation, the corporation would pay 15 or 16 percent on profit, would it not?

Mr. FULBRIGHT. Yes, sir.

Senator BLACK. Whether he would have to pay 4 percent or 65 percent or 72 percent; that is correct, is it not?

Mr. FULBRIGHT. That is correct.

Senator BLACK. So that in the actual operation of the payment of tax on that profit it fluctuates from nothing up to 72 percent, so far as those dividends are concerned, as paid out to the taxpayer, dividends from the corporate profits?

Mr. FULBRIGHT. Oh, yes.

Senator BLACK. Now, the individual earnings, the partnership earnings, do not fluctuate in that way?

Mr. FULBRIGHT. No, sir. Whether they distribute it or not, they must return their proportion of the income of the enterprise.

Senator BLACK. So that in reality one of the issues here is whether or not the disadvantages you have described, so far as the corporation is concerned, outweigh an effort to prevent such a wide fluctuation in the amount of taxes paid on the profits which go from the corporation, as compared with the profits that the individual gets from other concerns?

Mr. FULBRIGHT. I do not deny there are inequalities, but that is very rare, because business is generally run by corporations, and only small enterprises are run as partnerships.

Senator BLACK. Take yourself, as a lawyer.

Mr. FULBRIGHT. I would get stuck with it.

Senator BLACK. You have to pay on the amount of the brackets in which you happen to have your earnings?

Mr. FULBRIGHT. That is correct.

Senator BLACK. But if someone else invests in a corporation, even though he may have a large income of several million dollars, which would place him in the higher brackets, on the profit made on the corporate stock he would be below the rate you would pay on your income, even though you are in the low bracket?

Mr. FULBRIGHT. But when he dies the Government will get theirs.

Senator BLACK. The Government may and it may not. If that stays there for 5 or 6 years and they declare a dividend, or suppose he sells it.

Mr. FULBRIGHT. Then he pays profit on the increase in value.

Senator BLACK. A tax on the profit?

Mr. FULBRIGHT. Yes, sir.

Senator BLACK. What percentage of profit?

Mr. FULBRIGHT. If it comes in the capital net losses or gains, it would be in the schedule which runs from 1 year to 10 years, and scales from 30 to 90 percent.

Senator BLACK. And he formerly paid 12½ percent?

Mr. FULBRIGHT. Yes, sir.

Senator BLACK. We changed that by the most recent law.

Mr. FULBRIGHT. Yes, sir.

Senator BLACK. You have read where one man who everybody knew was very wealthy has paid no income tax at all, even though the corporations through which he did business, many of them, made profits, Mr. Morgan; if dividends had been declared on the stocks he had in various corporations, he would have had to pay an income tax, would he not?

Mr. FULBRIGHT. Yes, sir.

Senator BLACK. And the probability is if the dividends had been declared these corporations would have had to pay far above what the normal man would have to pay?

Mr. FULBRIGHT. Yes.

Senator BLACK. And to that extent it is an unfair operation of the present law?

Mr. FULBRIGHT. I know there are inequalities and I do not know any formula that will get us away from all of them, but if you had the excess profits tax, Mr. Morgan would pay a lot more.

Senator BLACK. You know that every effort we make to enact any kind of tax law that reaches those gentlemen is difficult; there are numerous holes and they always find them.

Mr. FULBRIGHT. I said before this committee when the 1934 act was up for discussion that a proper administration of a law like section 351——

Senator BLACK. What is that?

Mr. FULBRIGHT. That is where they allow the gains to accumulate in a corporation beyond the needs of the business enterprise.

Senator BLACK. That is 102, is it not?

Mr. FULBRIGHT. One hundred and two is the personal holding company, but 351 permits gains to accumulate where there is a presumption they are needed for investment in the company such as that.

Senator BLACK. It certainly is our duty to make an effort—we know we cannot have a perfect tax law, but we should see that no particular group is permitted to take advantage of any kind of device to pay smaller amounts of tax on their profits than others.

Mr. FULBRIGHT. But here you do just the opposite.

Senator BLACK. I understand that is your construction.

Mr. FULBRIGHT. There is no question about the correctness of that construction.

You asked a question about the increase in the number of copartnerships. When the Commissioner was on the stand he stated that in 1926 there were 295,000 partnerships and in 1935, 205,000; but if he had gone back to 1925 he would have shown there were only 209,414 partnerships making returns in 1925, or approximately the same as 1935. In 1918 there were only 150,000; in 1917, 75,000.

Senator BLACK. How many corporations in 1918?

Mr. FULBRIGHT. About half as many as now.

Senator BLACK. As a matter of fact it is true the corporation has been used as a device to keep from paying as much tax as they would have to pay doing business as a partnership or individual?

Mr. FULBRIGHT. That is the reason we enacted the sections I referred to—I may have to correct myself. I thought section 351——

Senator BLACK. That is immaterial.

Senator KING. Is it not a fact that individuals who have no purpose to evade tax find that because of the change in partners and other difficulties, it is advantageous to form corporations, because in this country you can conduct your business more effectively and economically and with less uncertainty through a corporation?

Mr. FULBRIGHT. Senator, if that were not so, there would not be any corporations, because they are the most vulnerable creatures to taxation by States, requiring reports, inspections, and things of that character. It is necessary where you have a large number of individuals interested in an enterprise to incorporate. When you have six or eight partners, as in my firm, we have some pretty big arguments, but when you get that in a business enterprise it breaks down of its own weight.

Senator BLACK. You can think of no reason why profits made through an investment in a corporation should not be taxed just as greatly as profits made by investment in real estate or professional business, or anything else?

Mr. FULBRIGHT. Oh, yes; there is.

Senator BLACK. What is it?

Mr. FULBRIGHT. It depends on the character of the business the corporation is engaged in. If they are engaged in the same character of enterprise, then you are correct.

Senator BLACK. There is no argument you can think of so far as the corporate device is concerned—there is no reason you can think of why profits received from a corporation as such should not bear just as much of the burden of taxation as those received from any other business?

Mr. FULBRIGHT. For example, this matter of surplus which was discussed this morning; there is a lot of difference between additional capital subscribed and piling up surplus. You cannot declare dividends and impair capital, but you can cut down the surplus.

Senator BLACK. Is there any reason, so far as our economic system or governmental system is concerned, why profit made in investment in a corporation should be subjected to either a smaller or greater amount of tax burden than profits made by an individual or partnership?

Mr. FULBRIGHT. I would have to take into consideration all of the factors.

Senator BLACK. I am talking only about the corporation as such. Is there anything sacred about a corporation?

Mr. FULBRIGHT. No.

Senator BLACK. Is there any reason why a person making a profit out of a corporation, as such, should be subjected to a greater or smaller tax than on profits made in some other way than by a corporation?

Mr. FULBRIGHT. I cannot answer that solely from the standpoint of Federal taxation.

Senator BLACK. Any standpoint.

Mr. FULBRIGHT. If they are in the same enterprise the burdens should be the same so far as Federal tax is concerned, but in the State of Texas a partnership does not have to pay anything. You have to take all of those disabilities into consideration.

Senator BLACK. I mean a corporation, as such, and because of the fact it is a corporation.

Senator KING. The following witnesses will be here at 9:30 tomorrow morning:

R. N. Denham, S. A. Sweet, Arthur T. Davenport, James I. Donnelly, Smith F. Ferguson, T. J. Priestley, Jr., Fred R. Fairchild, J. W. Oliver, and John W. O'Leary.

The committee will stand adjourned until 9:30 tomorrow.

(Whereupon, at 5:05 p. m., the committee adjourned until Saturday, May 2, 1936, at 9:30 a. m.)

REVENUE ACT, 1936

SATURDAY, MAY 2, 1936

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

The committee met, pursuant to adjournment at 9:30 a. m., Senate Finance Committee room, Senate Office Building, Senator Pat Harrison presiding.

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

The CHAIRMAN. The committee will be in order. Mr. Denham of New York City. Is Mr. Denham here? Mr. Reginald L. Sweet. Is Mr. Sweet here?

STATEMENT OF REGINALD L. SWEET, NEW YORK CITY, TREASURER, SWEET-ORR & CO., INC.

The CHAIRMAN. You are Mr. Reginald L. Sweet and you represent the Sweet-Orr & Co., Inc.?

Mr. SWEET. Yes, sir.

The CHAIRMAN. What business are you engaged in?

Mr. SWEET. Manufacturers of overalls and work clothes.

The CHAIRMAN. You may proceed.

Mr. SWEET. This is a report, gentlemen, written by Stanley A. Sweet, president of Sweet-Orr & Co., with offices at 15 Union Square, New York, to be read by myself, his brother. I am treasurer of that corporation. The company manufactures and sells overalls and work clothing. We have factories at Newburgh, Wappingers Falls, Port Jervis, N. Y.; and Philadelphia, Pottstown, Paradise, Mohnton, Pa.; and Joilet, Ill.

Congress is now considering a revenue act containing several new features which, in my judgment, should receive the most earnest and serious consideration of your committee. I am not a lawyer nor a tax expert, nor am I qualified to pass upon legislative matters. I am a businessman and represent a concern—Sweet-Orr & Co., Inc.—which has been in existence for 65 years. For more than one-half of that time I have been actively associated with it. This company of ours operates plants in different sections of the country, manufacturing overalls and work clothing, and has consistently employed union labor. Long before the establishment of N. R. A. we adopted a policy of dealing with our employees so that we have never had a strike nor any serious labor disputes during the long period of our

existence. We are regarded as pioneers in our attitude of fair, progressive standards for labor. I am sure that union officials, as well as the employees of our plants, will be glad to testify to these facts.

All of these years have not been easy ones. There have been good, but there have also been extremely bad ones. During the bad years we have not closed up our plants and discharged our employees, thus adding to the general distress, but have renewed our efforts and taken on new courage because of the need for protecting our workers and holding the organization together. As I will later illustrate, the cost of doing this has been substantial, but we have considered it worth while.

We do not consider ourselves very different from the average self-respecting business concern and we recognize that others also prosper or suffer during the different business cycles which have passed and undoubtedly will continue to pass, regardless of what human beings may do. I come here in the interest of my company and in the interest of the employees, whom I represent. I should like to present my views as to why the proposed tax on undistributed earnings of corporations is dangerous and possibly fatal to the average concern. It is my understanding that the proposed revenue bill provides a graduated tax, depending upon the amount of earnings distributed to shareholders, and that such graduation will result in a much lower tax as the rate of dividends increase. Thus the company which can afford to pay the largest amount of dividends will pay the least amount of taxes.

The dividend policy of our company has been a consistent one. Our directors believe that they have always distributed annually the maximum amount to its shareholders that the company could afford. Our record will prove the soundness of this policy. I do not need to hold a brief for our board. If we had distributed all our earnings annually to shareholders, our business would have passed out of existence long ago. Had we failed to provide adequate reserves in the prosperous periods for the losing years which we know will always occur, we could not give our employees steady work and reasonable wages in the days when they need it most.

Possibly a brief review of our figures for the past 20 years will be helpful in illustrating my point. During these 20 years the profits of our company for 16 profitable years amounted to $2,905,000. Out of these earnings the company paid $2,233,000 of dividends.

Senator KING. What year was that?

Mr. SWEET. This is a period of 20 years, 16 of which were profitable and 4 of which were unprofitable. In the 16 profitable years the profits amounted to $2,905,000, and out of these earnings the company paid $2,233,000 dividends, leaving a balance of $672,000. During this same 20-year period the company operated at a loss in 4 years to the extent of $1,277,000, so that shareholders were required to contribute substantial sums from their capital to cover this deficit of over half a million dollars, which resulted from the depressions through which we have passed. That contribution of the stockholders, I might say, consisted in a reorganization and reduction of the capital stock and the forgiving of a rather large amount of dividends which it accumulated. These figures may be presented to you in an-

other manner. Our earnings during the profitable years of this period amounted to $2,905,000, our net distribution to shareholders out of these earnings amounted to $1,628,000 or 56 percent approximately. The balance or 44 percent of our earnings was used to cover losses in the same period and was spent to protect the business during the depression years and to give labor steady employment and a living wage during the dark days. The average annual dividend return to our shareholders on this basis for the 20-year period is 3⅓ percent on the par value of our outstanding capital stock at the beginning of the period. Our net tangible assets at October 31, 1929, stood at $1,752,000 as shown by our books. Six years later, at the end of our fiscal year on October 31, 1935, it amounted to $1,126,000, a reduction of $626,000. If we do not restore some of this decrease we shall not be able to live through the next adverse business period.

We are now engaged in the difficult task of attempting to restore the reserves which we need to cover our losses and to give us the needed financial strength to enable our company to pass safely through the next depression, which will come again as surely as day follows night. We feel it our duty, not only to ourselves but to our employees, to do this and we would be derelict in this duty if we failed to do so. I should like to remind you that we have been in business 65 years.

In these reconstruction years only a small proportion of our earnings is available in cash, which is the only medium we can use to pay dividends or taxes. Most of it is invested in higher inventories, additions to plants, and so on. If a revenue bill is enacted which would force us to distribute our earnings in order to avoid excessive taxation it would thus be necessary to borrow larger amounts from banks, if the banks were willing to let us have the money for that purpose, which I doubt very much. Following the years 1921 and 1929 we were required to recognize this, for we received loans from banks only on condition that no dividends would be paid until working capital had been replenished to a substantial extent.

Should our company be required to accumulate its profits in the form of cash so that all profits can be distributed by way of dividends, obviously we could not afford to buy new machinery and equipment, build new plants and employ more labor, and create more values as our part of the national economy. Nor could we have in hand sufficient cash to pay the tax under the proposed revenue bill if no dividends were paid, for the reason that the percentage of cash available after a year is frequently considerably less than the tax which is now being proposed for a concern of our size.

It is quite conceivable that if this legislation is passed, corporations will be forced in self-protection to pay out all earnings in prosperous times in the hope that they could attract new capital when adverse times recur and when new money is needed to keep the business from bankruptcy or complete extinction. No sane board of directors would ever take such risks, for the reason that the new capital cannot readily be obtained in difficult years, and then possibly only at prohibitive cost and with prohibitive restrictions. Then, too, there is the legal responsibility upon directors to declare dividends only to the extent which is prudent after giving due consideration to all factors.

Quite frequently we run into a year when heavy losses are suffered, such as 1921, when our loss was $534,000, and in the period from 1930 to 1932, when our losses totaled $743,000.

Senator KING. Your losses in those 2 years exceeded your earnings in 20 years?

Mr. SWEET. In how many years, sir?

Senator KING. They exceeded your earnings for how many years? There was over a million-dollar loss there in those 2 years?

Mr. SWEET. Yes.

Senator KING. And your net earnings for the 20 years were, as I remember, something like a million and six or seven hundred thousand dollars.

Mr. SWEET. Yes. When profitable periods again recur it is not possible immediately to resume dividend payments. We must first cure the deficit and restore working capital to adequate levels. Under the proposed revenue bill, as I understand it, no adequate allowance is made for a corporation which is undergoing the task of recouping its losses and regaining a strong financial position to ensure a continuation of the employment of labor and capital. In fact, it is easy to calculate that following a year of heavy losses, a business might become financially embarrassed by the mere fact that it is earning a profit which it cannot pay out in dividends. For example, in the year 1921 we lost $534,000; in the succeeding year we started to earn a profit but could pay nothing in dividends. Under the proposed revenue act, a heavy tax is imposed upon such undistributed earnings which are used to restore lost capital, and this tax becomes a current liability which must be paid in cash. If we are to replace inventories and receivables which have been lost and if we are to improve our plants so as to be able to continue the employment of labor, and earn something on our capital, we have not the cash on hand to pay the tax. We would be forced to borrow it and I doubt very much if it were possible for the average business concern with a history such as ours to secure the bank credit necessary to pay the tax after a series of losing years.

On the whole, it strikes me that the proposed new revenue bill places an unusually hard burden upon smaller concerns and those which are not equipped with a surplus of working funds. I dare say that this description will apply to the majority of business concerns in this country. The larger companies and those already supplied with comfortable working capital will then have a decided advantage from a tax standpoint and naturally would use this advantage in competition with smaller and struggling companies. It appears to me that this must have been overlooked by those who drafted the proposed measure.

In our business we are constantly experimenting with new ideas, new processes, new markets, and new products.

Again, I dare say that this condition undoubtedly exists in practically all other businesses. In fact, the new ideas of today often become the backbone of our business tomorrow. When we fail in our development work our days are numbered. This development work requires the investment of cash and the taking of risks. Obviously when cash is invested in that fashion it is not available for any other purpose, such as dividends. If the proposed new revenue bill is enacted, we would have to materially curtail our develop-

ment work because we would have to pay a penalty in order to have sufficient resources to make experiments, which if successful, mean the employment of more labor and the creation of values which add to the national economy. We would be required to run our business so that all profits were available either for dividends or for the payment of taxes. Thus, the progress of our industry and our company would suffer to the detriment of our workers and unquestionably to the loss of the Nation because businesses such as ours are the basis of the revenue producers that support the Nation.

During the past 3 years changing trends forced us to develop new departments of business which have now become quite important to us. These new departments required a very large additional investment upon which we have not yet been able to pay dividends, but which we confidently expect will produce a reasonable return before long. Largely by reason of making these new investments we were able to keep our employees working on virtually a full-time basis since the time they began. That means through the worst period of the depression.

I am quite sure that this could not have occurred if we had not gone into such new ventures. The risk was considerable and the investment heavy. We were willing to undertake both of these, but the point I wish to emphasize is that if the proposed new revenue bill had been in existence at the time we contemplated adding these new departments, we should not have been able to proceed.

If we are competing against a concern which has a stronger working capital than ours, so that it can dispose of all its income by way of dividends, while we cannot do so, we are unfairly placed in a most disadvantageous competitive position. Is it the desire of the Congress to add to the burdens of the smaller companies and possibly to shift a heavier burden of taxation upon them as compared with the larger and stronger ones? I doubt this very much, yet this is the only conclusion I can reach after reading the proposed new revenue bill.

Again let me say that I am not a tax expert, nor do I feel qualified to advise this committee as to the type of legislation which might be adopted in place of the proposed measure. I am quite aware of the fact that the Government must have revenue to carry on its activities and that a very substantial part of such revenue must come from business. I am further confident that business can and will pay its proper share toward the support of Government, provided that such portion is fairly determined and properly distributed. As far as my company is concerned, we are ready to pay our part, but I wish to protest with all the power at my command against the scheme for doing so as outlined in the proposed new revenue measure.

In my judgment it is important that business should know at all times the amount of tax burden which it is required to pay in order to figure costs and prices. This is not possible under the new measure. Would it not be more advisable to adopt a tax procedure which would assess a fixed rate on the real earnings of a business? To my mind, real earnings are not necessarily those shown for one fiscal period but rather what a business can be said to earn on an average yearly basis. If we lose $100,000 in 1 year and earn $100,000 in the second year, we are no better off at the end of the second year than we were at the beginning of the first. If we are required

to pay a tax on the earnings of the second year while securing no deduction for the loss of the losing year, we are in fact worse off at the end of the 2-year period than we were at the beginning. On an income-tax basis, we actually suffer under such circumstances.

It is unreasonable to suppose that a tax plan could be worked out whereby a tax could be assessed on the earnings of a company over an average period of not less than 3 years, such as is working so successfully in England? Under such a plan, the losses of 1 year are deducted from the profits of the others and a truer picture of the earning power of an enterprise is presented. If such average earnings were determined from year to year, a tax could be assessed with more assurance that the particular business would be able to pay it without danger and without placing it in an unfair position with its competitors. I am confident that such a procedure would stabilize employment and it would undoubtedly increase it. We would then have a true income tax indeed, and a businessman could arrange his affairs so that the tax could be determined and paid with more assurance and without the penalties and dangers present in the existing law or those which are threatened in the proposed new revenue measure. I submit these thoughts to the committee for their consideration in the hope that they may help toward the solution of a most serious, far-reaching, and perplexing problem.

This report was signed by Stanley A. Sweet, president, Sweet-Orr & Co.

The CHAIRMAN. Thank you very much, Mr. Sweet. Mr. Denham: has he come in yet? (No response.)

Mr. Davenport?

STATEMENT OF ARTHUR T. DAVENPORT, NEW YORK CITY, CHAIRMAN, TAX COMMITTEE, INTERNATIONAL ASSOCIATION OF COTTON GARMENT MANUFACTURERS

The CHAIRMAN. You may proceed, Mr. Davenport.

Mr. DAVENPORT. My name is Arthur T. Davenport. I live at 303 Allen Avenue, Allenhurst, N. J. I am general manager for Sweet-Orr & Co., Inc., 15 Union Square, New York City, whose home office is at Wappingers Falls, N. Y., and who operate factories in New York State at Wappingers Falls, Newburgh, and Port Jervis, and in Pennsylvania at Philadelphia, Pottstown, Paradise, and Mohnton, and at Joliet, Ill.

I am chairman of the tax committee, International Association of Garment Manufacturers, 40 Worth Street, New York City. I am chairman of the tax committee, Union-Made Garment Manufacturers' Association, 120 South La Salle Street, Chicago, Ill.

Through the courtesy of your chairman may I be permitted to have the secretary of the I. A. G. M., Mr. A. F. Allison, to place before you a brochure on processor-tax refunds, outlining the various points which we will bring up, and we would like to request that this be written in the record as an introduction to our appearance in behalf of our members.

The CHAIRMAN. That may go in the record.

Mr. DAVENPORT. Thank you very much.

(The brochure submitted by Mr. Davenport is as follows:)

PROCESSING TAX REFUNDS—PROPOSED AMENDMENTS TO H. R. 12395, TITLE IV, SECTION 602 (b) AND TITLE III, SECTION 501 (d)

TAX COMMITTEE OF THE INTERNATIONAL ASSOCIATION OF GARMENT MANUFACTURERS, NEW YORK, N. Y., MAY 2, 1936

The International Association of Garment Manufacturers, a voluntary, non-incorporated, national organization, founded in 1908, at Toledo, Ohio, represents manufacturers of men's and boys' cotton garments, including shirts, collars, nightwear, underwear, pants, overalls, and other work and utility garments, and women's cotton undergarments and nightwear; member-employers in 42 States; 200,000 wage earners engaged in the industry; the International Association of Garment Makers' tax committee, appointed early in 1933, has served continuously since the processing tax was first under consideration. Executive offices, 40 Worth Street, New York, N. Y.

We submit:

1. That the cotton garment industry and the Government should not be further burdened at this time with unnecessary and costly methods of securing processing-tax adjustments on inventories of January 6, 1936.

2. That all those taxpayers, exclusive of first processors, who paid floor-stock tax as of August 1, 1933, or, if retailers, as of September 1, 1933, should be offered the option of accepting a prompt refund on the exact amount of floor-stock tax thus paid, in lieu of and in full settlement for any claims that otherwise would be computed on the basis of their inventories of January 6, 1936, as proposed in H. R. 12395.

3. That the above proposal not only offers the one practical method for quickly clearing up an entangled situation which has already produced no end of controversy and ill feeling, but it also has the decided advantage of saving money both for the Government and the taxpayer. As evidence thereof, please note:

(a) Approximately 1,000,000 taxpayers paid floor-stock taxes as of August 1 and September 1, 1933. Presumably an equal number will desire to claim tax adjustments on January 6, 1936, inventories. In the case of the cotton floor-stock tax, which represents over 65 percent of the total payments for all commodities, the Government collected about $57,000,000, of which about $30,000,000 was paid by first processors, who are not included, at their own suggestion, in this proposal, for a simplified method for tax refunds.

(b) Retail merchants paid a little over $14,700,000 floor-stock tax, of which $11,592,000 was on cotton.

(c) Thus, if all first processors are excluded from the optional method of computing tax refunds due on January 6, 1936, floor stocks, it is probable that les than $35,000,000 will be required to pay those taxpayers who elect to accept refund of the amounts they paid the Government as of August 1 or September 1, 1933, in full settlement of their claims based on January 6, 1936, inventories.

(d) Furthermore, in the case of cotton, floor stocks on January 6, 1936, were much larger than on August 1, 1933. In the cotton garment industry, for example, the biggest selling season of the year begins on or about January 1. Spring and summer merchandise is going into production so that deliveries can be made to wholesalers and retailers during February, March, April, and May, as cotton wearing apparel meets its heaviest demand for spring and summer wear. Since manufacturers, wholesalers, and retailers must all plan and work ahead of consumer requirements, it should be obvious that by August 1 and September 1, heavier wearing apparel for fall and winter must be in work, and concurrently the production and demand for cotton apparel in the wholesale markets will have slackened. Thus, tax adjustments on January 6, 1936, inventories, computed as such, will undoubtedly involve claims far larger than on the basis of 1933 floor-stock tax refunds.

(e) To the taxpayer, however, prompt payment by the Government of an amount already definitely determined by his own tax payment of 1933 floor-stock tax, being relieved of the extravagant expense involved in the countless computations and audits necessary to the determination of his claim, with certainty as to nothing except the probability of endless delays due to the many complications and technical problems involved, all these factors combine to make our proposed option attractive as a compromise proposal despite the fact that it may represent a discount upward of 50 percent of the amount the Government might otherwise ultimately pay.

(*f*) To the Government, regardless of other savings, the quick and easy method of refund we propose, should clearly represent a potential saving of millions of dollars of administrative expense. No audits, or hearings, or long involved calculations are required for the taxpayer who accepts refund of his 1933 floor-stock tax in full settlement of his tax adjustment claim on his January 6, 1936 inventory.

(*g*) Finally, the administrative expense that will be unquestionably incurred if title IV, section 602 of H. R. 12395 is not amended to offer the taxpayer the clear-cut and simple procedure we propose, will be all out of proportion to the amounts involved both to the Government and to the taxpayer.

4. As to title III of H. R. 12395, our brief review of conditions in our industry and particularly the burden of governmental competition which, in part, Congress and the United States Supreme Court have both agreed to be unfair and demoralizing to private industry, should make it fairly obvious that competitive price pressure, starting at the low base set by convict-made cotton garments, made it impossible to maintain average margins above costs that would cover and include both processing tax and N. R. A. differentials.

We do believe, for ourselves, and doubtless other affected industries as well, that subsection (e) (1) of section 501, title III, should be amended in the following respect, that 10 taxable years instead of 5 should be used where it is stated that "* * * the term 'average margin' means the average difference between the selling price and the cost of similar articles sold by the taxpayer during his 5 (change to 10) taxable years preceding the initial imposition of the Federal excise tax in question * * *"

5. Summary: Both of our proposed amendments to the tax bill will strongly serve the public interest.

It is a well-known fact that business losses were heavy during the years 1930–32 and in respect to many of the smaller manufacturing concerns, particularly those located in the smaller communities throughout the country, producing cotton garments for a limited market, earnings were very poor, even prior to 1930.

Thus a long period of capital loss has represented a drain upon employment resources which has, by no means, been restored.

Since Congress has clearly evidenced its intention to provide some method for adjustment of January 6, 1936, inventories, it would appear proper to suggest that the alternative proposal that such refunds be made speedily based on acceptance by the taxpayer of his 1933 floor-stock tax, will relieve financial pressure at a time when capital loss tends to reduce employment, and will be far more valuable if received by the taxpayer before the end of the current fiscal year, than if delayed, even though a larger refund is paid by the Government at a much later date.

We hold that it is the objective of the Government to restore employment and business earnings as rapidly as possible. Our proposal for an amendment to title IV, section 602 (b) if favorably acted upon will certainly assist the Government in its wider objective.

Also the amendment we propose to title III, namely, that computations for tax liability should be based upon 10 taxable years instead of 5 to determine the margin above cost, also represents equity, and reasonable relief to the taxpayer who has during the preceding 5 years been largely operating a subnormal and inadequate margin above cost. The 10-year period we propose is bound to present a better basis for determining an average margin as proposed in title III, section 501 and presents no greater difficulties than in the present provision of the bill.

We sincerely trust that our proposals will receive serious and favorable consideration.

COTTON FABRICS AND THREADS USED EACH YEAR BY THE COTTON-GARMENT INDUSTRY CONSUME 1,000,000 BALES EACH YEAR

To appreciate and understand what the invalidation of the processing tax, January 6, 1936, has meant to the cotton-garment industry, a brief review of events and conditions in the industry from August 1, 1933 to date, is essential.

FOUR BIG FACTORS OF COST INCREASES TOOK EFFECT ON OR BEFORE AUGUST 1, 1933

1. On July 17, 1933, the Cotton Textile Code, N. R. A. code no. 1, became effective. Shortly thereafter, N. R. A. cost differentials were established.

Price increases on cotton yarns and textiles averaged 5.54 cents per pound These increases were paid by the cotton-garment manufacturer

2. On July 31, 1933, the President, by Executive order, issued at request of the International Association of Garment Manufacturers, placed the cotton-garment industry under the hour and wage provisions of the Cotton Textile Code, pending the effective date for the Cotton Garment Code. This meant immediate cost increases in all goods in process, and in the fabrication of all cotton materials on hand in the cotton-garment factory on August 1, 1933.

3. As of August 1, 1933, the cotton-garment industry paid floor-stock tax on all cotton poundage inventories of that date.

4. On and after August 1, 1933, the price of cotton goods purchased but not delivered prior to that date was increased by the amount of floor stock or processing tax differential, in addition to N. R. A. differentials. Processing-tax differentials averaged over 5 cents per pound.

DID THE CONSUMER PAY THE PROCESSING TAX PLUS N. R. A. DIFFERENTIALS?

Decidedly not, so far as the cotton-garment industry is concerned.

Consumers buy cotton garments frequently and watch prices closely. Thus retail merchants strongly resist price increases that would disturb established-price lines, such as 49 cents, 69 cents, 99 cents, $1.05, and intermediate and higher price quotations.

Cotton garments are frequently featured in special sales, because price savings appeal so strongly to consumer buyers, largely in the lower income groups.

Thus at no time have cost increases of 1933–1935 been fully or adequately reflected in the average prices at which cotton-garment manufacturers sold their products.

Mr. DAVENPORT. Now, I will take these up in seriatim.

TITLES 1 AND 2

The attitude and opinions of the members of our associations, as they can be interpreted under the difficult conditions, are best expressed in the statement which has just been made to you on behalf of Mr. Stanley A. Sweet, who is the president of Sweet-Orr & Co., Inc.

TITLE 3

The committees are in entire sympathy with this portion of the bill, which provides that the Government should recover 80 percent of such refunds or abatements as might remain the property of those who have received them from the Government and from their vendees. The other provisions of this title are likewise satisfactory with the exception of section 501 (e), third line on page 231, providing that 5 taxable years preceding the imposition of Federal excise tax shall constitute the average margin of the taxpayer. On this point our committee desires to submit that the selection of these years is unfair, in that 1 year is the first year of the Roosevelt administration, 3 years of the worst depression the United States has ever suffered, and the fourth year is the only possible normal year.

Any test in our industry based on this 5 years would reflect an improper result, as during this period our members were struggling to keep employees at the machines, offering their merchandise for sale with a disregard of cost further than to see that the loss was made as small as possible.

The very nature of the deflationary movement at this time would support this not only in our industry but other industries as well. Our suggestion is that the provisions of this section be allowed to stand with the exception that the "five" on the third line shall be

changed to "ten", so that the test years shall be for a period from 1923 to 1933 and would cover 3 normal years, 3 boom years, 3 depression years, and the first year of the Roosevelt administration. The average of these 10 years will, in this industry, correctly reflect an average spread for test purposes, and we beg to submit the request that section 501 (e), third line on page 222, "five taxable years" be corrected to read "ten taxable years", as a step in equity and in furtherance of the true object of the title.

TITLE 4

In the interest of efficient procedure, both for the Government and our member taxpayers, we submit that justice and economy would best be served by an amendment to this title affording any taxpayer, who is entitled to refund thereunder, the option of taking the amount paid as of August 1, 1933 (or for retails as of Sept. 1, 1933), in full settlement of all obligations or rebates of processor tax payments as alternate to the provisions in H. R. 12395. In checking over this matter it is the opinion of the committee that if the provisions of title 4, section 601, are to be carried out, the cost of the necessary audit of the floor stocks filed as of January 6, 1936, and compared with a similar audit of floor stocks filed August 1, 1933, will call for an expenditure on the part of the Government of an amount even greater than the total amount of the tax. This estimate is computed on the number of floor-stock returns which have been filed as of August 1, 1933 (for retailers Sept. 1, 1933).

Number of returns: Floor stocks wholesale 174,659. (See p. 17, Annual Report of the Commissioner of Internal Revenue.)

Floor stock retail, 849,948. (June 30, 1934.)

Floor stock wholesale, 137,524. (See p. 23, Annual Report of Commissioner of Internal Revenue.)

Floor stock retail, 132,362 (June 30, 1935), a total of 1,294,493 returns, which if the $10 minimum is to be eliminated would probably reduce the total about one third, leaving the remaining two-thirds for an individual audit by the Department of Internal Revenue. On the other hand, we believe that an option for the rebate of the floor stock paid as of August 1, 1933 (or for retailers as of Sept. 1, 1933) would be acceptable in the interest of economy and equity by nearly all of the parties interested and would require no audit further than to insure the return of the amount as paid on August 1, 1933 (or for retailers as of Sept. 1, 1933) to the party who paid the tax, and if that tax at that time was accurately and honestly reported the rebate will be the same; otherwise, it would be otherwise. This accurate and automatic audit established with this economy to the Government would secure a still further saving, as in the cotton industry (which covers over 60 percent of the total amount to be rebated) the inventories in preparation for the spring season were uniformly much heavier on January 6, 1936, than they were in the middle of the fall season on August 1, 1933. Still further the refund on these inventories on January 6, 1936, on the cotton content under TD4433 averages approximately 12 percent more refund than the original 5 percent allowance for noncotton content arbitrarily adjusted on the floor-stock tax paid August 1, 1933. Notwithstanding the heavy pecuniary loss under this option which our

members would sustain, their desire for a prompt settlement and economical handling of the matter by the Government has led them to indicate to us their preference for this method of settlement. It is to be assumed, however, any party who can sustain the burden of proof under the present refund provision of the A. A. A. would be permitted to do so.

Mr. A. R. Joy, treasurer of Cluett, Peabody & Co., who has been a member of the committee for the last 3 years, will bring to you an illustration of the amount of clerical detail attendant upon the compilation of these inventories by our members and as a result, the amount of audit that the Government representatives must make in every instance in order that both of their inventories shall check accurately.

Mr. A. R. Joy and Mr. L. W. Turner will give you any further information you may desire.

Senator GEORGE. That option would not benefit anyone who went into business before such payment of the floor-stock tax?

Mr. DAVENPORT. No, sir.

Senator GEORGE. Your proposal is as to those who paid $10 or less?

Mr. DAVENPORT. That is right, sir.

Senator GEORGE. Going on the assumption that those who paid the floor-stock tax originally paid as little as possible, and therefore the Government would not be hurt, is that right?

Mr. DAVENPORT. I think you are correct, sir.

Senator LA FOLLETTE. Mr. Davenport, the 5 years preceding 1933 would give you 2 good years, would it not, 1928 and 1929?

Mr. DAVENPORT. No.

Senator LA FOLLETTE. Do you not consider 1928 as a good year?

Mr. DAVENPORT. This is for 1929, 1930, 1931, 1932, and 1933, because it is August 1, 1933.

Senator LA FOLLETTE. You do not think that 1928 was a good year?

Mr. DAVENPORT. 1928 was a good year and 1929 was not; not in the cotton industry.

Senator LA FOLLETTE. You are the first man that I ever heard of that did not regard 1929 as a good year. Nineteen hundred and thirty would be average, would it not?

Mr. DAVENPORT. No, sir; 1930 was a year of grief, as you heard from the statement of Mr. Sweet's report.

Senator LA FOLLETTE. How about 1931 and 1932? Those are the 2 poor years, are they not?

Mr. DAVENPORT. Nineteen hundred and thirty-one was bad, and 1932 still was bad, and 1933 started on the upgrade. You see, Senator, if they come under the 10 years, the law provides an arrangement with the Bureau of Internal Revenue to adjust it. Under the laws now written, it is mandatory that the Bureau of Internal Revenue should take 5 years, no more, no less, it almost forbids anything else. That is my interpretation of the law as to the way it reads. I am very frank to say the 10-year period is set up to make it advantageous for our members to take this option. We believe it is the right thing for them to do. That is the honest thing for them to do. They paid the money in good faith and the Government received it in good faith. It has

been retained by the Government and there is an obligation to return it at some time. The time has come and the Government offers that option to these 1,200,000 odd, of whom 849,000 people are in the cotton-goods industry. Some of them have from 100 to 2,000 employees. If the Government wanted to do the right thing, it would rebate that money to our people. As it stands now, as they view this, they say the Government can collect our $10, but it cannot rebate it back. That is their attitude of mind. Under this method they have an option.

Senator LA FOLLETTE. You mean the Government has the option or the taxpayer has the option?

Mr. DAVENPORT. The taxpayer has the option. The Government has provided a method of payment which is, to our knowledge, definitely more expensive than the option. The audit alone will require thousands of men. As a matter of fact, one computation that we have made, if there were 1,000 special employees today on this it would take 13 years and 4 months to complete it.

Senator BLACK. I would like to ask you one question. I notice your suggestion about the floor-stock tax. Do you have any idea how much the floor stocks were at the time the tax was paid as compared with the floor stock on January 6, 1936?

Mr. DAVENPORT. In our own case?

Senator BLACK. Yes.

Mr. DAVENPORT. The poundage of cotton is almost the same. The rebate is about 10 to 12 percent more. Mr. A. R. Joy, of Cluett, Peabody & Co., is here, and Mr. Turner, and they are ready to address you on that subject.

Senator BLACK. Would that tend to indicate how it compared with each year?

Mr. DAVENPORT. The fact is that the spring season is the heavy season for cotton goods, and January 6 is the very beginning.

Senator BLACK. I have heard quite some discussion about that plan.

Mr. DAVENPORT. These other gentlemen are prepared to talk on that subject. I know that roughly it is approximately double in the cotton-goods industry.

Senator BLACK. What is double?

Mr. DAVENPORT. The inventories of January 6, 1936. On the average it would be well over 25 percent more in net cotton pounds.

Senator BLACK. Is it your idea, or the idea of the association that you represent, that it would be better to take a smaller amount and get it without the detail contained in the bill? Is that the idea?

Mr. DAVENPORT. That is the idea. It will cost us what it will cost the Government. It will cost the Government between 25 and 30 million dollars.

Senator KING. How many companies do you represent?

Mr. DAVENPORT. About 225, I think. These two associations overlap.

Senator KING. They are American manufacturers?

Mr. DAVENPORT. They are American manufactures, union-made and nonunion also.

Senator KING. In various States?

Mr. DAVENPORT. Yes; in 42 States.

Senator KING. And some in the South?

Mr. DAVENPORT. Some in the South; yes. In every State in the Union.

The CHAIRMAN. Thank you, Mr. Davenport.

STATEMENT OF JOHN W. O'LEARY, PRESIDENT, MACHINERY AND ALLIED PRODUCTS INSTITUTE, CHICAGO, ILL.

Mr. Chairman, my name is John W. O'Leary. I am chairman of the board of the Arthur J. O'Leary & Sons Co., and I am appearing here on behalf of the Machinery and Allied Products Institute.

Since the hearings of the Ways and Means Committee of the House of Representatives on the recommendations of its subcommittee, which are substantially embodied in the proposed legislation (H. R. 12395) now before you, there has been further opportunity to study the effects which taxation of corporation surpluses in the form proposed would have if imposed upon manufacturers of machinery and capital goods, and to receive further expressions concerning the measure from the individual manufacturers within the 50 machinery industries comprising Machinery and Allied Products Institute.

These conclusions I wish to place before you. They are convincing that the radical change in corporation taxation suggested will do great violence to the very stability and progressiveness which has developed and made American industry great. Immediate effect of such legislation will be to effectually retard the natural and growing recovery now in progress, prevent private reemployment of the unemployed, and aggravate the problems of relief and of providing additional taxation to meet the growing demands upon the Federal Treasury. That over a period of years, through one or more cycles of economic depression, it threatens to bring about the substitution of Federal financing and control for American private enterprise, as a result of weakening corporations through financial policies influenced by this legislation, is a matter far beyond partisan politics and one deserving enunciation of policy by the American electorate.

Exhaustive testimony has been given before the Ways and Means Committee of the House and before this committee by businessmen and industrialists thoroughly conversant in management of corporate enterprise and the intricacies of our industrial and economic system. I refer to such testimony for the purpose of expressing full accord, for so far as I have been able to learn there is no division of opinion in business and industry, whether representative of units large or small, as to the undesirability of this proposed departure from established form of taxation, and as to the dangers and difficulties inherent in it.

Such dangers and difficulties apply to all of American corporate enterprise. There are still others which apply exclusively or with greater severity to certain segments of American industry, because of essential differences in the requirements, customs and physical characteristics of those certain industries. I refer to that major group which we commonly know as the capital-goods industries. These are the industries which produce the heavy machinery, equipment, and materials of lasting or durable character, as distinguished

from food, clothing and other consumption goods. That the capital goods industries do comprise a major group can best be shown by the number of our gainful workers which they normally employ. Estimates from the 1930 census indicate that of all persons employed or available for employment in manufacturing and mining industries, 65 percent were classified as producers of capital goods.

Statement of certain fundamental characteristics distinguishing the physical and financial operations of capital-goods industries from others will facilitate understanding of why this legislation is of such concern to the machinery manufacturers represented by the Machinery Institute:

First, capital goods are purchased through long-term investment. The chief purchasers of capital goods are corporations and businesses, rather than individuals, for their own use or consumption. Economic stability, the existence of business confidence in the safety of investment and future opportunity for profit, is essential to activity and full employment in the capital-goods industries.

Second, the purchase of capital goods is subject to severe cyclical fluctuations. The durable character of the products permits the indeterminate postponement of purchase, and this ability to defer demand is possessed alike by all users of capital goods. In times of depression it is utilized by many or most, as a simple matter of individual business prudence. But the capital-goods industries as a result are the first to feel the force of curtailed buying and are the last to resume activity after depression. Their status most accurately reflects the difference between good times and bad.

Third, the financial considerations in the management of companies engaged in capital-goods manufacture differ materially from those of other industries. (*a*) Ability to defer demand constitutes ability to place pressure on prices; prices fluctuate, and profits in poor times are impossible to achieve. (*b*) Capital goods manufacture is distinguished by need for a high proportion of skilled laborers. Quite apart from any question of the natural desire of capital-goods companies to keep their men employed despite low production, the need for highly skilled workers is such that almost without exception these employers have been obliged to maintain plants that are vastly larger than necessary for producing in times of depression the small volume of capital goods salable. (*c*) Manufacture of capital goods requires large investment in plant and equipment. Wide fluctuations in volume of business require large reserves of current assets. Turn-over of capital is much less frequent than in other industries and sales in ratio to assets are markedly smaller.

These characteristics of capital-goods industries are the result of natural economic laws. We cannot ignore them, but must recognize and provide intelligently for them. To attempt arbitrarily to govern them by tax factors rather than by good management sense will serve only to accentuate the dislocation and irregularity. We must realize that in attempting by such legislation as this to apply like standards to all of business and industry, we do ignore completely these essential differences bearing upon industrial stability and full employment, not only in the capital-goods industries themselves but also in the other industries and service activities dependent

upon capital-goods sales; the furnishing of raw materials, handling of finished products, operating of transportation facilities to haul them, performing of other tasks attendant upon manufacture and servicing, and the new occupations which continually spring forth as the result of full industrial activity.

Bearing these essential differences in mind, permit me to now place before you the particulars wherein the capital-goods manufacturers are adversely affected by the provisions of this proposed legislation. They are 10 in number, captioned as follows:

1. Effect of uncertainty and lack of confidence generated by the bill.
2. Effect of liberalized financial policy in deepening and lengthening depressions.
3. Effect in fostering industrial inefficiency and obsolescence.
4. Effect in penalizing new corporate enterprise, expansion of industrial activity and development of new products.
5. Effect in multiplying taxation on depreciation reserves.
6. Effect in imposition of heavy penalties on uncertain profits.
7. Effect in taxing capital gain while limiting capital loss.
8. Effect of "relief provisions", the exemptions from the proposed tax schedules.
9. Effect of proposed tax in actual cases had it been imposed during past years.
10. Effect of proposed tax in future years in impoverishing capital goods companies.

1. Effect of uncertainty and lack of confidence generated by the proposed measure. The very consideration of an involved, experimental bill which carries imposition of high rates of tax, which threatens to penalize future rebuilding of reserves depleted through depression years, and which involves arbitrary regulation of business and industry in influencing management policy, is discouraging and postponing orders for machinery and equipment. The consideration of this measure is hindering the recovery in progress in the capital goods industries.

2. Effect of liberalized financial policy in deepening and lengthening depressions. The bill is apparently based upon 30 percent as the average of net earnings desirable to be retained in surplus, and sets up tax rates which would heavily penalize management for retention of more than 30 percent. It can have only an effect of increasing the pressure for excess distribution of dividends and enforcing reliance upon borrowings or capital issues in time of need.

To attempt to prescribe for all corporations the proportion of net earnings to be retained in surplus is dangerous, and shows the fallacy of enacting legislation as vital as this on theory. Many corporations in the capital goods industry, still solvent and strong, would have been in receivership during the present depression on any such limited retention as 30 percent of profits of prior prosperous years. In some instances distribution of larger portions of profits is sound; in others, retention of less than 50 or 60 percent would be destructive. What would be good practice in one case would be suicidal in others.

The fallacy of relying upon borrowing when required in the future to meet operating deficits, contingencies, or enable necessary plant rebuilding or expansion should be more apparent at this time than

in many years. New capital issues declined in this depression to less than 4 percent of the volume of the years 1920 to 1930, and in 1935, after a gain of that year, were still less than 10 percent. Banks were unable to grant credit to corporations encountering deficits and debt, were in fact unable to extend accommodations in many instances even to those corporations with a sound asset position but in need of temporary working capital. Every businessman knows the folly of any such dependence. We also know the value of surpluses in this depression; that in the 13 years, 1921 to 1933, including the profitable twenties, manufacturing industry, while taking in $40,000,000,000, distributed 50 billions, 10 billions of excess distributions out of surplus, an excess of distribution of 25 percent of all income.

If we wish to perpetuate our industrial progress, we shall avail ourselves of past experience and by the application of sound common sense in management perfect our industrial system by regularizing its practices. If we should wish to discount the value of thrift and foresighted management and substitute extravagance and ultimate dependence upon Government credit and control in time of depression, we should embark upon exactly the type of experimental extreme as is embodied in this proposed legislation.

This tax will directly breed false optimism and stock speculations in times of profit. Social insecurity will result directly from such a measure as this through the extreme intensification of the peaks and valleys which all of us so earnestly desire be eliminated in our economic structure. By contributing to irregularity and extremes in payment and expectation of dividends, this measure will also immeasurably increase speculation in corporation credits and security-market operations.

3. Effect in fostering industrial inefficiency and obsolescence. Industrial efficiency is dependent upon vigilant and resourceful private enterprise, upon technological advance, in order that by making goods and services available to all at constantly decreasing prices the standard of living of all may be enhanced. The proposed bill will retard the purchase of plant equipment, bringing, gradually but progressively, industrial inefficiency and obsolescence. As in the past, the first retrenchment of corporations will be in omitting purchase of machinery and equipment. Corporations generally having drawn down their reserves through depression operations, demands for working capital under such conditions have in many cases transformed reserves for depreciation to mere bookkeeping items without counterbalancing current assets available for replacement of obsolescence. Increasing new investments in capital markets can come only with industrial efficiency, confidence in financial stability, and the opportunity for profitable operations. This measure, however, will make permanent the inadequacy of reserves, the uncertainty as to financial stability, and will bring retrogression in industrial inefficiency, and lessening of the opportunity for creating of wealth and the heightening of our standards of living. Cyclical fluctuations will be frequent and severe. In the capital-goods industries are elements most difficult to overcome in regularizing industrial supply and demand, yet in this bill are proposals which, instead of smoothing out the valleys, could hardly be more certainly proficient in accentuating them.

4. Effect in penalizing new corporate enterprise, expansion of industrial activity and development of new products and services. New enterprises, so vital to industrial progress, involves always a greater degree of business risk, a lesser degree of financial stability. New enterprise invariably depends for sustenance and growth upon the accumulation of reserves, upon ultimate financial stability and lessened risk by the route of retention of earnings in surplus. Faced with the alternative of distributing dividends or heavy tax penalties upon surplus retentions, new enterprise will be retarded. Most especially will the development of small business be retarded and prevented. Small businessmen anticipating new corporate enterprise, small businesses contemplating expansion and development of new products and services, under the conditions set up by this bill, will find serious handicap. The trend of sales of patents to larger interests, of mergers of small companies with larger corporations in order to attain financial stability and the use of surpluses, will be observed. No result could be less American or less desired by American businessmen and industrialists.

Lack of opportunities to assume reasonable business risks during the past few years has created an influx of capital to tax-exempt securities. Already, as has been shown in tables presented in connection with consideration of this bill in the hearings before the House Ways and Means Committee, there is strong financial inducement to invest capital in 3½-percent tax-exempt securities rather than in 6-percent non-exempt business risks. That inducement on $1,000,000 of capital is as much as $262,377; on $5,000,000 of capital it is $1,705,660. In the interest of revitalizing private enterprise and achieving full business and industrial activity and reemployment of the idle it is imperative that we adopt a course which will give assurance of confidence and capital for normal business risks. This measure in its effect is penalizing new corporate enterprise and expansion of industrial activity, moves in a direction diametrically opposite.

5. Effect in multiplying taxation on depreciation reserves. Let me at once recognize that the proposed bill itself suggests no change in the allowable deductions for depreciation. However, the accounts of many corporations are currently being scanned by the Bureau of Internal Revenue under Treasury Department Order 4422 in an effort to increase revenue by reduction of allowances for depreciation of plant and equipment. Such a policy is fully justified when and if it can be shown that depreciation is excessive and does actually over-protect corporations against wear and tear and, more important, future obsolescence. But in conjunction with this tax on corporation surplus the policy of that treasury department order presents two considerations:

First, it is evident that corporations which are not content with a reduction in their provisions against future loss by depreciation through wear and obsolescence which may be advised or insisted upon by the Bureau of Internal Revenue, will wish to offset such reductions in full or in part by increasing their surplus or other reserve accounts. To offset such reductions by additions to surplus, corporations would in effect not only be denied exemption from taxation on the amount of such reductions, but would be under the

necessity of paying upon those offsetting reserves, not a normal Federal income tax, but the entire corporation surplus tax of several times the rate.

Second, many times the major projects of plant expansion or rebuilding to adjust to new technological methods or to overcome new obsolescence in products or equipment or both, involves investment beyond the amounts of applicable depreciation reserves. Such additional investments if made out of surplus will have been taxed, not a normal tax, but the entire corporation surplus tax of several times the rate, and to the extent that the policy of decreasing depreciation reserves is followed will the condition of multiplication of taxation be accentuated.

6. Effect in imposition of heavy penalties on uncertain profits. An example of the inequity of the tax and difficulties it presents is demonstrated by the effect of legislation already enacted of a type which is also appearing in other proposed legislation. Such legislation purports to limit profits. In the case of Navy contracts, this limitation is 10 percent, and the act authorizes the Secretary of the Navy and the Secretary of the Treasury to determine factors which enter into costs. Under the rulings to date it is impossible for the seller to determine his profits until his report is examined and approved.

Conservative management requires that expected profit be not distributed until it is assured. Under this bill such retained contingent profits must be taxed as undistributed income, with the possibility that the profit will not finally appear. Present large contracts both under way and already completed, place the manufacturers in a position of reckless gambling.

7. Effect in taxing capital gain while limiting capital loss. The proposed bill retains the limitation to $2,000 of deduction of capital losses in excess of capital gains. Yet the proposed bill requires the inclusion of all capital gains in the income to be taxed. Thus in effect there is a tax on capital instead of income. If a tax of such larger proportions is to be levied against income on the basis of the proportion undistributed, it would seem that it would be unthinkable to apply that heavy tax against anything but the true net income after deduction of all business losses. This equity however, the proposed bill does not embrace.

8. Effect of the "relief provisions", the exemption of certain companies from the full corporation surplus tax. The proposed bill sets up a confusing multiplicity of exceptions to the heavy penalties against retention of income in surplus. Necessarily so, because there are innumerable instances, many lines of business, many circumstances in which and under which such exceptions from a tax which assumes confiscatory proportions in event of retention in surplus of a substantial portion of income, becomes an absolute necessity. No better support for the statement that this bill will retard and discourage corporate activity and full reemployment could be offered than to refer to these "relief provisions."

The exceptions so made set up a system of corporate inequalities, under which competition necessarily becomes unfairly competitive. Debt-ridden corporations, it is proposed, will not pay a tax of 42½ percent of "adjusted net income" while making no dividend distri-

bution; instead they will pay but 15 percent on the portion represented by excess debt. Companies in receivership are subject to lower rate. By all of such exceptions a premium is placed upon past deficiencies of those corporations. Such deficiencies may take any number of forms. Excess distribution of dividends may have been made without provision for replenishment of plant and equipment by which profits might have been retained and debts repaid. That a tax preference is given in such a case is another factor which would tend to discourage rather than encourage industrial efficiency. Equalization of opportunity and advantage, rather than creation of artificial and arbitrary discriminations, should be our endeavor.

Banks, trust companies, and insurance companies have been specifically exempt from the full corporation surplus tax—for the obvious reason that the nature of their business is such as to require heavy reserves and to demand and necessitate heavy relief. We submit that manufacturers of capital goods are in exactly this position. Capital-goods manufacture requires heavy capital investment, the characteristics of the industries are such as to necessitate large reserves of current assets, as well as heavy fixed investments. The large investment in plant equipment and inventory as related to cash position differs materially from the requirements in many other industries. Turn-over of inventory is conspicuously less frequent.

These distinguishing characteristics are best demonstrated by reference to some figures drawn from comprehensive comparisons of operating and financial ratios assembled by a recognized authority. The following comparisons are between financial and operating ratios in management capital-goods industries, consisting of machinery, iron and steel, railway equipment, electrical manufacturing, and so forth, and consumer goods industries, including such items as food, clothing, tobacco, gasoline, and so forth.

Inventory turn-over, expressed in dollar of sales per dollar of inventory. Machinery manufacturing industries, for each dollar of inventory, show $2.16 of sales, or a turn-over ratio of 2.16.

The average for capital-goods industries appears as $3.52, higher largely by reason of the substantially higher ratio for the iron and steel industry ($5.02).

The ratio figure of 2.16 for machinery contrasts strikingly with the ratio for consumers-goods companies of 4.45, more than double the rate of machinery-industry turnover.

Capital turnover expressed in dollar of sales to dollar of total assets. Machinery sales appear as 57 cents per dollar of total assets. The average, with other durable goods industries, is higher, 72 cents, including in this case automobiles at 96 cents and electrical manufacturing at 85 cents.

The machinery industry figure of 57 cents contrasts with the figures for consumers goods industries of $1.04, a difference, expressed in percentage, of 83 percent above the machinery industry figure.

Fixed-property investment turnover expressed in dollar of sales per dollar of fixed property investment. Consumers goods industries show sales of $3.83 per $1 of fixed property investment, a figure 65 percent above the ratio for the machinery industry of $2.32 per $1. The average, with other durage goods industries, is approximately the same, $2.37.

Sources from which capital is drawn:

(*a*) Current liabilities. In the case of consumers goods industries 19 percent, more than double the figure for capital goods industries of 8 percent.

(*b*) Reserves. In the consumers goods industries 3 percent, or 66 percent below the figure for the capital goods industries of 5 percent.

(*c*) Net worth. In the consumers goods industries 6 percent, or 16⅔ percent below the figure for capital goods industries of 7 percent.

The CHAIRMAN. Are we to understand, Mr. O'Leary, from your apparent criticism of those provisions in the law with reference to debt-ridden corporations and those that have made contracts as to debts, that provision should be eliminated?

Mr. O'LEARY. It must be eliminated if you have equality in tax. I think it should not be eliminated because a similar consideration should be given to competitive enterprise.

9. Effect of proposed tax in actual cases had it been imposed in past 5 years. Extended study has been made of the income, cash, and reserve accounts of a number of machinery manufacturers in order to determine as far as possible the effect of the proposed tax had it been in effect during a preceding period of 10 years, the 5 predepression years 1925 to 1930, and the 5 depression years 1930 to 1935. These contrasting periods afford excellent illustration of the effect of the proposed tax upon the solvency of companies in capital-goods industries. This study, which as you will observe from the nature of this form used in compiling and computing the figures, has involved extended detail, brings out (*a*) the amount of the tax in those years upon the actual income and upon the basis of the distributions actually made, (*b*) the effect year by year of the surplus tax in depleting cash and current assets, and (*c*) the amount of the tax in those same years had the dividend-disbursement policy of the company been sufficiently liberalized to reduce the amount of surplus tax paid to 15 percent per annum, present normal Federal income tax plus, reflecting the change thereby made in the surplus of the company from year to year and the effect upon the solvency of the company during the following lean years.

Certain of such examples were presented in the statement of Machinery and Allied Products Institute before the Ways and Means Committee of the House. Several others are also attached to this statement. They are self-explanatory, showing clearly what the imposition of the proposed tax threatens in bringing capital-goods companies to the point of insolvency or enforced borrowing to meet the tax in cash, and in making permanent unemployment either because of inability to conduct operations in some cases, or because of the retardent to resumption of normal activity and return of new private enterprise. The examples submitted then and now may fairly be considered as representative of the rank and file of the machinery industry.

Senator KING. In the industries that you represent, iron, steel, copper, and lead are important factors, are they not?

Mr. O'LEARY. They are; yes, sir.

Senator KING. You have had a fluctuation in the price of copper from 14 cents to 18 cents, and in the lead from 3 cents to 5 cents and

6 cents, and other minerals with varying prices. Those are contributing factors to the uncertainty of setting up reserves, of measuring your losses or profits in the future, isn't that true?

Mr. O'LEARY. That is correct. We must have an ample surplus to take care of it.

Mr. Chairman, I am not going to try to read these different results that we have illustrated in our exhibit, but I would like to have them go in the record.

The CHAIRMAN. You may put them in the record.

Mr. O'LEARY. I do want you to recognize that these are all actual corporations, taken from their actual figures, and then after having gone through the 10-year period showing what their present surplus is and working capital, we have tried to carry out what it would have been under this tax, bearing in mind that at the present time, during these years of no profit, we would have had no tax, but in spite of that you will find example after example in which the entire working capital of the corporation would have been exhausted, and it would have had to quit business any time between 1930 and 1935, and none of them would have had any working capital at that time.

Our problem then becomes one of, "What are we going to pay the taxes with? We have nothing in our surplus accounts after this disposition of earnings, but bricks, mortar, machinery, good will, patents, and whatnot, and of course we cannot pay taxes with that sort of thing. If we use our cash for the tax, which we would have to do, we have nothing left for other operations. The examples cover corporations of small size and large size, and there are a number of them, and the form used will also be attached, so that your own people can study how it was done and why.

The CHAIRMAN. It may be included in the record.

(The exhibit and form sheets submitted by Mr. O'Leary are as follows:)

EXHIBIT A

The following figures concern a company which commenced operations in early 1930. During the 6-year period ending with 1935 all income except $21,000, which was paid in dividends and Federal income tax of $63,000, was used to build up a reserve of $367,000 against future contingencies and for business expansion.

Had the proposed tax been in effect during these years and the same nominal dividends disbursed, the additional tax outlay required, over and above the tax actually paid, would have amounted to $113,500, or about one-third of the accumulated reserve.

In order to reduce the rate of tax under the proposed schedule to 15 percent, an additional dividend distribution of $221,000 would have been necessary, which, together with the tax payable in that event of $66,000, would have consumed $287,000 of the $367,000 reserve, largely exhausting working capital and preventing further growth of the company.

EXHIBIT B

During the first 3 years of the depression period, 1931 to 1935, inclusive, this surplus $1,565,000, represented largely in current assets.

During the next 5 years an operating deficit of $497,000 resulted, which was met out of surplus. Current assets at the end of 1934 were less than one-third the amount at the end of 1929.

The increment to surplus of $1,565,000 would have been reduced by $399,238 had the proposed tax been in effect and the same dividends paid.

Had the company in the predepression period distributed 55 percent of its adjusted net income in dividends, in order to reduce taxes to 15 percent, the additional drain would have amounted to $968,100. Available cash and marketable securities would have been insufficient by $211,100 to pay such dividends and tax.

EXHIBIT C

During the first 3 years of the depression period, 1931 to 1935, inclusive, this company operated at a combined net loss of $150,000, during which time no dividends were paid or taxes payable.

For the years 1934 and 1935 net earnings amounted to $82,000. No dividend distribution was made, but Federal taxes in the amount of $11,400 were paid, making the net loss for the 5 years $79,400.

Had the proposed tax on corporation surplus been in effect during these 2 years and no dividend distribution made, Federal taxes would have amounted to $34,850, or an increase of $23,450, or 206 percent, increasing the loss for the period to $102,850.

Under a policy of increasing dividend distribution to stockholders to a point which would reduce the Federal tax to a gross of 15 percent of net income, the company would have had to disburse in dividends 55 percent of net earnings, or $45,100, and pay Federal tax of $12,300, a total of $57,400, or an increase of $46,000 above the amount actually paid in dividends and taxes. The cash reserve would have been insufficient to meet the additional demand, and in the face of operating deficits bank borrowing would unquestionably have been impossible.

EXHIBIT D

During the 5 years of depression, 1930 to 1934, inclusive, this company operated at an aggregate loss of $434,818 which entirely consumed the surplus built up in the years previous to the depression period and caused a reduction in working capital of 55 percent.

During the predepression years 1925 to 1929 the company disbursed in dividends the sum of $258,247 and paid Federal income taxes of $84,724.

Under the proposed tax, with the same dividend disbursement, the amount of Federal tax payable would be $179,992 or an increase of $95,268.

If, in order to reduce the tax rate of 15 percent under the proposed tax, dividend disbursements of 55 percent were made, dividend payments of $399,554 and tax payment of $108,969 would be required or an increase of $165,550 over the amount already paid in dividends and taxes.

The additional drain on this company's resources would have wiped out cash of $73,000 entirely and forced the company to realize $92,000 and additional funds for working capital, by borrowings in the face of operating deficits from 1930 to 1933 and but a small profit in 1934.

EXHIBIT E

Total surplus of this company at the end of 1929, accumulated over a period of many years, amounted to $6,717,320 which enabled it to finance operations during the following 5 years of depression while sustaining an aggregate operating loss of $2,795,974.

Analysis of this company's figures for the 5-year period prior to 1930 discloses the fact that had the proposed tax been in operation and had the same rate of dividend disbursement been maintained, the additional charge against the accumulated surplus reserve would have amounted to $1,008,190; if dividends of 85 percent had been paid in order to reduce the tax to 15 percent the additional cash outlay required would have been $1,694,185. Under these conditions it would have been impossible for the company to have accumulated a surplus sufficient to carry through the depression period.

With the reserve account now reduced to less than 50 percent of its predepression amount, should the proposed tax become effective and discourage the rebuilding of surplus account the position of this company in any future years of unprofitable operations would involve serious capital impairment.

EXHIBIT F

One company, during the predepression period, the 5 years from 1925 to 1929, inclusive, had net earnings of $9,592,330 in dividends and $1,034,086 in Federal income taxes, a total of $4,626,416, or 51 percent of net earnings.

Had the proposed tax on corporate surplus been in effect for this period and had the same dividend distribution been maintained, Federal taxes would have amounted to $2,143,023, or an increase of $1,109,837.

Analysis of the cash and marketable securities account for the years 1926 and 1927 shows that they would have been insufficient and a cash deficit of $609,238 would have been created in 1926, increasing to $836,402 in the following year. To meet this deficit it is obvious that the company would have had to realize cash from other assets or would have been forced to take recourse to borrowing in order to meet the demands for cash distribution. The company's receivables for the year 1926 in the amount of $1,630,916 and for 1927 of $1,178,000, if convertible into cash, would have been partially offset by accounts payable of $489,918 in 1926 and $1,053,788 in 1927, and the company therefore would be forced to a large extent to rely for cash upon its remaining current asset of inventory of $1,636,954 for 1926 and $1,737,720 in the following year. It is perfectly apparent therefore that its position with reference to current operations and ability to take advantage of opportunities for reductions in material cost, or in operating cost through replacing obsolete plant equipment, would at best have been seriously impaired.

Carrying the analysis of this company for this predepression period further, it is unquestionable that in these years when the company was making a net profit, if it had been faced with a choice of a conservative dividend policy which would allow reserves for future loss period, plant expansion or other contingencies, but under the necessity of impoverishing such reserves and the interests of its stockholders by the payment of a prohibitive surplus of confiscatory proportions or on the other hand, of increasing its distributions to its stockholders to a point which would reduce its Federal tax to a gross of 15 percent of net income, it would probably have chosen the latter alternative. This would have required distribution in dividends of 55 percent of net income, a dividend disbursement (after Federal taxes of $1,159,169) of $5,561,636 would have been necessary, and this would have required a cash outlay of $2,094,487 over and above the amount actually paid. Where, therefore, the surplus tax if the conservative dividend policy had been maintained, would have required an additional cash outlay of $1,109,837, if a more liberal dividend policy had been followed the drain on current assets of the company would have been increased to $2,094,487.

Extending the analysis of this company to the 5 year depression period, 1930 to 1934, inclusive, we find that the company distributed $4,023,052 in dividends and Federal income taxes. But in doing so the company suffered a deficit of $716,897. Its reserves were reduced by 35 percent and its working capital, the excess of current assets over current liabilities, suffered an impairment of 51 percent from the 1929 balance. The company's position had been materially weakened by the maintenance of operations during the depression period. But had the company entered the depression period in the weakened condition which would have been brought about by the application of the proposed corporation surplus tax in the preceding period, either with or without the added effect of encouragement of a more liberal dividend policy, it is self-evident that operations of the company would have proceeded with great difficulty if not necessarily suspended in entirety and that further unemployment would have resulted.

EXHIBIT G

Another company, one which despite drastic reduction of its volume of business, continued to employ through the 5 depression years an average of 63 percent of the number of employees of the preceeding 5 prosperous years, started that prosperous period with surplus of $938,570 fully represented by current assets. During the period it added to surplus $1,222,000, more than one-half of which it held in current assets.

During the 5 depression years, operations reduced surplus $1,449,198. Suppose this company had not set aside those additional reserves of $1,222,000?

As it was expressed to me, "The years of depression, as will be noted, cut deeply into our surplus, and, had we not been fortunate enough to have had a substantial surplus when the business depression came, we could not have withstood the loss and undoubtedly would have been forced out of business along in 1932, as funds could not have been obtained from the banks. This would have resulted in a great loss to our stockholders, beside throwing many men out of employment."

EXHIBIT H

Another example—another company, during the 5 predepression years, had net earnings of $3,421,430. Its distributions were $1,160,000 in dividends and $424,703 in Federal income taxes, to total $1,584,703, or 46 percent of net earnings.

Had the proposed tax on corporate surplus been in effect for this period and had the same dividend distribution been maintained, Federal taxes would have amounted to $881,845, or an increase of $457,752, an increase of 108 percent.

Analysis of the cash and marketable securities accounts shows that an added tax distribution of $457,752 would have reduced the available cash resources of the company by 43 percent.

Carrying the analysis of this company for this predepression period further, it is questionable that in these years when the company was making a net profit, if it had been faced with a choice of a conservative dividend policy which would allow for reserves for future loss period, plant expansion or other contingencies, but under the necessity of impoverishing such reserves and the interests of its stockholders by the payment of a prohibitive surplus tax of confiscatory proportions, or, on the other hand, of increasing its distribution to its stockholders to a point which would reduce its distribution for Federal tax to a gross of 15 percent of net income, that it would probably have chosen the latter alternative. This would have required distribution in dividends of 55 percent of net income, a dividend disbursement (after Federal taxes of $512,014) of $1,877,387 would have been necessary, and this would have required an outlay of $805,298 over and above the amount actually paid. Where, therefore, the surplus tax if the conservative dividend policy had been maintained, would have required an additional outlay of $457,752; if a more liberal dividend policy had been followed, the drain on current assets of the company would have been increased to $805,298.

Extending the analysis of this company to the 5-year depression period, 1930 to 1934, inclusive, we find that the company distributed $739,676 in dividends and $33,450 in Federal income taxes. But in doing so the company suffered a deficit of $1,723,118. The company's position had been materially weakened by the maintenance of operations during the depression period. But had the company entered that depression period in the weakened condition which would have been brought about by the application of the proposed corporation surplus tax in the preceding period, either with or without the added effect of encouragement of a more liberal dividend policy, it is self-evident that operations of the company would have proceeded with great difficulty if not necessarily suspended in entirety and that further unemployment would have resulted.

EXHIBIT I

Here is another example. During the predepression period, the 5 years from 1925 to 1929, inclusive, this company, a smaller company, had net earnings of $179,153. Its distributions were $8,000 in dividends and $24,089 in Federal taxes, a total of $32,089, or 18 percent of earnings.

Had the proposed tax on corporation surplus been in effect for this period, and had the same dividend distribution been maintained, Federal taxes would have amounted to $72,143, or an increase of $58,054.

Analysis of the cash and marketable securities accounts shows that they would have been insufficient and a cash deficit of $35,238 would have resulted. To meet this deficit it is obvious that the company would have had to realize cash from other assets or would have been forced to take recourse to borrowing in order to meet the demands for cash distribution.

Carrying the analysis of this company for this predepression period still further, it is unquestionable that in these years when the company was making a net profit, if it had been faced with a choice of a conservative dividend policy which would allow reserves for future loss period, plant expansion or other contingencies, but under the necessity of impoverishing such reserves and the interests of its stockholders by the payment of a prohibitive surplus tax of confiscatory proportions, or on the other hand of increasing its distributions to its stockholders to a point which would reduce its distribution for Federal tax to a gross of 15 percent of net income, that it would probably have chosen the latter alternative. This would have required distribution in dividends of 55 percent of net income, a dividend disbursement (after Federal taxes of

$26,874) of $98,534 would have been necessary, and this would have required an outlay of $93,519 over and above the amount actually paid. Where, therefore, the surplus tax if the conservative dividend policy had been maintained would have required an additional outlay of $53,054, if a more liberal dividend policy had been followed the drain on current assets of the company would have been increased to $93,519. The cash shortage would have been increased to $80,503.

Extending the analysis of this company to the 5-year depression period, 1930 to 1934, inclusive, we find that the company operated at a loss in each of the first 4 years and that negligible profit was earned in the fifth year. The company's built-up surplus had been materially weakened by the maintenance of operations during the depression period. But had the company entered that depression period in the weakened condition which would have been brought about by the application of the proposed corporation surplus tax in the preceding period, either with or without the added effect of encouragement of a more liberal dividend policy, it is self-evident that operations of the company would have proceeded with great difficulty if not necessarily suspended in entirety and that further unemployment would have resulted.

EXHIBIT J

Take the significant case of still another company. Profits for the predepression 5-year period were $13,000,000. Sales during the next 5 depression years shrank to less than 30 percent of the previous 5-year average. Loss approximated $18,000,000. That $18,000,000 had to come out of surplus, and that a substantial surplus had been accumulated meant sustained employment to a large number of workers in the capital-goods industry during the depression period.

EXHIBIT K

Another example: This company during the predepression period, the 5 years from 1925 to 1929, inclusive, had net earnings of $155,000. It distributed $23,000 in Federal income taxes, nothing in dividends. Had the proposed tax on corporate surplus been in effect for this period, and had the same dividend policy been maintained, Federal taxes would have amounted to $65,875, or an increase of 188 percent, an added disbursement of $42,875.

Analysis of the cash and marketable securities accounts shows that they would have been insufficient and a cash deficit of $9,875 would have resulted. To meet this deficit it is obvious the company would have had to realize cash from other assets or would have been forced to take recourse to borrowing in order to meet the demands for cash distribution. The company's receivables amounted to $336,000; if convertible into cash would have been entirely offset by accounts payable of $343,000 and the company therefore would be forced in large extent to rely upon its remaining current asset of inventory. It is perfectly apparent therefore that its position with reference to current operations, ability to take advantage of opportunities for reductions in material cost, or in operating cost through replacing obsolete plant equipment, would at best have been seriously impaired.

Carrying the analysis of this company for this predepression period further, it is unquestionable that in these years when the company was making a net profit, if it had been faced with a choice of a conservative dividend policy which would allow reserves for future loss period, plant expansion, or other contingencies, but under the necessity of impoverishing such reserves and the interests of its stockholders by the payment of a prohibitive surplus tax of confiscatory proportions, or on the other hand, of increasing its distribution to its stockholders to a point which would reduce Federal tax to a gross of 15-percent net income, it would probably have chosen the latter alternative. This would have required distribution in dividends of 55 percent of net income, a dividend disbursement (after Federal taxes of $23,250) of $85,250 would have been necessary, and this would have required an outlay of $85,500 over and above the amount actually paid. Where, therefore, the surplus tax, if the conservative dividend policy had been maintained, would have required an additional outlay of $42,875, if a more liberal dividend policy had been followed the drain on current assets of the company would have been increased to $85,500.

Under these conditions cash reserves of $33,000 would have been wiped out and a $52,000 cash deficit created.

	Predepression period, year ended—						Depression period, year ended—					
	1925	1926	1927	1928	1929	5-year total	1930	1931	1932	1933	1934	5-year total
Historical earnings and surplus data:												
(1) Net income before Federal income tax and dividends	$	$	$	$	$	$	$	$	$	$	$	$
(2) Deduct dividends paid (exclusive dividends paid with capital stock)												
(3) Net income before Federal income tax												
(4) Deduct Federal income tax												
(5) Net income												
(6) Reserve accounts at end of period:												
(a) Surplus and undivided profits												
(b) Contingency reserves												
(c) Other surplus reserves, if any												
(d)												
(e) Total												
(7) Total depreciation taken as deduction in Federal tax returns												
Computation of proposed tax:												
(8) Percentage of net income paid in dividends, percent												
(9) Rate of tax, percent												
(10) Net income before Federal income tax (item 3 above)												
(11) Deduct proposed tax on adjusted net income												
(12) Undistributed net income												
Effect of the proposed tax on surplus:												
(13) Reserve accounts at end of period (item 6 (e) above)												
(14) Deduct net income (item 5 above)												
(15) Remainder												
(16) Add undistributed net income (item 12 above)												
(17) Adjusted reserve accounts at end of period												
Historical financial data (at end of period):												
(A) Cash												
(B) Marketable securities												
(C) Accounts and notes receivable												
(D) Inventories												
(E) Total current assets												
(F) Deduct total current liabilities												
(G) Net current assets (working capital)												
Effect of the proposed tax on cash position:												
(H) Cash (item A)												
(I) Marketable securities (item B)												
(J) Total (item H plus item I)												
(K) Assumed dividends (assume payment of annual dividends of 55 percent of net income, paid to reduce tax rate to 15 percent)												

	Predepression period, year ended—						Depression period, year ended—					
	1925	1926	1927	1928	1929	5-year total	1930	1931	1932	1933	1934	5-year total
Effect of the proposed tax on cash position—Continued. (L) Proposed tax (15 percent of item I)	$	$	$	$	$	$	$	$	$	$	$	$
(M) Total (item K plus item L)												
(N) Actual dividends paid												
(O) Actual income tax												
(P) Total (item N plus item O)												
(Q) Additional cash required (item M less item P)												
(R) Cash balance (item J less item Q)												

Mr. O'LEARY. I think it would be very much worth while for you to go over that. I think it will demonstrate the very disastrous effect this sort of a tax bill would have upon our type of industry.

Senator KING. Before leaving that question may I make an inquiry? What would you do with some of these corporations that are sick? Would you nurse them along a little by giving them the discriminations that are here provided? How would you deal with those?

Mr. O'LEARY. Frankly, Senator, I think there is not very much to that. It is a great deal like giving a man that is about to be electrocuted a good breakfast before he goes into the chair. It is not a very serious matter. I brought it up to show the competitive disadvantage which it creates.

Senator KING. Undoubtedly that is true.

Mr. O'LEARY. It may be that that is the only way you can manage it, but it is not a vital matter; it is not as vital as the other things.

Senator KING. It seems to me, without expressing a definite opinion, that in this period of depression, with these casualties, unless there is some little favoritism shown them, that perhaps it will merit and warrant a departure from strict equity and equality in taxation.

Mr. O'LEARY. I think you may have to follow that method, and we would not feel very badly about it, because we are always for somebody getting something, if they can.

10. The effect of proposed tax in future years in impoverishing capital-goods companies: If by reason of a tax such as proposed in this bill, capital-goods companies emerging from a depression of unprecedented severity are to be prohibited from or heavily penalized for rebuilding their reserves so dangerously depleted during past years, the effect so far as their reserves are concerned can be likened to a continuance of depression conditions, with the possibility of utter insolvency should another cycle of depressed business be encountered during the effective period of this tax.

I emphasize to you again the important distinctions between the operating needs of capital-goods companies and those in many other industries. Exactly what these differences mean in relation to com-

parative profits is shown in the following figures comparing the percentage of loss to sales of companies manufacturing consumption goods. The figures are the result of classifications from the Dun & Bradstreet 1933 manufacturing survey.

(The matter referred to follows:)

	Percent profit (+) or loss (−) to net sales	Companies analyzed
Capital goods	−3.9	409
Consumers' goods	+3.0	780

Here is substantial difference—strong evidence of the need in times of industrial activity for building of surplus and perfecting of utmost financial stability by capital-goods companies. Further tangible evidence of the severity of depression upon capital-goods companies can be observed in the tabulation of "net earnings" of industrial-machinery manufacturers, issued by the Treasury Department. The consistent and substantial deficits shown, in lieu of net earnings, explain adequately why a survey of durable-goods manufacturers at the end of 1933 showed an average shrinkage of surplus of all companies reporting to 55.3 percent of 1929 reserves.

Companies which have sustained heavy losses and have been forced to deplete current assets (working capital) to maintain operations and employment must rebuild working capital and reserves if they are to be prepared to maintain themselves in business, retain their credit standing, rebuild their plants for competitive efficiency, and contribute to the reemployment in all occupations which, after all, is our primary objective of recovery.

Senator KING. What is the date of that publication of the Treasury Department to which you have just referred, their survey of capital goods?

Mr. O'LEARY. I do not have the date right here. The date is given, "Issued by the Treasury", and it is at the end of 1933, so I presume it is the last tabulation of that type.

Senator KING. I wish you would get me a copy of that, Mr. Helvering.

Mr. HELVERING. Very well.

Mr. O'LEARY. All the experience, skill, and resourcefulness of able management will be called into play to achieve that objective on a firm and stable basis. At a time such as this we can ill afford to experiment with further barriers and retardants which place a penalty upon thrift and sound management, build upon shifting sands, and leave our major problems for future advertence.

We urge upon your committee the most serious consideration of any such change, confident that exploration of the effects of the proposed taxation will result in failure of this radical proposal.

Senator KING. I do not think I misunderstood you. You do feel that banks and insurance companies, and a few of those organizations, because they are required to maintain reserves, might be distinguished from the usual corporation?

Mr. O'LEARY. I think they should be, Senator.

Senator COUZENS. Mr. O'Leary, have you given any consideration to the graduated tax?

Mr. O'LEARY. As taxpayers we would like very much to see expenses cut. We know you have to tax us more and more in the future. The only suggestion which I think of in connection with that, if we are to carry out the general theory or principle of taxing undistributed earnings it would be to base the graduated tax on a rising percentage of undistributed earnings in relation to invested capital.

Senator COUZENS. Well, that goes back practically to the old theory of the excess-profits tax.

Mr. O'LEARY. Almost; except in this you involve the undistributed net earnings; that is, you put that factor in. I think that that would be a sound method of taxation and would be more equitable than any scheme which would destroy surplus, because what I am trying to show to you this morning is that you cannot take all industry and put it on the same basis in the treatment of its undistributed earnings. The chewing-gum manufacturer can distribute 90 percent of its earnings without any trouble because it has a current cash operation, but our industries cannot do that. We must accumulate large reserves and hold them for several years in order to meet these cyclical changes which comes to us.

Senator COUZENS. What have you to say, Mr. O'Leary, with respect to the unfairness of the existing system for the small stockholders, of which there are millions of them? In other words, a small stockholder having to pay a high corporate tax? The corporation, on its earnings, pays a wholly unfair rate of taxation as compared with other people having a small income; is that not true?

Mr. O'LEARY. I do not think I follow you on that. At least, it does not sound right to me.

Senator COUZENS. In other words, if a man has $10,000 invested in a corporation and he pays the tax of a corporation of 15, 20, or 22 percent, whatever it is, he pays a more unfair return on his so-called earnings or dividends than a man who had $10,000 invested in real estate, for example, in other than corporate form and received the same amount of earnings. Is that not an element that ought to be remedied?

Mr. O'LEARY. If I catch your question, Senator, you mean that through the payment of tax by the corporation and then again by the individual in his own affairs, that he is really taxed more than the man who is not in the corporation?

Senator COUZENS. That is true, is it not?

Mr. O'LEARY. That is always true.

Senator COUZENS. Is not that an unfair method of taxation?

Mr. O'LEARY. Well, I presume you could call it that; but I always have felt that, after all, a man is a free agent as to what he will invest in. It is a great deal like whether we shall have a partnership or a corporation. After all, we can incorporate if we want to. There is no injustice in that, as far as I can see. If a man wants to get rid of the difficulties of a partnership tax all he has got to do is to incorporate. Now, we do not have to pass laws to do that, and we do not have to create different taxation to do that.

Senator COUZENS. I am afraid I probably did not make myself clear. It is not a question of incorporation. At times a man may have a $600 income from a piece of real estate; he may own it in fee simple, and he would pay a tax on $600, if he was in that tax bracket, and yet if he had the same amount of investment and got $600 out of the corporation he would pay 15 percent before he got it, and then he would fall in whatever tax bracket he came in thereafter. So a small man who happens in the corporate form pays a greatly excess tax over and above the other who earns the same amount of money.

Mr. O'LEARY. That is correct.

Senator COUZENS. Do you think that is a fair method?

Mr. O'LEARY. No; I do not think it is.

Senator COUZENS. Do you think we ought to try in some way to reach a situation of that sort?

Mr. O'LEARY. I do not think it is as serious as it is theoretically unsound. I do not believe it is really a very serious matter. That is my feeling about it.

Senator COUZENS. It is quite apparent that you are not a small stockholder.

Mr. O'LEARY. Yes; I am. As a matter of fact, one of these examples is my own corporation.

The CHAIRMAN. Thank you very much, Mr. O'Leary. Mr. Smith F. Ferguson.

STATEMENT OF SMITH F. FERGUSON, NEW YORK CITY, VICE PRESIDENT, GENERAL TIME INSTRUMENTS CORPORATION

Mr. Chairman and gentlemen of the committee: Last August I had the privilege of appearing before you in support of an amendment to section 351 of the Revenue Act of 1934. You, at that time, recommended such an amendment and the Senate adopted it. When the 1935 revenue bill went to conference, your recommendation contained in the Senate amendment was stricken out. The proposed House tax bill which is now before you, entirely eliminates section 351 of the Revenue Act of 1934.

Permit me to now state that the entire elimination of section 351 in the pending 1936 Revenue Act has to a very large degree cured the objection I voiced last year of an unfair burden that section placed on the company I represent and those similarly situated.

The CHAIRMAN. You are satisfied then?

Mr. FERGUSON. That is correct, Mr. Chairman. My only reason for now appearing before you is to urge that if during your deliberations you should find it necessary (but I hope you will not so find) to restore section 351 to the tax bill you are now considering, that you in that case, again give consideration to a similar amendment to section 351 as was adopted by the Senate last year.

In order to save your time I will not now repeat the arguments I previously made. In order, however, that our ideas and argument may be again recorded, I would respectfully ask that the following brief be spread upon the record of this hearing.

BRIEF IN SUPPORT OF A PROPOSED AMENDMENT TO TITLE 1A, SECTION 351, OF THE REVENUE ACT OF 1934—SURTAX ON PERSONAL HOLDING COMPANIES

The purpose of the Congress in enacting section 351 of the Revenue Act of 1934 was doubtless to prevent the evasion of surtaxes by the accumulation of earnings in the treasury of the corporation defined in the act. No opportunity is afforded a corporation to show that it has used and disbursed its earnings for a proper and legitimate business purpose. If the conditions as to ownership of the majority stock and source of income exist, the tax is automatically assessed.

Section 351 is working a grave hardship to those corporations which fall within the definition of personal holding companies but which are in fact organized and operating for strictly business purposes and using earnings to develop and expand legitimate business. A holding company, so-called, may be supervising and directing the operations of manufacturing units which it controls and using and expanding its earnings to develop and expand the business of such manufacturing subsidiaries, and yet it is taxed on such earnings by Section 351, on the theory that the earnings are being accumulated in its treasury to evade surtaxes on stockholders.

The section subjects a corporation organized in accordance with law and for sound business reasons to a high penalty tax, in addition to the normal corporation income tax, in cases where there is absolutely no basis in substance or in fact for imposing a penalty tax.

Consider the facts as to the General Time Instruments Corporation of which I am vice president, and which is one of many corporations similarly situated and affected by section 351. That company was organized on November 20, 1930, to bring under common ownership the Western Clock Co., of LaSalle, Ill., and the Seth Thomas Clock Co., of Thomaston, Conn. The purpose was to create a company which would cover a wider field of time-telling instruments. The Western Clock Co. manufactured alarm clocks and nonjeweled watches, and the Seth Thomas Clock Co. manufactured high-grade mantel clocks and tower clocks. It was believed that many economies would result from uniting these two companies and combining the management capacity of both and coordinating many of their activities. A committee was appointed of six gentlemen connected with the management of the companies to work out the best plan for their unification. It was finally decided to form a corporation and exchange its stock for the outstanding shares of the two constituent companies. No stock at that time was offered or sold to the public.

The General Time Instruments Corporation now owns all of the capital stock of the Western Clock Co. and owns all of the capital stock of the Seth Thomas Clock Co. There are approximately 178 separate stockholders of the General Time Instruments Corporation. A large number of these stockholders scattered throughout the world, with no financial or business connections, are by statute, because of family relationship, reduced to five individuals. The corporation owns no stock, bonds or other securities of any other corporation, other than the constituent companies. Its income is mostly derived from interest and dividends received from the constituent companies. Its only other income consists of payments made to it by the constituent companies to cover the expenses of the research laboratory and for managerial and other services rendered by the parent corporation. During 1935, income from this latter source amounted to less than 12 percent of the total income from all sources.

The General Time Instruments Corporation was organized without any regard whatsoever to the matter of avoiding taxation. Its organization was dictated by sound business reasons. It is an important business enterprise in an industry that is essential to the existence of every other industry and to our economic stability and national security. In carrying on its business it has become necessary for the General Time Instruments Corporation to use dividends derived from the stock of the Western Clock Co. to finance the Seth Thomas Clock Co. because, while the market for alarm clocks and low-grade clocks manufactured by the Seth Thomas Clock Co. has been recently practically nonexistent. It is of direct benefit to the stockholders of the General Time Instruments Corporation that its funds be used to assist the Seth Thomas Clock Co. and its employees during this depression. The General Time Instruments Corporation has also found it necessary to use earnings derived from dividends on stock of the Western Clock Co. for plant reconstruc-

tion and for recquipment at the Seth Thomas Clock Co. Yet this corporation which uses and proposes to use and disburse its earnings for sound business reasons is subject to a high penalty tax.

In view of these facts and conditions, we are proposing an amendment to section 351, which will in a large measure, remove the grave hardship it is now working on sound business corporations, and at the same time, will leave all the teeth in the section, so far as it applies to holding companies organized to evade taxes.

We respectfully suggest the following amendment but, as stated above, only in case section 351 is restored to the bill now pending:

"Section 351 (b) (1) of the Revenue Act of 1934, is amended by adding at the end thereof, the following:

"If in the case of an affiliated group of corporations, as hereinafter defined in this paragraph, the sum of the portions of the gross incomes of all members of the group derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stocks or securities) gains from the sale of stock or securities, is less than 80 per centum of the sum of the gross incomes of all members of the group, then the common parent corporation of such affiliated group shall not be considered a personal holding company. As used in this paragraph, an 'affiliated group of corporations' mean one or more corporations connected through stock ownership with a common parent corporation; if the common parent corporation owns directly, on January 1, 1936, and during the entire taxable year at least 95 per centum of the stock of such other corporations. If such common parent corporation acquires directly after January 1, 1936, at least 95 per centum of the stock of each of one or more additional corporations and (1) such stock in each of such additional corporations was owned by such common parent corporation during the entire taxable year and (2) it is established to the satisfaction of the Commissioner that the acquisition of such stock in each such additional corporations was not in pursuance of a plan having as one of its principal purposes the prevention of the imposition of the surtax upon the shareholders of such common parent corporation or the shareholders of any other corporation, then such additional corporations shall be deemed to be members of the affiliated group of corporations connected with the common parent corporation for the purpose of this section. The term 'stock', as used in the last two sentences, does not include nonvoting stock which is limited and preferred as to dividends."

If this amendment is adopted, then corporations organized as holding companies, which supervise, direct, and finance manufacturing companies which they control, can use dividends derived from a prosperous subsidiary to aid or expand the business of a weaker unit, without subjecting such earning to this very high penalty tax as called for in section 351.

Permit us to point out that we feel quite confident that the above-suggested amendment fully protects the Government; that is, it would not defeat the real purpose of the law and provide a loophole for people who wish to form personal holding companies in order to evade surtaxes.

May we further point out that the "on January 1, 1936" date given in the above-suggested amendment will fully protect the Government as we are very confident that no companies were formed for the purpose of attempting to evade the object and intent of the personal holding-company definition between the time the 1934 Revenue Act became effective and January 1, 1936.

It will also be noted that the suggested amendment provides that if anybody should form or acquire a corporation after January 1, 1936, with the object of attempting to evade the surtax on shareholders, the Commissioner has jurisdiction to determine whether or not it was formed for evasion purposes.

Section 351, as now worded and in force, is not just or fair. It so works as to drastically inflict grievous discrimination and injury to honest businessmen by subjecting them to a high penalty tax on earnings used and expended for legitimate purposes. This discrimination and hardship will, in a large measure, be corrected by the amendment we have proposed, or, preferably, it should be entirely eliminated from the law, as the present proposed House bill provides.

The CHAIRMAN. Thank you, Mr. Ferguson. Mr. Priestley.

STATEMENT OF T. J. PRIESTLEY, JR., PRESIDENT, THE PRIESTLEY PRINTERS, PHILADELPHIA, PA.

Mr. Chairman, I want to give good reasons for condemning the proposed new tax law, but more particularly do I want to explain that by honest, fair, and equitable taxation you may obtain all the funds needed by the Treasury Department and at the same time correct our economic ills, encourage initiative and facilitate the pursuit of happiness. Fair taxation is in keeping with Democratic principles, Republican ideals, and the aims of social security. This accomplished the citizens of all parties from the North, South, East, and West may join in harmony with the Liberty League in singing "My County 'Tis of Thee, Sweet Land of Liberty."

I fear that if a correct answer to our tax problem—which I think holds the key to all of our economic ills—is not soon found, the nightmare of further increased taxation will be dwarfed by the consequences which may follow.

As I understand it our personal-income-tax plan is nearly right, excepting for the nontaxable securities clause. The reason that it is nearly right is because dollars are taxed in proportion to dollars received, which is a correct measure. We do not question how a man spends it. He may have two or three houses, yachts, fast horses, and so forth. You just say to him, "If your income is $100,000 you pay one-third of this amount to the Government; if it is $1,000,000 you pay two-thirds; if you make $20,000,000 you pay three-fourths." Now, when we come to taxing business we use a false measure entirely. Business should be taxed in proportion to the business done.

So, Mr. Chairman, when enacting a new tax law, I beg of you to give your greatest consideration to the tax as an instrument to cause the rehabilitation of small industries, to the end that legitimate reemployment may be spread to the masses, which will advance general prosperity and promote social security. This can be accomplished—only by taxation—fair taxation.

The privilege to tax is the privilege to destroy.

The duty to tax fairly and equitably is the duty to preserve.

Many corporations are adding to their surplus the profits which the President believes should be distributed to their stockholders. While these corporations are paying to the Government a tax of at least 13½ percent on their net earnings, they are saving to their large stockholders, by retaining these profits, between 50 and 70 percent of the amount that would have been paid to them.

These same corporations are using every legal subterfuge to evade taxation, and this is done with the connivance of our Government, which abets and condones the taking of every advantage by the corporations which may be legally straight but not altogether righteous.

This prudence is commended by the Government, and if the managers of these corporations failed to serve the best interests of their stockholders, their stockholders would dispose them.

As a class, you will find that most all businessmen prefer to pay an honest and fair tax, even though it cost them more, than to pay a tax that is so crooked that Government agents have to bend six ways trying to enforce it.

Take as an illustration the Government's suit against the former Secretary of the Treasury, whose integrity is unquestioned, but who had an opportunity to know of and use every successful precedent to evade a vast portion of his taxation, which a less wealthy citizen in like position (not having such information) would be compelled to pay.

The CHAIRMAN. Whom are you talking about—Mr. Ogden Mills?

Mr. PRIESTLEY. No; the former Secretary of the Treasury, Mr. Mellon.

Senator COUZENS. I disagree with you there on your conclusions.

Mr. PRIESTLEY. He has had several rebates, however, so it may show that I am right about the crookedness of the tax.

The CHAIRMAN. Go ahead, Mr. Priestley.

Mr. PRIESTLEY. The wrong should not be laid to either Government tax enforcement or to the corporations. The fault is that the present plan of taxing the net profits of business is wrong, unfair, and incompetent, and a forcing tax on undivided surplus is in the same category, but it has in addition for its background malicious regimentation, so that the profits honestly made by a corporation may not be spent or divided in the best manner by the directors, but must be subject to Government dictation. This plan of taxation will not put more men to work, and it will not advance prosperity nor promote personal economic security, and therefore should be discarded in favor of an honest, fair, and equitable tax plan that will do this.

For instance, if a large corporation overproduced to the extent of millions and fails to make a profit, the Government receives no taxes; industry in the same line is heavily taxed and depressed; and the workers are thrown out and general chaos has been and is the result.

Then again, if a large corporation overproduced to the extent of millions and fails to make but a very small profit, the Government receives no appreciable taxes; industry in the same line is still heavily taxed and general chaos is the result.

A progressive gross business tax, taking but a small percentage of the advantage that accrues to each corporation in proportion to its volume of production or sales would give the Federal Government ample revenue, eliminate the taxing of the poor man's dollar and place the unemployed back into legitimate jobs; thus increasing both production and consumption by the many instead of just a few.

You may remember that I appeared before this committee on July 31 last, advocating a progressive business tax which was in harmony in every essential with the tax proposed by our President in his message to Congress on June 19. President Roosevelt then promulgated a plan of progressive taxation from approximately 10 to 17 percent of the net earnings of corporations.

During the 10 minutes which was granted to me just before this committee adjourned I tried to explain the soundness of this proposition, while condemning the damnable mechanics of the proposal.

I argued then, as I do now, that some such fair and honest plan of business taxation to help reduce monopolistic machine advantages should be enacted promptly in order to place back into legitimate

jobs the growing numbers of the unemployed and therefore reduce taxation.

President Roosevelt's plan of progressive taxation on net earnings, the N. R. A. and the A. A. A. had as their objective the most logical, the most humane and the soundest American policy which has ever been presented to the people of the United States since Thomas Jefferson wrote the Constitution, and this objective is the part of the promise which our President made in his platform of 1932, which the people voted for, and are now demanding "Equal rights to all, special privileges to none."

But the mechanics of operation were so inhuman, illogical and un-American that these pen-achieves failed utterly to accomplish their purpose.

Let me take one concrete case as an example: The Government officials know how many bushels of wheat are demanded for consumption and exportation in a given time; they know, too, that if all the large wheat growing farmers and corporations would produce their maximum number of bushels, they alone would produce more than enough to supply the need, without taking one bushel from the six million smaller farmers. Therefore, the idea was to reduce the production of the large wheat growers and increase the production of the smaller farmers to the point where production would be in harmony with the demand. This, then, would allow the smaller farmers to exist and sell their wheat at a fair price, while the larger corporations would receive a fair profit, per bushel, for growing less wheat.

If the attainment of this objective were followed through to all industry, each citizen could be happy with his share of our national abundance and individual social security would rest on each citizen's thriftiness.

And this sound American objective may be attained without running counter to our esteemed Constitution.

Now, what happened was this: The Government paid tribute to the large corporations for not hurting the smallers farmers, while the large corporations benefited most.

The Government used as a measure for bushels, acreage of nonproduction, so that some of these large wheat growers produced more bushels of wheat per acre on the remaining acreage, thus receiving checks for false reduction.

To pay this tribute, the poorer man was taxed more burdensomely.

As a further monstrosity, the Government imported more wheat than could have been grown on the acreage put out of production.

The fault of these inconsistencies rests with our public officials who fail to enact an honest tax plan for business.

To reuse a quotation used by our President: "On your heads; in your hands; the sin or saving lies."

We have the illogical spectacle of paying $961,064 to a Puerto Rican corporation; $862,460 to a Hawaiian producer; $92,237 to a California beet-sugar producer; $65,505 to a Colorado beet-sugar grower for not producing too much sugar.

The progressive business tax proposes a tax on production or sales, so that individual overproduction will be taxed fairly for

monopolizing any field of endeavor, rather than receiving a bonus for alleviating so much misery.

The total production in each line of business would be divided by the number of enterprisers, in order to ascertain the "fair amount" in each line. For each "fair amount" over the first fair amount, a 1-percent tax would be added progressively.

A check for $150,000 to a hog-raising corporation for not raising too many hogs. This was in California, whose State motto is "Eureka" (I have found it).

A check for $115,750 to an Arkansas cotton grower—State motto, "The People Rule."

While the Government paid thousands of checks for not producing, the absurdity of the thing may be comprehended when you realize that acreage was used as the measure of production, so that these large corporations were paid for reducing their acreage, while at the same time they increased their production on their remaining acres. A net-profit tax is no less inconsistent.

The plan of the progressive business tax advocates a progressive tax in proportion to a fair amount of business done in each line of business, and it is interesting for you to note (from the U. S. Census Report of Manufacturing for 1929) that man-production advantage increases very materially to the corporations in proportion to their increased total production or sales, and this predominant advantage should not be used against the national security.

By these statistics man-production increases like this: Corporations producing from 5,000 to 20,000 man-production, 3,083; from 20,000 to 50,000, 4,739; 50,000 to 100,000, 5,544; 100,000 to 250,000, 5,765; 250,000 to 500,000, 6,102; 500,000 to 1,000,000, 6,504; 1,000,000 to 2,500,000, 7,089; 2,500,000 to 5,000,000, 7,801; 5,000,000 and over, 11,789.

This shows that man-production in the lowest-volume bracket of production was $3,083; in the middle bracket, $6,102; while in the higher bracket with superefficient mass-producing machinery, man-production was $11,789. This shows that the larger corporations could have paid each of their 2,442,326 employees $76.70 per week in addition to the amount they then paid without making their competition more keen than the corporations doing between $2,500,000 and $5,000,000 annually.

The 210,959 establishments produced $70,434,863,443; this would average approximately one-third million for each establishment. On this basis if one-third million were to be considered a "fair amount" the 15,449 companies doing between $333,000 and $500,000 would each pay to the Government in taxes $198. While their man-production advantage over their nearest competitor would amount to $19,456 and the Government would receive $3,058,902.

The 10,395 companies doing between $500,000 and $1,000,000 would each pay to the Government in taxes $1,035, while their man-production advantage over their nearest competitor would amount to $47,436, and the Government would receive $11,913,825.

The 7,430 companies doing between $1,000,000 and $2,500,000 would each pay to the Government $27,956, while their man-production advantage over their nearest competitor would amount to $126,360, and the Government would receive $207,713,090.

The 2,479, manufacturers doing between $2,500,000 and $5,000,000 would each pay to the Government $162,705, while their man-production advantage over their nearest competitor would amount to $316,128, and the Government would receive $113,815,695.

The 1,834 corporations doing over $5,000,000, averaging $15,530,088, would each pay to the Government $3,572,058, while their man-producing advantage over their nearest competitor would amount to $1,228,268, and the Government would receive from them $7,622,595,532. Many of these corporations are operating in violation of our antitrust laws.

The idea of the progressive tax is that the State shall receive back one-half of that which emanates from the State, so it would amount to the Government receiving about $4,000,000,000 and the State receiving sufficient for its needs.

Senator COUZENS. Before you leave may I ask for the source of the figures, Mr. Priestley?

Mr. PRIESTLEY. They are from the '29 United States census of manufacturers.

The CHAIRMAN. Thank you, Mr. Priestley. Mr. Fairchild.

STATEMENT OF FRED ROGERS FAIRCHILD, PROFESSOR OF POLITICAL ECONOMY, YALE UNIVERSITY, REPRESENTING MANUFACTURERS ASSOCIATION OF CONNECTICUT, INC.

Mr. FAIRCHILD. Mr. Chairman and members of the committee: I have been asked by the Manufacturers Association of Connecticut to appear before you and to present their viewpoint with respect to the revenue bill which you are considering. In asking me thus to represent them, the association has given me no instructions but has left me free to express my own convictions. This permits me to place before you my criticism of the pending bill, not merely from the viewpoint of the special interests of an association of New England manufacturers, but from the broad viewpoint of the public interest.

Senator CONNALLY. May I ask you right there: Do you mean that the manufacturing concerns turned it over to you and told you to do what you wanted to do about it, that they have no views of their own?

Mr. FAIRCHILD. It does not mean they have no views of their own.

Senator CONNALLY. Whoever they are, they chose you to express their views for them?

Mr. FAIRCHILD. I will faithfully present what is their interest.

The CHAIRMAN. I understand you are a professor in Yale University?

Mr. FAIRCHILD. Professor of political economy in Yale University, New Haven, Conn.

Senator CONNALLY. Have you ever been a member of the brain trust?

Mr. FAIRCHILD. I have never been so honored.

The CHAIRMAN. You mean the brain trust of the Democratic Party or the Republican Party?

Mr. FAIRCHILD. I am innocent of participation in any brain trust, Senator. It is this aspect of the case which has my in-

terest as a student of economics and taxation. It is because of the belief that in this case the interests of the manufacturers of Connecticut are generally coincident with the welfare of the whole people of the United States that this association feels safe in thus entrusting their representation to me and that I am willing to represent them. I could do so on no other terms.

In a great Nation like ours there are inevitably many men of many minds. I am fully aware that in the minds of those who are interested in the pending revenue bill there are various viewpoints and various motives. Doubtless there are those who believe that an attack upon industry is in the public interest. To such, demonstration that this bill might seriously affect the well-being of thousands of American industrial enterprises would not present an argument against it. In opposition to this viewpoint may I state my own conviction that the welfare of the American people is not served by a division into contending groups and a conflict in which whatever injures one group is regarded as a gain to the others. On the contrary I am convinced that the welfare of the whole people is inseparably bound up in a healthy condition of industry. Particularly at this time, when the American people—still in the grip of the severest and longest depression of history—are looking for the recovery of healthy economic activity and prosperity, it is essential that governmental action be so far as possible calculated to encourage, rather than to discourage, business enterprise. For it is a well-attested fact that, in a world such as ours, those forces which promote economic recovery have their origin in the minds of the entrepreneurs. When the future offers prospect of profitable enterprise, then those who are responsible for business policy make the decisions which speed up industry, swell the demand for capital goods, and increase employment, wages, incomes, and consuming power. It is thus that recovery comes. On the other hand whatever tends to reduce the chance of profitable business discourages industrial expansion and prolongs depression.

Another theory, rather widely held in America today, is that we have had too much saving and too little spending, that in consequence productive capacity has outgrown consuming power and so caused industrial depression, and that the way to recovery involves discouragement of saving and encouragement of spending. Those who hold this theory may look with favor upon the pending bill as tending to force a larger distribution of the earnings of industry into the hands of stockholders, who, it may be presumed, will be inclined to spend some at least of the resulting dividends, representing funds which would otherwise be saved and reinvested by the corporations. That this would be the consequence of this bill is, I think, true. That economic recovery would thereby be promoted is, on the other hand, precisely contrary to the truth. I would not choose to weary you, even did my time permit, with the theoretical analysis of this matter. May I simply state as my firm belief that the rather popular theory which I have summarized is based on false economic premises. Economic depression is not brought about by too much saving. Economic recovery will be retarded, not hastened, by any measures at this time which tend to check saving and investment, especially in the products of the so-called heavy industries.

In thus paying my respects to certain theories which I regard as fallacious and pernicious, I have sought, so to speak, "to clear the decks for action" upon what I believe is the real issue in connection with this bill. I shall from now on assume that I am addressing those who sincerely desire both the recovery of economic prosperity upon the foundation of a healthy and prosperous industry and the promotion of a sound and equitable tax system for the National Government. I should like to say a few words on these two matters, taking them in the reverse order.

First of all may I state most emphatically my conviction that the existing policy of deficit financing is unsound and fraught with great danger to the future stability and well-being of the Nation. It might appear that I should therefore welcome any measure which proposes to increase the tax revenue and so, presumably, to reduce the deficit. Actually my position is quite the contrary. The time to increase taxes is when consideration is being given to the balancing of the budget. The burden of taxation in the United States is already very heavy; it is already presenting an obstacle to economic recovery. The present bill, while it presumes to add some hundreds of millions to the Government's revenue, indicates no intention of balancing the budget. Its enactment, even assuming that the estimates of its yield should prove correct, would leave the enormous deficit still enormous. The people would have the increased load of taxation, and they would still have the deficit, both imposing heavy drags on economic recovery.

I believe that the Congress should take no action in the way of new or increased taxes except in connection with a real balancing of the whole Federal budget. Such balancing will require attention to expenditures as well as revenues. I am certain that the present level of governmental expenditures could be greatly reduced without serious loss to the efficient functioning of government. At the same time it is quite probable that additional taxes may be found necessary. Of course taxes are never welcome to those who have them to pay. But increased taxes which are required to balance the Budget would present a very different face to industry from those which leave the deficit still with us. Accompanied by vigorous reduction of expenditures, and as the price of a balanced Budget, necessary increases in the tax load, will, I am confident, be accepted philosophically, if not cheerfully. For I can think of no action by the Congress which would give more encouragement to industry and more effectively stimulate economic recovery than the prompt balancing of the Budget along lines such as I have suggested.

This matter has an even more direct connection with the pending bill. The existing Federal income tax is an exceeding complicated thing. It involves intimate relations with the multitudinous conditions of business. It involves complex relations between corporations and partnerships and individuals.

Senator CONNALLY. Right there, if we balance the Budget we have to levy a good deal more tax than we levy in this bill, isn't that true?

Mr. FAIRCHILD. I hardly think so, Senator.

Senator CONNALLY. If you can show us how to do that, if you can show us how to balance the Budget and still keep down the taxes, we would be glad to have you do so.

Mr. FAIRCHILD. I did not say that. I think the Budget can be balanced by a combination of a reduction of expenditures and a moderate increase in taxation, and it is in that connection that I would hope that such an increased taxation might be undertaken.

Senator KING. You do not welcome a deficit of approximately 6 billions of dollars, do you?

Mr. FAIRCHILD. I do not welcome any deficit, Senator.

Senator KING. Neither do I.

Senator BAILEY. If the volume of national income should increase from 55 billion dollars to 70 billion dollars you could balance the Budget on the present taxes, could you not?

Mr. FAIRCHILD. I could not answer that definitely, although I am very certain that the present revenue system would, in a condition of increased prosperity, bring in very much greater revenue, which seems to me again to be a reason against making changes involving new and untried tax laws at this particular time.

Senator BAILEY. Income has increased since 1932 from 30 billions to 55 billions. Those are the figures of the Department of Commerce. If it was increased 15 billions more you would have 70 billion dollars. Are you prepared to testify as to what the revenue would be on 70 billion dollars' income at the present taxes?

Mr. FAIRCHILD. I would be quite unable to give you any precise figure, of course, on that hypothetical question.

Senator BAILEY. Well, it would produce as much revenue as would be produced under this bill, additional revenue, so there would be no necessity to levy additional taxes.

Mr. FAIRCHILD. I can answer that latter part of the question in the affirmative. I do not believe that additional taxation eventually should be necessary.

Senator BAILEY. If people are going to have a 70-billion-dollar income in the next year there would be no necessity for the present taxation to raise, as I understand, 6 billion dollars.

Mr. FAIRCHILD. I have made no research which would permit me to answer that in such a precise figure, but I think I can agree with the general principle of your statement.

Senator BAILEY. I hope the experts from the Government will give us some information on that.

Mr. FAIRCHILD. They are certainly far more competent than I am to answer a question of that sort.

Senator KING. It would depend, Senator, may I be permitted to interpolate, upon the bracket in which that additional income may fall. It may be that a large part of that 70 billion dollars would consist of increased wages and increased earnings among those who would pay but little, if any, taxes.

Senator BAILEY. That is true, but I think if we had a 70-billion-dollar income we can assume that that would be properly distributed. I would like to have the experts from the Treasury Department tell us about that.

Senator KING. I join in that request too.

Senator BAILEY. That is the most constructive way out. If we can build the business up to a national income of 70 billion dollars I know we would receive enough revenue so we would not have to increase the taxes. I would like to get the Treasury Department to look into that and give us some information on that.

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

Mr. FAIRCHILD. During the history of the law its complexities have steadily increased. And with the constant mounting of the tax rates the considerations involved in these complexities have grown steadily more serious. At the same time progress has been made in meeting these problems through the gradual building up of an elaborate mass of administrative rulings and legal decisions. In this manner the people have become adjusted to the tax system.

The present bill proposes to sweep away the essential features of this tax system, so far as it relates to corporations, and to substitute a new system based on different principles. Whatever may be the defects of the present system, it has at least the advantage of experience. Both the taxpayers and the administration have become familiar with it and adjusted to it. An essentially new system would require once more the painful and laborious process of adjustment, of building up administrative rulings, of judicial settlement of disputed interpretations, of learning by experience. This would not only place a new burden of uncertainty and expense upon industry, retarding the progress toward recovery. It would also throw an element of uncertainty into the Government's finances. In spite of the best efforts to calculate the probable yield of the proposed tax measure, this is still a matter of prediction, and no one can be sure that the new tax will produce the hoped-for yield. This is a poor time to introduce new hazards into the Government's revenue system.

The CHAIRMAN. May I ask you, Mr. Fairchild, if we did not adopt the corporation tax and we had the surtax only, would you think the method proposed here would be a very fair, equitable method?

Mr. FAIRCHILD. I think I am going to comment on that very point a little later. If I do not touch on that I hope you will ask it again.

Furthermore, I would point out that, even though the modified tax system of the present bill should become law, there would be no assurance that anything had been definitely settled. The deficit would still remain. Inevitably, sooner or later, the problem of balancing the Budget will have to be faced. At that time there will doubtless be tax legislation. The method of taxing corporations, the relations between corporation taxes and individual taxes, may again be revised. Business may again have to undertake the painful process of readjustment. To my mind this presents a powerful argument against overhauling the income tax at the present time, whatever the merits of the proposed changes may be, and another powerful argument in favor of postponing all fundamental tax legislation until it can be undertaken as part of a thorough revision of Government finances and a real balancing of the Budget.

I come now more specifically to the merits of the pending bill. I am frank to say that in my opinion our existing income-tax laws are far from perfect, especially in the relations which they set up between the corporations and their stockholders. Corporations are generally taxed on (substantially) all their net income. In consideration of this, the stockholders are not taxed upon their dividend income so far as the normal tax is concerned. Their dividends are subject to the surtax. Now, in view of the fact that the corporation tax is at rates from 12½ to 15 percent, while the indi-

vidual normal tax is at 4 percent, this concession represents a very inadequate adjustment on account of the "stoppage at the source" which the corporation income tax may be considered to represent. A more exact adjustment would be accomplished by making dividends subject to both normal tax and surtax and then allowing a credit against the stockholder's tax aqual to his proportional share of the income tax paid by the corporation.

This would do justice to the larger shareholders.

Senator CONNALLY. Right there let me ask you a question about that. Is it not true, at least on theory, that a corporation may retain, or it may pay out all or any part of its current income and that the rate of tax in the hands of the ultimate stockholder will be just exactly the same?

Now, you can make a point there that the corporation could not retain what it needed without being penalized. If that is true, then the only consideration that the corporation would have would be: "How much money do we need out of current revenues as a reserve or surplus?" It is just that consideration alone, because it will not make a bit of difference to us as to the tax, whether we distributed it all or whether we distributed none of it, or whether we distributed part of it, and then we are putting it down to the real economic factor alone of how much of the current revenues ought this corporation to retain for its own working capital, without pressure from big stockholders to keep it in the treasury and without pressure from little stockholders to pay it out, do you realize that?

Mr. FAIRCHILD. Does that not overlook the fact that under the present bill the directors of a corporation, in deciding how much to retain of a given amount of earnings to add to surplus, would have to face a very heavy tax and that might influence their vote as to the amount of their earnings to be distributed to stockholders?

Senator CONNALLY. Well, the stockholders would pay it when they get it. In the aggregate they will pay the same tax, whether it is all distributed or whether none of it is distributed.

Mr. FAIRCHILD. I do not believe that that is the way it will work out.

Senator CONNALLY. That is what we are trying to do. If you show us what is wrong with it, we will try to fix it.

Mr. FAIRCHILD. I cannot show you how to fix it, because I do not think it can be done.

Senator BLACK. May I ask you a question? I understand you favor the principle of equalizing the payment of the tax on the income derived either from corporate activity by the individual or from other sources?

Mr. FAIRCHILD. Yes.

Senator BLACK. And your objection to this bill, as I understood it, is that the mechanics adopted to bring about that end results in some kind of coercion on the stockholders that requires them to make a decision in reference to that which they should not have to make in order to accomplish your purpose.

Mr. FAIRCHILD. Yes; and I go a little further than your question implies, because my objection is fundamentally to the punitive and discriminatory tax on undistributed earnings. I do not regard that

at all as a necessary part of the mechanics to accomplish this purpose.

Senator BLACK. May I ask you one other question? I understood you to say you approve the President's objective of taxing undistributed earnings?

Mr. FAIRCHILD. Well, I approve the principle of taxing corporations only on the undistributed part of the earnings and leaving the rest to be passed to the stockholders. I might avoid any misunderstanding by saying that that implies there shall be no discriminatory or punitive tax upon the undistributed earnings, no tax to force a greater distribution than would follow from the wise discretion of the directors themselves.

Senator BLACK. If the law simply provided that the individual stockholder should be assessed each year on his earnings, whether it was distributed or not, that would not be coercive so far as the corporation is concerned, would it?

Mr. FAIRCHILD. In other words, treat the stockholder the same as we now treat partners of a partnership?

Senator BLACK. Yes.

Mr. FAIRCHILD. I think that is a very interesting proposition from a theoretical point of view. Of course, as you recognize, there would be serious practical obstacles.

Senator BLACK. I understood your thought was that the earnings that the individual would derive from corporate activities should bear the same rate of tax as the tax on earnings which he derived from any other source.

Mr. FAIRCHILD. Precisely, sir.

Senator BLACK. So that if the law did simply provide an individual should, year by year, include in his individual tax return the earnings from all sources, including the increased earnings that he had by reason of the corporate fund, then that would meet the objection you have as to the coercive feature of the bill?

Mr. FAIRCHILD. I think it would, and it would be sound if it could be practically carried out. It might, perhaps, imply some revamping of the definition of "corporate net earnings", because you can see that a certain difficulty might come about if stockholders were required to pay a tax on earnings which had appeared only in the form of an increased inventory or increased accounts receivable. I am not prepared offhand to say that some detailed modifications would not be required. But so far as the broad principle goes, I think that would be sound.

The CHAIRMAN. Is there anything in this bill, Mr. Fairchild, that would prevent a corporation from paying out all its earnings to its stockholders and then tax rights for additional stock?

Mr. FAIRCHILD. No.

The CHAIRMAN. You think that is all right in theory?

Mr. FAIRCHILD. I have discussed that with people in practical affairs who understand those matters better than I do myself and I know there are some serious difficulties there. In other words, that does not entirely meet the situation. In the first place, there are expenses and complications involved in every issue of new capital by a corporation which would be required.

The CHAIRMAN. That would remove the inequities of the imposition of taxes on the corporation, as you say, and the individual.

Mr. FAIRCHILD. It also might compel a corporation to build up a larger capital than it wished. The principal objection to that, I think, Senator, is that it would fail to provide this cushion for meeting succeeding periods of depression, which the surplus of a corporation now provides. You see, if the corporation got this back in new capital it would have increased its capital stock, and it is a very serious thing to impair your capital stock in order to keep up wages or to keep up a steady rate of dividend payment; whereas you can do that out of the surplus. That is what the surplus is for. So that that proposition which would, in part, correct the difficulty I think would not entirely correct it.

Furthermore, of course there is always difficulty of persuading all of your stockholders to come back with their dividends in reinvestment in the company. So far as it goes, I think that point, in part, meets the objection, but only in part.

The CHAIRMAN. All right, you may proceed.

Mr. FAIRCHILD. It would not correct the injustice which is now done to the stockholder of modest means whose income comes all or chiefly from dividends. Consider a man, married and with two dependents, whose entire fortune is invested in the stock of a certain corporation and who has no other source of income. Suppose his share of the corporation's earnings, before the Federal income tax is paid, is $4,000. If this corporation is taxable at the 15-percent rate, this man's dividends are reduced by $600 from what they would have been had there been no income tax on the corporation. Consider now another man with a net income of $4,000 from sources other than corporation dividends. This taxpayer takes advantage of the personal exemption of $2,500, credit for dependents of $800, and earned income credit of at least $300. The balance of his net income, $400, is taxable at 4 percent, and his tax is $16. The other taxpayer bore a burden of $600, paid by the corporation. The effect of our present system is to deny to the poorer stockholders who have little or no other income either the whole or a part of the personal exemption, the credit for dependents, and the earned income credit, to which the spirit of the law at least entitles them.

The simple means of correcting the present injustice, to both the large and the small shareholders, would be to cease taxing the corporations on that part of their net income which is distributed in dividends to stockholders. Tax the corporations only on the undistributed part of their earnings. As to the stockholders, treat dividend income exactly like other income, and tax each stockholder at whatever rate his total income indicates. The purpose should be to make the income tax a personal tax so far as possible, taxing corporations only on their undistributed earnings in order that no part of corporate earnings should entirely escape taxation. I have long been on record in favor of such a modification of our income-tax structure.

I have gone into this matter somewhat in detail because two of the announced purposes of the present bill are to remove serious inequities and inequalities between corporate, partnership, and individual forms of business organization, and to remove the inequity as between large and small shareholders resulting from the present flat

corporate rates, and because the pending tax proposal, particularly in its original form as offered by the President, seemed to be moving in the direction of a more personal income-tax structure.

Few persons would, I think, fail to find themselves in sympathy with the two purposes of this bill which I have quoted. On the other hand, disappointment must come with realization that the bill does not appear well adapted to accomplish this purpose. The original plan of the President proposed to tax corporations only on their undistributed earnings. This feature is, I think, commendable. The present bill, while taxing all corporate net earnings, makes a distinction between the part which is distributed and that which is retained by the corporation. Both plans, however, appear to destroy whatever virtue they might thus claim by introducing the notion of a punitive tax on the undistributed part of corporate net income. Under these circumstances the degree to which injustice as between large and small shareholders is removed becomes problematical at best.

To take one extreme supposition. Assume that a corporation should distribute its entire earnings for a given year. It would then pay no tax, its shareholders would be taxed in accordance with their respective total incomes, and equity would apparently be accomplished. But if this complete distribution were the result of a tax which penalized the holding of undistributed earnings and compelled distribution contrary to the best judgment otherwise of the directors of the corporation, then the greater equity as between large and small shareholders might have been accomplished at the cost of injury to the interest of all shareholders.

To take another example. If a corporation in the second group named in the bill should hold 30 percent of its earnings undistributed, it would, under the rates of schedule II pay a tax of 15 percent on its entire net income, being the top rate of the present tax. The small shareholder would not be in any way relieved from the inequity he now suffers, while all shareholders would suffer an additional degree of double taxation on account of the normal tax on their dividends. They might in addition be the losers so far as the heavy tax discrimination against undistributed income had compelled a distribution of their corporation's earnings greater than would otherwise have been wise policy.

For any case between these two examples; i. e., when the undistributed earnings are less than 30 percent, there is the possibility of a partial correction of the present inequity to small stockholders, possibly offset by injury to the corporation through an unwise distribution of earnings. On the other hand, in all cases where more than 30 percent of earnings are withheld from distribution, the small shareholders are in nowise relieved from the injustice they suffer under the present law.

In brief, whatever the tendency of the proposed plan to do justice to the small shareholder, it is inapplicable or of small consequence except when earnings are entirely or almost entirely distributed, and it is largely nullified by the consequences upon the corporation of an ill advised distribution of earnings. As to the larger shareholder, there are two effects: (1) The subjection of dividend income to the normal tax, increasing the tax burden by so much, and (2) the rais-

ing of certain stockholders to higher income-tax brackets through the increase in individual incomes resulting from a forced increase in dividends. As regards the removal of inequities between small and large shareholders, all that is here accomplished is the somewhat heavier taxation of the larger shareholders. But it is to be noted that this result, so far as it relates peculiarly to the large shareholders, is accomplished only to the extent that the tax forces a greater distribution of corporate earnings than would otherwise have been considered sound policy by the directors. And so far as this affects adversely the present stability and the future prospects of the corporation, the injury is done to small shareholders as well as to large.

I am unable to avoid the conclusion that, largely on account of the discriminatory treatment of undistributed earnings, the contribution of this tax proposal toward removing inequalities as between different forms of business organization and as between small and large shareholders is very small, and that whatever it might accomplish along this line is entirely overshadowed by the unfortunate consequences which would follow from the discriminatory tax upon undistributed earnings.

Without doubt it is this punitive treatment of undistributed income which is the heart of the present bill so far as it relates to the income tax. The intention is evidently to force by means of a graduated scale of rates, the distribution of corporate earnings to a degree substantially greater than would otherwise take place or to impose a drastic tax when for any reason such greater distribution cannot be made. This means that the judgment of directors as to what disposition of earnings is most favorable to the welfare of the corporation—and so to its stockholders both large and small—is no longer to be left free to operate. The unfortunate effects of such a policy upon the stability of business corporations, upon the prospects of future profitable business, upon the confidence with which those who direct the destiny of American business shall view the future, and so upon the rate at which the American people shall escape from economic depression would appear well nigh obvious.

Upon this phase of the matter I think I need not dwell. This subject has already been ably presented in great detail by representatives of American business and others who have testified before the Ways and Means Committee of the House of Representatives and whose testimony is doubtless at your disposal. Similar testimony has already been presented you and doubtless will be presented as these hearings proceed. You are thus hearing, on this point, from men who are far better qualified than I to demonstrate by practical evidence from American business the general truth as to the dangerous consequences of a tax policy which would tend to force distribution of corporate earnings and interfere with the building up of business enterprises and the strengthening of industry to meet the hazards of the future through "plowing back" into the business a liberal portion of current earnings.

There remains one corollary of this aspect of the problem upon which I should like to comment briefly. I think that the more this tax proposal is subjected to searching analysis, the more apparent becomes a tendency which I do not believe could have been foreseen

or intended by its framers. There seems no escape from the conclusion that this program is bound to affect unequally different classes of corporations and that in general its consequences will be less serious and less harmful in the case of the large and prosperous corporations, whereas its effects will be most felt—ruinously in some cases—by the small, the young, the struggling corporations.

An old, well-established corporation, which has grown to great size and has established a comfortable surplus out of the earnings of past years, may face without great concern the tax changes which this bill contemplates. It may be under no compulsion in the near future to hold earnings to offset past losses. Its present surplus may be adequate to provide the necessary cushion for possibly less prosperous times in the future. It may therefore be in position to distribute all or nearly all of its current earnings in dividends. It may even find its tax load materially reduced as compared with that which it bears under the existing taxes which affect corporate incomes.

The CHAIRMAN. Mr. Fairchild, in that connection, there is nothing in this bill that would prevent the issuance of these dividends. If the dividends were issued the tax would be in the hands of the shareholder or stockholder.

Mr. FAIRCHILD. I did not quite understand your question.

The CHAIRMAN. Well, if they issue stock and carry with it the idea that the stockholder would bear the tax instead of keeping it in the corporation——

Mr. FAIRCHILD (interrupting). You mean issue a stock dividend?

The CHAIRMAN. I mean the corporate fund.

Mr. FAIRCHILD. That does not build up a surplus, though, that increases the capital organization.

The CHAIRMAN. That is why we are trying to build up a cushion. Whether it is a large enough cushion to sit on or not I do not know.

Mr. FAIRCHILD. Yes. On the other hand there are those corporations which are fighting for "their place in the sun." There are young corporations, which should grow by putting back into the business perhaps the greater part of their earnings during their first years. There are newly established enterprises which must of necessity accept losses in their early stages which in the normal course of events will be offset by the profits of later years. There are corporations, both young and old, whose business is of so seasonal a character that the natural course of events brings an alternation of good years and bad years, losses and profits. There are young corporations which, though prosperous, have not yet built up sufficient surpluses to enable them to look forward with confidence in their ability to withstand future periods of unprofitable business; they are as yet in no position to maintain a steady policy either of employment or of dividend payments in a future depression.

In all these cases sound business policy dictates "plowing back" into the business a substantial part of current earnings. In some instance distribution of earnings in dividends may be impossible or even illegal. The proposed tax plan would either force a distribution which might be destructive of strength and future prosperity or would impose upon undistributed earnings a heavy tax which might be ruinous.

Upon this subject also you have doubtless heard or will hear testimony from those who are able to give demonstration from the practical facts of business experience. I would only add that such consequences as these upon the least able of the country's corporate enterprises would mean, not merely the perpetration of fresh injustices when the removal of injustice was the avowed purpose, not merely particular hardship against which the enterprises affected have the right to expect protection from the Congress, but—what is of even greater moment from the viewpoint of the public welfare—would threaten to place a heavy obstacle in the path of industrial recovery.

May I conclude by expressing the opinion that this Congress would act wisely in postponing tax legislation until such time as it can form part of a program for balancing the budget and that, if tax legislation must in the opinion of the Congress be enacted at this time, the measures adopted be free from any force which would compel a distribution of corporate earnings in excess of that which is dictated by sound business policy.

I thank you for your patience.

Senator LONERGAN. Mr. Chairman, I would like to ask him a question with relation to the question asked by Senator Connally.

Is it not a fact that Mr. Hubbard, the president of the Connecticut Manufacturers Association, is in Europe and that is the reason he is not here to present the case of the manufacturers?

Mr. FAIRCHILD. I think it is a fact that he is in Europe.

Senator LONERGAN. Well, the secretary wrote me a letter to that effect. Is it not a further fact that the manufacturers of the State of Connecticut have been able to carry on during the depression due to the fact that they had the ability to build up reserves?

Mr. FAIRCHILD. I think that is undoubtedly true.

Senator LONERGAN. And is it not a further fact that industrial employment in the State of Connecticut has increased more pro rata, than in any industrial State in the Union in the last year?

Mr. FAIRCHILD. I could not answer that.

Senator LONERGAN. That is what the governmental agencies tell me.

Mr. FAIRCHILD. No doubt it is true.

Senator LONERGAN. Now, do you believe that we should adopt this suggested plan or that we should increase the rates that now exist, that apply to individuals, partnerships, and corporations?

Mr. FAIRCHILD. Well, I believe, Senator, as I have already said, that now is not the time to seek an increased revenue tax at all, but if I were asked to make a choice between those two methods, I believe I can honestly say that industry would suffer less from an increase in rates of existing taxes than from the introduction of this new type of taxation.

Senator LONERGAN. Yes, sir.

Mr. FAIRCHILD. I believe, from my own viewpoint, that that would be the sounder policy.

Senator BLACK. Doctor, I asked you two or three questions a while ago, and I want to supplement them. I now understand it is your belief that the present system of taxing corporate profits does work inequities as between the large stockholders and the small stockholders?

Mr. FAIRCHILD. Yes. Those small stockholders who do not have other income against which they can take the exemptions and the credits which the law grants.

Senator BLACK. And as a matter of fact, the only small group of stockholders that would receive what you call equity and justice under the present system would be that particularly small group of the whole that it just happens if they had to pay the tax individually they would pay exactly the same rate as individuals as the tax that happened to be imposed upon the corporation, whether it is 15 or 16 percent?

Mr. FAIRCHILD. Those are small stockholders?

Senator BLACK. Small or large.

Mr. FAIRCHILD. The stockholders who derived their dividends from a corporation which was able to distribute the great bulk of its income would receive some benefit from this bill, because the corporation would pay a lighter tax than now, and the stockholders themselves would at least be no worse off than they are now.

Senator BLACK. Then that being true, you ought to believe, do you not, that every citizen who is taxed should be taxed on exactly the same basis as to all earnings that every other citizen is?

Mr. FAIRCHILD. Under the income tax?

Senator BLACK. Yes.

Mr. FAIRCHILD. Yes. So far as this is possible, I think that is the ideal.

Senator BLACK. And you also believe that there is no way that that can be done in connection with corporation taxes and individual taxes except in some way to have a plan with the objective which you said you agreed to, which would provide that the profit each year should be included in the income-tax return of the individual instead of attempting to put a flat rate on a corporation?

Mr. FAIRCHILD. That would do it. I think it would also be done substantially—and this was my own suggestion some years ago—if the corporation were taxed only on the undistributed part of its income at a reasonably flat rate. That is not quite so perfect an adjustment, but I think it has the advantage of being more practical.

Senator BLACK. It does get down to the proposition, so far as your position is concerned, if I understand it—and I do not want to be incorrect about it—that the present system does have inequities and injustices because the small stockholder is frequently taxed more by the assessed rate and the large stockholder is frequently taxed less by the assessed rate than they would be if it came into their hands individually?

Mr. FAIRCHILD. My comparison is not so much between large and small stockholders.

Senator BLACK. I mean the ones in the higher bracket. The stockholders that happen to be in the very low bracket are compelled to pay a higher tax by reason of the excess-profits tax?

Mr. FAIRCHILD. No; I do not think you quite get my point, Senator. I do not think the present flat rate necessarily means a low tax on the shareholders in the high brackets. What it does mean is a higher tax on those in the low brackets.

Senator COUZENS. What the Senator says is correct with respect to those in the high brackets if the earnings are retained.

Mr. FAIRCHILD. Yes; if the earnings are retained according to the judgment of the directors of the company, then the shareholders in the large brackets pay a lower tax than they would if the earnings were distributed. That is self-evident. I had not thought of that as being a criticism of the present plan.

Senator BLACK. What I was getting at is it is agreed by all students of taxation, such as you are, that there should be some effort made of some kind—you do not think it should be made now by this bill—there should be some effort made to bring about an equal taxation of income, but your objection is that the system adopted not only has an incentive to make for a distribution which might not otherwise exist, but it is your belief that it absolutely would compel the board of directors to make the distribution when, in their judgment, it might not be wise to do so.

Mr. FAIRCHILD. Yes, sir. I believe the present bill accomplishes very little in the way of increased equity between large and small corporations, as it would work out, and that the slight gain, if there is any gain at all, is entirely offset by the very unfortunate consequences of having that compulsion.

Senator BLACK. That is, you consider that the benefits that would be gained would be offset by what you consider to be the disadvantages.

Mr. FAIRCHILD. Yes; and the fact that in most cases there would not be any advantage at all. In every case where the corporation held back an undistributed 30 percent or more of its earnings I cannot find any advantage whatever to the small shareholder.

Senator KING. Doctor, would you care to express an opinion—I shall not ask you to do so unless you care to do so—as to the effect of this measure in its present form upon holding companies, holding companies that are legitimate and are forced, because of the nature of their business and the laws of the various States, or of the countries in which they are operating, to have holding companies?

Mr. FAIRCHILD. That is an aspect of this bill, Senator, that I am sorry I have not studied with very great care, but from a brief examination of that part of the bill it would appear evident that the holding companies are likely to be subjected to additional and heavier burdens; and insofar as holding companies are an essential mechanism of industrial organization, I think that is something that the Congress ought not to undertake.

Senator KING. Some companies, mining companies, by reason of the laws of the various States and by reason of the diverse operations in which they are engaged, to achieve the same objective feel it necessary to organize holding companies. For instance, one will be formed to construct the smelter; another will be formed for the purpose of conducting the mining operations per se; another will be formed for transportation purposes per se; and yet the same stockholders control all of them through this holding company. I was just wondering whether you had given any thought to that or not. I should be very glad, if you find time, to have you communicate with the secretary your views with respect to the effect of this bill upon holding companies.

Mr. FAIRCHILD. I can say, offhand, that, of course, the holding companies, in certain instances, have been used to further unsound

financial organization and financing; we all know that; but on the other hand I regard the holding company as an entirely proper, useful, and meritorious device in the conduct of corporate business, and any tax device which in any blanket way seeks to penalize the holding company I should regard as ill-advised. It seems to me in that case it should be our problem to seek out the specific evils of the holding-company organization and attacks those evils directly.

Thank you very much.

Senator LONERGAN. Mr. Fairchild, is it not a fact that the reduction of the reserve in any corporation materially affects the stock values and the credit of that corporation?

Mr. FAIRCHILD. I am very sure it does.

The CHAIRMAN. Thank you, Mr. Fairchild. Mr. Oliver.

STATEMENT OF J. W. OLIVER, NEW YORK CITY, REPRESENTING THE AMERICAN MANAGEMENT ASSOCIATION

The CHAIRMAN. Mr. Oliver, you represent the American Management Association?

Mr. OLIVER. Yes, sir. I approach this problem as a taxpayer and a citizen interested in the Nation's welfare. As a student of taxation, I am identified as follows:

1. Chairman of the tax committee, American Management Association.

2. Member of the national tax association and regularly appointed delegate to the annual national tax conferences.

3. Member of the tax committee, New York Merchants' Association.

4. Secretary, the Linen Thread Co., Inc., 60 East Forty-second Street, New York.

I present only my personal views, as none of the organizations with which I am identified have held meetings to discuss H. R. 12395, nor have they authorized me to speak for them.

RECOMMENDATIONS

I come before you to urge consideration of the following suggestions:

(1) In order to accomplish the removal of "the inequity between large and small shareholders resulting from the present flat corporation rates", the new revenue measure should provide:

(*a*) Credit to stockholders in computing their own personal Federal-income-tax liability to the extent that a Federal tax has been paid on dividends distributed to shareholders.

(*b*) Net loss carry-over as deduction from either one or both of the 2 succeeding years' taxable earnings.

The CHAIRMAN. Have you arrived at any estimate as to what that would cost in lost revenue?

Mr. OLIVER. I have not, sir. I was under the impression that that question might come up, and my answer would be that you would have to increase the individual rate—the rate on individuals—to make up for that. I realized there would be a loss.

Senator KING. May I inquire as to your business? You say, "American Management Association." What does that mean?

Mr. OLIVER. The American Management Association is about what that title implies. It is made up of large corporations interested in all forms of management. It happens to be entirely different from a trade association that might have a particular point of view. It represents all classes of manufacturers, all classes of business organizations.

Senator KING. Small and large?

Mr. OLIVER. Small and large.

(2) In order to insure a more equitable determination of "unjust enrichment", I would have the rule for determination of whether or not the burden of unpaid taxes was shifted, apply only in cases where the net profit on the article exceeded 5 percent of the gross sales price. For the determination of net profit on a sale, allow such deductions for manufacturing, administrative, and selling costs as are permitted in the general computation of net income of manufacturing and selling merchandise under the regular provisions of income-tax laws—rules and regulations as to the allocation of these expenses to the particular sale to be prescribed by the Commissioner of Internal Revenue.

I might say at this point, gentlemen, that I mention 5 percent here only as a matter of convenience. I do not mean to say that 5 percent establishes what is fair earnings and that earnings in excess of that would be unfair. I am doing that purely from an administrative standpoint. I think it would be very helpful both to the taxpayers and to the Commissioner of Internal Revenue.

To the extent that net profit computed in this manner on the sale of articles hitherto subject to excise taxes (or exactions denominated as taxes) exceeded 5 percent of the gross sales, the rule laid down in title 3, for determining whether or not the burden was shifted, should apply. However, this rule should be modified so as to bring about a comparison of the current margin of profit with that of 4 pre-Agricultural Adjustment years; 2 of these years should be 1928 and 1929 and the other 2, 1931 and 1932. The purpose of specifying these 4 particular years is to insure that the taxpayer will be using an average that is not unduly weighted by depression experience.

(3) In order to do equity, title 4 should reenact the refunding provision of section 21 (d) of the amended Agricultural Adjustment Act in a modified form that would insure original processors receiving the same treatment contemplated for secondary holders of merchandise.

(4) In order to insure uniform and fair treatment in respect of floor-stock-tax refunds, this act should specifically provide for the refunding of precise amounts equal to the floor-stock tax collected upon each basic agricultural commodity, or items subjected to the tax, at the inception of each of the different processing or compensatory taxes under the Agricultural Adjustment Act.

COMMENT ON THE FOREGOING BRIEF SUGGESTIONS

With respect to item (1) which deals with corporation taxes levied on profits before they reach shareholders, it is respectfully submitted that there is consideratble merit to the general contention that the tax assessed against the corporation controverts the principle of abil-

ity to pay which is recognized in establishing graduated rates of taxation on the individual. To the extent that a corporation pays, under the present law, or more heavily, possibly, under future laws, a tax on its earnings, the Federal Government is in fact levying such a flat rate of taxation against the shareholder, be he a poor man or a rich man. If it were possible to force a distribution of income equal to current earnings each year without having to adopt unworkable administrative provisions and without having to take special recognition of the different classes of taxpayers as somewhat provided for under the proposed revenue measure, then the graduated tax rate, based on ability to pay, would properly apply without any adjustment in case of the individual.

By allowing a shareholder credit for the pro rata amount of the Federal tax applicable to his dividends received, it makes no material difference what rate of tax has been assessed against the corporation, because such tax becomes a payment on account of the shareholder's personal tax liability. This would eliminate, I believe, the inequity that results from classifying corporations under different divisions so as to have them fall into different rate classifications, whether these different rates are applied for the purpose of forcing distribution or whether they are applied because the corporation finds itself in the peculiar position of being unable to distribute its earnings.

Whenever a corporation, having previously paid out all of its available surplus in dividends, suffers a substantial loss, it will have a deficit. Thus, in the following year, its earnings (a portion, if not all) are required to restore the deficit and cannot be paid out in dividends. Hence, it is necessary to allow that corporation to absorb prior years' losses in determining corporate taxable income for the current year, or else the tax load fails to fall ratably on the "beneficial owners of the business profits."

Regarding item (2)—determination of "unjust enrichment"—the proposal outlined in title 3 would assess an 80-percent tax on the net income resulting from the sale of certain articles. Under the definition of "unjust enrichment", a taxpayer may find himself branded as "unjustly enriched" should he make $1 net profit on a $1,000 sale, if it so hapepned that the average margin during the pre-Agricultural Adjustment Act period was less than that obtaining in the case of the $1,000 current sale. Obviously a profit of 5 percent or less on the sale of an article cannot be properly called "unjust enrichment." I would have no quarrel, however, with a revenue measure that attempted to lay down different rates of earnings by classifications of commodities limiting the profits that are to be subjected to the test of "unjust enrichment."

By so limiting the rate of net profit that could be earned without application of the 80-percent tax, the administrative procedure, both with respect to the Government and the taxpayer, would be simplified. The administrative and overhead savings from such simplification would overshadow the loss in taxes on these small earnings. Then to the extent that a taxpayer does earn more than the limit that is free of the 80-percent tax, the rule as to what extent he shifted the burden could be applied. Such a rule, however, should embrace a 4-year period as an average for normal profits

prior to the Agricultural Adjustment Act, one-half of which would be predepression and the other half subsequent to the depression. The particular rule laid down in title 3 is manifestly unjust, because it is so heavily weighted with depression experience.

Regarding item (3)—refunds under the Agricultural Adjustment Act resulting from exportation, sales to charitable institutions and the conversion of cotton into large bags, and so forth—section 601 (a) specifically reenacts certain provisions of the amended Agricultural Adjustment Act. According to the report of the Ways and Means Committee accompanying H. R. 12395—

> the enactment of this section will serve to remove doubts as to the legal authority of the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, which have existed since the decision of the United States Supreme Court holding the Agricultural Adjustment Act invalid, to continue the making of refunds under the provisions of sections * * *

referred to. However, section 601 (b) excludes from the benefits of section 601 (a) the processor or other person who paid the tax. The explanation given in the report of the Ways and Means Committee for excluding the actual taxpayer is * * *

> for the reason that the claims of such persons are within the benefits of section 21 (d) of the Agricultural Adjustment Act, as amended.

Obviously the Bureau of Internal Revenue has been powerless to make refunds on legitimate claims filed under the provisions of the Agricultural Adjustment Act because of the failure of the court to rule on such sections of the Agricultural Adjustment Act as had to do with making refunds. But just why the Ways and Means Committee report would recommend the granting of specific authority to make refunds in case of nontaxpayers and specifically preclude the original taxpayer is not explained, other than to say the original taxpayer has his remedy under section 21 (d).

Furthermore, if it is the intention of Congress to reenact certain provisions that have to do with making refunds, why not reenact section 21 (d) insofar as it lays down the rules for making refunds in the case of the original processor so that the Bureau of Internal Revenue will have a clean-cut procedure to follow with respect to all claims for refund now outstanding or later to be filed? It is respectfully submitted that the passage of H. R. 12395 without adequate protection for the original taxpayer would subject Congress to the criticism that it had deliberately tried to embarrass the original taxpayer because so many of the large processors obtained injunctions that led to the difficulty we are now experiencing. If we honestly review this matter in retrospect, we must conclude that our present difficulty arises as a result of Congress having enacted in the first place an invalid law and not the result of taxpayers protesting this illegal exaction. I therefore recommend the exclusion of section 601 (b) in order that all claims for refund may be handled without discrimination with the hope that Congress may escape the stigma that would result from the passage of such apparently discriminatory legislation.

In the report of the Ways and Means Committee explaining why the determination of the Commissioner of Internal Revenue was final and not subject to judicial review and further, that interest on claims is disallowed, on the grounds that there is doubt as to the

legal status of these claims, I respectfully submit that Congress should not pass provisions of doubtful validity in a revenue bill. If there is doubt about the validity of a statute that would allow claims for refund without proof that the tax was paid, it would in my opinion, be far better for Congress to enact only such provisions as would enable the recovery of taxes actually paid.

With regard to item (4) it is respectfully submitted that Congress should provide a uniform enactment in making refunds of floor-stock taxes to the end that all taxpayers are treated alike. Section 602 provides for refunds of floor-stock taxes figured at conversion factors regardless of whether or not the tax had actually been paid, to all holders of merchandise as of January 6, but section 602 (a) specifically excludes from the benefit of this provision the original taxpayers.

Again quoting from the report of the Ways and Means Committee—

> the original taxpayers are excluded * * * for the reason that their rights to refund are governed by section 21 (d) of the Agricultural Adjustment Act as amended.

However, nothing is contained in this report indicating a desire to have section 21 (d) reenacted and to remove any doubts that might prevail as to the right of the Bureau of Internal Revenue to make refunds under that section of the invalidated triple A.

The committee was motivated by the desire to reimburse secondary holders of merchandise for the equivalent of the tax, which is in a measure complementary to the original floor-stock tax assessed against him, so that the merchandise owned by these secondary holders can move in commerce, untaxed, without financial loss to the owners. It is my opinion that were Congress to adopt this procedure, it would tread on dangerous ground for the very reason that it would be authorizing the Bureau of Internal Revenue in many instances to make "refunds" which were not refunds at all, because the tax has never been collected.

It is my belief that substantial equity would be obtained and Congress would not be exceeding its powers if instead of providing for refunds of doubtful character Congress would specifically refund all of the original floor-stock taxes collected. In this way refunds in fact would be made as only the tax actually collected from a taxpayer would be dealt with—processors and other holders of merchandise subjected to a floor-stock tax at the inception of the act all became taxpayers.

Finally, the congressional act authorizing refund of floor stock taxes originally collected would be comparatively simple from an administrative standpoint. In my opinion Congress would be authorizing a smaller appropriation if it should give back the precise amounts originally collected as floor-stock taxes, because there were many small merchants and dealers who, either as a result of ignorance or intended evasion, did not file floor-stock-tax returns in the first instance. Furthermore, an extensive amount of work has been done by the Bureau of Internal Revenue in proving the correctness of these returns. Thus the Bureau would be relieved of the tremendous expense of auditing and finally approving the refunds which would obtain were Congress to specifically authorize payments based on stocks on hand as of January 6.

Finally, section 602 (i) of the proposed revenue bill denies the allowance of interest on these claims and also denies the right of judicial review on the theory that such payment is not required by law but is only justified as a matter of equity. It is recommended that Congress enact only such refunding provisions as are justified by law and which will be "justified as a matter of equity and sound policy."

In conclusion, let me emphasize the necessity of Congress taking recognition of the prime importance of simplicity, the avoidance of doubtful provisions in the new revenue measure from a legal standpoint, and the necessity for reenacting section 21 (d) with a definite explanation of how section 21 (d) is to operate insofar as it involves the proof as to whether or not the burden of processing or compensatory taxes was shifted.

I would suggest that section 21 (d) be reenacted, but so modified as to specifically state that the rules laid down under title 3 (unjust enrichment) for determining whether or not the burden was shifted should precisely apply in the case of processors who seek refund of an illegally collected exaction on the grounds that they were injured thereby. Undoubtedly, there are some processors who in fact absorbed either all or a portion of the processing taxes while in effect and to the extent that they can prove this under specific rules laid down by the law, they are as equally entitled to the refund as any other persons intended to be the beneficiaries of such provisions as have been proposed for enactment in this bill.

Senator KING. But if they passed on the tax then, under your view, they would not be entitled to it? That would follow, would it not?

Mr. OLIVER. That is what I suggested, Mr. Senator, for the very reason that section 21 (d) does attempt to set out the procedure whereby you can obtain a refund of the tax which can be shown not to have been shifted.

If section 21 (d) is to be retained it should be reenacted in a form that would avoid uncertainty.

Senator KING. You do not believe that section as it now stands is sufficiently clear?

Mr. OLIVER. I do not think you could find any court or any economist that would ever agree as to what constituted passing it on, but I do believe the Congress could lay down a rule that would become a valid law.

AMENDMENTS PROPOSED BY O. W. OLIVER TO H. R. 12395

SUGGESTED NEW SECTION TO COVER CREDIT TO SHAREHOLDER FOR TAX PAID BY CORPORATION

SEC. 34. Whenever a dividend is paid out of accumulated net taxable income on which the corporation has previously paid a tax in accordance with the provisions of title 1 of this Act, the recipient of such dividend shall be allowed as a credit against his tax, for the taxable year in which the dividend is received, his pro-rata share of the tax so previously paid by the declaring corporation.

For the purpose of this section dividends shall be deemed to have been paid out of the most recently accumulated net income so taxed. No credit to the stockholder under this provision, however, shall be allowed with respect to dividends paid out of the current year's earnings to the extent that such dividends are utilized by the payor corporation as a dividend credit under section 27 for the current taxable year.

SUGGESTED NEW SECTION TO COVER NET LOSSES

SEC. 122. NET LOSSES (a) *Definition of "net loss."*—As used in this section the term "net loss" means the excess of the deductions allowed by this title over the gross income, with the following exceptions and limitations:

(1) *Nonbusiness deductions.*—Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall be allowed only to the extent of the amount of the gross income not derived from such trade or business;

(2) *Capital losses.*—In the case of a taxpayer other than a corporation, deductions for capital losses otherwise allowed by law shall be allowed only to the extent of the capital gains;

(3) *Depletion.*—The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value, or to percentage depletion under section 114 (b) (3);

(4) *Interest.*—There shall be included in computing gross income the amount of interest received free from tax under this title, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b);

(5) *Net loss not to produce net loss.*—In computing the net loss for any taxable year a net loss for a prior year shall not be allowed as a deduction.

(b) *Net loss as a deduction.*—If, for any taxable year, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be allowed as a deduction in computing the net income of the taxpayer for the succeeding taxable year (hereinafter in this section called "second year"), and if such net loss is in excess of such net income (computed without such deduction), the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year (hereinafter in this section called "third year"); the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary.

(c) *Capital net gain or loss in second years.*—(1) *Capital net loss.*—If in the second year the taxpayer (other than a corporation) sustains a capital net loss, the deduction allowed by subsection (b) of this section shall first be applied as a deduction in computing the ordinary net income for such year. If the deduction is in excess of the ordinary net income (computed without such deduction) then the amount of such excess shall be allowed as a deduction in computing net income for the third year.

(2) *Capital net gain.*—If in the second year the taxpayer (other than a corporation) has a capital net gain, the deductions allowed by subsection (b) of this section shall first be applied as a deduction in computing the ordinary net income for such year. If the deduction is in excess of the ordinary net income (computed without such deduction) the amount of such excess shall next be applied against the capital net gain for such year, and if in excess of the capital net gain the amount of that excess shall be allowed as a deduction in computing net income for the third year.

(d) *Capital net gain or loss in third year.*—If any portion of a net loss is allowed as a deduction in computing net income for the third year, under the provisions of either subsection (b) or (c) of this section and the taxpayer (other than a corporation) has in such year a capital net gain or a capital net loss, then the method of allowing such deduction in such third year shall be the same as provided in subsection (c).

(e) Net losses applicable under this section shall be only those accrued in any taxable year beginning after December 31, 1935.

AMENDMENT TO SECTION 501

Page 234.—Line 3: Strike out the word "such" and substitute therefor the word "the" and after the word "Tax" (end of line 3) insert the following: "imposed and described in subsection (a) (1) hereof."

Page 237.—Line 9: Strike out the following language after the word "the" "five taxable years preceding the initial imposition of the Federal excise tax in question." Substitute therefor the following: "four-year period consisting of the taxable years 1928, 1929, 1931, 1932."

Page 238.—Line 10: At end of sentence add the following: ": however, no tax shall apply with respect to any sale on which the net income is less than 5 percent of the gross sale."

SUGGESTED AMENDMENT TO SECTION 601

Page 240.—Strike out subsection (b) lines 23 to 25 inclusive. Insert as part of subsection (a) on line 22 after the date of January 6 1936, the following: "providing that the claims of original processors (or taxpayers) shall be allowed only with respect to the products of commodities upon the processing of which the tax was paid prior to January 6, 1936."

SUGGESTED AMENDMENT TO SECTION 602

Page 242.—Line 6: Strike out the following words: "except that no such payment shall be made to the processor or other person who paid or was liable for the tax."

Substitute for portion deleted: "*Provided*, That the claim of a processor shall be allowed only with respect to the products of commodities upon the processing of which the tax was paid prior to January 6, 1936."

SUGGESTED NEW SECTION 603

SEC. 603. The provisions of Section 21 (d) (1) of the Agricultural Adjustment Act, as amended (and the conversion factors and regulations prescribed under such act for the purpose of such section), are hereby reenacted: *Provided*, That nothing herein contained shall affect the provisions of Sections 601 and 602 hereof: *Provided further*, That the precise rules for determining the extent to which the burden was borne by the taxpayer as set forth in Title 3 shall be the basis for claims for refund under this section.

The CHAIRMAN. The committee will stand adjourned until 9:30 o'clock Monday morning. The witnesses who expect to testify will appear then.

(Whereupon, at the hour of 12:15 p. m., the committee adjourned to 9:30 a. m., Monday, May 4, 1936.)

REVENUE ACT, 1936

MONDAY, MAY 4, 1936

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

The committee met, pursuant to adjournment, at 9:30 a. m., Senate Finance Committee room, Senate Office Building, Senator Pat Harrison presiding.

Present: Senators Harrison (chairman), King, George, Walsh, Barkley, Connally, Byrd, Lonergan, Black, Gerry, Guffey, Couzens, Keyes, LaFollette, Metcalf, and Capper.

Senator GEORGE. The committee will be in order. Mr. C. L. LaRue representing the Illinois Manufacturers Association. Is Mr. LaRue present?

Mr. CLAUSEN. I believe he is listed as the next witness.

Senator GEORGE. Is Mr. Clausen here, representing the United States Chamber of Commerce?

STATEMENT OF FRED H. CLAUSEN, HORICON, WIS., REPRESENTING THE UNITED STATES CHAMBER OF COMMERCE

Mr. CLAUSEN. Mr. Chairman and gentlemen, I am Fred H. Clausen, president of the Van Brunt Manufacturing Co., Horicon, Wis. As chairman of the committee on Federal finance of the Chamber of Commerce of the United States, I appear in behalf of that organization.

I understand that we are limited in our discussion to such proposals in the President's message of March 3 as are reflected in the pending bill. There is not included among these proposals any fiscal program which by combining a reduction of expenditures with an equitable tax measure is designed definitely to balance the Budget. We will, however, endeavor to keep our discussion within the limits imposed.

A definite limitation of time for our presentation has also been indicated and this as made it necessary for my colleagues and myself to study carefully means of limiting our discussion to a brief survey of some of the more important aspects of this new taxing plan which is designed primarily to obtain large increases in revenues, directly or indirectly, from corporate earnings.

Our discussion divides itself readily into three general headings:

1. Budget and business aspects.
2. Banking, investment and credit features.
3. Inequalities and technical difficulties involved in the bill.

I shall deal with Budget aspects of the pending bill and with certain general business effects, but must ask the assistance of my

associates upon the chamber committee in developing certain other phases—Mr. Alvord's help in connection with inequalities and technical difficulties, Mr. Osgood's assistance in connection with banking, investment and credit features, and Mr. Fernald's aid in accounting phases, particularly those connected with computations of the proposed taxes.

BUDGET AND BUSINESS ASPECTS

Businessmen generally recognize the necessity for an early return to a balanced Budget. It is not possible to accept this bill as a means to that end.

1. The added revenue to be derived is highly uncertain and insufficient. It is less than the budgeted increase in ordinary expenditures for the next fiscal year.

2. It replaces a method of corporate taxation which is understood and which on the basis of a gradual improvement in business will continually produce substantially larger revenues.

3. We believe that any plan to balance the Federal Budget is unworkable that does not provide for a collateral reduction in governmental expenditures. An increase of ordinary expendiures of over $3,000,000,000 from 1934 to 1937 is too fast a pace to keep up with.

4. This is the fourth tax increase and the fifth tax measure applied to business since 1932. After each added impact we still find the Government with a deficit. This fiscal year we will experience the largest revenues, the largest expenditures, and the largest deficit in the peacetime history of the country. Managers of private business would not think of meeting such a situation by limiting their efforts to increased assessments on their stockholders. That is why we are out of step with this bill.

5. Organized business has not always opposed increased taxes. In 1932, in a referendum the chamber membership endorsed increases in normal and surtaxes, increases in corporation taxes, a reduction in personal credits and levying of excices at low rates on a broad range of articles not of the first necessity, all so combined with a reduction of expenditures as to obtain a balanced Budget.

All the increase in taxes recommended in that program were applied but none of the reductions. The Budget was not balanced, and here we are today worse off than before. Is it too much to ask that the present condition receive realistic treatment, with greater consideration given to sound policies and economic effects and less to political expediency?

Businessmen cannot support a bill which has for its thesis the assumption that taxes on incomes of commercial and industrial corporations are being generally evaded or avoided. It is clear that actual avoidance of taxes by corporations and their stockholders is limited to a very few instances.

6. This plan would raise the peaks of Federal revenue in years of prosperity and deepen the valleys in years of depression.

Under our present system all corporations in the United States for the 4 years 1930-33, as a group, sustained a loss of 9.1 billions of dollars. Nevertheless, during the same years they paid dividends out of accumulated surplus of 14.5 billion, on which stockholders paid individual surtaxes.

In spite of this support, Federal income-tax receipts dropped from 2.4 billion in 1930 to 746 million in 1933. With the accumulation of adequate reserves prohibited except at penalty rates in the manner this proposal contemplates, we can readily foresee what an embarrassing situation the Government would face in future depression years.

7. I am convinced that the public does not have any adequate conception of the volume of taxes now being levied and their effects on business activity and employment.

Senator KING. Would it interrupt you if I should make an inquiry?

Mr. CLAUSEN. Not at all.

Senator KING. I would like to inquire whether these figures are accurate: In the 13-year period from 1921 to 1933—you gave the last 4 years—out of total dividend of $50,700,000,000 their total net income for the same period was only $41,000,000,000. In other words, they paid out in dividends greatly in excess of their net income.

Mr. CLAUSEN. Yes, sir; those are accurate figures from Government statistics. Frankly, at times I wonder if the Congress, which is now considering additional taxation, appreciates the extent of the burden of present taxes.

All taxes are absorbing 20 percent of the national income. If taxes kept pace with expenditures, the exactions of government would be over 30 percent. This is true in spite of the estimated increase in national income from 39.5 billion dollars in 1932 to 53 billion in 1935.

Since corporate earnings, distributed or undistributed, will have to bear the brunt of the proposed increased taxes, the burdens already placed on such earnings must not be ignored. A survey was made of 23 large and medium-sized corporations, representative of various lines of business and selected at random. As a group these corporations showed income of $648,000,000 in 1935. They paid $350,000,000 in taxes, exclusive of processing taxes and Federal and State gasoline taxes. The taxes paid by these corporations were equivalent to 54 percent of the earnings available to their stockholders. Discussions of Federal taxes usually fail to take into account State and local tax obligations.

Federal corporate income taxes can no longer be increased without attention to similar taxes imposed by the States. In 1935, 39 States imposed corporate income taxes, the rates averaging about 5 percent. When taken in conjunction with the present Federal rates, a total income tax of about 20 percent, not to mention other taxes, is now imposed upon corporations doing business in 29 States.

Now come the social-security taxes with their ultimate rates totaling 6 percent of pay rolls. My only emphasis here is that high taxes on the productive forces of a country, whether of agriculture, industry, or commerce, never provided social security or promoted the reemployment of workers in private enterprise.

EFFECTS ON MANAGEMENT AND OPERATION OF CORPORATIONS

My approach is based on experience as a servant of a business corporation trying to carry out his obligations to the employees, the

public, and his stockholders. Most men in my position do not profess technical knowledge of tax laws, but they are painfully conscious of the impact of taxes.

After reading the testimony of the Treasury advisers before this committee, I realize that they speak a different language. I also realize that they have a definite assignment and that is "to get the money." To do this they must needs develop a formula and try to make it stand up.

Certain definite objections were advanced by businessmen before the Ways and Means Committee to the principles contained in this bill. The attempt has now been made by Government representatives to answer them. I want to refer to some of these objections and indicate the point of view of a business manager trying to measure the impact on his enterprise.

1. In the first place, industrial management today, in the larger enterprises is ordinarily not being personally conducted by stockholders having the largest ownerships. If such stockholders are in active control, it is usually because they have the ability to do the job.

The primary job of management is to so operate the business as to assure its permanency over the years, and promote its gradual growth. The basic elements of such a program require intelligent and fair treatment of workers, customers, and the general public, and do not include evasion of taxes or any other Government requirement as a factor in the control of business conduct.

2. Each year's business is not a separate operation complete in itself. The argument of the Treasury adviser is based on the theory that it is a workable policy for a corporation to distribute each year, substantially 100 percent of its adjusted net income. Such a theory assumes a condition which does not exist; that is, a continuity of volume and distribution from one year to another with no variation in capital requirements.

3. The theory is advanced that the expansion and growth of corporation enterprises should be from without and not from within. I quote:

> Corporations that desire additional capital for expansion or other purposes can obtain such capital by the sale of additional shares to their own stockholders or to investors generally.

What does such a statement involve?

(1) Annual change of capital structure.

(2) Machinery of stockholders meetings and charter changes.

(3) Complications of fractional shares.

(4) Assumption of ability and willingness of stockholders to subscribe, or of the corporation's ability to find a par market.

(5) Every increase in shares reduces the equity of the stockholder unable to increase his holdings in proportion.

(6) A substantial financing cost can upset market values. Such a theory is contrary to the genesis and growth of American business enterprise, and should not be recognized by congressional action. The principal is the same whether we start from the 30-percent base, which has been assumed with doubtful warrant as the normal amount of earnings retained, or from any other base.

4. Another assumption is made that we oppose this bill because it would discriminate against the small corporation as compared with

the large. That is not our full contention. It should be recognized that prosperity of corporations is not measured by size. In fact, in recent years, size has often been a liability and not an asset.

Our statement made and here repeated is that this proposal discriminates against the financially weak corporation in favor of the strong one, regardless of size. But since, according to the estimates of the Treasury representative, 83 percent of the corporations in 1936 will have incomes of $10,000 or less, obviously the great number of corporations with weak financial structures must also be small ones.

The Secretary of the Treasury referred to the recognition of taxation according to "ability to pay." This bill violates that principle instead of supporting it. It permits "ability not to pay taxes" to operate in favor of the strongly financed corporation. As another has stated, the measure would seek to make nonpayment of dividends a taxable offense.

5. In reference to our representation that surpluses usually are represented by assets other than cash, such as inventories and permanent improvements, Mr. Haas calls attention to the fact that surpluses as such are carried on the liability side of the ledger. The same might have been said of capital. Permit me to remark in passing that management invariably finds that a balance sheet without a surplus as a liability is a well-nigh insurmountable obstacle when it has to go to a bank seeking credit.

It is true that liquid position (relation of quick assets to current liabilities) does influence dividend policy. It is also true that dividends must be curtailed when earnings are reduced unless there are surpluses from prior years on which to draw.

The surplus position of American corporations was reduced to the extent of over $17,000,000,000 during the 3 years 1931–33. In addition, there are accumulated preferred dividends (of large amounts) due to stockholders today.

It is also the rule and not the exception that management considers the establishment of a liberal dividend policy as one measure of success. A statement of the total of corporate earnings not distributed is no proper basis for the charge that they were retained because of the desire of the great majority of corporations to permit their shareholders to avoid taxes.

6. The disposition of earnings and the maintenance of a favorable balance sheet is a realistic thing to each individual management. The application of a government rule based on a 30-percent average or any other amount may be harsh or lenient to varying degrees. A business cannot operate as an average corporation.

I can well understand that many corporations, long established, with abundant reserve capital and quick turn-over, might be temporarily satisfied with this new tax proposal. On the other hand, companies in industries, such as mine, with slow turn-over, large notes, and accounts receivable, and some companies with limited capital, will find it necessary to submit at once to excessive rates of taxation because of absolute inability to disburse a large part of their earnings.

7. During the chamber's annual meeting this past week, I was approached by businessmen asking what exemptions have been made for that part of earnings allocated to the purchase of new machinery or for construction. My answer, of course, was "there is none."

The reply has been invariably: How does the administration expect cooperation in its reemployment efforts if the durable-goods industries have to take the impact of this kind of tax legislation? I promised to submit that question, and there it is.

8. Permit me to point to another apparent inconsistency in the Government program. The Social Security Act was supported by the argument, and it was the strongest one that could be advanced, that corporations set up reserves for depression years to meet business requirements, and by the same token reserves for unemployment should be established. The recognition of thrift, orderly savings, a reserve cushion for contingencies—a factor of safety—must be allowed if the permanency of our business institutions is to be maintained. The application of penalty rates of taxes against the establishment of adequate surpluses, essential and suited to the needs of a particular business according to its peculiar situation, is the negation of security.

9. The plan would tend to provide substitution of public control for private management in important fiscal operations of business. It would promote improvident and unstable dividend policies in many companies. In others it would engender such uncertainties concerning the sound course to pursue as to subject the management to grave difficulties with shareholders and creditors. It presents the danger that corporate management would be subject to serious criticism and even lawsuits if liberal dividend policies, followed to escape taxes, gave rise to charges of dissipation of assets.

10. The plan would make the corporation the target of Government exaction instead of recognizing that it is the means through which private employment and economic stability can be restored.

In conclusion, we are here not to defend tax evasion or avoidance, but to protect the solvency and development of American business enterprise.

This closes the discussion on the first of our three principal topics. Another topic is the inequalities and technical difficulties involved in the pending bill. Mr. Alvord, who will cover this subject, is delayed; but Mr. Osgood, who is ready, will be our next witness.

I would like to make this statement with reference to another of our principal topics, and that is banking, investment, and credit features of the pending bill. I am not a banker and this subject will be discussed by a man who has had a lifetime experience in this field, Mr. Roy C. Osgood, of Chicago.

Senator KING. Mr. Osgood.

STATEMENT OF ROY C. OSGOOD, CHICAGO, ILL., REPRESENTING THE UNITED STATES CHAMBER OF COMMERCE

Mr. OSGOOD. Mr. Chairman, gentlemen, my name is Roy C. Osgood. I am the vice president, heading the trust department, of the First National Bank of Chicago. I appear as a member of the committee on Federal finance of the Chamber of Commerce of the United States. As indicated, I shall discuss the banking, investment, and credit aspects of the pending bill.

The more important consequences upon the financing of American trade and industry that might be expected to follow from the enactment of a tax measure in the form as passed by the House of Rep-

resentatives on April 29, and now pending before your committee, may be briefly summarized. Passage of such a measure would:

1. Make more difficult the acquiring of capital to finance the establishment of new business enterprises, whether of small or large size.
2. Increase the difficulties of the corporation which has impaired capital or credit and seeks to improve its financial position.
3. Adversely affect the interests of bondholders and other long-term creditors of corporations besides making this type of credit more difficult to obtain.
4. Restrict the amount of merchandise and other short-term credit extensions between business firms themselves and between business firms and their customers.
5. Seriously affect the ability of a great many corporations to repay existing bank loans and handicap them in obtaining bank credit in the future.
6. Weaken the investment position of preferred stockholders and impair the usefulness of preferred stock as an important instrument of corporate finance.
7. Tend, from the long-time point of view, to jeopardize the investment position of common stockholders and definitely lead to greater instability in dividend payments.
8. Tend to increase the number of bankruptcies.
9. Tends to diminish, if not dry up, one of the most important sources of capital for investment in business enterprises, namely, corporate savings.
10. Grossly discriminate as between the capital needs of corporations in various types of business, and likewise discriminate as between the financially entrenched and the financially unentrenched corporation by failure to recognize the true nature of surpluses and earnings from which dividend payments are made.
11. Further divert capital into tax-exempt securities.

I propose to discuss briefly the basis of the statements made above and to illustrate certain of them by pointing out the likely effects of the proposed legislation in actual situations.

NEW ENTERPRISES

What relief is there for a newly established corporation which finds it essential to conserve all or most of its earnings and build up its working capital, in order not only to survive but also to meet the competition of well-established corporations, with adequate surpluses, which can pay out the bulk of their earnings in dividends?

It is true that section 14 of the pending bill attempts to offer a means for a new concern to recoup its early losses without paying the high penalty tax upon retained earnings imposed under section 13. Once any accumulated deficit has been made up, however, normal growth through the plowing in of surplus earnings would be precluded except as to such portion as would be left after the imposition of the high rates proposed upon undistributed statutory net income.

The founders of a business generally anticipate that it will have to go through a lean period and make provision accordingly, but the critical stage in its existence may continue even after the concern begins to show net earnings. It is usually necessary for the

corporation to go through a period of "seasoning" before it may obtain additional capital from existing shareholders, but certainly outside capital with which to expand, or even to negotiate bank loans upon favorable terms. The payment of dividends by a corporation at this stage of its development usually would be unwarranted, even if funds were available for the purpose. A 42½-percent levy upon such a concern would be indefensible and would inevitably serve to deter the investment of capital in new enterprises. Perhaps this point may be illustrated by an actual case.

This company, a manufacturing concern, was organized in the latter part of 1934. One major company manufactures between 90 and 95 percent of the total output in this field. The new enterprise, however, is making real progress, but it requires a substantial amount of capital and must conserve all of its earnings if it is to attain a position where it can compete upon more favorable terms with its only principal competitor. It has been able to obtain bank loans only by pledging its accounts receivable. If bank loans are to be had upon more favorable terms, it must build up its working capital position.

The payment of dividends at this time, or within the next few years, would so cripple the working-capital position as to make continued operation impractical. Section 10 of the pending bill relating to debt relief, does not apply. Net profits are running at approximately $100,000 a year. It has an accumulated deficit of $20,000. Under the so-called relief afforded by section 14, the corporation would have to pay a tax of 15 percent upon a portion of its net income equivalent to the deficit of $20,000, or $3,000. It would have to pay, in addition, a tax of 42½ percent upon $77,000 of the remaining $80,000 of net income, or $32,725, a total tax of $35,725.

Senator KING. I suppose it would have to pay the income tax of the State, that would be plus State taxes?

Mr. OSGOOD. Yes; and of course all other general taxes applicable to its business.

Assuming that earnings continue at the present rate, will it be required in the second year of this tax to pay $42,500 for the privilege of retaining $57,500? Under such circumstances, it would be compelled to pay a drastic penalty in its competitive struggle with a well-established business, which has practically a monopoly in the field and would be able to pay out most of its earnings in dividends and thereby avoid paying even its present amount of taxes.

The high tax on this new company would materially lengthen the time before it could become a good bank credit risk, and before it could be established firmly enough to withstand any substantial decline in its operations because of adverse business conditions. It likewise would postpone the time when the owners might begin to receive returns upon their investment.

ESTABLISHED CORPORATION

What real relief is there under the proposed tax measure for an established corporation which has inadequate working capital and whose accumulated earnings and profits of past years are invested almost entirely in real estate and plant? Is such a corporation to be penalized if it retains sufficient net earnings to build up its working

capital? To modernize its plant or equipment? To employ additional labor? It would seem so.

The effects of the proposed legislation upon such a company may be succinctly illustrated by the following example which portrays an actual situation:

This company has been in the printing trade for approximately half a century. It is well known in its field. Substantial losses were experienced beginning in 1931. Its working capital declined to a point where current liabilities exceeded current assets. To secure its indebtedness, it assigned accounts receivable to its creditors and also gave them a mortgage on the property. As business improved, it used its profits to retire indebtedness. The mortgage debt has just been paid.

The company's current assets are now slightly in excess of its current liabilities. The business is at a point where much of the profits should be used to rehabilitate the plant by purchasing and installing new heavy machinery which is greatly needed. The remainder of the profit should be used to build up working capital. Net earnings in the current year are expected to be approximately $100,000. The company is not in a position to pay dividends. Its tax, therefore, under the proposed plan would be $42,500.

Because of the heavy tax the company probably would find it necessary to use the portion of the net profit remaining after the payment of tax to add to working capital and would find it imperative to forego the purchase of the new machinery necessary to rehabilitate its plant and add to the number of employees that would be needed to handle increased operations.

Assuming that the corporation should go ahead and spend $10,000 for new machinery, it would have to pay a penalty for the privilege of accumulating that $10,000 of $7,931. The cost of the machinery in effect would be increased by nearly 75 percent.

BONDED INDEBTEDNESS

The attractiveness of a corporation's bonds to investors depends to a large extent upon the ability of the corporation to set aside earnings with which to retire such obligations. The placing of a premium upon overly generous distribution of earnings to stockholders, as proposed, will tend inevitably to reduce the margin of corporate savings available for the protection of bondholders and the redemption of fixed obligations. The imposition of high taxes, moreover, upon corporations which cannot, for one reason or another, pay out their earnings in dividends will impair the solvency of many concerns which have outstanding bonds. This assertion may be made notwithstanding the so-called debt relief provision (sec. 16) of the bill. The relief afforded is inadequate and unrealistic in a wide variety of cases as is illustrated by the following example:

Five years ago this corporation constructed an office building on property owned by it. It then issued for the purpose $2,000,000 of 20-year bonds, with annual sinking-fund requirements of $100,000 per year. The Treasury Department fixed a 40-year life for the building and an allowance of $50,000 a year depreciation. The corporation now has approximately $60,000 a year net income which,

added to the $50,000 depreciation allowance, will just about meet its sinking-fund requirements and the present Federal income taxes.

The corporation has a previously accumulated surplus of $1,000,000 about one-half of which is represented by the amount of prior sinking-fund payments set aside for the retirement of the bonds. Because of this situation, section 16, relating to debts, affords only partial relief. Under the proposed tax plan it could not retain $50,000 out of net earnings for payment into the sinking fund. Taxes would absorb $15,645 out of the net income of $60,000, leaving only $44,355. If it held back the tax out of the $60,000, it would be required to default on its sinking-fund payment and might be forced into receivership.

This competition is based upon an amortization of the debt excess of $500,000 (over the amount of surplus) spread at $33,333 annually over the remaining 15-year life of the bond issue. If under the provisions of section 16, the apparent option given the taxpayer to get a technical amortization credit for tax purposes of $100,000 annually for a 5-year period were availed of, it probably would mean a tax of 22½ percent upon the entire $60,000 of net income. In either event, however, the corporation would be obliged to default on its sinking-fund payment.

It is also assumed that the sinking-fund contract creates a debt within the meaning of section 16, because the "trust deed" securing the 20-year bonds contains the sinking-fund debt contract. On the other hand, the next annual sinking-fund debt of $100,000 at any given computation date runs less than 3 years and perhaps may be construed to be a short-term debt not within the purview of the relief section. If the sinking-fund requirements cannot be construed as a debt within the relief provisions of section 16, then the tax would be computed at 42½ percent and would be $25,500, thus enlarging the default.

If the corporation were already in receivership, then only a 15-percent tax (as proposed in section 105), or $9,000, would be due. In such a case receivership would seem advantageous both for the creditors and the stockholders.

If the corporation had a prior deficit exceeding the current net income then only a 15-percent tax (as proposed in sec. 14) would be due.

Why should the corporation be discriminated against as compared with a corporation in receivership or a corporation which has a deficit?

PREFERRED STOCKHOLDERS

If the proposed legislation were passed, many preferred-stock holders would see a material weakening in the protection that should be afforded their investment by adequate common capital and surplus and by a safe margin of earnings. They would find that corporations would not be able to set aside, except by paying excessive taxes, sufficient surplus earnings to act as a cushion for dividend payments in years of low earnings or losses. They would find that corporations, in many instances, would have difficulty in setting aside the funds with which to retire preferred stock out of earnings. In short, preferred shareholders in many corporations might find themselves

involuntarily placed in the role of primary-risk takers, as the equity of the common-stock holders became impaired either through heavy taxes or excessive dividend distributions.

Section 15 is intended to afford relief through earnings retention under contracts not to pay dividends. Generally, such contracts fall into two classifications: (1) Those found in trust deeds securing bond issues, where the contract is to maintain working capital at a required ratio, and restrict the payment of dividends of any kind that will impair the agreed ratio; and (2) those where the prohibition is contained in the preferred-stock contract, and relates to the payment of dividends on junior stock while sinking-fund or dividend requirements of the senior stock are in arrears.

Such intended relief as might be afforded by reason of section 15 of the proposed bill relating to contracts not to pay dividends is negligible. Even where the provisions of section 15 are called into play, a tax of 22½ percent on a portion of the income, and perhaps a higher tax on the remainder as contrasted with the present corporate tax of approximately 15 percent, would be levied. Are the relief provisions of section 15 applicable to sinking-fund requirements in the case of preferred-stock contracts? Are such contracts debt contracts within the scope of section 16? Consider a few examples of the problem:

1. It is provided that a milling concern on the Pacific coast must set aside 25 percent of its net profits after preferred dividends as a sinking fund for its preferred stock issues.

2. A dairy concern in the mid-west has preferred stock sinking fund requirements of 3 percent of the largest amount of preferred stock outstanding in any year.

3. A restaurant concern has preferred stock sinking fund requirements amounting to 10 percent of net profits until the sinking fund equals the amount of outstanding preferred.

4. An electrical manufacturing company has preferred stock sinking fund requirements of 15 percent of net profits after taxes and preferred dividends until the sinking fund equals 115 percent of the outstanding preferred.

These are comparatively simple illustrations. Consider, however, a corporate structure having: first, a mortgage debt with both sinking fund requirements and prohibitions against payment of dividends on stock that will impair the quick asset ratio; and second a preferred stock issue with both sinking-fund requirements and dividend prohibitions relating to junior stock. Do either of or both sections 15 and 16 give relief in such cases?

DEBTS TO BANKS

What real relief would a corporation have under section 16 if, as a result of the depression, it should find itself owing substantial amounts to commercial banks which amounts it is not in a position to liquidate. The indebtedness was not incurred to acquire capital assets. At the time the loans were made, maturity dates probably were 90 days and certainly not over 1 year. Actually, these loans have changed from ordinary commercial short-term indebtedness and are dependent for their liquidation upon the ability of the company to earn money and to retain its earnings for the payment of mer-

chandise, and short-term seasonal debts as well as the loans first described.

Under the present situation, it may be necessary for the banks to renew the indebtedness periodically and look for its gradual liquidation over a period of several years. If the high rates proposed upon undistributed earnings should be placed in effect the time within which the loans may be liquidated will be materially lengthened. The question immediately arises whether or not the debtor will prefer receivership. Consider an illustration:

The company is an old southern business house. The unfortunate condition in which its customers, who were cotton producers, found themselves in 1930 resulted in their inability to pay for goods bought from the company. Heavy losses were experienced for several years and the company faced bankruptcy. A substantial sum was owed to several banks. The banks decided, because of their confidence in the management, they would not permit the company to face bankruptcy, but each bank would lend it new money, permit it to serve its territory, and liquidate its old bank debts gradually, as business might improve. About $150,000 was due the banks on the old debt. Operations turned profitable. The bank debt was paid down to $118,000. Each year the company gets new loans from the banks which it repays by the end of the year and, out of remaining earnings, retires a part of its old bank debt.

Gradually the company is working back. A recent annual report showed $17,000 in earnings before taxes and a further reduction of the bank debt to about $100,000. At the rate it is now earning, the old debt can be retired in less than 7 years. Under the proposed law it would have to pay in taxes approximately $7,000 of its annual earnings of $17,000 and its past-due bank debt would require over 10 years for liquidation. The company cannot pay dividends in the face of the long-overdue bank loan; it can only liquidate debt. The sum of all its debts computed under subsection (a) of section 16 is not in excess of the accumulated earnings and profits of the corporation and therefore, no "relief" is afforded. Its assets, however, are such that they could not possibly be liquidated readily. For the "privilege" of doing what sound business finance and good judgment dictate, and a past-due bank debt necessitates, the stockholders will have to wait over 3 years longer for dividends than they would under the present law. The bank also has to wait 3 years longer to get its debt paid.

A bank finds a company temporarily in distress. It arranges to extend the company's bank debt over a period of 2 years in order to give it a chance to survive. Is the company to be denied such relief as may be afforded under section 16 because the maturity of the debt is less than 3 years and obviously was not incurred in the acquisition of capital assets, but merely represents an extension of existing bank debt which originally was incurred in connection with the buying and selling operations of the business? Consider this case:

A company is engaged in the canning of food and uses the products from thousands of acres of land owned by farmers in its State. Income fluctuates greatly and is influenced by the weather, plant pests, and all factors affecting farm income. The seasonal nature of

the business necessitates substantial bank borrowing during the period of the canning pack.

The company proceeded successfully until 1932, when its net income dropped sharply. Its working capital then stood at $243,000. For several years difficulties due to the depression resulted in net losses. At the close of 1934 its net loss was $29,000 for the year, and its working capital had dropped below $82,000. It had $168,000 of bonded debt, of which $15,000 of principal and about $5,000 of interest were due. It needed loans of $190,000 to meet these interest and principal payments and conduct its canning operations for the coming season. The loan was a border-line credit case, but the banks and one of its creditors decided to cooperate.

Weather conditions in 1935 were such that the company experienced an unusually large and successful pack. It showed a net profit of $62,000 from its operations. It urgently needs every dollar of this profit to add to its working capital. No dividends should be paid if the company is to build up its financial position to protect the bondholders and to enable it to obtain credit at the banks, which it needs during its busy season. The sum of all its debts computed under subsection (a) of section 16 is not in excess of the accumulated earnings and profits of the corporation. However, its accumulated earnings are represented largely by a canning plant.

Under the present tax law it has set aside $8,500 for Federal taxes. Under the proposed tax law, if it attempted to conserve its income and strengthen its position as it should, it would be compelled to pay a tax of 42½ percent, or $26,350, leaving only $35,650 to add to its working capital. This would leave the business still a borderline credit risk, considering also its bonds outstanding.

Due to the fluctuations in income it is imperative that the earnings of the good years be conserved until the company is built back to a sound position. This year if its farmer customers experience a drought, excessive rains, or plant pests, the company may show a loss in its operations. In all fairness the banker can hardly be expected to loan repeatedly to a company whose credit position is seriously endangered if the earnings of good years cannot be conserved until the company is built back into a sound position. The fact that none of the relief provisions would be applicable to any new bank loans after March 3 of this year, would be a further deterrent. The retention of these earnings is necessary also if the bondholders of this company are to be protected from possible default. To permit the company to use its income to improve its working capital position and to retire its bonds would greatly improve its financial standing and would tend to insure farmers owning thousands of acres of farm land of a market for their products. Why should this situation be denied remedy because of a debt condition not covered by section 16?

Another case is as follows:

A business borrowed $100,000 from a bank for its seasonal operations and then made about $100,000 in profits for the year before taxes of $16,000 under the present law. Due to rising inventory costs and the need to employ additional workers, the corporation found itself with insufficient cash at the end of the year to repay its bank loan and also to distribute its earnings to escape the high rates

of taxes that are proposed to be levied. If the corporation retains its earnings for the purpose of liquidating its indebtedness it would have not $84,000, but $57,000 for the purpose of debt liquidation. The net results is that the business is deprived of $26,500 at the year end for debt reduction as a result of the new tax proposal.

OTHER FINANCING

There are several other financing questions that should be considered and that may need exceptional treatment if such a law is to be enacted—

1. *Plant extension financing.*—In the railroad, public utility and industrial field many companies have arranged for future plant expansion through the means of borrowing under provisions of outstanding mortgages. Such mortgages customarily provide that future bonds may be issued to a definite percentage of the value of fixed property acquired or constructed, provided the net earnings of the corporation applicable to the payment of bond interest amount to 2, 2½, or 3 times annual interest on the outstanding bonds and those about to be issued. Those in charge of this bill should cause an examination to be made of a sufficient number of such cases to see the effect of this law as it is now drafted upon such financing programs. The proposed law may have a seriously adverse effect upon such plant extension programs through increasing the tax costs by causing distribution of earnings to a point where future bonds cannot be issued under these outstanding mortgages. If the increased taxes cause earnings applicable to bond interest to be reduced below the applicable ratios such new bonds cannot be issued.

2. *Prices of outstanding bonds.*—The same character of investigation should be made as to the effect of the proposed law on the bond holdings of savings banks, insurance companies, and trust funds and other investors. Generally speaking, a corporation must earn enough to cover its bond interest at least two times in order to have its bonds sell at par in an ordinary market. This coverage is known as the margin of safety, and is recognized by all careful investors. Many bonds that during the depression period have not been earning full bond interest are now earning it between one and two times, so that the recovery of the price of such bonds on the market has approached or reached par. If companies that are in such earning situations find that added taxes under the proposed law will so decrease net earnings applicable to bond interest that this ratio of safety margin will be reduced, the prices of the bonds of such companies are bound to decline.

3. *Contracts after March 3, 1936.*—Serious consideration be given to contracts for financing that have been created since March 3, 1936, and are now outstanding. No relief is given them under the law now drafted but the same hardship exists that caused the drafting of sections 15 and 16.

Similar consideration should be given to debt retirement contracts that will have to be created under reorganization plans already in process. Some of these plans will have to be materially altered to the detriment of the creditors and stockholders alike unless future contracts can be given remedies under provisions similar in general character to sections 15 and 16. Some of these plans are in the

courts for final approval, some will have to be resubmitted to the creditors and stockholders, and some will be placed in an almost hopeless position unless remedies can be found and made applicable, without taking into consideration similar situations that may arise in the future.

NATURE OF SURPLUS EARNINGS AND PROFITS

A representative of the Treasury has testified that "the item of surplus occurs or the liability side of a corporation's balance sheet and does not necessarily represent cash or marketable securities or inventories or any other type of liquid asset."

Such a statement is reassuring, because an important consideration which seems to underlie the pending tax proposal is that surpluses—and earnings—are always readily available for distribution in the form of dividends or taxes. Let us examine for a moment the real meaning of the terms "surplus", "earnings", and "profits."

Surplus as has been stated is not a synonym for cash. A corporation's surplus account, generally speaking, represents the excess, if any, of the assets over general liabilities and capital stock liabilities. Frequently the bulk is in lands, buildings, equipment, matereials—raw and in process—finished products, customers' accounts in process of collection, prepaid insurance, and a hundred other items necessary to the conduct of the business. The cash in bank, usually a small percent of the corporate assets, is needed for operations, payrolls, supplies, payment of bills, etc. A corporation with a large surplus may have insufficient cash and other current assets.

The Treasury representative has testified also that in no case, in his opinion, "can it be stated that a corporation with an accumulated book surplus is in a better competitive position than another corporation with equal assets and similar liabilities and equally good management that has no book surplus." He has stated likewise that in many cases corporate surplus may result from undervaluation of capital stock or a giving of large and sometimes fictitious value to intangible assets. He might have pointed out also that some corporations are still carrying the accumulated operating deficits of the past few years while others have eliminated them from their books by the simple expedient of reducing the par or stated value of their capital stock, and setting up a surplus.

This matter of corporate surplus raises a question that goes to the very heart of the pending bill. If surpluses are unimportant why, for example, did the House of Representatives restrict the so-called debt relief provision (section 16) to corporations with indebtedness in excess of their accumulated earnings and profits or, in other words, in excess of earned surplus?

One asks, moreover, why several of the most important industrial States (including Illinois, Ohio, New York, Pennsylvania, and North Carolina) have enacted drastic laws prohibiting the payment of dividends by corporations except from their earned-surplus accounts? Why have heavy liabilities been placed upon directors of corporations who fail to heed these statutes? The answer is that surpluses are needed to protect the interests of creditors of a corporation and the stockholders for whose welfare some of the proponents of this measure seem to have great concern.

A few of the more important reasons why corporations have need of surplus may be briefly stated: The existence of a surplus has a direct effect upon the credit position of a corporation with its trade customers, banks, and others. It is an important factor in the decisions of investors as to whether they will purchase the bonds, stocks, or other securities of a corporation. It furnishes a cushion to meet such contingencies as inventory losses, and to meet obsolescence occurring as a result of mechanical improvements.

CORPORATE EARNINGS AND PROFITS

Underlying any consideration of corporate surplus or profits is the assumption that the integrity of the stockholder's investment has been maintained. Earnings, like surplus, are in no sense piled-up cash. They must be reemployed in raw materials, the wage and salary cost of product, accounts receivable, maintenance of plant and equipment, and numerous other items if the corporation is to continue to operate. A corporation may have large earnings found in such assets and yet be under the necessity of reducing them to cash before they are available for dividend distribution. It is a common occurrence to see a growing and profitable business in need of all the cash assets it can command to meet the rising costs that attend increased commerce. In periods of business upturn or of rapidly rising prices—especialy periods of price inflation—increased wage and inventory costs may make such heavy drafts upon the cash position of a business as to require the retention by it of all or most of its earnings.

TAX-EXEMPT SECURITIES

The levy of the proposed high rates not only upon corporations that by the nature of their business must retain a substantial portion of their net earnings, but also upon stockholders, would place an additional premium upon tax-free investments, both by individuals and by corporations.

A representative of the Treasury has taken issue with the above statement from several points of view. After careful consideration of his objections, we are forced to the conclusion that they do not meet the future investment policies of individuals and corporations, and that it would divert into the tax-exempt fields capital that is needed for the development of business and industrial units of large size, especially those affected by alternating periods of prosperity and depression.

The point was made by the Treasury representative that the income from tax-exempt securities constitutes only a small portion of the total income of corporations. This fact in no way diminishes the investment desirability of tax-exempt securities. Nor is the problem, as was contended, one of converting existing investments into tax-free obligations, but of finding profitable and relatively safe employment for savings out of future income.

The point also was made that the yield upon tax-exempt securitis is, in many cases, very low. To this should be replied that the same thing is now true of other types of investment securities, including many of speculative character. As regards net yields, however, tax-exempt issues offer advantages to many investors.

As the Treasury representative pointed out, a substantial proportion of tax-exempt securities is purchased by individuals with large incomes. As he also stated, new tax-exempt issues of good quality are currently being offered at 4 percent or less. One explanation of this, of course is the considerable demand already existing for tax-exempt securities among investors in the higher income groups. Another explanation is the artificial scarcity of other types of new investment offerings. That low coupon rates are not barrier to the purchase of tax-exempt securities by wealthy individuals can be readily demonstrated. An individual with $100,000 income subject to tax, who is debating whether to invest funds in tax-exempt or other types of securities, finds that he will be as well off, from the standpoint of net yield, by buying a tax-free municipal bond with a yield of 3.04 percent as he would be if he bought a taxable security yielding 8 percent. Under present investment conditions, where high-grade railroad, utility, and corporation bonds cannot be purchased to yield better than 4 percent, an investor with $50,000 of net income, buying a bond to yield 4 percent, gets a yield, under present income taxes, of 2.6 percent. This is about the yield of the highest grade, long-term municipal bonds in the present market.

Passage of the pending measure would be likely to induce new purchases of tax-exempt securities by corporations. With a high tax upon undistributed earnings, such tax-exempt income as a corporation might receive, would take on new importance for the reason that it could be fully retained, tax free. Assuming that a corporation were under the necessity of retaining all of its earnings in liquid form and therefore would be taxed at the rate of 42½ percent upon such earnings a 2.3 percent tax-exempt would be as attractive from the standpoint of net yield as a 4-percent taxable bond, or a 2.8-percent tax-exempt security, as against employment of the funds in active business risks at 5 percent. In view also of the fact that banks may no longer pay interest upon demand deposits, and that there would be a need, under the pending measure, for corporations to keep themselves in a more liquid position than formerly, a substantial demand for tax-exempt investments might be expected from corporations in the employment of their reserve funds.

In support of his contentions the Treasury representative declared that the net amount of tax-exempt State and municipal securities outstanding declined slightly between June 30, 1931, and June 30, 1935, and predicted that the volume of such securities would not increase greatly in the future. It should be pointed out that the early part of the period referred to was one of tremendous decline in the issuance of municipals, and that a substantial upturn was under way during the latter portion. This is clearly shown by reliable statistics indicating large increases during 1934, 1935, and the first 3 months of 1936.

As evidence of the potential amounts of tax-exempt financing that may be expected to be forthcoming, the P. W. A. had pending before it on March 31, 1936, applications for non-Federal projects estimated to cost over two and a quarter billion dollars. Part of this sum, of course, is proposed to be obtained from the Federal Government in the form of grants. How many projects not on this list are in contemplation cannot be estimated, but the number is

large. The fact, however, that States and municipalities have indicated their desire to undertake construction projects costing more than two and a quarter billion dollars in the near future—most of which will be financed by bond issues, whether there are sold to P. W. A. or to private investors—indicates the probability of substantial issuance of municipals in the near future.

REPLENISHING CAPITAL THROUGH THE SALE OF RIGHTS

It is confidently stated that the penalty on the retention of earnings imposed by this measure will discourage the saving of sufficient earnings in large as well as small corporations for expansion and other proper purposes. One of the Treasury witnesses has said that free access to the organized capital markets offers "abundant opportunities to all profitable corporations" of medium and large size for such additional capital funds as they may require. It is interesting to note that out of more than 400,000 corporations making income tax returns, less than 4,000, or 1 percent, have their stocks traded on the security exchanges of the country. This indicates the extent to which corporations avail themselves of the organized capital markets of the country. It would be pertinent to ask what sources of funds are open to unprofitable corporations or those which barely break even or make only small profits.

The witness further stated that any medium-sized or large corporation whose stock is traded on the securities market may obtain through the issuance of stock rights, the reinvestment in its business of capital equal to all or any desired portion of its current earnings that have been distributed in dividends. An extended discussion might be had as to the impracticability of any such widespread replenishment of capital, but it is generally sufficient to say that as a substitute for corporate saving such a general plan is utterly impracticable. Briefly, it may be said that there has been left out of the calculation the general tendency on the part of average stockholders to spend and not reinvest dividends; the reduction of the dividends in the hands of the stockholders by the normal and surtaxes paid upon them, leaving, in many cases, an unsubstantial portion for reinvestment; the general lack of power to make such reinvestment by trustees and other fiduciaries; the difficulty of exercise and sale of rights in downward or narrow markets; and the machinery involved and the expense to the corporation. Generally speaking, it may be said that where refinancing through the sale of rights has proved attractive on the market, it has been because of the fine credit reputation of the corporation whose stock is involved, a reputation obtained through retention of sufficient earnings to act as a cushion for stable dividends and other corporate needs. In other words, a condition which it seems to be the avowed purpose of this measure to discourage.

Senator CONNALLY. Mr. Osgood, I will ask you a question. Have you made any recommendations as to how additional taxes ought to be secured?

Mr. OSGOOD. No, sir.

Senator CONNALLY. You are just against the bill?

Mr. OSGOOD. I am against the bill as it stands; yes, sir.

Senator CONNALLY. You haven't any suggestions as to how we will get the added revenue?

Mr. OSGOOD. No; it was our understanding that under the rules of these hearings we were limited in the scope of our testimony, Senator, to the provisions of the pending bill.

Senator KING. Mr. H. B. Fernald.

STATEMENT OF H. B. FERNALD, MONTCLAIR, N. J., REPRESENTING THE UNITED STATES CHAMBER OF COMMERCE

Mr. FERNALD. Mr. Chairman and gentlemen, my name is Henry B. Fernald, of Montclair, N. J. I am senior partner of Loomis, Suffern & Fernald, certified public accountants, of New York City. I appear as a member of the committee on Federal finance of the Chamber of Commerce of the United States.

As has been indicated, I shall speak of some of the accounting and technical aspects of the proposed tax upon corporate income. My discussion will be limited to the tax applicable to the ordinary corporation which does not come under the provisions relating to banks, insurance companies, and the other corporations which are excluded from the general proposal.

By an exceptionally ingenious scheme of nomenclature and alternative schedules of rates, the mathematics of this proposal are written in this bill to state the tax at relatively low rates applicable to the entire net income, instead of stating it at the higher rates applicable to income which is not distributed. However, I need not tell you that it is an appalling thing to place these schedules before the ordinary taxpayer, with the requirement that he must, at his peril, make his computations under this law, swear to the correctness of his returns, and accept the consequences for any errors he may make.

The situation is bad enough under present law, where the taxpayer computes his net income as best he can and then sometime within the next 2 or 3 or more years, receives notice from the Commissioner stating any errors as the Commissioner sees them and imposing an additional tax. But this tax is no more than the taxpayer would have had to pay if he had correctly determined and computed his net income in the first instance. Likewise, if the taxpayer appeals to the Board of Tax Appeals or to the courts, the final decision is simply the same amount of tax which he would have been required to pay if his own first computation had been in accord with the final determination.

Under the proposed law the result is different. If the taxpayer correctly computes his net income and pays dividends to that full amount, no tax is imposed. If, however, the taxpayer has done the best he could, but at some future date the Commissioner, or possibly the courts, make a final determination of an additional amount of net income the tax may be very heavy. Perhaps the taxpayer has made every conscientious endeavor he could to determine correctly the amount of net income. Perhaps he may have tried scrupulously to follow the regulations then in effect. Nevertheless, if the Commissioner, because of some change in his own regulations, some new decision of the courts, some one of the thousands of Bureau rules and decisions which have never been made public, determines an additional amount of income, that additional amount may be taxed

as undistributed net income, and under this bill it will be too late for the taxpayer then to remedy the situation by making a distribution. Certainly this is gross injustice. Two possible remedies appear. First, and most effective, do not enact this kind of a law. Second, if enacted, at least provide that in case of determination of a deficiency by the Commissioner, where no fraud or misrepresentation is involved, the taxpayer shall have a reasonable time, possibly 3 months after such determination becomes final, within which to make without penalty the distribution to stockholders which would give rise to a corresponding dividend credit. This latter, if done, would place the matter as nearly as may be on the same basis as the present law, where an additional determination by the Commission carries with it only the same tax that the taxpayer would have had to pay if he in the first case had made such a determination.

Examples of inequities.—It is stated that the tax proposed will more equitably impose the tax liabilities on corporate income. Let us examine that contention.

To simplify our discussion, let us assume that we are dealing with corporations where the special interest credit of section 26 is not involved and the adjusted net income is the same as the net income.

To avoid possible complications of sections 14, 15, and 16, let us consider what this tax will mean to a corporation which is formed and starts in business in 1936.

(*a*) Under schedule I of section 13:

If its net income were $10,000 and it had $1,000 of undistributed net income (whether because this $1,000 had never been realized in cash but was simply represented in accounts receivable, accruals, etc., or whether, if received, the cash had been used for the needs of the business) its tax would be $100, or 10 percent of the undistributed net income.

If its undistributed net income were $2,000, its tax would be $250 more, or 25 percent on the additional $1,000 undistributed net income.

For a third $1,000 undistributed net income the additional tax would be $400 or 40 percent on that amount. If undistributed net income were more than $3,000 then the additional tax would be 55 percent of any additional amount of undistributed net income.

I cannot believe that those from the Treasury Department who have urged the favorable treatment small corporations would receive under this bill have appreciated that these small corporations may be charged with 55 cents tax for $1 of undistributed net income. Nor can I believe that when they have spoken of how easily a small corporation might issue obligations, stock rights, etc., they have considered all the legal and technical questions which would have to be met by a corporation to do this legally and effectively.

Suppose such a corporation with $10,000 of net income could not distribute $4,000, its tax would be $1,300, leaving a balance of $4,700 it could pay as a cash dividend. If it tried to make full distribution by distributing $6,000 in cash and $4,000 of its notes or dividend warrants, it would have to guess what might be the market value of such notes. If it figures that they should sell at 75, for example, it would have to recognize that its dividend credit would be $1,000 less than its net income, and it would still have a tax to pay, and the

amount of this tax would be an impairment of its capital (assuming that this $10,000 of net income was the same as the amount of earnings and profits which under the State law it might distribute to its stockholders).

It would be possible to work out a differential formula of the amount of obligations of a market value of 75, which it could issue and still leave it with a sufficient surplus to pay the resulting tax. It would be quite an interesting mathematical problem, but I doubt if it would appeal to the business man trying to find out where he would stand.

Of course, such a theoretical computation would be rather useless, because the taxpayer would not know whether or not the 75 figure would be the finally determined market value for such obligations, unless there should be some collusive agreement to establish a market price at this figure, but any such collusive agreement might be disregarded by the Commissioner, and possibly might be subject to penalties for fraud and other criminal liabilities.

Suppose a stockholder who receives $1,000 of such dividend warrants can sell at 75, but those who receive $10 or $20 of such warrants can only realize a price of 40 or 50 for them, what will be determined as a fair market value of such obligations which will be the basis for the corporation's dividend credit?

We might similarly wander through the complications of trying to borrow the funds with which to pay a cash dividend, with rights to the stockholders to reinvest it in purchase of stock. Suppose part of the stockholders refuse to make such reinvestment, where would the fund come from to pay off the money borrowed for such a dividend? Would the directors be liable for improvident payment of dividends? Could we expect the larger stockholders to supply the money for the benefit of other stockholders who would not go along with the plan?

If the corporation used some of the next year's income to pay off the tax, then further complications would come in trying to work out the next year's status.

It all seems too fantastic to be given serious consideration. Perhaps the simplest, easiest, and cheapest thing that a corporation could do would be to pay its $1,300 tax, because of the $4,000 income it was not in a position to distribute.

On the other hand, a similar corporation, but amply financed, could distribute its entire net income and have no tax to pay. Is it equitable that the stronger corporation should have no tax to pay, whereas the poorer corporation had to pay a tax of $1,300?

(b) *Under schedule II of section 13.*—If a newly-established corporation had $100,000 net income, and it had $10,000 of undistributed net income, its tax would be $4,000, or 40 percent of the undistributed net income.

If its undistributed net income were $20,000, its tax would be $5,000 more, or 50 percent of the additional $10,000 undistributed net income.

On a third $10,000 of undistributed net income the additional tax would be $6,000, or 60 percent of that amount. If the undistributed net income were more than $30,000, there would be $1 of additional tax to be paid for each $1 of additional undistributed net income.

Suppose then, this corporation had $30,000 of its net income which had not been received in cash and could not be distributed, its tax then would be $15,000 (50 percent of the undistributed net income) and it could pay a dividend of $55,000.

We might try to follow this corporation through and show the difficulties it would have in trying to work out some plan of dividend—scrip, notes, cash dividend and stockrights, etc., which would make it unnecessary to pay this heavy tax for its misfortune in being unable to distribute its full earnings. Perhaps, relatively, these difficulties might be less than for a smaller corporation, because this corporation might be able to pay the necessary attorney's and accountants' fees and still save something as compared with a $15,000 tax; whereas the smaller corporation might find it cheaper to pay its tax.

Such a corporation, nevertheless, having to pay a $15,000 tax, or having to go to a lot of difficulty and expense to avoid doing so, is not very equitably treated compared with a better financed corporation in a position to distribute its entire income and therefore have no tax.

Let us carry this example further. Assume this corporation is considering the purchase of additional machinery at a cost of $10,000, which would enable it to increase its business and give additional employment and make it a purchaser of additional materials from others. It must realize, however, that if it takes this $10,000 for purchase of machinery, thus increasing its undistributed net income to $40,000, it will have to pay a tax of $25,000; that is, an additional $10,000 of tax for the additional $10,000 undistributed net income. In other words, it finds the purchase of this $10,000 of machinery would cost it $20,000. There is no probability of sufficient profits to justify such a transaction.

If this were a corporation which had a prior surplus, it might minimize the tax in some such manner as the following:

Assume in 1936 it has $100,000 net income, but only $70,000 of realized cash income available. Instead of reserving from such cash $15,000 for payment of tax and distributing only $55,000, it might take a chance and distribute in 1936 the entire $70,000. Then its tax for 1936, under schedule IIA, would be only $9,375. Suppose it also purchased the $10,000 of machinery on credit and planned to pay for it also out of its 1937 income. Then, if in 1937, it again had $100,000 net income, with no increase of uncollected accounts, accruals, etc., so that the entire $100,000 was collected in cash and there was no further expenditure for capital items or nondeductible accounts, it could perhaps distribute all of that $100,000, except the $9,375 it had used to pay its 1936 tax and the $10,000 it had used to pay for machinery. In 1937 it could pay approximately $80,000 in dividends and would have $6,000 tax for 1937 (to be paid in 1938), because of the amounts it had used in 1937 to pay its tax of the prior year and because of the machinery purchased. At that point its total of these taxes would be $15,375.

Suppose in 1938 it again has $100,000 net income, all of which it is able to distribute, except the $6,000 it has taken to pay its 1937 tax. If it distributes the entire balance of $94,000, its tax for 1938 will be some $1,700 to be paid in 1939. To this point its taxes would have aggregated $17,000.

Senator CONNALLY. You deducted that, though, in the former year, did you not?

Mr. FERNALD. No; not for the payment of the $6,000.

Senator CONNALLY. You accounted for it?

Mr. FERNALD. Yes; but we haven't had the cash. When we take the cash out of our next year's realizations of income, we are not able to distribute that amount and therefore we must pay the tax on the amount we fail to distribute, because we took that money to pay the tax of the prior year.

Senator CONNALLY. I know, but you carried over $6,000 assets out of 1937 into 1938, so you are not out that $6,000 twice?

Mr. FERNALD. I have only deducted it once from our cash here.

Senator CONNALLY. All right.

Mr. FERNALD. Without attempting to compute the whole following chain directly or by differentials, let us assume that, before it got through paying each year the tax on the preceding year's tax, we have an aggregate of something less than $18,000. Of course, this is substantially less than the $25,000 it would have had to pay if it had, out of its 1936 available cash, reserved the amount required to pay its tax for that year and to pay for its machinery purchased.

I realize no business runs thus smoothly and evenly. There probably would not have been an even $100,000 of net income for each year, and the business would not have run along with steady balance of accounts receivable and inventories and with no need for further machinery purchases. Variations of income from year to year might make the aggregate tax more or less.

The point I want to make is that the involvements of the tax computation in such a simple case as this are so great that it is hard to say where they might lead. No business man in the ordinary conduct of his affairs could try to follow them all out, but when he realizes, as he will shortly realize, that if he buys additional machinery or tries in any way to expand his business he is going to be subjected himself to a liability which may run as high as $1 tax for each $1 he retains for use in the business, he will feel that he cannot afford to go ahead with new plans, except as and to the extent that he may see a ready market at a fair price for his capital stock. He could not exercise ordinary business judgment in planning his business operations.

To borrow money from the bank, to issue bonds or debentures, is only deferring the evil day. If he uses his earnings to pay off these obligations he is surcharging himself with a heavy tax which a more fortunate competitor will not have to pay.

Take another case of a manufacturing corporation which estimates it will have $100,000 of income for this year. It is willing to take that and apply it to increased pay roll and increased purchase of materials and supplies, to build up its inventory of goods on hand. However, it will see that if it does this and so has $50,000 of undistributed net income, it will have to pay a tax of $35,000. This is equivalent to a 70-percent penalty tax against increased employment and increased purchases of materials, and so forth, with no probability of a profit sufficient to warrant such a surcharge.

Does the Congress mean to put any such penalty tax against increased employment? It looks as if the Government were saying on

the one hand, "Please use your earnings to increase employment" and then proposing to say by this tax bill, "We will penalize you heavily if you do." This simply does not make sense.

There is not a man on this committee that would talk that way as an individual, and I do not believe you want to talk that way as a committee. All I can believe is that the complications and involvements of these schedules are so great that they have concealed the real nature of this tax and the disastrous effect it will have on business and on employment.

Then there is schedule III as an alternative schedule for adjusted net income of more than $10,000 and less than $40,000. I think I know how it is intended a tax should be figured under this schedule. All I will say of it is that I wish before this bill comes to a vote every member of this committee and every Member of the Senate would sit down personally and himself figure out a few tax problems under this schedule.

The difficulty of determining "net income."—I have been presenting examples in which we start with known figures. The taxpayer starts with the unknown, that is, with "net income."

Nothing better illustrates the uncertainty and difficulty of net-income determinations than the information presented by Mr. Oliphant for the 2 years and 9 months ending March 31, 1936, which appears on pages 612 to 614 of the printed record of the hearings on this bill before the Committee on Ways and Means:

There were 450,000 revenue agents' reports which proposed aggregate additional taxes of over $752,000,000. The aggregate collected was some $479,000,000; 95,000 refund claims were filed; 72,000 claims were allowed for over $45,000,000; 11,000 cases are now pending in the courts; 41,000 deficiency letters were issued asserting $490,000,000 tax.

Amounts determined without necessity for issuance of final notices of deficiencies were $246,000,000, as against $357,000,000 proposed by revenue agents. Here the especially trained experienced revenue agents recommended 45 percent more in amount of deficiencies than the Bureau finally agreed was due.

Over 47,000 cases were considered by the General Counsel's office and closed during the period. There is no statement of the number of cases considered, but not yet closed.

Yet under this bill if the taxpayer is able before the end of the year to wade through all of the doubts and complications involved in the determination of his income, determine the amount correctly, and make distribution thereof to stockholders, the corporation will pay no tax. If it fails to do this more accurately than the Department is able to do within 3 years after the end of the year, it may have to pay a heavy penalty tax.

The dividend credit.—Under section 27, as introduced in the House, the corporation had 2½ months after the end of the year within which to determine net income and make distribution thereof. This was bad enough. As passed by the House, only the dividends paid during the taxable year are to be taken into account. The thought seems to be that a corporation may estimate its last month's earnings with sufficient accuracy so this will be no particular hardship. The corporation with a large previously accumulated surplus and ample cash funds might perhaps make its distribution on the basis of such

an estimate. A corporation without a prior surplus, or one without abundance of available cash, might not safely do so. Here again the well-financed corporation may have a substantial advantage over the poorer corporation.

Even if a successful estimate of earnings might be made, that does not give the cash necessary to pay the dividends.

Subsection (i) as to intercorporate dividends is an exceedingly involved and uncertain provision, probably of very limited application. It is a special provision applicable if 80 percent or more of the gross income of a corporation is derived from dividends and if 50 percent or more of any class of stock of that corporation is owned by another corporation.

No one knows what "gross income" is. The law itself long since gave up any attempt at definition. It states in section 22 that gross income includes certain specified items and "gains or profits and income derived from any source whatever." The Commissioner has never considered it important and the tax returns do not attempt to show a figure for total gross income. I understand it is virtually unadjudicated, because it has not been of material importance to determine which items were deductible in computing gross income as distinguished from the amounts to be deducted from gross income. Yet, as you know, in this section the total amount of gross income is going to be exceedingly important. How many years will it be before the meaning of "gross income" may be reasonably adjudicated so that a taxpayer might make this computation with some reasonable assurance that it would be correct?

Since this subsection is stated by the committee's report to be intended to prevent a delay in dividend distributions, in view of the 2½ months which the bill as presented to the House had allowed for dividend distributions, it seems to be rather surplusage now that the 2½ months' extra period has been eliminated.

The relief provisions.—There are four special relief provisions, sections 14, 15, 16, and 105.

Section 105 provides for a flat 15-percent tax on the net income of a corporation in receivership or in bankruptcy. Of course, such a corporation could not fairly be subjected to a heavy penalty for failure to distribute its earnings as dividends. The only misfortune about this is that it puts such a premium on receiverships.

If a corporation stands on its own feet without any such conditions as would bring it under one of the other relief provisions, but needs to borrow cash to meet current requirements to reopen plants, to increase its pay rolls and business, or for other purposes, it might consider borrowing perhaps $100,000 from a bank, expecting to pay it back out of earnings. It finds, however, that if it had $100,000 earnings in the first year, it could pay $57,500 on the debt and $42,500 in tax. In the second year, if it had earnings amounting to $74,000, it could pay the balance of $42,500 on the debt and $31,450 in tax. Thus it would take $174,000 earnings to enable it to pay off $100,000 borrowed from the bank. It finds, however, that if it were in receivership it could pay off such a loan of $100,000 with earnings of only $117,150, i. e., with earnings of $100,000 the first year, it could pay $85,000 on the debt and $15,000 tax, and in the second year it could pay the balance of $15,000 on the debt, with only $2,250 tax. In this case there would be a premium of some $57,000 for

going into receivership. Innumerable illustrations of this kind could be given.

Section 14 provides for a 15-percent tax. This section is entitled "Accumulated earnings and profits less than adjusted net income." The House committee report refers to this section as relating to "corporations with a deficit." The bill, however, does not use the word "deficit" but refers to "accumulated earnings and profits of the corporation." This term is not defined by statute, and there is great liberality in accountants' treatment of it.

Section 115 of the present law refers to earnings and profits accumulated since February 28, 1913, and those accrued prior to March 1, 1913. The regulations have never attempted really to define the term. Article 115–1 of regulations 86 states that "among the items entered into the computation" are certain ones there stated. No such importance has been attached to the expression in the present law as would be attached to this provision, which may make the difference between a 15-percent tax and a possible 42½-percent corporation tax.

Presumably it will be necessary for the taxpayer who wishes to establish his right to the relief under this section to go back year by year to the first year of the corporation and make an entirely new set of computations different from those he has ever made before, and to do this on some basis that no one is willing to attempt to define.

It seems clear this expression does not mean statutory net income. Presumably it would not mean the earnings or profits or the deficit shown by the books nor the surplus or deficit that might properly be shown on a statement for the Securities and Exchange Commission. Presumably it would not mean the surplus earnings or profits available for distribution as dividends under the appropriate corporate law of the State which governed the dividend declarations of any particular corporation.

Apparently the section is intended to permit this relief to a corporation without requiring it actually to go into receivership and so be assured of the 15-percent rate rather than to try to stand on its own feet and risk a possible 42½-percent tax.

In any event, there seem many cases where a corporation would not be safe, under State laws, in trying to pay out as dividends during the year entire amount of its statutory net income, yet would not fall within the provisions of this section. For such a corporation it may be a choice between a possible 42½-percent tax or the 15-percent rate under a receivership, unless it is in the more fortunate class with stockholders who have the resources to pay in additional funds or is in a position where it can raise funds by sale of capital stock without too great sacrifice.

Always it must be remembered that if the corporation proposes to sell any securities it must consider and comply with the requirements of the Securities and Exchange Commission, and may have considerable delay before it can have its application prepared and sanctioned by the Commission.

Here, again, it is not going to be a simple thing for the ordinary small corporation to make such complicated computations as are required under section 14 (a) (2).

Section 15 gives the relief of the 22½-percent tax in case of a particular type of contract executed prior to March 3, 1936. Apparently this is a very limited application. Contracts entered into after March 3, 1936, with no less reason and justification, and contracts which no less effectively prevent payment of dividends, will not receive the benefit of this provision.

Section 16 relates to indebtedness existing on March 3, 1936, and evidenced by certain particular instruments of particular maturities and to some extent limited to indebtedness incurred for particular purposes. If a corporation can establish that its debt complies with all these requirements and if the sum of all such debts exceed the amount on a specified date of its accumulated earnings and profits (that uncertain and undefined term), then, under particular conditions, the corporation may get the relief of paying a 22½-percent tax.

The whole section seems very unfairly discriminatory. Corporations whose debts do not comply with every one of these complicated and difficult provisions will not get this relief. The corporation which bought machinery for cash, but borrowed for operating expenses, is denied the relief which another corporation may have which used cash for operating expenses and borrowed for the purchase of equipment. The debt incurred March 2 may have a relief that one incurred March 4 may not bring. A particular type of instrument evidencing the debt may bring relief, but a slightly different instrument may not bring it. It is hard to see why all forms of indebtedness which effectively prevent the use of earnings for payment of indebtedness should not receive equal relief.

Here, again, the very complications and doubts regarding what may or may not fall within sections 15 and 16 may form a distinct incentive, if not a need, to seek relief in receivership.

In fact, in many cases the corporation will have no option. Many corporations owning office buildings, apartments, hotels, and so forth, with heavy bonded debt, would be forced into receivership, if required to pay a 42½-percent tax.

Is this a desirable kind of a tax? Let us grant that much of the difficulty, complexity, and confusion in the bill is due to the hurried drafting of it; grant that some of its discriminations and unfairness might be cured if adequate time were taken to consider the matter and revise the bill. But even after we grant all this, the essential trouble seems to be with the very nature of the proposal.

Secretary Houston's recommendation of 1920. Commissioner Helvering has cited to you the Annual Report of Secretary of the Treasury Houston, for the year 1920, as recommending the principle of this bill. I wonder if the Commissioner had the full recommendations of this report before him when he wrote that. I want to cite to you some extracts from that report and from the letter of the Secretary to the chairman of the Committee on Ways and Means which appears in that report. I will only cite brief extracts but urge that you read that entire section of his report to see how far the proposal of this bill departs from Secretary Houston's recommendations. I quote from that report [reading]:

> The business interests of the country have a right to know in advance the rate of taxation they will be called upon to pay (p. 25).
>
> An imperfect and uncertain tax affects the future even more adversely than the present * * * (p. 30).

Complexity in tax laws violates the most fundamental canon of taxation, that the liability shall be certain and definite. It is not merely a source of irritation, labor, and expense to the taxpayer; but when conjoined, as it is in the present law with the heavy rates of taxation which exigency has forced upon us, it becomes a major menace, threatening enterprise with heavy but indefinable future obligations, generating a cloud of old claims and potential back taxes which fill the taxpayer with dread, creating, to be sure, an attractive source of additional revenue, but clogging the administrative machinery and threatening, indeed, its possible breakdown (p. 30).

The heavy surtaxes cause real hardships when income earned over a period of years is realized or received in 1 year and taxed as a lump sum in that year (p. 31).

While it is vitally important that saving and reinvestment as little as possible. Our present surtaxes offend greatly in this respect. We attempt to levy surtaxes, rising to 65 percent upon ordinary income, while there are thousands of millions of tax-free securities in the market, the income from which is practically exempt from all taxation. The result is to make investment by weather taxpayers in the expansion of industry or foreign trade unattractive and unprofitable. It is obvious this situation should be remedied.

The remedy which most commends itself to my judgment at the present time is to reduce (e. g., by one-fourth) surtaxes attributable to that part of the net income which is saved and reinvested in business or property yielding taxable income and at the same time to limit the total amount of such reduced surtaxes to the same percentage (e. g., 20 percent) of the reinvested income as the rate imposed upon the undistributed profits of corporations. The maximum tax upon such saved income would thus be approximately the same, whether reinvested by the individual, the partnership, or the corporation, and whether reinvested personally by the stockholders of the corporation or by such corporation for its stockholders. If at any later date the profits of a corporation which had paid the undistributed profits tax came to be distributed, a credit equal to the tax already paid by the corporation could, if it were thought wise, be easily granted to the stockholders.

We cannot long continue to collect surtaxes rising to 65 percent upon income from ordinary business and investment, while exempt interest at a remunerative rate can easily be secured from tax-free bonds. We must take something less than 65 percent or in the end take nothing * * * (p. 34).

Since the adoption of the heavy war surtaxes in the Revenue Act of 1917, the Treasury has repeatedly called attention to the fact that those surtaxes are excessive; that they have passed the point of maximum productivity and are rapidly driving the wealthier taxpayers to transfer their investments into the thousands of millions of tax-free securities which compete so disastrously with the industrial and railroad securities upon the ready purchase of which the development of industry and the expansion of foreign trade intimately depend (p. 36).

It seems idle to speculate in the abstract as to whether or not a progressive income-tax schedule rising to rates in excess of 70 percent is justifiable. We are confronted with a condition, not a theory. The fact is that such rates cannot be successfully collected. Tax returns and statistics are demonstrating what it should require no statistical evidence to prove * * *. Whatever one may believe, therefore, about the abstract propriety of projecting income-tax rates to a point above 70 percent, when the taxpayers affected are subject also to State and local taxation, the fact remains that to retain such rates in the tax law is to cling to a shadow while relinquishing the substance. The effective way to tax the rich is to adopt rates that do not force investment in tax-exempt securities (p. 36).

The simplest remedy for this situation would be a general reduction of the higher surtaxes, accompanied by increases in the low surtax rates * * *. But if for the immediate future it is found impracticable to reduce the higher surtaxes * * * an effective remedy might be found in limiting the surtax rates possibly to about 20 percent on that part of the taxpayers income which is saved and reinvested in property or business yielding taxable income (hereinafter referred to as "saved" income), leaving higher rates, perhaps the present rates, upon income which is spent or wasted or invested in tax-free securities (p. 37).

One partial substitute for the excess-profits tax would be a tax on the undistributed profits of corporations as nearly as possible equal to the surtax imposed upon the saved income of the individual. If individuals doing business in

partnership pay 20 percent on undistributed profits, individuals doing business through the medium of the corporation should pay 20 percent. This plan could be applied in many different ways: (1) The distributed profits of the corporation could be substituted for the so-called excess-profits credit of the excess-profits tax and the remaining or taxable profits be taxed at 20 percent; or (2) a 20 percent tax on undistributed profits could be applied as a corporation surtax under title II of the revenue act; or (3) corporations could in form be subjected to the same progressive surtaxes as individuals, a proposal which would prove very advantageous to all corporations with small incomes, with a proviso that the total surtax should never exceed an amount equal to 20 percent of the undistributed profits (pp. 30–40).

Furthermore, the most troublesome problem of income taxation is the same in case of both corporations and unincorporated taxpayers, i. e., the repressive effects of heavy rates when applied to income which is saved and reinvested. That and many other problems of person and corporation income taxation will best be decided when linked together. We are now taxing reinvested income of individuals at rates which may exceed 70 percent. The error of this treatment appears plainly when we attempt to apply such rates in the case of corporations. It would be unthinkable to tax the saved income of corporations at 70 percent (p. 40).

The Secretary also suggests the possibility of adopting—

a compensatory corporation tax, or "corporation surtax at a flat rate", such as he states and had recently been adopted in the United Kingdom. The Secretary quotes from a discussion of this tax by the Chancellor of the Exchequer April 19, 1920, in which such tax is described as a "corporation tax levied at the rate of 1 shilling to the pound" (i. e., 5 percent) to "run concurrently with excess-profits duty", and, to prevent the new tax constituting too severe a burden on the ordinary shareholder of existing concerns with large issues of debenture and preference shares "in no case shall the duty exceed 2 shillings to the pound" (i. e., 10 percent) on the profits which remain after the payment of such interest and dividends on existing issues of debentures and preference shares (pp. 41–42).

The Secretary concludes this section of his report, as follows:

Two hundred million dollars is probably a maximum allowance for the loss of revenue that would result in 1922 if the excess-profits tax were replaced (as of Jan. 1, 1919) by an undistributed profits tax of 20 percent. New taxes capable of yielding approximately this amount should be selected from the additional taxes suggested below or from other sources in case the undistributed profits tax is adopted (p. 43).

Does the present bill, in any material respect, conform to the standards which Secretary Houseton recommends? It is complex, imperfect, and uncertain. No one can know in advance the rate of tax he will be required to pay; it is a graduated and not a flat tax; it passes far beyond the 20-percent rate the Secretary recommended; it penalizes saving and reinvestment; it is an attempt to remedy the damage and loss of revenues due to excessive surtaxes on individuals by imposing equivalent rates on corporations directly contrary to the entire spirit and specific recommendations of the Secretary's report. If you will read that report and guide your action on this bill by what the Secretary there recommends. We can ask no more.

Employment of corporate surpluses.—Mr. Haas, the Director of Research and Statistics of the Treasury Department, has presented certain figures from the Statistics of Income for the 3 years 1931, 1932, and 1933 apparently to support a contention that corporate surpluses "were not used to any great extent, in the aggregate, to maintain employment during the depression." Since he points out that the aggregate figures "are subject to the limitations of all aggregate and composite data" and "are not necessarily representative of

the experience or practices of any particular corporation", I need not enlarge upon that point. I do not want to weary you with many figures, but do want to cite a few figures to give a somewhat better perspective than I think you might get from those Mr. Haas presented. For example:

The deductions of 15 billion dollars for depreciation, depletion, and bad debts during the 3 years 1931, 1932, 1933, do not seem so large when compared with over 263 billions of other deductions for cost of goods sold, and all the other deductible costs and charges of the business. Actually the total deductions for depreciation and depletion of 12 billions are only 4½ percent of the total statutory deductions.

As to the nonfinancial corporations that reported no net income for this 3-year period, reference is made to aggregate losses of 12.1 billion dollars and 9.5 billion dollars of it are ascribed to so-called "valuation deductions", i. e., 3 billion dollars losses for bad debts and sale of capital assets, and 6.5 billion dollars for depreciation and depletion. I do not think the 3 billions of losses for bad debts involved can possibly be so lightly brushed aside. Certainly a surplus was needed to take care of these for they never could be made good out of deficits. Nor do I think we can lightly brush aside 6.5 billions for depreciation and depletion. If cost of plant and equipment cannot be made good out of profits, it is not going to be made good at all. But let us look at what the statistics show for this period for these "nonfinancial" corporations with no net income.

Total statutory deductions	$137,500,000,000
Depreciation and depletion	6,500,000,000
Deductions other than depreciation and depletion	131,000,000,000
Losses for bad debts and sale of capital assets	3,000,000,000
Balance, representing cost of goods sold, operating expenses, taxes, interest, and other deductions	128,000,000,000

It was after this expenditure, which includes over 3 billion for taxes, that they showed the compiled net deficit of 12 billion dollars. True, some of these corporations paid an aggregate of $2,970,000,000 in cash dividends, not taken into account above. Grant that some of them might have survived even if they had not had accumulated surpluses, but anyone who knows actual conditions need not be told that many of them could not have continued their part in this aggregate of $130,000,000,000 of expenditures if they had not had their previously accumulated surpluses.

No assemblage of aggregate statistics disputes the fact which we know that corporate surpluses have enabled corporation after corporation to come through the depression. Without the building up of corporate surpluses we cannot hope for business to develop and prosper. Unless business does develop and prosper we cannot solve our unemployment problems and the Government cannot hope for its substantial revenues.

Conclusion.—The proposed tax is not sound in principle; will prove unjust, discriminatory, and difficult in practice, and will be impracticable of reasonable administration. It puts a premium on bankruptcy and receiverships. It will bear lightly on the well-established, strongly financed corporation, and bear heavily on a less fortunate competitor. It will make it practically impossible for new business to be started. It will not help busi-

ness; it will not help reemployment; it will not add to the wealth and prosperity of the country; it will not give the Government a substantial and continuing source of revenue.

Senator BLACK. I want to ask one question. With reference to the receivership clause, if the bill should be passed, I mean if the general idea should be passed that you oppose, do you think it is unwise to include the provision with reference to receivership?

Mr. FERNALD. I think you must include such a provision. I think it would be unthinkable to tax the life out of a corporation in receivership.

Senator BLACK. You would favor, if the bill is passed, in spite of the objections that you make to it, the inclusion of that clause?

Mr. FERNALD. Oh, yes. I think it must be in.

Senator BLACK. What about the debt-ridden corporation provisions, do you think they should be included if the bill is passed?

Mr. FERNALD. I think if the bill is passed, you will have to give more liberal relief than you have here so as not to put such a premium on going into receivership.

Senator BLACK. In other words, you think that sections 15 and 16, which are intended to give relief to so-called debt-ridden corporations, that the difference between that amount of tax and the amount of tax that would have to be paid if the corporation was thrown into the hands of receivers, would automatically be that continuing incentive to go into the hands of receivers?

Mr. FERNALD. The amount of tax might possibly be, but I am not so much disturbed about the differential in the tax, although in some cases 7½ percent might be a consideration—as I am about the impossibility of knowing whether under this very complicated system which Mr. Osgood has been referring to, the corporation might not be able to get relief. In other words, I am more disturbed about the corporation finding itself unable to get relief by those two sections than I am about the differences of the 7½ percent in the amount of the tax, although I will grant that in some cases, 7½ percent will be considered a material amount. The differential, of course, might be much more than 7½ percent. In some cases it might run as high as 27½ percent on part of the corporation's income.

Senator BLACK. In other words, you think that sections 15 and 16 as they are now written would have an element of uncertainty which would be an incentive to the corporation to go into the hands of a receiver in order to escape that provision, and come under the receivership clause?

Mr. FERNALD. Yes, sir.

Senator CONNALLY. You spoke about the inducement of going into receivership. Do you think that corporations would want to entail the expense of receivership, the receivership fees and all of that, and all to avoid a part of this tax; that that would be the controlling consideration? Would they not lose more in the loss of prestige through going into receivership, and the charges of the receivership, than they could possibly pay by the payment of the tax?

Mr. FERNALD. Undoubtedly in some cases they would, but in other cases I think they would have no option but to do it, because I think the creditors would force them. There are some cases in which people do not feel that it is such a terrible disgrace to go into bankruptcy—or rather into a receivership. Particularly I think you

would have a most alarming situation if you have the general excuse of "We are forced by the Government into this receivership through no fault of our own."

Senator CONNALLY. Most receiverships eat up the corporate assets in large measure, and I do not think that would be a controlling excuse to go into receivership, to avoid a tax, if they could pay and still stay out of receivership.

Mr. FERNALD. I grant it is going to be a question.

The CHAIRMAN. Thank you. The next witness is Mr. E. C. Alvord.

Before Mr. Alvord starts, may I say to the committee members that we are going to meet this afternoon at 2 o'clock and take those that we failed to get this morning. The meeting this afternoon will be held in the District of Columbia committee room in the Capitol.

I may say before we start, that I am in receipt of a letter sent in from the Institute of American Meat Packers, of 39 East Van Buren Street, Chicago, signed by its president, which will be placed in the record, calling on everybody interested in this question to come to Washington and ask to be heard, et cetera, before this committee.

I may say to these gentlemen that we are going to give them an opportunity to be heard, but not everybody to repeat on these propositions.

Senator CONNALLY. That letter was sent out some time ago, was it not?

The CHAIRMAN. That letter was sent out on April 21. It might be well to read it just to show the propaganda that is on for the delay of this legislation.

(The letter is as follows:)

INSTITUTE OF AMERICAN MEAT PACKERS,
Chicago, April 28, 1936.

OSWALD & HESS CO., INC.,
Pittsburgh, Pa.

GENTLEMEN: Do you want your funds which the Supreme Court said should not be collected from you as processing taxes wrested away, in considerable part, under the guise of a tax on "unjust enrichment"?

Do you want processing taxes, which turned consumers away from the products of the American swine grower and the American pork packer to fish and other foods, levied on all classes of livestock processing—hogs, cattle and calves, sheep and lambs?

Do you want a heavy tax—a tax on undistributed earnings—saddled on your business every time rising prices increase the value of your inventories, and, while automatically putting more of your working capital in product, show a profit in your financial statement that is nonexpendable, but that nevertheless will be taxed?

If not—if you agree that the tax proposals which have been made are more important to your business and stockholders than anything else now before you—it is recommended that you protect that business by taking the following steps immediately:

1. Buy a railroad ticket to Washington. (Plan to be there by Monday, if possible, and stay there as long as advisable.) Before you go—

2. Write the chairman of the Senate Committee on Finance, Senator Pat Harrison, Senate Office Building, Washington, D. C., that you are going to Washington and will appreciate an opportunity to be heard.

3. Write or telegraph one of the Senators from your State requesting him to see the chairman of the Senate Committee on Finance and arrange for time for you. When you get to Washington—

4. Call on the Senators and Representatives from your State and explain to them clearly, thoroughly, and honestly how the tax proposals would affect your business. They are entitled to this information. It is important to you that they have it.

Item 4 is the most important recommendation of all. The packer who wants to protect his own business from unjust and damaging taxation should not wait to ascertain whether an opportunity for a hearing by the Senate Committee on Finance will be granted to him. What is even more important is a thorough "hearing" by the Senators and Representatives from his own State concerning the effect of the proposed taxation on his business. An opportunity to put the facts before them justifies the trip.

If you regard the subjects of taxes on so-called "unjust enrichment", processing taxes, and taxes on undistributed earnings—including increases in inventory investment—as important to your business, then it is recommended that you take your part individually along with the dozens of others in this industry who are going to Washington to see that the Senators and Representatives from their States understand clearly and accurately the damage which the proposed taxes might do to numerous businesses.

This task of explanation is not one that anybody else can do for you. The facts of your business are different from the facts of anybody else's business. The Senators and Representatives from your State are entitled to know at first hand (a letter, telegram, or telephone call is not adequate) how the proposals would affect your business.

With all deference and with no intent of presumption, we submit that there is no way in which any packer can apply his effort in the next week or two more effectively in behalf of his business than by taking the steps recommended above.

Will you take your part?

Please get in touch with me when you arrive at the Mayflower Hotel. I shall be glad to be of service to you in any consistent way. To get to you any information we have or may receive that will be useful to you while you are in Washington, we shall need to know how to reach you. It will be appreciated if you will fill in the enclosed blank if you have not already filled in one like it.

Sincerely yours,

INSTITUTE OF AMERICAN MEAT PACKERS,
WM. WHITFIELD WOODS, *President*.

P. S.—In explaining the effect the tax proposals would have on your business, you probably will find it very useful indeed to have financial figures concerning your company at hand for reference or citation.

The CHAIRMAN. So I may say to some of these gentlemen who have come here from the far corners of the country that you may not have an opportunity to be heard, but those who represent your views will, as far as the committee can within reason hear that side of the proposition.

STATEMENT OF ELLSWORTH C. ALVORD, WASHINGTON, D. C., MEMBER OF THE COMMITTEE ON FEDERAL FINANCE OF THE UNITED STATES CHAMBER OF COMMERCE

Mr. ALVORD. My name is Ellsworth C. Alvord. I am engaged in the general practice of law in the District of Columbia. I appear before you as a member of the committee on Federal finance of the United States Chamber of Commerce.

Our committee has given exceptional consideration to the message of the President of the United States, on March 3, 1936, proposing the revenue policies embodied in the bill now pending before you; to the report of the Subcommittee of the Committee on Ways and Means, upon which hearings were held by the Committee on Ways and Means; and to the bill H. R. 12395, now pending before you, which incorporates many of the policies proposed by the administration

Before I begin my statement I do want to express the highest appreciation of the work of the experts and draftsmen upon whom

the burden of preparing this bill is primarily placed. They have done an extraordinary job in the time available. The difficulties which I shall point out are difficulties primarily inherent in the policies dictated to them to put into the bill.

Senator COUZENS. Let us assume that you understand the routine here very well. Are you going to offer amendments, assuming the proposal suggested is going through?

Mr. ALVORD. Senator, I shall be glad, within whatever time is given to me, to assist in preparing amendments. I might answer you more directly, however, by telling you that if the job of incorporating the policies which are presumably incorporated in the bill devolved upon me—that if you gentlemen decided the policies and we attempted to draft them without questioning the soundness of such policies at all—I am confident that it would take me 2 years before I could propose a bill which would carry out those policies with reasonable certainty and in reasonable form.

Senator BARKLEY. You would be slower than you used to be when you were up here.

Mr. ALVORD. I think I would be working faster to have it within the 2 years' time. And I am very serious in that. I think you will appreciate the reason for and the basis of my statement as I go on.

Considering the entire proposal, beginning with the message of the President down through the report of the subcommittee of the Committee on Ways and Means, the bill itself as reported by the committee, the committee's report and the bill as passed by the House, it is the recommendation of our committee first that this bill be scrapped.

Senator CONNALLY. Would you mind putting in the record all the names of your committee? You say "our committee", and you do not give the names of the committee.

Mr. ALVORD. I will be glad to. The members of the Committee on Federal Finances of the United States Chamber of Commerce are as follows:

Fred H. Clausen, chairman; president, Van Brunt Manufacturing Co., Horicon, Wis.
Ellsworth C. Alvord, Alvord & Alvord, Munsey Building, Washington, D. C.
Raymond H. Berry, Berry & Stevens, Penobscot Building, Detroit, Mich.
W. Dale Clark, president, Omaha National Bank, Omaha, Nebr.
Lammot du Pont, president, E. I. du Pont de Nemours & Co., Wilmington, Del.
Fred R. Fairchild, professor of political economy, Yale University, New Haven, Conn.
H. B. Fernald, Loomis, Suffern & Fernald, 80 Broad Street, New York, N. Y.
Edwin G. Merrill, chairman of the board, Bank of New York & Trust Co., New York, N. Y.
Roy C. Osgood, vice president, First National Bank, Chicago, Ill.
H. S. Wherrett, president, Pittsburgh Plate Glass Co., Pittsburgh, Pa.

The CHAIRMAN. You are representing now the United States Chamber of Commerce?

Mr. ALVORD. Yes, sir.

Senator BARKLEY. They recommend that the bill be scrapped. Assuming that we have to raise some $800,000,000, do they offer a substitute plan?

Mr. ALVORD. Senator, I will be very glad to discuss that with you as I go along.

Senator BARKLEY. The trouble is that up to date nobody has suggested where we can get this money, and it would be helpful if some of those who want to tear down this system or this policy would erect one in place of it.

Mr. ALVORD. Senator, I will make this offer to you. If you will tell me how much money you need, I will be glad to submit alternate proposals to you gentlemen, any one of which I think would be better than those incorporated in the bill, and will produce your revenue.

Senator BARKLEY. The President in his message stated how much was needed, but this bill is far short of what he said was needed, but this bill attempts to raise about eight hundred million dollars, so that you might use that as a figure.

Mr. ALVORD. I am going to discuss precisely that question as I go along.

We recommend, first, that this bill be scrapped in its entirety; second, that no revenue legislation be undertaken until a sound fiscal program embodying control over expenditures as well as raising revenues has been prepared, one which can be followed.

As I understand the purposes of the bill—I shall not attempt at the present time to explain its various provisions—but as I understand the purposes of the bill, they are, first to balance the 1937 ordinary Budget. I am coming to your point right now, Senator Barkley. The first purpose is to raise sufficient additional revenue so that the so-called general or ordinary expenditures of our Government will not exceed our revenues actually received, during the fiscal year 1937—the year ending June 30, 1937; second, to prevent tax avoidance; third, to remove inequalities; and fourth, to simplify our tax structure.

Senator BARKLEY. Let me ask you. You are advocating the balancing of the Budget, the ordinary expenditures, for the fiscal year 1937?

Mr. ALVORD. Yes, sir.

Senator BARKLEY. Do you include in the ordinary expenditures the additional amount required for the bonus?

Mr. ALVORD. Let me put it this way: I am referring to the 1937 Budget as submitted by the President on the 6th of January, coupled with the special message of the President of March 8, following.

The ordinary Budget was transmitted to Congress, as you know, before the Supreme Court decision in the *A. A. A. case* and before the enactment of the bonus. The March 3, 1936, message is designed to balance the 1937 Budget, additional revenues being necessary by reason of these two occurrences: First, the decision of the Supreme Court throwing out the processing taxes and the A. A. A. Act; and second, the enactment of the bonus.

Senator BARKLEY. Do you regard those two additional items as part of the Budget?

Mr. ALVORD. The President in his 1937 Budget includes somewhat in excess of $600,000,000 for farm relief.

Senator BARKLEY. That is in his supplementary message?

Mr. ALVORD. That is in the original Budget.

Senator BARKLEY. Of course, that was supposed to be offset by taxes then in force.

Mr. ALVORD. That is true, but taxes, also, are embraced in his estimated revenues of some 5 billion six.

Senator BARKLEY. Well, I do not want to take the time to pursue that further. However, you used the words "ordinary budget", and I think it is well to understand that we are here not because of the ordinary Budget, but because of the extraordinary Budget, the things that are necessary but that are not a part of the ordinary running expenses of the Government, and I want to know if you include these unforeseen items that have been the basis of this measure in your term "ordinary Budget"?

Mr. ALVORD. Farm relief clearly is one of the running expenses of the Government. However, I have no term "ordinary Budget." To me, there can be but one Budget, showing all receipts and all expenditures. That, in effect, is what is claimed for the present Budget, but the classifications in the present Budget, coupled with the President's message of March 3, require a segregation of certain expenditures into what are termed "regular" or "ordinary" expenditures, and second, into what are termed "emergency" or "relief" expenditures.

I have attempted to analyze for myself, at least, the policies upon which this bill is based.

I understand them to be about as follows: First, we should tax business profits at precisely the same rates, whether earned by corporations, partnerships, or individuals.

Second, the effective way of doing that is by taxing all those profits to the individuals and forcing the individuals to pay the tax upon them, with no tax upon the corporation. The individual pays whether or not those profits are distributed to him. And then we come to the third proposition—and this is where the difficulty comes since everyone agrees substantially with the first two propositions. The difficulty results from the fact that our constitution says that we cannot tax individuals upon the undistributed profits of their corporations. Consequently, the third proposition is that we will enact purely arbitrary provisions designed to bring about the same results regards of consequences.

It is the position of our committee——

Senator CONNALLY (interposing). Let me interrupt you right there. Do you agree that the really fair way to tax business income is to tax it in the hands of the ultimate taxpayer or stockholder or partnership?

Mr. ALVORD. Theoretically, Senator, that is very sound. Our difficulty comes, however, in administration.

Senator CONNALLY. I want your position on the record on that.

Mr. ALVORD. In theory, I agree.

Senator CONNALLY. That is the theory of this bill.

Mr. ALVORD. That is not the theory of the bill, as I will show you as I go along.

Senator CONNALLY. Forget the bill. Do you agree that the theory is sound that contemplates the payment by the ultimate receiver of the profits, who is the stockholder or business partner, that the tax ought to come out of him ultimately in the same ratio that his other income pays a tax?

Mr. ALVORD. Certainly, but bear in mind that what it does is to abandon over a billion dollars that you get from the corporations, forcing you to collect it instead from some tens of thousands of individuals. Theoretically it is sound; practically it is not.

Senator BLACK. I understood also that you said you agreed with the first objective of the policy you mentioned?

Mr. ALVORD. Yes, sir.

Senator BLACK. Would you repeat now that first policy which you say you agree with? The first one, as I understood it, was that all business profits, whether those profits are made through a corporation or by individual activities or partnership activities, or joint-stock activities, should be taxed on the same basis by the Government, if that can be done?

Mr. ALVORD. In theory that is perfectly sound.

Senator BLACK. In theory that is just and right?

Mr. ALVORD. Yes, sir.

Senator BLACK. And in theory, which we understand to be the fundamental principles of justice, any system which does not do that is discriminatory against certain citizens?

Mr. ALVORD. I admit that.

Senator BLACK. You admit it?

Mr. ALVORD. Yes, sir.

Senator BLACK. I thought that was what you said.

Mr. ALVORD. Yes, indeed. Our present law is admittedly arbitrary.

Senator BLACK. And discriminatory?

Mr. ALVORD. And discriminatory.

Senator BLACK. And unfair to the citizens?

Mr. ALVORD. And unfair to the citizens; yes, sir. But my difficulty is that the bill that is before you is far more arbitrary, far more discriminatory, and far more unfair.

Senator BLACK. That gets down to the simple issue——

Mr. ALVORD (interrupting). It gets down to practical application.

Senator BLACK (continuing). To the simple issue that you admit that the law as it is is unfair and unjust and discriminatory against citizens, and you are opposing this bill, and you propose now to show that, in your judgment, this one is even more unfair?

Mr. ALVORD. That is right; that is it exactly.

Senator CONNALLY. And it would take you 2 years to get one that would not be unfair?

Mr. ALVORD. We have tried for years to get some of the discriminations out of the present law and could not do it. Then we had something to work on. This is revolutionary. You are scrapping everything you have now and starting all over again.

I want to point out to you, first, that the 1937 Budget will not be balanced by this bill even if you include all the additional revenue from the additional sources which the administration has recommended.

Senator COUZENS. Let us talk about the bill and not about the Budget.

Mr. ALVORD. All right, sir; but I want to point this out to you, Senator, because it is important in connection with the consideration of the bill. Under the statement of the Secretary of the Treasury, only $310,000,000 can be expected from the corporation tax for the

fiscal year 1937; only $310,000,000 out of the $620,000,000 estimated to be necessary by the President in his message of March 3, 1936. It is just my honest opinion that if all you want to raise from corporations is $310,000,000 for the fiscal year 1937, you can do it much more readily and at much less risk by retaining the present law.

Senator BARKLEY. That would only apply for 1 year?

Mr. ALVORD. That is true.

Senator BARKLEY. The reason for that is that the fiscal year is only one-half of the calendar year for which this tax is applicable.

Mr. ALVORD. I also appreciate that it takes a very arbitrary provision adopted on the floor of the House to get you any revenue for 1937. But my better answer is precisely the words of the Secretary of the Treasury, who tells us that we cannot now consider estimates for 1938. Consequently, you are confined to a consideration of estimates for 1937.

One of the basic objections of the bill is to prevent tax avoidance. Undoubtedly there is tax avoidance under the present law. No one would claim otherwise. So far as we know, however, the statute is fairly adequate to prevent tax avoidance. The problem, the primary one, is of administration, and your present administration is very effective. But that is not the type of tax avoidance to which the officials of the administration refer in this bill.

They find tax avoidance in this single factor: Taxes are avoided if a corporation fails to distribute to stockholders money which the corporation needs in its business. To which I counter, the real issue now confronting you is not this kind of tax avoidance at all. The real issue is: How much more money do you want to get out of business profits? You are now getting about $900,000,000. This bill says, "Get $620,000,000 more." You are increasing the burden on business profits by two-thirds, excluding the amount of tax paid by individuals on dividends, which I think ought not to be taken into consideration. You are increasing your burden by two-thirds, and you are increasing——

Senator BARKLEY (interposing). By one-third, is it not?

Mr. ALVORD. $900,000,000; and you ask for $600,000,000 more.

Senator BARKLEY. Yes; that is right; two-thirds.

Mr. ALVORD. One of the further purposes of the bill is that it should remove inequalities. Now, let me get down to a practical discussion of these so-called inequalities.

The first inequality to be removed under the bill, stated in the majority report of the Committee on Ways and Means, is that inequality under the present law resulting from the imposition of different rates upon corporations and individuals. The statement in the report is based upon the fact that under the present law, corporations are taxed at a flat rate, graduated in the lower brackets by income; partnerships are not taxed at all; individuals are taxed upon their distributive shares of partnerships, and upon the dividends which they get from the corporation.

This bill is designed to remove that inequality, and the only illustration which I have seen used is the illustration of the different tax liabilities if I carry on business as a corporation, as a partnership, or as an individual.

And now, Senator Black, my first answer to you is this: Although that inequality theoretically exists, I am not worried a great deal about it, when all that the partnership or the individual has to do is to incorporate. If the individual incorporates, then he is taxed at precisely the same rate that other corporations are and at precisely the same rates that his competitors are. Secondly, I do not know of any existing partnerships, or any individuals, carrying on business of any substantial size in direct competition with industrial corporations. The inequality is theoretical, but it is not a practical one.

Senator CONNALLY. Your remedy to remove the inequality is to make everybody incorporate. Why would it not be just as fair to make everybody pay as they would pay as individuals instead of making them incorporate?

Mr. ALVORD. If we could do that, I would say go ahead and do it.

Senator CONNALLY. That is what we are trying to do.

Mr. ALVORD. That is not what you are doing, Senator. I think you will realize that as we go along.

Senator CONNALLY. You help us perfect this plan so as to accomplish what we are trying to do. That would be much better than scrapping it. You admit the theory is sound, but you want to scrap it. You help us patch it up and put in a new spark plug or two to get it going.

Mr. ALVORD. My services are at your disposal, Senator, but I must tell you that it will take 2 years to do it, and I think you will find out why as I go ahead.

Senator BLACK. Take a lawyer who works and gets an income, there is no reason why he should pay a greater percentage on that for which he works, is there, than an individual who buys some stock in a corporation should pay on those profits?

Mr. ALVORD. No.

Senator BLACK. You would not advocate lawyers incorporating, would you?

Mr. ALVORD. Of course that cannot be done. But lawyers are not in competition with corporations, and they are all on the same footing, so there is no practical inequality.

Senator BLACK. You would not recommend that even if you could?

Mr. ALVORD. No. It would be unnecessary.

Senator BLACK. You would not recommend it for doctors?

Mr. ALVORD. No, sir. The same applies to doctors.

Senator BLACK. As a matter of fact, it has been an idea in this country, and I think you probably would agree with it, that the man who obtains an increased income by work should not be compelled to pay any more than the amount that a man pays who increases that income by investment in a corporation?

Mr. ALVORD. This has been the solution for it—the solution which Great Britain adopted, and the solution which we adopted, in force for a great many years—give your professional men a credit for earned income. That cuts the rate down to somewhere near a reasonable rate. The present law is entirely inadequate, and I agree with you that there is a theoretical discrimination. I would be very glad to see a decreased tax on lawyers and doctors and other professional men.

Senator BLACK. You do not recommend that they be incorporated, do you?

Mr. ALVORD. No, sir; not at all.

Senator CONNALLY. They are usually too busy incorporating someone else.

Mr. ALVORD. Now, with respect to this first inequality, this disparity of tax between the business income of corporations, partnerships, and individuals, I am convinced it is purely a theoretical inequality. There is not enough in it to justify scrapping the present law and passing this bill.

The second inequity which this bill is designed to cure is the existing inequity, which I admit exists under our present law, resulting from a flat-rate tax upon the corporation regardless of the size of the income of its stockholders. Certainly you are collecting a 15-percent tax today in effect from individuals who otherwise would not be in that category. That is the second inequity of the present law which this bill proposes to remove.

Senator COUZENS. Is there any practical way of doing that, outside of the other impediments of the bill?

Mr. ALVORD. Certainly this bill does not do it.

Senator COUZENS. I asked the question whether there was any practical way of doing it, leaving aside for the moment all the other impediments of the bill.

Mr. ALVORD. Your individual credits are designed to take care of that in part. Your exemption from normal tax is designed to take care of it in part. By the time we get through making the computations you will find the disparity is not so great.

Senator COUZENS. I think it is very great.

Mr. ALVORD. Some discrimination is there, I admit. I do not know how to remedy it overnight.

Senator WALSH. Could it not be worked out by some division of profits?

Mr. ALVORD. That has to do with the rate a corporation pays. I think Senator Couzen's questions had to do with the rates imposed on the individual.

I cannot see how you are going to remove that inequity by merely varying the rate of tax which you impose upon a corporation, even to the extent of increasing it to 42½ percent, and then by also taxing the individual stockholders upon the dividends that they get from the corporation. Anyone agrees that this adds immeasurably to the disparities and inequities of the present law.

Senator COUZENS. I think we would have no difficulty in agreeing upon that, but under this bill it is assumed that an effort is to be made to distribute earnings. If that be the case, then there would be equity between the stockholders.

Mr. ALVORD. If all the earnings were distributed, yes, sir; and that brings me up to my next subject.

Senator GEORGE. Suppose all earnings were taxed with an adjustment made back to the individual stockholder in the lower brackets?

Mr. ALVORD. It does not remedy the defect that Senator Couzens sees because under the British system every stockholder pays 22½ percent.

Senator GEORGE. But an adjustment is made back to the stockholder who is in the lower bracket than 22½ percent.

Mr. ALVORD. He gets a slightly reduced rate.

Senator GEORGE. I thought he got a refund.

Mr. ALVORD. I do not believe so.

Senator COUZENS. That was the testimony here the other day, that where a person paid no tax in the dividends he received from a corporation, he goes to the Treasury and gets a refund if the corporation had to pay the tax.

Mr. ALVORD. I am talking about the first withholding by the corporation. When the corporation pays dividends and they are taxed, that is their contribution. It is quite true that when the individual subsequently makes up his tax return for that year if his tax liabilities are less than 22½ percent, then he gets the difference back through a very efficient system of refunds.

Senator COUZENS. Is that a practical scheme?

Mr. ALVORD. Very much more practical than this.

Senator GERRY. Do they work that on the same theory as collecting from the source?

Mr. ALVORD. Yes, sir.

Senator GERRY. And they do that with the corporation the same as they do with the individual?

Mr. ALVORD. That is the basis of the British system. Mr. Parker is here and he can tell you what percentage is collected at the source; he studied it very carefully. Mr. Parker says that about 75 percent of the British tax is collected at the source.

Senator CONNALLY. How about the tax paid at a higher rate than 22½ percent?

Mr. ALVORD. He pays a surtax.

Senator CONNALLY. He has to report that?

Mr. ALVORD. Yes, sir.

Senator CONNALLY. When?

Mr. ALVORD. For the fiscal year for which he receives a dividend. If it is not paid out, then the corporation pays 22½ percent on it, and the corporation can keep it just as long as it wants to.

I might point out to you that a plan almost identical with the plan of this bill was under consideration by the British for a period of 3 years, and a commission called the Colwyn commission, named after its chairman, rendered a very extensive report in which it rejected this system absolutely.

Senator GERRY. Would it not be very much easier for the British to make refunds than it would for us on account of the size of the country and the question of the States?

Mr. ALVORD. Senator, the only thing you would have to do, if you were going to adopt such a refund system would be to place great confidence in your administrative officials. You would have to give them that confidence, and they are entitled to it. Your refund machinery is also very slow. You have to have an effective machine which will turn out the refunds as rapidly as they come in. If you do that, I think the British system would work.

Now, let us come back to what seems to be the basic theory upon which this bill is supposed to work. Senator Couzens says it is designed to compel corporations to distribute all their earnings and

profits, so that those earnings and profits may then be taxed in the hands of the individuals.

Let us take a look at corporations generally. I group them into four classes from the point of view of dividend-paying ability—and here again we begin to see the difficulties confronting us.

First, we have the class of corporations restricted by law in payment of dividends. Some of those corporations are taken care of under the bill; many of them are not. For example, banks, fiduciaries, trust companies, insurance companies, are restricted by law in payment of their earnings in profits. They are taxed at special rates under the bill.

Senator CONNALLY. They are taxed at a flat rate.

Mr. ALVORD. That is true, though I might point out that, in the case of insurance companies, their additions to reserve are not included in taxable income.

A second group of corporations, taxed at a 15-percent rate, are those which, under the laws applicable to the declaration of dividends, cannot pay dividends. The law relating to the payment of dividends is about as complicated as any subject in the field of corporation law. Volumes are written about it; I won't attempt to cover it. Briefly, however, I will outline two general prohibitions. You have got to go to the laws of each of the States plus the common law to find out just what the law is, but there are two general principles:

First, a corporation cannot declare dividends if the payment of those dividends would impair its capital. There are a large number of corporations that do not come under this rule at all, but it is a general rule applicable to business corporations.

Second, a corporation regardless of earnings and profits, and regardless of capital, cannot declare a dividend if the payment of that dividend would render it insolvent. There are corporations that have a balance sheet showing accumulated earnings and profits of $10,000,000, but the payment of a penny might render them insolvent. They may already be insolvent. Their assets are tied up in plant and equipment.

The effort is made in the bill under section 14—in my humble opinion it is a very poor effort—to take care of the first rule, namely, that a corporation cannot declare dividends if it would impair its capital. Section 14 is not coextensive with that rule by any means. I will try to show you when we come to a discussion of it that no effort is made to take care of the second rule. You are going to force corporations to declare dividends, even if it makes them insolvent, or pay a 42½-percent tax.

My second class is those corporations prohibited by contract from declaring out all of their earnings as profits. Section 15 is designed to take care of these corporations, but again a very feeble effort has been made, limited only to past transactions and covering only an insignificant number of contracts. Ordinary contracts involved in bonds and debt agreements usually embody two provisions, neither of which is contemplated by this bill. The first provision is that the corporation must build up a sinking fund. Sometimes the contract requires the corporation to add a percentage of its earnings and profits each year to the sinking fund. More

frequently it requires the addition of a percentage of the debt to the sinking fund whether or not there are earnings and profits, but if there are earnings and profits, certainly the sinking-fund requirement must be met out of them. There is not a provision in the bill to take care of this situation.

A second very ordinary provision in bonds and debt contracts is that the debtor corporation must maintain a specified ratio of quick assets to quick liabilities, or a specified working capital. There is not a single provision in the bill to take care of this type of contract, although it is one of great importance, much more usual than the insignificant type of contract covered by the bill.

Third, we have the corporation prohibited, not by statute or by contract, but prohibited by sound common sense, by its business policy, from distributing dividends—the corporation which has a standing debt, with no contract provision for its retirement, and yet has to make additions, betterments, improvements, replacements, and that type of expenditure. There is not a provision in the bill to take care of these corporations, and yet they are in the same situation practically as corporations in the first two classes.

Fourth, we have the corporation which from the point of view of its current earnings and profits may distribute without limitation. Do you not see the tremendous advantage you are giving that corporation, a corporation of sufficient financial strength to declare out all of its earnings and profits of the year, which pays no tax at all?

Senator CONNALLY. The present law makes no discrimination as between all these classes?

Mr. ALVORD. It does not, because tax liabilities are not governed by the percentage of undistributed earnings.

Senator CONNALLY. They are all taxed under the present law at the same rate, upon their net income?

Mr. ALVORD. Yes, sir.

Senator CONNALLY. You do not give any advantages to the corporation that has to pay the sinking fund?

Mr. ALVORD. No; but the present law does not impose a penalty of 42½ percent. It may not give such a corporation an advantage, but it does not subject it to the positive disadvantage of a higher tax by reason of its weak financial position, as does this bill.

Senator CONNALLY. But the present law provides that whether they distribute earnings or whether they do not, the tax will be the same to the ultimate payer of the tax, and the corporation can then determine the necessity of declaring dividends without pressure from the big stockholders to hold them, and from the little stockholders to pay them out?

Mr. ALVORD. That is true.

Senator COUZENS. Have you in your mind or in your figures anything anywhere to indicate the number of corporations which have built up surpluses for the purpose indicated by Senator Connally, that is, of not distributing for the purpose of avoiding high surtaxes?

Mr. ALVORD. If that was the Senator's question, I missed it.

Senator COUZENS. It was not exactly his question but it was implied.

Mr. ALVORD. Senator, if I recall correctly in reading the hearings rather hurriedly, that precise question was asked in the House. It

was asked of the Treasury officials who were requested to give some estimate as to the number of corporations which are accumulating surpluses purely for tax purposes. I have not seen the answer. My own opinion of it is this——

Senator COUZENS (interposing). That is what I am trying to get.

Mr. ALVORD. That the number of corporations now accumulating excessive earnings and profits not needed in the business are very limited.

Senator COUZENS How limited?

Mr. ALVORD. Perhaps I can answer it this way: We have two provisions of the present law, section 102 and section 351, designed to force the distribution of money not needed in the business. My guess is that the Commissioner may send out maybe 5,000 deficiency letters a year under these sections.

Senator COUZENS. Is that about correct, Mr. Commissioner?

Mr. HELVERING. I think that would cover it, perhaps.

Senator COUZENS. That would indicate by that statement that there were probably 5,000 corporations out of 250,000 or more that do hold money up that is not needed?

Mr. ALVORD. Not at all. That merely indicates that there are about 5,000 which somebody thinks are holding up distributions.

Senator COUZENS. But their thinking so is based upon their income-tax returns.

Mr. ALVORD. It is the investigation of the revenue agent. He suspects that they are expressly withholding the money, but the number of cases finally closed asserting a section 102 penalty, for example, is in the hundreds rather than the thousands.

Senator COUZENS. The very statement itself indicates the inefficacy of the section, and that is what in part this bill was drafted to remedy.

Mr. ALVORD. I just want to add one statement, Senator. One reason that there are not more deficiency letters—I am not at all suggesting that the Commissioner is not doing a good job—one reason that there are not more is that those sections have real efficacy in that they do actually compel distribution of tremendous amounts, and of course those cases never show up in the statistics.

Senator COUZENS. You mean the influence of the section compels it?

Mr. ALVORD. The influence of the section compels it; yes, sir.

Senator WALSH. Senator Couzens, could we not get some information from the Commissioner where penalties have been imposed?

Mr. KENT. I supplied the clerk of the committee a few days ago with a memorandum which we prepared for the House Ways and Means Committee showing the present number of cases pending and the history in recent years of the Bureau's operations under those sections.

Senator WALSH. You imposed penalties under those sections?

Mr. KENT. Yes, sir.

Senator WALSH. How many a year on the average?

Mr. KENT. I would have to refresh my recollection on that.

Senator COUZENS. I think that is in the office here.

Mr. ALVORD. I would be very much interested in seeing that memorandum; I did not know it had been prepared.

The effect of those two sections, I repeat, comes in that they actually do compel substantial distributions, and it is only those taxpayers who think they can get by with it or do not know the law against whom the Commissioner actually proceeds.

Senator CONNALLY. The reverse of that is if there were not some urge to make it, a great many more would do it.

Mr. ALVORD. You are applying a policy for about 5,000 corporations in this country to every single corporation in the country.

Senator CONNALLY. No. You just stated that a great many more paid without being assessed because of the influence of the section, so you cannot limit it to the 5,000.

Mr. ALVORD. I am talking about the bill.

Senator CONNALLY. It would be several times that number.

Mr. ALVORD. In any event you have adopted that policy as a policy to be applied to all corporations.

Senator GERRY. Have you not got a provision in this bill where if a corporation is not earning more than $10,000, it pays a lower tax?

Mr. ALVORD. Yes, sir.

Senator GERRY. So if there were a corporation that had very valuable assets but very small earning power, it could pay a very much lower tax, and the very big corporation could be used for that purpose of not distributing even with a small number of stockholders.

Mr. ALVORD. That is very true, Senator. I think that point was brought out before you came in.

Senator GERRY. I wondered how many corporations like that there are. For example, I think the attention was called the other day to a mining corporation, but it seems to me that as this thing went, that that was a possible loophole right there, and a very big one, for an inequality.

Mr. ALVORD. I have never seen any statistics, and I do not suppose any exist. Generally speaking, we think that the strong corporation is one, which has two things, first, large assets, and, second, large income. But I quite agree with you, and that is where I differ with the "ability to pay" doctrine which the Secretary of the Treasury asserted the other day. He picks solely on annual income as a measure of ability to pay. Even if we should adopt that principle in the imposition of taxes—which I would do only with qualifications—the Commissioner picks solely on annual net income as a measure of ability to pay. He forgets entirely the importance of assets and property. Your point, Senator, is perfectly well taken. The bill says to a corporation possessing substantial assets, "If your income is small, your tax will be small."

Senator BARKLEY. The income-tax theory is based upon ability to pay according to the income and not according to the value of assets, out of which you take the tax.

Senator GERRY. There is another point right here on that, because this is a question of withholding, and they could pay very much less and go into the question of where it was held by very few people, and collect their assets in that way. I have not studied it enough, but it seems to me, under the testimony, that there was a possibility that it might be a loophole, and that is why I was seeking light. I think that ought to be looked into by the experts.

Mr. ALVORD. Certainly this inequity of the present law does not appear so great if you also include assets along with annual income in determining what our rate of tax should be.

Senator BLACK. May I ask you a question right there to get it clear with reference to that inequity? You made a statement a few minutes ago in answer to my question, and I understood you in one instance that it was theoretical largely, the inequity that exists. Now, I have here, and I want to ask you if I am correct—and I may be wrong in my assumption: Let us assume in the year 1930 there were two stockholders of a corporation, owning $1,000 of stock each. One of them is a very small income-tax payer, and he comes within the 4-percent bracket. His tax on that $1,000, if it went to him directly, would be $40, would it not?

Mr. ALVORD. Yes, sir.

Senator BLACK. And if it is paid through the corporation, it would be what?

Mr. ALVORD. Roughly 16½ percent, not including all of your corporation, income, excess-profits tax, and various franchise and other State taxes. He would get half of the balance after the payment of about 16½ percent by the corporation. You can say roughly that he has paid 16½ percent, if you want to look through the corporate structure.

Senator BLACK. He has paid four times as much——

Mr. ALVORD (interrupting). Before it comes to him.

Senator BLACK. As he would have had to pay if it had been a tax on dividend?

Mr. ALVORD. Exactly.

Senator BLACK. In other words, he has paid about $16 instead of about $4?

Mr. ALVORD. That is right. May I make my point clear right there? This bill does not remedy that situation in the slightest degree.

Senator BLACK. I want to get the picture of what the law is now. Let me give you another. Let us take another man who is getting that same $1,000 dividend. He has stock in the corporation and he is in the 72-percent bracket. How much tax would he have to pay on that $1,000 dividend if it came to him individually?

Mr. ALVORD. 72 percent.

Senator BLACK. What would that be?

Mr. ALVORD. Somewhere around $720.

Senator BLACK. If it does not come to him individually but it is paid out through the corporation paying the 16½ percent, how much would he have to pay?

Mr. ALVORD. The corporation has already paid 16½ percent, and he also pays about $720.

Senator BLACK. Not that year.

Mr. ALVORD. The next year.

Senator BLACK. How do you know he would pay it the next year?

Mr. ALVORD. He would unless he happens not to be in the same surtax bracket.

Senator BLACK. Suppose it is held in there for 15 years——

Mr. ALVORD (interrupting). That is different.

Senator BLACK. And in the meantime, the situation has entirely changed.

Mr. ALVORD. That is probably true, but your question was, if distributed to him.

Senator BLACK. I am talking about it being distributed in the same year that the corporation gets the 4 percent. In other words, how much income tax does he save?

Mr. ALVORD. Can I state the problem which I think is in your mind—that is, where the corporation does not distribute that year but retains it?

Senator BLACK. That is right.

Mr. ALVORD. The corporation will pay the 16⅔ percent, and the individual himself will not pay a single penny upon the amount withheld by the corporation, nor will the other stockholders. They will all be paying 16⅔ percent.

Senator BLACK. In other words, he will save as I figure it, about $560 on that $1,000.

Mr. ALVORD. You cannot call it a saving, because the corporation tax would be paid in any event.

Senator BLACK. The 16⅔ percent?

Mr. ALVORD. Yes.

Senator BLACK. If you take the 16 percent off, this man who is in the 72-percent bracket has failed to pay into the Treasury $560?

Mr. ALVORD. That is right.

Senator BLACK. The man who was in the 4-percent bracket instead of saving $560, has lost about $12, hasn't he?

Mr. ALVORD. That is right.

Senator BLACK. So that that is not really a theory, but as between those two, that is far more than a theory, and is the injustice which you mentioned a few minutes ago?

Mr. ALVORD. Yes, sir; this injustice or discrimination exists, but the bill does not cure it.

Senator BLACK. We will come to that after a little while, but if the bill did cure it, it would serve a very wholesome economic purpose and would be in the int rests of decency and judgment, would it not?

Mr. ALVORD. If we could go back to my second principle which I stated in the very beginning, yes.

Senator BLACK. If the bill as passed eventually does cure that inequity and fix it to where each of them has to pay according to his ability on the rates, it would accomplish a very wholesome purpose for the whole Nation.

Mr. ALVORD. I will answer that; yes. I sympathize with that. Your statement is a little too broad, though.

Senator BLACK. It is completely unjust for the little stockholder who gets a $1,000 dividend to have to pay more than he would have to pay if it was paid out to him, than to have the big stockholder who gets the $1,000 dividend have to pay about 10,000 percent less than he would.

Mr. ALVORD. I do not feel quite as strongly as you do about it. While theoretically it is unjust, I do not feel quite as strongly as you do about it for two reasons.

Senator BLACK. It is more than a theory to the two individuals, is it not?

Mr. ALVORD. I do not feel quite as strongly about it. I think it is still pretty much a theory.

Senator BLACK. You think it is still a theory?

Mr. ALVORD. I think it is very sound to collect through a corporation 16½ percent of the income going to individuals who otherwise would have no tax at all. Whether the rate should be 16 percent, I don't know. I can refer you to testimony, however, in previous years where it was testified that 12 percent is as high as you should go. The moment you get beyond common sense, the discriminations——

Senator BLACK (interposing). The 72 percent has become the policy of the Government for the man who comes within that bracket?

Mr. ALVORD. It is in the present law, but I hope it is not the established policy.

Senator BLACK. It is the law now.

Mr. ALVORD. Seventy-five percent now.

Senator BLACK. You, of course, oppose it; you are, of course, opposed to that high tax on high income tax brackets?

Mr. ALVORD. Yes.

Senator BLACK. But if we were to cut it down to 50 percent, the same thing would still be true?

Mr. ALVORD. That is right.

Senator BLACK. It is far more than a theory to the hundreds of thousands of small taxpayers who are required to pay a great deal more tax on their profits by reason of the fact that it is earned through a corporation than they would if it came to them individually. It is more than a theory, but is an absolute injustice, is it not?

Mr. ALVORD. Yes, sir, that discrimination exists, but this bill does not touch it.

Senator BLACK. That is what we are trying to do. But it is certainly also true, is it not, that it is completely and wholly unjust for this $1,000 dividend to be paid through a corporate device in such manner that one man who has little stock and gets a $1,000 dividend has to pay four times as much as he would have to pay on other individual earnings, while a man who happens to be in the higher income-tax brackets pays perhaps 1,000 or 10,000 percent less?

Mr. ALVORD. Senator, your solution in this bill does not eliminate this inequity at all; it merely increases the inequity. It increases it by keeping the rate up as high as 42½ percent. The big stockholders may save less, but the small stockholder stands to lose even more, unless full and free distribution can be made, which is not often the case.

Senator BLACK. Before we get to the remedy, that is the injustice and the inequity to which you referred in the beginning in stating that it is wrong and ought to be corrected?

Mr. ALVORD. That is true.

Senator BLACK. And that is a clear illustration of it, is it not?

Mr. ALVORD. That is true, but I do not feel quite as strongly as you do about it.

Senator BLACK. You mean as to the result?

Mr. ALVORD. That is right.

Senator BLACK. Whether you believe or feel the same as to the result, the result is there and it is wholly unjust under the American system or any other system?

Mr. ALVORD. It was that situation, Senator, which in the old days forced us to attempt to keep the normal tax rate and the corporation rate somewhere near the same.

Senator BLACK. The same thing would also apply with reference to the individual, that we absolutely abandoned the sort of income tax when it is paid through the corporation, insofar as corporation profits are concerned, but we keep it in existence as to the tax of individuals and partnerships.

Mr. ALVORD. Well, again, that does not worry me so very much practically.

Senator BLACK. Whether it worries you or not, it is true, is it not?

Mr. ALVORD. Yes, sir; it is true.

Senator BLACK. In other words, we have got an income tax where people should pay according to their ability and according to their wealth and their income; we have that graduated tax on individuals who make their money outside of corporations, but if the profit comes through the corporations, if it is paid through the corporation, that graduated tax does not apply, does it?

Mr. ALVORD. That is true. You remember, we abandoned the graduated tax on incomes in 1921.

Senator BLACK. I understand that, but even with the graduated taxes as we had it on incomes, that same inequity and injustice still applied, did it not, so long as the individuals who had the small amount of stock had to pay out of all proportion of what he had to pay on his profits from any other sources, but the man who was in the high brackets had to pay altogether less?

Mr. ALVORD. That is true; but it is not nearly as bad in practice as it sounds.

Senator BLACK. Whether or not it is bad in practice, it runs right through the system?

Mr. ALVORD. That is true.

Senator GEORGE. We will suspend now until 2 o'clock. The witnesses will please report in the District of Columbia Committee room at 2 o'clock.

(Whereupon, at 12 noon, a recess was taken until 2 o'clock of the same day, at the District of Columbia Committee room, Capitol Building.)

AFTERNOON SESSION

The committee reconvened at 2 p. m., at the expiration of the recess, in the District Committee room, Capitol Building.

The CHAIRMAN. The committee will be in order.

STATEMENT OF ELLSWORTH C. ALVORD—Resumed

The CHAIRMAN. Mr. Alvord, did they finish with you this morning?

Mr. ALVORD. No, sir; they did not.

The CHAIRMAN. You may proceed.

Mr. ALVORD. I think maybe I should review for the benefit of the committee the four classes of corporations which I enumerated this

morning in order that the committee can have those four classes in mind as I go through the provisions of the bill.

First, we have the corporation which is restricted by law in payment of dividends; second, we have the corporation which is prohibited by contract from paying dividends; third, we have the corporation which is prohibited by sound business policy from paying dividends; and, fourth, we have the corporation which, so far as its earnings and profits for the particular year are concerned, may distribute without limitation.

I might also point out as to these types of corporations that the nature of their income and the nature of their tax liabilities are about as varied as the number of corporations; and all the innumerable situations must be borne in mind if you are going to impose a reasonable, fair, and equitable tax burden.

For example, you have a corporation which is in a long-term production business, with peaks and valleys of income, waiting a long time to realize income.

Senator COUZENS. What about the installment houses?

Mr. ALVORD. I was going to make the comparison with the mail-order house, or the chain store, which has a very rapid turn-over and a substantial income each year. You also have the person who sells on the installment plan under the very technical terms of the existing law, who reports a fraction of his income in the year and spreads the other income over future years.

Now, with those situations in mind, let me point out, purely from the point of view of equity, what the pending bill does. It first imposes a flat-rate tax of 15 percent upon banks, trust companies, and insurance companies, regardless of the size of their income and even though, as I stated this morning, in no case does the net income of insurance companies include additions to the reserve required by law. They are all taxed 15 percent.

Certain corporations, for example corporations in receivership or bankruptcy, and certain corporations which have a peculiar type of debt or have a peculiar relationship between their accumulated earnings and profits and their net income for the year, will be taxed on a portion of their income at least 22.5 percent. All the other corporations are going to be taxed at rates varying from zero to 42.5 percent, depending entirely upon the ratio of their dividend declarations to their adjusted net income.

Now, "adjusted net income" is a very carefully and arbitrarily defined term, but a corporation which cannot distribute all its net income before the end of the year will be penalized as high as 42.5 percent by reason of that.

Now, adjusted net income has absolutely nothing to do with dividend-paying ability. Dividends are paid from earnings and profits. "Earnings and profits" is an accounting concept based upon accepted accounting principles which vary considerably, and upon the particular practices of the business. But generally, under State law, dividends are payable only out of earnings and profits.

Now, there is a great deal of difference between earnings and profit for dividend-paying purposes and net income under the law. They

are never the same. Let me give you just one illustration. I cite many of them in the memorandum which I will file with the reporter.

Under the present law a corporation which has a peculiar type of a security loss has earnings and profits diminished by the amount of that loss. No accountant in the world would disregard that loss in computing earnings and profits to determine the funds available for the payment of dividends, but the net income of that corporation completely disregards that loss. So that, for purposes of easy illustration, we have a corporation with a net income of $100,000, excluding the security loss of $100,000, with earnings and profit at zero and with nothing out of which it can pay dividends, and you tax it $42,500.

Senator COUZENS. What kind of a house would that be that would have a security loss?

Mr. ALVORD. Almost any corporation which has investments.

Senator COUZENS. Yes; but not these other kind of corporations which are producers, manufacturers, and so on?

Mr. ALVORD. Oh, yes, Senator. For example, it is very frequent for a corporation which is building up a cash position for the future to pay a debt, for example, to invest cash and to carry it forward until the maturity of the debt.

Senator CONNALLY. You say which had no net income?

Mr. ALVORD. Your statutory net income is $100,000.

Senator CONNALLY. How about an individual? What would happen to him?

Mr. ALVORD. He is in the same boat.

Senator CONNALLY. That is it exactly.

Mr. ALVORD. That is not the answer, Senator. The individual is not penalized $42,500 for it.

Senator CONNALLY. I do not know what the answer is. I asked you if the individual would be treated in the same way and you said he would be.

Mr. ALVORD. He is going to be taxed on $100,000; yes. That is rather obvious.

Senator WALSH. He is treated the same way for computation purposes but not for tax purposes?

Mr. ALVORD. That is right. In other words, you are going to penalize your corporation $42,500 by reason of that loss.

Senator CONNALLY. Let me get that straight. Suppose that same thing happened to an individual. He would be taxed just like a corporation, would he not?

Mr. ALVORD. He does not have a penalty. He is taxed at ordinary rates.

Senator CONNALLY. It might be more and it might be less, depending upon his income-tax bracket. Why is that an argument? If you are going to leave an individual in that fix why is it a discrimination to treat the corporation in exactly the same way?

Mr. ALVORD. Under the existing law you do treat the corporation in exactly the same way. You impose a tax on the $100,000.

Senator CONNALLY. In the case of the individual you may tax him 50 percent?

Mr. ALVORD. Depending on his other income; yes, sir.

Senator CONNALLY. Certainly.

Mr. ALVORD. But you are imposing a penalty upon that corporation of $42,500 by reason of the fact that it had a security loss.

Senator CONNALLY. No, because it made $100,000. It was not anybody's fault that it had a security loss with bad management of the corporation. If you had an individual loss he would pay just the same as the corporation. Do you think it is fair for the individual to be taxed and the corporation to be exempted?

Mr. ALVORD. You have the actuality to deal with.

Senator CONNALLY. That may be; but all that we have got before us is this particular bill.

Mr. ALVORD. That is in the bill.

Senator CONNALLY. Would you leave the individual in the same fix that he is in now?

Mr. ALVORD. No; he would not be in the same fix. You are not penalizing the individual. That is my point. You are penalizing the corporation $42,500 by reason of expenses not under its control. You are taxing a loss 42.5 percent.

Senator CONNALLY. Suppose it had not made a loss but made $100,000, then what?

Mr. ALVORD. Then its penalty would not be so big. You tax 42.5 percent on income of whatever nature, if retained.

Senator CONNALLY. I do not think you are quite frank with the committee.

Mr. ALVORD. I am trying to be. I am sorry.

Senator CONNALLY. If there had not been a loss, if no dollar of income had been lost, it could still pay out the $100,000 and pay no taxes, but because it did, in spite of the loss, still have an income of $100,000, it is taxed 42.5 percent.

Mr. ALVORD. It is not in spite of the loss; actually, there were no profits.

Senator CONNALLY. The loss has nothing to do with the taxes.

Mr. ALVORD. Yes, Senator; because the corporation, at the end of the year, has zero earnings and profits.

Senator CONNALLY. All right.

Mr. ALVORD. And yet you force it to pay $42,500.

Senator CONNALLY. Whether it had the loss or whether it did not have it did not have anything to do with its making $100,000?

Mr. ALVORD. That might be true for computing net income, but certainly its ability to pay dividends is decreased by $100,000.

Senator CONNALLY. That may be, but it is not a fair statement to say that this bill taxes the company because it had a loss.

Mr. ALVORD. Maybe I should state it with a sugar coating on it, but nevertheless the fact is you are taxing the loss 42.5 percent. That is just one of the many illustrations which I shall give in the statement showing the difference between earnings and profits and net income. Again, I remind you it is earnings and profits that govern dividend-paying ability and not net income.

Now, let me take up the next proposition. The bill requires the corporation to determine its earnings and profits, and then its net income, and then declare and pay dividends before the end of its taxable year. There isn't a corporation in the country that knows what its earnings and profits are before the end of the year. It takes months after the end of the year to make out its income-tax return and compute its earnings and its net income. That is only the beginning. After computing its own net income, it then goes on for several years with contests before the Bureau of Internal Rev-

enue, and perhaps with litigation before its income is finally determined.

The CHAIRMAN. Does not the carry-over provision cover that? If you pay too much then you carry over.

Mr. ALVORD. No. Take the corporation which makes every effort in the world to comply with the principles and the policy of this bill—it cannot be done, it just simply cannot be done. It will pay out too much, or it will not pay out enough. Your determinations must be made before the end of the taxable year, and your dividends must be paid. Now, that is just utterly impossible. That provision went in as an amendment on the floor of the House.

The CHAIRMAN. It went in to save some revenue?

Mr. ALVORD. It went in to give you revenue in 1937.

Senator CONNALLY. Under the present system what is the usual policy for paying dividends by the corporation? As a rule it is the 1st of January, is it not?

Mr. ALVORD. Your ordinary corporation of financial standing usually pays dividends quarterly. When its quarter begins depends entirely on the fiscal year of that corporation.

Senator CONNALLY. Is it not true that banks and financial companies are only taxed 15 percent and do not they usually pay the dividends on the 31st of December? How do they arrive at it and pay it out promptly on the 31st of December?

Mr. ALVORD. Suppose you were sitting on the board of directors of the corporation; we have a report made by the comptroller; he gives us his computation of earnings and profits, not of net income, and normally your dividends will be less than your accrued earnings and profits for the year, and you can declare your dividend. But when you attempt to specify accuracy to a penny, not only so that your dividends will compare with earnings and profits but also with adjusted net income, then you are just asking an absolute impossibility.

Senator BLACK. Where is that amendment, please, sir? Do you recall the page?

Mr. ALVORD. Section 13. You start back to section 13 to get your definition of net income.

Senator BLACK. 27(a)?

Mr. ALVORD. 27(a) says the only credit you get will be for dividends paid during the taxable year.

I will pass by this double and multiple taxation with just a short statement in my memorandum. I merely invite your attention to the fact that you have double and multiple taxation in its worst possible form in this bill.

Then I come to what I call complexities. I would like to point out just a few of them to you and then I will finish. It takes a man of the genius of Mr. Parker, or the ability of an expert accountant to make the computations under the bill. I do not profess to be able to make them exactly. I will just pass over them.

The CHAIRMAN. You could make them, could you not?

Mr. ALVORD. I do not know whether I could or not. I will tell you what we did. We tried to compute the tax liability of a corporation with a net income of $39,000 and a $10,000 debt, and it took an expert accountant eight pages within which to make the computation.

The CHAIRMAN. I want to say to your client that I think you could make it out in less time than that.

Mr. ALVORD. Thank you, sir.

Let me mention to you one subject which, so far as I know, has not been discussed with you at all. You will recall business trusts, joint-stock companies, and so on, are taxed as corporations. The moment I saw no change in that provision I anticipated the entire State of Massachusetts to come in here on the very broad and competent shoulders of Senator Walsh. This is the situation: bear in mind we are taxing a business trust, a Massachusetts trust.

Senator CONNALLY. You will have to stir them up when they print this today and they will be down here.

Senator WALSH. There are some of them probably still here.

Mr. ALVORD. My guess is they just haven't seen the bill yet. Now, you are going to tax a business trust, for example, based on its distribution, or its failure to distribute.

What is the situation of the Massachusetts trust? It falls entirely outside of the four classes of corporations specified by you. The legal power of a business trust to declare and pay dividends is governed by the provisions of the trust instrument under which it is created. Some of them can declare out all of their earnings and profits, some of them cannot declare out a penny of their earnings and profits, and what is more there is no power in any way to change the provisions of the trust instrument.

Senator WALSH. Which businesses are now using the so-called Massachusetts trust?

Mr. ALVORD. It is very common in Massachusetts; it is very common in Illinois, and very common in California.

Senator WALSH. I suggest you amend the Federal Trade Act to place the Massachusetts trust under the control of the Federal Trade Commission. They were escaping on the theory they were not a corporation.

Mr. ALVORD. In other words, Senator, you are going to have your Massachusetts trust stuck with a penalty of 42.5 percent when the trust instrument forbids the paying out of all or a portion of their earnings and profits of the year, and no one has the power to prevent it.

Senator WALSH. Some of the trusts include that provision.

Mr. ALVORD. Oh, frequently. Your trust instrument normally specifies exactly what can be paid out. My point is, that the trust indenture restricts the amount that may be paid out in dividends. There is typically no power to change it, and no power to avoid the tax.

The CHAIRMAN. Have you any constructive suggestions along that line, as to how to fix the bill in that particular?

Mr. ALVORD. My answer to that is "no."

The CHAIRMAN. Your answer is to put off the bill for 2 years. As you stated this morning, it would take 2 years to get it out?

Mr. ALVORD. It would take 2 years to get it out.

The CHAIRMAN. If you have got some constructive suggestions with reference to the Massachusetts trust, that is what we want.

Mr. ALVORD. I haven't had the time to give to it. I doubt if I could find the solution. Here is my statement. This is merely one

illustration of an arbitrary provision necessary to enforce another arbitrary provision.

The CHAIRMAN. Does that come in under section 15?

Mr. ALVORD. No. I will come to that in a second.

The CHAIRMAN. You do not think it is good, but you have no constructive amendment?

Mr. ALVORD. A simple provision, Senator, would be to tax your business trusts, associations, joint-stock companies, at a flat rate, as you do the banks and insurance companies. That is the only offhand solution I could give you.

Senator CONNALLY. You spoke about the terms of these trusts and contractual relations. Of course, nobody can contract against the payment of a tax.

Mr. ALVORD. That is true, and they are taxed under the present law.

Senator CONNALLY. So it is not sound public policy for the Government to ignore, I mean to fail to ignore the fact that they do make all sorts of contracts, and if we excepted all those things we would never collect any taxes, we would never be able to enforce any law, because the corporations and individuals would contract against doing the very things that they should do.

Mr. ALVORD. No. You tax them under the present law now. All of these contracts restricting the payment of various dividends have no effect at all upon Federal taxes.

Senator CONNALLY. Certainly not. You are urging that, though as a reason why the tax bill should not be in the present form, because they have obligations under contract.

Mr. ALVORD. Certainly. They should not be taxed the same as corporations when their ability to pay dividends is more restricted.

Senator CONNALLY. We cannot pay attention to that, because if we did we would never get anywhere.

Mr. ALVORD. Senator, you do not have to impose a penalty on them; you can tax them at a reasonable rate.

Senator CONNALLY. We tax them like we do anybody else that is not a corporation.

Mr. ALVORD. Yes; but no penalty.

The CHAIRMAN. Mr. Alvord, if you make an exception, where a State passes a law, such as you have stated in Massachusetts, would that be an invitation then for other States to do the same thing?

Mr. ALVORD. They are not created under the statutes of Massachusetts, they are created under general equity principles.

The CHAIRMAN. I thought you stated they had a statute in that State governing that.

Mr. ALVORD. No; they have no statute on that at all. It is called a common-law trust.

Senator WALSH. That is it exactly. It has no statutory standing at all. It was originally started as an investment trust, but it has gone out of that field. In every State in the Union they are known as Massachusetts trusts.

Mr. ALVORD. That is right.

Senator WALSH. While the Federal Trade Commission has jurisdiction over corporations and partnerships and individuals, there is some doubt whether they do have control over the so-called Massachusetts trusts, because they are not corporations or partnerships.

The CHAIRMAN. That is what we discussed on the floor of the Senate.

Senator WALSH. He is referring to that same type of instrument to carry on business.

The CHAIRMAN. All right, Mr. Alvord.

Mr. ALVORD. In the case of your Massachusetts trust there is complete lack of power to prevent the imposition of the penalty. In the case of the joint-stock company it takes 100 percent vote of the holders of its stock before it can amend the charter, and the charter is the thing that determines its dividend-paying ability.

Now let me get down to the computation of earnings and profits. We start out under section 13 (a) and we have a definition for adjusted net income. Then starting with adjusted net income, which is merely ordinary net income deducting tax-exempt interest on Government obligations, we then start to compute undistributed net income. Undistributed net income under the bill means your adjusted net income. Do not accuse me of getting too technical here, because that is the way it is in the bill. It means your adjusted net income minus two things, minus the dividend credit and then minus the taxes.

Then let us find out just by one simple problem what it means. Let me point it out to you. That has to do solely with the computation of earnings and profits under the bill.

Gentlemen, you recall five separate, distinct, and different computations of earnings and profits under this bill, and here they are: Your dividend credit under section 27 (a) incorporates section 115 (a). Which is the same as existing law. That section says that a distribution is a dividend if paid out of earnings and profits accumulated since February 28, 1913. So that under the bill you must first compute all your accumulated earnings and profits from February 28, 1913, down to the end of the taxable year.

Senator BLACK. Pardon me. You say that is in the old law?

Mr. ALVORD. Yes; that is in the old law. But you have to do that now for only one purpose, Senator. Most taxpayers do not have to do it.

Senator BLACK. Whatever the purpose is, it is being done now?

Mr. ALVORD. Only in very rare cases. The only issue, under present law, is whether or not that distribution will be taxable to the individual stockholder when distributed. Now those problems are pretty well ironed out. You have got your question of the pre-March 1, 1913, appreciation in value. You have got your question of depletion and depreciation. All of those questions have kept the Bureau of Internal Revenue busy for 20 years, but most of those things are pretty well ironed out. Most corporations are not concerned over it.

Senator COUZENS. They particularly apply to questions of liquidation, do they not?

Mr. ALVORD. Yes; if your distribution is not out of earnings and profits then that distribution reduces the basis is the first computation of the stock which, for the purpose of computing gains and losses, when you sell the stock or when you liquidate the corporation.

The second computation arises under section 14 (a). Section 14 (a) I have been told is designed to protect the corporation prohibited

by statute from declaring dividends, but it does not do that at all, it only bites off a very small part of the problem. Section 14 (a) does this: It says that if accumulated earnings and profits from the beginning of the corporation down to the beginning of the taxable year, plus earnings and profits during the taxable year, to which you add back distributions out of earnings and profits during the taxable year—if that is less than your adjusted net income for the year so that you have a deficit, then you will be subject to a 15-percent rate on the amount of the deficit and the normal rate of the balance.

Now, let me show you what that requires. It requires a computation of earnings and profits from the date of organization of the corporation down to the beginning of the taxable year in the case of corporations existing prior to March 1, 1913.

Senator WALSH. Do you think you will be required to go behind that time?

Mr. ALVORD. Oh, yes; that is what it says, absolutely. I do not think there is any doubt about that.

The CHAIRMAN. The House intended to fix it February 28, 1913?

Mr. ALVORD. It certainly did not.

Senator BLACK. Is that in section 14?

Mr. ALVORD. That is section 14 (a); yes, sir. The House certainly did not so limit it. If you do so fix it then it means you abandon completely your test of dividend-paying ability, to the extent that that is a test. So that is your second computation of earnings and profits.

Your third computation of earnings and profits is the earnings and profits within the taxable year involved, 1936 for example.

Your next computation of earnings and profits is a computation again of earnings and profits limited to the taxable year in determining whether or not dividends have been paid out of it.

Now I will sum this up by telling you that I am quite certain that there are no fixed, uniform rules governing the computation of earnings and profits. You cannot get an accountant to agree, you cannot get a businessman to agree, you cannot get an economist to agree on that. Earnings and profits are probably the most flexible thing in the whole accounting system. We say that they are computed according to sound accounting principles and the usual practices of the particular business.

Senator BLACK. How is it done now?

Mr. ALVORD. It is not particularly important, Senator, now.

Senator BLACK. It is not particularly important to know about your profits when you come to make up your income-tax return?

Mr. ALVORD. No, sir.

Senator BLACK. All that I have seen showed the profits.

Mr. ALVORD. You cannot find an income-tax return which requires you to state earnings and profits.

Senator WALSH. That is net income, is it not?

Mr. ALVORD. It is not net income. Just before you came in, Senator, I stated there were innumerable differences. Many of them are here in the written statement that I have, showing you the differences, regular, sound, every-day existing differences between earnings and profits and net income.

Senator BLACK. You mean as between gross earnings and net earnings?

Mr. ALVORD. The so-called phrase of "earnings and profits" is very different from gross income and very different from gross earnings.

Senator CONNALLY. Some profits might be made from some other source than current income?

Mr. ALVORD. That is true.

Senator CONNALLY. Increasing the value of assets and things of that kind?

Mr. ALVORD. That is true.

Senator CONNALLY. That is a factor that makes them variable, is it not?

Mr. ALVORD. No; it is a fact that there are no uniform rules.

Senator CONNALLY. When you say "income and profits" that means something more than income, does it not? You would not use the word "profits" if it was confined to income?

Mr. ALVORD. As a lawyer I would say they mean the same thing. As an accountant perhaps they are different.

Senator BARKLEY. In making out an income-tax schedule under the present law the net income, which is the only thing required to be stated in the return itself, requires a process of calculation by which that is arrived at?

Mr. ALVORD. As to earnings and profits, no, sir; there is no place on the tax return, as far as I know, for that.

Senator BARKLEY. Whether it is in the tax return or not, somebody has got to calculate it.

Mr. ALVORD. True. The accountants do it. The books of your corporation will show it. Your accounting report will show it at the end of the year.

Senator BARKLEY. If the Treasury wants to check up on it there has got to be a record somewhere by which they arrive at this net sum that they include in their income-tax reports.

Mr. ALVORD. What they do, Senator, is to require you to file a very complicated schedule in which you attempt to reconcile the net income shown on your tax return with your books. It causes a great deal of difficulty.

Senator BARKLEY. They do that with respect to individuals too. If there is any question about the tax that you pay as an individual you have got to have something to show that the computation is correct.

Mr. ALVORD. Let me give you a little illustration which I think you will be interested in, Senator. Take a corporation which has securities which cost $1,000,000. The market goes down and they are worth $100,000. The board of directors, believing it is following a sound financial policy, meets and says, "Hereafter the books of the corporation shall show those securities to be worth $100,000 rather than $1,000,000." They had been carried theretofore at cost. I will gamble with you that the Bureau of Internal Revenue will never deduct that $900,000 in computing earnings and profits unless it is to its advantage.

Senator CONNALLY. Why should it do that when you will not allow an individual to do that? He can only deduct $2,000 as a loss.

Mr. ALVORD. Very well, Senator. Your tax is based on net income, but it is going to be governed by a dividend-paying ability, which

in turn is governed by earnings and profits. I just showed you how impossible it is to compute earnings and profits, and you require five different computations under the bill.

Senator BLACK. If you could not compute earnings and profits could you compute net income?

Mr. ALVORD. Oh, yes. Your statute tells you what to put in the net income.

Senator BLACK. The statute tells you what to put in the net income, but you get that by starting out from your gross income and your gross expenses, and you finally arrive at your net income. It seems to me like those figures would come in whether they have been uniformly put on the income-tax returns or not.

Mr. ALVORD. I do not know that I can explain it further than this: Your income-tax return starts out, after you get through giving your name, in the case of the corporation: "Proceeds from the sale of goods; gross receipts from the sale of goods", and then it allows you certain specified deductions from that, such as cost of goods sold, which you compute by the inventory method, such as labor and so forth. Never do you approach the earnings and profits of the corporation. You start with specified items to be included in gross income, and then from that you deduct certain specified items.

Senator BLACK. The expenses?

Mr. ALVORD. You normally call them expenses. Now, suppose down in your State a very wise corporation set aside $100,000 to protect themselves against floods, a noninsurable risk, out of earnings and profits this year, or $10,000 a year for 10 years. It is nondeductible, and you pay a tax on it anyhow, but you pay at a fairly reasonable rate. Under the bill you make it pay 42.5 percent.

Senator BARKLEY. Take the case of your $1,000,000 worth of securities that you have been carrying on the books at par, and then the board of directors decided, all of a sudden, to write off all of it but $100,000, of course they still retain the stock in their portfolio.

Mr. ALVORD. That is right.

Senator BARKLEY. Suppose they sell it; what happens?

Mr. ALVORD. If they sell it, they then get $900,000 loss—which again is not allowable in computing net income. I am talking about earnings and profits.

Senator BARKLEY. That is a real loss instead of a speculative loss.

Mr. ALVORD. That is a real loss, Senator, and you still do not allow it. Here is the difference, Senator—and that is why I spent some time on this thing—the difference is whether your corporation is taxed at 15 percent or 42.5 percent. Now, to me it is almost unbelievable that Congress would impose either a 15-percent rate or a 42.5-percent rate, based on computations which, in effect, no one can make and which, at least, will be variant for all your taxpayers. Certainly they will give you a figure on earnings and profits, but the earnings and profits will seldom be computed on the same basis, and the tax levies on one or the other will vary tremendously.

Senator CONNALLY. Will not the Commissioner of Internal Revenue under this bill make regulations to make it uniform?

Mr. ALVORD. I am glad you asked that question, and I am glad I do not have to write the regulations.

Senator CONNALLY. I observe that it is much easier to tear up a bill than it is to write it.

Mr. ALVORD. Nobody knows it better than I do. I can stand here and tear it down easily.

Senator CONNALLY. And it will take you 2 years to put it together.

Mr. ALVORD. Yes; it will take 2 years to put it together. Destructive criticism is simple, that is why I hesitate to do it.

Senator CONNALLY. If you were Commissioner of Internal Revenue, and this bill were passed, would not you issue some regulations that would be general in their application, and do away with what you are saying there in the case of the varying conditions in two different corporations?

Mr. ALVORD. Certainly, I would have to do something.

Senator CONNALLY. Would you do that?

Mr. ALVORD. I would do the best job I could.

Senator CONNALLY. You would try to?

Mr. ALVORD. Yes; I would try to.

Senator CONNALLY. If he sees that the interest of the Government would be hurt, he would do the fair thing.

Mr. ALVORD. No doubt about that. He will do the very best job he can. The question is: How good a job can he do? He would do the best job he can possibly do in the time available. What does the Commissioner have to do under this bill? He has to get the regulations out to the taxpayers. Certainly he ought to get them out not later than the first of September. The bill becomes law in June. He has June, July, and August. It is going to be a pretty hot summer in the Bureau of Internal Revenue. I do not think he can do it.

Senator CONNALLY. That is their trouble.

Mr. ALVORD. No; I do not think you ought to inflict the impossible on them.

The CHAIRMAN. You cited a case of some concern in fixing its deductible net income, and so on, where it carried flood-control insurance to the amount of $100,000.

Mr. ALVORD. Yes.

The CHAIRMAN. In all your experience do you know of any concern that carried flood control as an item of that kind?

Mr. ALVORD. In reserves?

The CHAIRMAN. Yes.

Mr. ALVORD. Certainly they carry contingency reserves. All of the very large corporations carry contingency reserves.

The CHAIRMAN. Flood-control reserves?

Mr. ALVORD. I mean damage by flood. Certainly they carry contingency reserves. You will see it in the balance sheets of almost every corporation in the country.

The CHAIRMAN. I thought that was just a little far-fetched.

Mr. ALVORD. The items that go into the general reserve for contingencies are submitted.

The CHAIRMAN. If it has its own insurance, do you think that ought to be deductible?

Mr. ALVORD. Deductible for what purpose, Mr. Chairman? In computing net income?

The CHAIRMAN. In computing its adjusted net income.

Mr. ALVORD. I do not think that the Bureau would allow a reasonable reserve for self-insurance.

The CHAIRMAN. I thought you would take that position.

Mr. ALVORD. I am talking now about computations of earnings and profits. Let me give you another illustration. In computing earnings and profits under 115 (a), as I read it, it provides that if a corporation makes a liquidation in kind, or if a corporation pays scrip to pay $100,000 dividends or gives a note, that note has a market value on the day that it is given. That is a very broad assumption, but we will assume that it had a market value on the day that it is given of 95. Under section 115 and under section 27 (a) the corporation gets a dividend credit of only $95. What does it get? How much of a deduction is there in computing earnings and profits under section 115 (a) and how much of a deduction is there in computing earnings and profits under 14 (a)? There is just no answer to it.

Well, now, I will end this by telling you that these are just facts that I have been talking about so far. I give you six very specific questions in this memorandum, each of which you will find governed by decisions and usually the court decisions are conflicting. They relate to the computation of earnings and profits. If you were to ask me about any one of these six questions, I could not give you the answer, and I could not give you the answer by the end of this year. I can tell you what the various courts have decided, but that is all.

Well now, I think I have probably taken as much time as I should on section 14.

Senator WALSH. I would like to ask you a question. The purpose of this bill is to encourage the distribution of net earnings by corporations by requiring them to pay dividends to their stockholders. It is argued that that is a restriction amounting to a penalty upon a corporation that desires to accumulate a reserve, and that corporations ought not be subjected by law to penalties because of that worthy objective. Now, I will inquire from you if section 113 does not remove that objection.

Mr. ALVORD. Section 113?

Senator WALSH. Yes.

Mr. ALVORD. You mean section 14, do you not?

Senator WALSH. Section 115.

Mr. ALVORD. No; there is nothing in section 115, as far as I know, which even touches the problem.

Senator WALSH. That provides for distribution of rights instead of cash?

Mr. ALVORD. Yes.

Senator WALSH. Why does not that leave the corporation plenty of opportunity for all the reserves it needs? It seems to me, as far as I have been able to understand the question, that is vital, that is the heart of this bill. Let me hear your views about that.

Mr. ALVORD. It will take me quite a while to discuss it, but let me give you a typical example. Suppose you and I are the stockholders of a corporation. You happen to be a public official and, therefore, not very wealthy, and let's assume that I happen to have money.

Suppose we want to issue rights. Let us assume we both own 50 percent of stock now. Suppose we wish to issue some stock rights requiring each of us to pay $50,000 back into the corporation. Have you got the $50,000 to make the contribution? The answer is "no."

Senator WALSH. But the rights are worth $50,000.

Mr. ALVORD. Oh, but they are not, Senator, if your stock is selling below par, because under ordinary corporation law a corporation cannot issue its own stock for less than par. I am making rather broad statements for the purpose of illustration. Now, suppose the stock in the market is selling for 75, are you going to get very elated about your opportunity to pay 100 for it? You can go out in the market and buy all you want for 75. Your stockholders are not going to pay 100.

Senator WALSH. Then you do not think section 115 is of special value?

Mr. ALVORD. No, sir.

Senator WALSH. Representations from industrial concerns and financial concerns indicate to the contrary. They say they would be unalterably opposed to this bill if it was not for that section.

Mr. ALVORD. This morning Mr. Osgood and Mr. Fernald both discussed the possibilities under section 115 and the issuance of scrip, but not at length.

Senator WALSH. I did not hear that, I am sorry.

Mr. ALVORD. I would be glad to give you more testimony on it.

Senator WALSH. I will read the record.

Mr. ALVORD. My answer is that section 115 only covers 50 percent of the cases.

Senator BARKLEY. Your illustration of the ownership of all the stock between you and Senator Walsh is hardly typical.

Mr. ALVORD. Senator Black will tell you that is a favorite device of the majority in control to get rid of the minority. That is a favorite device, is it not, Senator?

Senator BLACK. Well, that along with others is successful in most instances.

Mr. ALVORD. That is only one. What you do is to force the individual to give up his share of the equity in the corporation every time he hasn't got the money to pay back into the corporation to buy more stock.

Senator BARKLEY. My observation has been that most of these rights are issued carrying with them some particular special privilege. I see that a great number of them are to the stockholders. If the stock is registered on an exchange they register the rights and the rights are bought in by the public just like the stock is bought in by the public, because presumably by paying 1½ or 2½, whatever the rights may sell for, they obtain some advantage in the purchase of the stock which inures originally to the stockholders.

Mr. ALVORD. Let me answer your question directly. My difficulty with the whole bill is that it is based entirely too much on theory and not on practice. There are, if I recall the figures, only about 4,000 corporations in this country registered on the stock exchange. What are you going to do with the other 450,000? They are the fellows I am talking about. The 4,000, if anybody can, can take care of themselves, but you have got 450,000 more for which there is no readily available market value not only for securities but for rights.

Senator BARKLEY. What proportion of these 450,000 that are not registered issue rights?

Mr. ALVORD. You are going to force them to under this bill.

Senator BARKLEY. That is not an answer to my question.

Mr. ALVORD. They do not do it.

Senator BARKLEY. That is what I thought.

Mr. ALVORD. They do not do it under the present law, Senator, because they do not have to. If you enact this bill, instances are so numerous I am afraid I might confound you. Take the ordinary case of an industrial corporation which has an inventory—most of them do—and let us say that after the end of the year its inventory depreciates in value; but its income is computed on an inventory of a high value. Take your hides up in Massachusetts, Senator. They gave us trouble for years. Within 3 days the price of hides fell down about 10 percent, if I recall, of their prior value.

Senator WALSH. And sometimes more than that.

Mr. ALVORD. Now, how are they going to pay a dividend? They are going to have to give something for it, and if they give a piece of paper, the piece of paper will not be worth anything, or it will be of such small value that the dividend credits the corporation gets might as well go out of the window.

I will close by telling you that section 15 with respect to contracts not to pay dividends will not cover 1 percent of your cases. Bear in mind that contracts not to pay dividends are seldom in those specific terms. Your provisions, as developed this morning, are of two types, but are of all the various kinds that the imagination of a lawyer can devise.

Senator BARKLEY. What do you suggest as a substitute so it will cover all the cases?

Mr. ALVORD. If you want to cover all the cases, I would take some such classification as I have given you. First of all, the corporation is forced by statute not to pay dividends. Tax at a flat rate. If a corporation is prohibited by contract, you do not care what contract it is. It does not make any difference whether it has any specified wording in it or not. If it is prohibited by contract from declaring dividends, tax it at a special rate to the extent it is so prohibited.

Then when you come to corporations prohibited by business policy, I do not know of any other solution, if you are going to keep them on a reasonable relative basis, but to tax them at a flat rate. That means scrap the bill and tax under the existing law.

Senator WALSH. That means this bill goes out of the window.

Senator CONNALLY. On the whole, Mr. Alvord, you favor the flat corporation tax rather than any plan of this kind?

Mr. ALVORD. Certainly, without any question, and I think as certainly I would favor the British method over this. In my opinion, this is the worst conceivable attempt, the worst conceivable method for the taxation of corporate profits.

Senator CONNALLY. Although you agree to the soundness of the theory?

Mr. ALVORD. The theory; yes, sir. What I have been trying to give is absolutely nothing but a practical application of that theory. I have only skimmed the surface. I have covered the subject more fully in my memorandum.

The CHAIRMAN. That may be included in the record.
Mr. ALVORD. Thank you.
(The memorandum is as follows:)

Our committee recommends that:
(1) The pending bill be scrapped.
(2) New taxes should not be imposed until after a sound fiscal program for both expenditures and revenues has been prepared.
I shall discuss the application and effect of the specific provisions of the bill, relating to the proposed new corporation tax.

II. PURPOSES AND POLICIES OF THE PROPOSED CORPORATION TAX

Briefly summarized, the earnings and profits of a corporation are taxed under our present tax laws as follows:
(1) A flat-rate tax upon the net income of the corporation, graduated from 12½ percent upon net incomes not in excess of $40,000; (2) the imposition of a surtax upon dividends distributed to individuals, graduated from 4 percent upon surtax net incomes in excess of $4,000 up to 75 percent upon surtax net incomes in excess of $5,000,000; and (3) the imposition of penalties to compel corporations, of the classes described and under the conditions specified in the statute, to distribute their earnings and profits. Associations, joint-stock companies, business trusts, and the like are taxed as corporations. The incomes of individuals and of partnerships are subject to a normal tax of 4 percent and to the surtaxes at the above rates. The present corporation income tax is estimated, in the Budget, to yield for the fiscal year 1937 in current revenues $823,600,000.
The bill as passed by the House of Representatives proposes to substitute an entirely new method of taxing corporate incomes. Its more important provisions may be outlined as follows: (1) A tax is imposed upon the "adjusted net income" of the corporation, at graduated rates which are based upon the ratio of its undistributed net income to its adjusted net income; (2) dividends received by a corporation are included in its taxable income; (3) individuals are subjected to an additional tax of 4 percent upon all their dividends, both common and preferred, which also remain subject to the surtax of the present law; (4) banks, trust companies, insurance companies, and corporations in receivership or bankruptcy are taxed at the flat rate of 15 percent; (5) foreign corporations are taxed at the flat rate of 22½ percent; and (6) under certain circumstances, and in the case of certain types of income, a flat rate is imposed, for example, a rate of 15 percent upon the amount necessary to restore a deficit in earnings and profits; a rate of 22½ percent upon the amount which, by reason of specific contract provision, cannot be paid in dividends; and a rate of 22½ percent upon certain amounts to retire certain types of indebtedness existing prior to March 3, 1936.
After reviewing the message of the President, the report of the subcommittee of the Committee on Ways and Means, the testimony of the officials of the administration, and the report of the majority members of the Committee on Ways and Means, and after an attempted analysis of the provisions of the bill which has just passed the Houses of Representatives, I have summarized the purposes of the bill and the policies upon which it is based.
The stated purposes are—
(1) To "balance" the 1937 budget except for "the item for relief"—that is, to raise additional revenues for the fiscal year 1937 adequate to meet the so-called regular or ordinary expenditures for the year ending June 30, 1937;
(2) To prevent tax avoidance;
(3) To remove inequalities; and
(4) To simplify our tax structure.
The policies upon which the pending bill is based, as I understand them, may be fairly outlined, as follows:
(1) All business profits should be subjected to the same tax, whether earned by a corporation, partnership, or individual.
(2) To accomplish this aim, the individual stockholders should pay the tax upon their corporation whether or not its profits are distributed.
(3) Inasmuch as our Constitution prohibits the taxation of individuals upon the undistributed profits of a corporation, we should adopt an arbitrary substitute for our present system, regardless of consequences.

III. SUMMARY OF OUR POSITION

In direct contrast to the above-stated purposes and policies of the pending bill, it is our position that—

(1) The 1937 Budget, excluding the item for relief, will not and cannot be balanced, even assuming that all the additional taxes recommended by the administration are imposed.

(2) The staggering statements of tax avoidance under our present system are unfounded.

(3) The inequalities, which the proposal is designed to remove, do not exist in fact; and inequalities and discriminations will result far greater and more serious than those alleged to exist.

(4) Our income-tax structure will be overburdened by the complexities, ambiguities, and inadequacies superimposed upon it by the pending bill.

(5) The same income is subjected, unnecessarily, to double and even multiple taxation.

(6) The proposal is utterly impractical, unworkable, and unsound.

IV. THE 1937 BUDGET

On March 3, 1936, the President stated:

"On January 3, 1936, in my annual Budget message to the Congress, I pointed out that without the item of relief the Budget was in balance;" and then stated that $620,000,000 must be raised by some form of permanent taxation by reason of estimated losses in revenue as a result of the decision of the Supreme Court of the United States in the so-called *Agricultural Adjustment Administration case*, and the enactment of the Adjusted Compensation Payment Act, both of which occurred after his annual Budget message. The majority report of the Committee on Ways and Means states specifically that the bill is based upon the President's request.

A discussion of detailed figures is now not necessary to support my previous statements that the new corporation tax will not and cannot increase revenues for 1937 by the required $620,000,000. The Secretary of the Treasury, before the Finance Committee, on Thursday of last week, confirmed my opinion. He stated: "The net additional revenue to be expected from the application of the corporate income tax is estimated to be $310,000,000 in the fiscal year 1937."

If the administration is satisfied with $310,000,000 of additional revenue from corporations for 1937, it is my opinion that the realization of this amount will be more certain and the risks considerably less hazardous, if the present method of taxing corporation incomes is retained.

V. ASSERTED TAX AVOIDANCE

Unquestionably there is some tax avoidance under present law. It seems to be generally admitted, however, that our existing statutes are adequate. The problem is primarily one of administration.

The pending bill, however, is not designed to prevent tax avoidance of this character. The majority report of the Committee on Ways and Means and the Secretary of the Treasury base their statements of tax avoidance solely upon the amount of taxes which would have been paid if all corporate income had been distributed to stockholders. It would seem to me that we should also be told that the full corporation tax upon the income referred to has been paid; that corporations paid in 1935 practically $550,000,000 in income, capital stock, and excess profits taxes; that the Treasury estimates over $700,000,000 for this year, and practically $1,000,000,000 for 1937; that corporations paid in income taxes from 1925 through 1936 (a period corresponding as closely as available statistics permit, with the period used by the Treasury statistician in his testimony before the Committee on Ways and Means) the sum of 10¾ billions of dollars; and that we should be advised of the amount of the undistributed corporate income which safely, soundly, and legally could have been distributed.

The present law is adequate to compel the distribution of substantially all the profits not needed in the business of the corporation. Sections 102 and 351 of the present law are quite effective. It seems to me that the pending bill cannot be supported by such assertions of tax avoidance. The real issue is whether earnings and profits needed in the business of the corporation should be taxed at the rates and in the manner now imposed.

VI. ALLEGED INEQUALITIES IN THE PRESENT LAW

I readily admit that arbitrary provisions of the present revenue law result in numerous inequalities, inequities, and discrimination. The advocates of the pending proposal, however, claim that it will remove only two of them. All the rest of them, including the truly serious and unnecessary provisions, remain.

The inequality, which is alleged to exist in our present system and which the proposal is primarily designed to remedy, is the taxation of business profits of corporations, partnerships, and individuals at different rates. Comparable tax liabilities upon the business incomes of corporations and partnerships are cited. But the answer is a practical one. Individuals and partnerships seldom, if ever, carry on business of any substantial size in competition with corporations. Furthermore, this theoretical inequality can readily be cured by the formation of a corporation. Any businessman, feeling the effect of a discriminatory tax burden, in favor of an incorporated business and against himself as an individual or a member of a partnership, can transfer his business to a corporation and carry it on under tax liabilities identical with those of his competitor. Certainly no one can become unduly alarmed about the possible existence of an inequity which can be cured by the taxpayer himself, at slight expense and no inconvenience.

A secondary inequity to be removed by the present bill is that between large and small shareholders resulting from the present flat corporation rates. I cannot believe that this is urged seriously. The advocates of the new principle acknowledge that earnings must and will be retained by the corporation. Large and small shareholders alike will bear the tax and penalties to be imposed upon corporations by the pending proposal. I find it difficult to appreciate how an inequity existing by reason of a 15-percent rate will be removed merely by changing the rate and perhaps by increasing it to 42½ percent. If small shareholders are bearing too great a relative burden under the present law, the remedy must lie in another direction.

VII. INEQUALITIES INHERENT IN THE PENDING BILL

At the time of our appearances before the Committee on Ways and Means, a bill embodying the proposals was not available. Our testimony was necessarily based upon the subcommittee's report. Nevertheless, it was a relatively simple task to point out innumerable inequalities and discriminations, all of which must necessarily result.

Before entering upon a discussion of them, however, it may be helpful if I group corporations into one or more of four classes from the point of view of their ability to pay all their earnings and profits in dividends:

(1) Corporations restricted by law in the payment of dividends—such as banks, insurance companies, and fiduciaries which are compelled by statute to set aside in a reserve a portion of their earnings and profits; and corporations prohibited from declaring dividends, which, for example, would impair capital;

(2) Corporations prohibited by contract from paying dividends, for example, by a clause in a mortgage indenture requiring the retention of annual earnings and profits to retire the indebtedness, or to maintain working capital ratios;

(3) Corporations prohibited by sound business policy from paying dividends—such as a corporation having an outstanding indebtedness, a portion of which, as a matter of sound financial policy, must be retired annually out of earnings and profits; and a corporation which must finance, out of its earnings and profits necessary additions or replacements, or prepare for future losses; and

(4) Corporations which can pay out in dividends all their earnings and profits of the particular year.

We must also not overlook the fact that some corporations, both small and large, have already accumulated an adequate surplus to carry them over future business exigencies, while others have little or no surplus. Some corporations are well financed and have excellent credit standing, while other corporations, regardless of size, or current income, have a weak financial structure and poor credit. Corporations earning reasonably large incomes are able to employ competent counsel and consultants, while smaller corporations usually follow less reliable advice. Some businesses provide reasonably steady income, while violent fluctuations are common in other fields.

Let me now examine the application of the pending bill.

(1) The bill discriminates in favor of certain businesses and against others. For example, banks, trust companies, and insurance companies will be taxed at the flat rate of 15 percent, while income from other business enterprises may be taxed as high as 42½ percent.

(2) Corporations in receivership or in bankruptcy are taxed at the flat rate of 15 percent, whereas corporations in active competition with them will be taxed at higher or lower rates contingent upon their dividend-paying ability.

(3) The American income of foreign corporations is subjected to a 22½-percent tax, and they will be more favorably situated than a domestic corporation which is engaged in the same business and which is compelled to accumulate, for example, 40 percent of its adjusted net income; and may be less favorably treated if the domestic corporation is able to declare and pay a substantial percentage of its adjusted net income in dividends.

(4) A corporation having a deficit will pay a tax of 15 percent of its net income, while its competitor may again entirely escape taxation, or pay a substantially smaller or larger tax.

(5) A corporation which is under a contract obligation not to distribute a portion of its net income is compelled to pay a tax of 22½ percent upon that portion, while other corporations will have their tax liability governed by other factors.

(6) A corporation having a certain type of debt, evidenced in a certain manner, having certain maturities, or incurred for certain purposes, will pay a tax of 22½ percent upon a portion of its income; whereas other corporations having other debts, or no debts at all, will be subjected to the graduated rates.

(7) A corporation having a debt contracted prior to March 3, 1936, may have a portion of its income taxed at 22½ percent; but a corporation forced to incur an indebtedness after March 3, 1936, will pay as much as 42½ percent if it is forced to devote its earnings and profits to its retirement.

(8) The corporation which posseses an adequate surplus will be in a position to escape all taxation by distributing all its net income; whereas its competitor, less favorably situated and financed, will be compelled to pay substantial taxes.

(9) A corporation compelled by sound business policy to retire indebtedness out of its earnings and profits for the year will be penalized severely as compared with a corporation which has no debt or is sufficiently strong financially to make other provisions for debt retirement.

(10) A corporation selling on a cash basis—such as chain stores and mail-order houses—may be much more favorably situated than the corporation compelled to sell on credit.

(11) "An intermediate subsidiary" of an affiliated group will be forced to pay a tax of 42½ percent under certain circumstances, even though, by reason of legal obligations or of sound business policy, those circumstances cannot be changed.

(12) The tax liability of "intermediate subsidiaries" will vary from zero to 42½ percent as a result of changes in types of income or in stock ownership.

(13) An affiliated group of corporations may be more favorably treated than separately owned corporations; and one affiliated group of corporations may pay less tax than another group.

(14) Corporations whose stockholders are able to purchase additional stock will distribute all their earnings and pay no taxes; but corporations with stockholders less fortunately situated will be forced to shoulder substantial tax burdens.

(15) Tax liabilities will be greater in the case of corporations requiring funds for replacements, additions, betterments, and expansion, and forced to finance the expenditure in whole or in part out of earnings and profits.

(16) The greater the hazards of the business enterprise the greater will be its tax liabilities, for it will be compelled by sound business policy to accumulate earnings to meet future losses.

(17) Corporations requiring but a relatively small investment will be in a position to distribute substantially all their income; whereas corporations with large investments in plant and equipment must provide for replacement.

(18) Corporations engaged in long-term operations, with fluctuations in annual volume and income, will pay greater taxes than corporations earning a reasonably steady annual income.

(19) The proposal will retard the growth of competition and will tend to aid, if not create, monopoly.

(20) Rather than lighten the load upon the small shareholder, he will be forced to withstand the higher tax if the directors of his corporation withhold anything over 80 percent of the corporation's earnings. His tax will not be levied according to his income class, but according to the dividend-paying ability of his corporation and the dividend policy of the directors.

(21) The unwary and the poorly advised will suffer terrific penalties, and the well-advised may escape free, or with lighter burden.

There is no equality when income is subjected to the graduated taxes proposed by the pending bill.

VIII. DOUBLE AND MULTIPLE TAXATION

Congress in the past has made every effort to avoid double or multiple taxation of the same income. The following merely enumerates a few of the instances in which the same income is subjected to double and multiple taxation:

(1) All surplus accumulated prior to January 1, 1936, out of earnings on which the corporation has already paid a tax, will be subject to a second tax when distributed to the individual stockholders.

(2) All corporate earnings made after January 1, 1936, upon which the penalty tax at the proposed rates has been paid, will again be taxed when distributed to the stockholder.

(3) Earnings which have been taxed to the corporation under the so-called "relief" provisions will again be taxed when distributed.

(4) American citizens who own stock of foreign corporations will be subjected to multiple taxation upon the earnings of the corporations.

(5) The earnings of banks, trust companies, and insurance companies will be taxed at the flat rates proposed, and again subjected to tax if, as and when distributed to shareholders.

In addition, the inclusion of all dividends in the taxable income of corporations may result both in multiple taxation and in an increase of tax upon them from a rate of 15 percent to a rate of 42.5 percent.

IX. THE PLAN IS UNWORKABLE AND IMPRACTICABLE

In my testimony before the Committee on Ways and Means I discussed at length the unworkability and impracticability of the plan. I have seen no answer as yet to the statements I made.

(1) The relation between earnings and profits and statutory net income.

The net income upon which the proposed tax is to be imposed is admittedly an arbitrary figure. It is computed under the provisions of the applicable revenue laws, the regulations and rulings of the Treasury thereunder, and the innumerable decisions of the Board of Tax Appeals and the courts. On the other hand, the earnings and profits of a corporation are computed in accordance with accepted business practices and sound accounting principles.

Dividends are payable out of earnings and profits, not out of statutory net income. Seldom, if ever, will the two correspond. Usually taxable net income, particularly when corporate dividends are included, will be in excess of the earnings and profits. And yet the bill bases its penalties upon the ability to distribute net income to stockholders.

The following are a few illustrations of the differences:

(1) A corporation may have an actual deficit for the year by reason of a loss upon the sale of capital assets, which is, of course, immediately reflected by a decrease in its earnings and profits. The loss (except to the extent of $2,000), however, is not an allowable deduction in computing net income.

(2) A so-called reorganization will seldom be considered by accountants as giving rise to earnings and profits. On the other hand, any gains may be included in taxable net income, even though computed solely on paper.

(3) The dissolution of a subsidiary will not be considered as creating earnings or profits out of which dividends may be paid. Under the present revenue act, however, a gain on the liquidation of a subsidiary may be included in net income.

(4) A corporation may establish certain reserves for contingencies, such as a reserve against decrease in value of securities or inventories, which will decrease its earnings and profits for the year. A reserve of this nature is not an allowable deduction in the computation of net income.

(5) Many other reserves are frequently established by a corporation and deducted in the computation of its earnings and profits. Reserves for em-

ployees' liabilities, for repairs and renewals, for fire insurance, for pension liabilities and other employee benefits, etc., are typical. Reserves of this nature are not allowable deductions in the computation of one's income.

(6) A consistent depreciation policy is usually followed by a corporation in the computation of its earnings and profits. The amount of depreciation thus reflected on a corporation's books, however, is frequently not the amount allowed in the computation of net income.

(7) In many instances expenditures classified by a corporation as repairs and charged as such on the books are classified by the Bureau as replacements and renewals, and are not allowed as deductions in computing net income.

(8) Contributions to a pension plan to cover prior service benefits will decrease the amount available for the payment of dividends. Only a portion of these contributions, however, are allowed as deductions in computing taxable net income.

(9) In the case of a consolidated group of corporations, normally dividends will be paid only out of consolidated earnings and benefits. Since the abolition of consolidated returns, however, taxable net income is computed for each separate corporation. Thus, if one or more subsidiaries sustained a loss during the year, the consolidated earnings and benefits would reflect the subsidiaries' losses, whereas each separate corporation would be taxable upon its separate net income, and no allowance would be made for the losses of the subsidiaries.

(10) Taxes assessed against local benefits, or for municipal improvements, of a kind tending to increase the value of the property assessed, are not allowable deductions; but would decrease earnings and profits for the year.

(11) If a corporation mortgaged property for more than its cost, and if the property should then be sold under foreclosure, the corporation would probably be required to include the difference in its taxable net income, even though the entire proceeds of sale were paid over to the mortgagee. This amount is not earnings and profits. A somewhat similar situation exists in the case of the forfeiture of long-term leaseholds.

(12) Shifts of income by the Bureau of Internal Revenue from one year to another are frequent. Consider, for example, a corporation which had computed its income for the year 1936 as being $100,000 and has distributed this entire amount. It may have had certain transactions which it believed had given rise to profits in 1937 and it so included them in 1937 income, which was also fully distributed. On the books of the corporation they were considered as 1937 earnings. But in 1939 or 1940 the Commissioner decides to include the profits in 1936 income. The corporation would then be subject to a penalty tax for failure to distribute its entire 1936 income, even though it made full distribution of such profits in 1937. Moreover, if the corporation paid such a tax in 1940, this amount could not be taken into account in computing the 1940 earnings, which the corporation would be required to distribute; and serious impairment of the corporation's credit, as a result of the imposition of unanticipated taxes, might easily result and the value of its outstanding securities might be seriously affected.

(2) Net income cannot be computed until after the end of the taxable year. Unbearable tax burdens are imposed by the bill upon undistributed net income; and net income will be considered undistributed unless it is paid out as a taxable dividend during the taxable year.

In many instances the tax returns will not be prepared or filed for several months after the close of the taxable year. And after they are filed, the Treasury and the taxpayer may contest for years its taxable net income. The revenue agent makes an examination. He proposes adjustments. Conferences are held. Disputed items are forwarded to Washington. Further conferences are held. Thousands of cases are referred to the General Counsel's office. Several thousand deficiency letters are mailed each year, and thousands of petitions are filed with the Board of Tax Appeals. The current decisions of the Board of Tax Appeals and of the courts involve taxable net income extending back to 1918. Final decisions with respect to the taxable years 1928 and 1929 probably preponderate in the court and Board decisions of today. The issues involved are innumerable. There seems to be no end to new problems, new issues, and litigation. The Treasury issues regulations and then amends them; makes a decision and reverses it. The Board and the courts override regulations. The Commissioner of Internal Revenue loses a substantial percentage of cases in litigation. If the Commissioner cannot compute taxable net income of a

corporation after years of consideration, how can the corporation itself be expected to compute its net income with accuracy, even if a reasonable time were afforded? And the penalties for error are terrific and unavoidable.

(3) Dividend policies: Under the bill, the board of directors, before the end of the year, must determine the extent to which they may legally declare dividends, and whether the dividends will be taxable. They obtain advice and decide these questions. They next consider sound business policy. Doubtless, they will take into account the following factors, as well as others:

(*a*) The amount of available cash;

(*b*) The outstanding indebtedness which should be retired, in whole or in part;

(*c*) Maintenance of the proper ratio of current assets to current liabilities;

(*d*) Business prospects for the immediate future and probable hazards;

(*e*) Reasonable reserves to meet probable contingencies;

(*f*) Necessity for repairs, replacements, betterments, additions and expansions, and the available methods for financing them.

(*g*) Additions to reserves for uninsurable risks, such as losses by floods, explosions, and the like;

(*h*) Appropriate reserves for preferred dividends; and

(*i*) If this bill becomes a law, then the effect of their decision upon the tax liability of the corporation.

All this must be done before the end of the year. And in addition, the checks must be drawn and mailed.

X. COMPLEXITIES

Perhaps I am in a position to discuss the complexities of our present tax laws—certainly, at least as much as anyone else. I regret the utter impossibility of the present situation. The statute is unreadable, beyond comprehension, and ambiguous. The maze of regulations, rulings, and decisions is appalling. There is no certainty. Tax liabilities are not known and cannot be computed. There is no finality within a reasonable period of time. Regulations are amended, and rulings are reversed, frequently with retroactive application. Litigation is prolonged. The expense to the taxpayer and the Government adds a heavy load to the tax burden. I predict that our present income-tax system will some day fall of its own weight. I am forced to accept my share of the responsibility.

But I shudder to contemplate the consequences of a virtually complete uprooting, in a few weeks' time, and the substitution of new statutory provisions, in an unknown and unexplored field, piled upon the present complexities of computing taxable net income, and with the Government and the taxpayer sharing dollar for dollar in the error.

Many of the innumerable problems involved in the present bill become apparent by an analysis of its provisions, which I shall undertake orally. Other problems cannot be anticipated. It is my opinion that much more time than is now available will be required to formulate and draft adequate answers.

Permit me now to propound a few of the obvious problems arising under the specific provisions of the pending bill. Some of them are easy of solution, when the precise problem is appreciated. Others are incapable of solution, except by further resort to arbitrary answers. Unfortunately it will be necessary to keep in mind most of my prior analysis, in order to understand the questions I ask.

(1) *Computation of tax on corporations.*—Mr. Fernald has discussed the impossibility of computing tax liabilities under the proposed schedules. I merely add that as I read the provisions of the bill I asked, Can anyone understand them?

With a feeling, first of relief and then of anxiety, I pass the computation problems on to those versed in higher mathematics.

(2) *Application to business trusts.*—As I have stated, business trusts, associations, and joint stock companies are to be taxed as corporations, under section 701. Accordingly, the rate imposed is to be governed by the ratio of their dividends, paid during the taxable year, to their "adjusted net income" for the year.

I call your attention to a few of many well-known facts:

(*a*) Distributions by a business trust are governed by the trust instrument itself.

(b) Distributions by a joint-stock company are governed by the terms of its "charter."

(c) The right to amend the trust instrument of a business trust is typically not reserved, for such a reservation destroys the protection that goes with the trust form of doing business.

(d) The right to amend the charter of a joint-stock company requires the unanimous consent of its members.

It is a fallacy to assume that the continued classification of these types of taxpayers with corporations, which was for the purpose of effecting equality of taxation under existing law, will have the same effect under a brand new system of corporate taxation. What, for instance, will be the predicament of the business trust whose trust instrument cannot be amended? What assurance will there be that unanimous consent of the members of a joint-stock company can be obtained to effect charter amendments which may be necessary to avoid an abnormal tax rate? Is it reasonable to assume that business trusts and joint-stock companies have all been set up without reservations in their trust instruments and charters which may prevent the free distribution of earnings where, for instance, a program of development has not been completed, or debts exist to be satisfied?

I most emphatically urge that this entire question of the effect of the new bill on the old classification of business trusts, joint-stock companies, and other associations with corporations, should be given full consideration before the provisions of the bill are enacted into law.

(3) *Computation of earnings and profits.*—The following computations of earnings and profits are required:

(a) Earnings and profits accumulated after February 28, 1913, in order to determine the "dividend credit", under section 13 (a) (2) (A), which in turn incorporates the provisions of section 27, with this latter section incorporating section 115 (a).

(b) The accumulated earnings and profits during the entire history of the corporation, in order to determine for the purposes of section 14 (a) whether the 15-percent rate applies, and, in the case of a corporation existing prior to March 1, 1913, I merely point out in passing, that its earnings and profits accumulated prior to that date have never been and possibly cannot be determined.

(c) A computation of earnings and profits, apparently without regard to section 115 (a), in order to add to "accumulated earnings and profits" the amount of any "distribution during the taxable year of earnings and profits", for the purposes of section 14 (a).

(d) A computation of earnings and profits for the taxable year, as one of the preliminary steps in determining "the adjusted-net income" for the taxable year.

(e) A computation of earnings and profits as specially defined in such contracts as may fall under section 15.

(f) A computation of accumulated earnings and profits "as of the day before the first day of its taxable year beginning after December 31, 1935", under section 16 (b) for the purpose of determining the possible application of section 16.

I am quite incapable of pointing out all the problems involved in the computation of either "earnings and profits" or "accumulated earnings and profits." It seems to be generally admitted that there are no definite, reasonable uniform rules governing accountants and economists. But I am glad to point out a few illustrations of the complex legal problems involved, which are certainly entitled to consideration.

(1) Is a corporation's paid-in surplus available or capable of "absorbing" subsequently incurred operating losses, or must they be made up out of earnings and profits?

(2) In computing the amount of accumulated earnings and profits available as of a particular dividend rate during a taxable year, should the results of the entire year be prorated back to such dividend date, or should the actual results of operation up to such date control?

(3) To what extent does a change in the identity of stockholders affect the rule of the *Sansome case* (60 F. (2d) 931), that surplus of a corporation acquired in a tax-free reorganization remain surplus in the hands of the acquiring corporation?

(4) Are dividends paid in one class of stock on another class of stock of the same corporation distributions of earnings and profits?

(5) Does a distribution in kind reduce accumulated earnings by the fair market value of the property distributed or by its cost or other basis to the corporation?

(6) To what extent will State law requirements and accounting principles govern in the computations of accumulated earnings for Federal tax purposes?

(4) *The so-called relief provisions.*—Sections 14, 15, and 16 of the bill are, I presume, intended to eliminate all the hardships which might befall the corporate taxpayer by reason of inability to distribute a sufficient amount of its earnings to avoid an abnormal tax rate. These provisions have been discussed in detail by other speakers. I offer merely a sufficient analysis to disclose their utter inadequacy.

Section 14, I am told, is intended to cover those cases in which the corporation is prohibited from distributing its current earnings by reason of prohibitions imposed by State law. If such be its purpose, then certainly it fails therein.

The existence or nonexistence of accumulated earnings and profits is only one of the tests under State law for determining the corporation's right to make a distribution to its stockholders. For example, it is a typical provision of State law that a corporation cannot declare a dividend during insolvency resulting from the inability of a corporation to meet its current liabilities. The corporation may have ample accumulated earnings invested in fixed assets and still be prohibited from making a distribution. Such a corporation will not be in a position to enjoy the "benefits" of section 14 and will be presented with the choice of incurring penalties under State law or penalties under the Federal tax statute.

In the second place, does section 14 contemplate a tax concept or a State law concept of "accumulated earnings and profits." If the first, then the corporation may be presented with the same choice as that facing the insolvent corporation. For example, under the Federal tax law, the surplus of a corporation acquired in a tax-free reorganization remains surplus in the hands of the acquiring corporation, at least where there is a substantial identity of stockholders. Under the corporate law of some States, the same is true. Under the corporate law of others, it is not. In the latter cases, a corporation may be compelled to pay tax at normal rates by reason of State prohibitions. On the other hand, if the laws of the various States are to control for the purposes of section 14, then discriminations will result.

If section 14 is for the purpose of protecting corporations faced with State statutory prohibitions against distributions, why should its purpose not be set forth directly. I would suppose that it would be a simple matter to provide a special classification for corporations which find themselves in such a predicament. Tax rates should not be increased by reason of legal incapacity to distribute earnings.

Section 15 deals with corporate taxpayers who have executed written contracts prior to March 3, 1936, which expressly prohibit them from paying dividends. To the extent of such a prohibition, the corporation is accorded the "relief" of an increase, in the existing rate, to a rate of 22½ percent. I see little justification for such a tax rate resulting from contractural incapacity where a lower rate is proposed in the case of legal incapacity. Furthermore, efforts on the part of the drafters of this provision to restrict its application, or perhaps fear on their part of so-called loopholes, result in a reduction in the availability of the section to an absurd degree.

In the first place, where the contract has been executed prior to March 3, 1936, the section provides that it must have been executed by the corporation. Does the section apply to cases where the obligation is carried over from a predecessor corporation? The contract must expressly deal with the payment of dividends and the requirements of the section are not met if the obligation not to distribute arises by necessary implication. The section is inapplicable if the contract permits payment of dividends in any form, although stock dividends will not entitle the corporation to a dividend credit under the bill.

In the second place, I see no reason why bona-fide contracts of this sort entered into by the corporation subsequent to March 3, 1936, which are frequently necessary in order to permit the corporation to obtain necessary funds for its business activities, should not entitle the corporation to the benefits of the section. This bill proposes to deprive the corporation of use of its own earnings for development purposes, for instance, except under penalty of an abnormal tax rate. The answer to objections on this score has been that the corporation can always obtain funds from other sources if they are needed. I am convinced that the answer is based solely on collegiate theory. But if

this is a solution, then certainly a corporation should not be unduly hampered in raising what funds it may need.

Section 16 is subject to the same criticism. Again, arbitrary, unreasonable, and impractical provisions have been inserted to restrict the application of the section, with resulting discriminations and hardships. Debts of the past are all that are to receive consideration. Debts of the future must be paid from sources other than earnings if an abnormal tax rate is to be avoided. The corporation's own earnings cannot be availed of. No such inequitable restriction is necessary in my estimation to protect the Government, in the collection of its revenues, from a creation of fictitious or unnecessary obligations merely for tax-avoidance purposes. As to the debts of the past, only those meeting the specific requirements of section 16 are to be recognized. They must have had a maturity at the time of issue of at least 3 years, or must have been incurred either prior to March 4, 1933, or in connection with the acquisition of capital assets. The classification is quite arbitrary and arbitrary classifications always result in discriminations. A corporation should not be prohibited from employing its earnings to reduce or satisfy out of earnings any bona-fide debt, wherever entered into, and for whatever legitimate purpose.

I admit that a revision of sections 14, 15, and 16, to produce effective and equitable classifications, might result in a loss of revenue under the proposed bill. But certainly this is no reason why such a revision should not be made. The Federal Government has never before relied solely upon arbitrary classifications and discriminations or upon the deprivation of corporations of their right to properly employ their earnings, as means of raising revenue. I cannot believe that such means have now become necessary. I deplore the resort to them.

(5) *Credit for dividends paid.*—Time does not permit me to attempt to add to what has already been said of section 27. I pass it with the prediction that years of litigation are ahead to determine its legal effect and application.

(6) *Corporations in receivership or bankruptcy.*—The time when a corporation is "in bankruptcy" may be controlled by section 1 of the Bankruptcy Act, subsection (11) of which provides: "Date of bankruptcy" or "time of bankruptcy" or "bankruptcy" with reference to time shall mean the date when the petition was filed. Apparently this applies both to voluntary and involuntary petitions, for subsection (11) reads: "A person against whom a petition has been filed" shall include "a person who has filed a voluntary petition."

The time when a corporation is out of bankruptcy, however, raises many problems not covered by section 105 of the tax bill.

(a) Suppose a corporation applies for and obtains a discharge in bankruptcy. Under the bankruptcy statute, the court may revoke this discharge at any time within 1 year from the date thereof, upon certain proof. Suppose there is such a revocation. What is the taxable status of the corporation for the intervening year?

(b) Suppose the court denies an application for discharge, and the corporation appeals, obtaining a reversal on appeal. Was it "in bankruptcy" during the period of appeal?

(c) Suppose the corporation does not make application for a discharge within the statutory period of 12 months from the date of adjudication. Can it remain "in bankruptcy" indefinitely, or prolong the period for tax purposes, in this way?

(d) Suppose the corporation has petitioned for a reorganization under section 77B of the Bankruptcy Act, after bankruptcy proceedings have been instituted. Is it "in bankruptcy" thereafter? What is its status while the petition is being heard or while the reorganization is being effected? Section 105 makes no reference at all to a corporation in reorganization under section 77B, whereas it is obvious that a corporation in such a situation is entitled to relief from the tax provisions.

(e) Section 105 also makes no allowance for the fact that a corporation may be in bankruptcy or receivership for a part only of the taxable year. If a corporation has been in bankruptcy for 11 months of the taxable year, it is patently unfair to collect the full tax if it has been discharged just before the time of making return.

I suggest that your legal advisers propound similar questions as to corporations "in receivership."

I could continue indefinitely. But your legal advisors and experts are better qualified than I. They know the problems. Give them time to analyze them and present them to you for serious consideration and solution.

XI. CONCLUSION

It is the opinion of our committee that the adoption of the proposed plan—
(1) Will have a substantial adverse effect upon the economic and business conditions of the country, retarding recovery and reemployment.
(2) Will seriously impair the financial strength of corporations and depreciate the value of their bonds, notes, and other evidence of indebtedness, and preferred stock.
(3) Will increase inequities and impose discriminatory taxes.
(4) Will increase complexities and uncertainties in the computation of tax liabilities.
(5) Will subject corporations to severe penalties by reason of circumstances beyond their control.
(6) Will result in duplicate and multiple taxation of the same income.
(7) Is unworkable and impractical.
(8) Is unsound when tested by accepted principles of taxation.

One of my colleagues on the chamber committee has prepared a valuable statement upon limitations of State laws upon the rights of corporation directors to declare dividends, including conflicts with the theory of the House measure. Mr. Berry, who is present, had expected to appear for the Detroit Board of Commerce, but is being called back to Detroit by an emergency case. We ask the privilege of presenting his statement as part of his testimony.

STATEMENT OF RAYMOND H. BERRY, DETROIT, MICH., REPRESENTING THE DETROIT BOARD OF COMMERCE

Mr. BERRY. Mr. Chairman and gentlemen, my name is Raymond H. Berry, attorney, of Detroit, Mich. I appear here on behalf of the Detroit Board of Commerce. I am a member of its board and chairman of its tax committee. I am also a member of the committee on Federal finance of the Chamber of Commerce of the United States.

In view of the testimony of my associates on the finance committee of the United States Chamber of Commerce, I will give no consideration to budget requirements nor to the administrative problems involved in the bill before you.

The considerations I wish to advance are related in the main to phases of the present tax proposal which, it has seemed to me, conflict with the requirements of the several States in conformance with which corporations have to operate.

RESTRICTIONS OF DIVIDEND PAYMENTS

Cash dividends.—The present bill is aimed at a system of taxation which will obtain revenue principally from individuals through the operation of the individual income tax. In order to protect the base of that tax the corporate schedules are so drafted as to require corporations to declare out as dividends most of their annual net income, or, at any rate, to give them the strongest possible incentive for doing so. Apparently, therefore, the bill assumes that corporations are able to declare as dividends most, if not the full amount, of each year's annual net income; if they cannot do so or decide not to do so, very high penalty taxes apply.

It seems to me that this assumption ignores the existence of a great mass of statutory rules and judicial decisions which have been built up in the States that charter our corporations and which restrict the power of directors to declare dividends. In general,

the objective of the States has been to safeguard as far as possible the creditors and shareholders of corporations against undue dividend declarations, which objective, of course, is in conflict with the basic purposes of the present bill.

In general, the State enactments dealing with dividend declarations seek to prevent the impairment of the capital of corporations. The laws range from relatively severe restrictions to relatively liberal provisions. These restrictions seem to resolve themselves into two general classifications:

(1) In one group of States—including Pennsylvania, New York, and Ohio—dividends may not be paid if by their payment the amount of the corporate assets will be depleted below the total of its liabilities including the stated value of its capital stock. In other words, dividends may be paid only out of surplus.

(2) In another group of States—including California and Delaware—the corporation is permitted to pay dividends out of net earnings so long as such payment does not reduce the net assets of the corporation below the stated value of its preferred stock. This might permit the payment of dividends by a corporation which had earnings for the year in question despite an accumulated deficit for prior years.

In at least one State—Iowa—apparently, dividends may be paid despite the impairment of capital, provided that impairment is not sufficiently great to affect outside creditors of the corporation.

In practically all of the States the surplus out of which dividends may be declared must be earned surplus and may not represent mere unrealized appreciation of assets.

LIABILITY OF DIRECTORS

Responsibility for adherence to these statutory restrictions upon dividend payments is placed squarely upon corporate directors. I understand it to be a general principle of law that directors are bound to use due care in the management of the corporate affairs and that in case of willful or negligent payment of dividends they are jointly and severally liable to the corporation at any time within 3 years for the amount of such dividend or other corporate distributions with interest at 6 percent per annum. This, at least, is the general law in Michigan.

The proposed tax plan, however, places an incentive upon directors to declare dividends representing a major portion of their estimate of the corporate earnings, so as to reduce the amount of taxes that would have to be paid by the corporation. In other words, it is an invitation to the management to declare dividends as there is a natural incentive to minimize taxes. There is a serious danger that the directors may hew too closely to the line in declaring dividends. Instances may occur where dividends declared with full intention to observe the law will operate to impair the capital of the corporation.

This danger is increased because statutory net income for tax purposes and net earnings as determined under sound rules of accounting may differ greatly. Consequently a dividend declaration equal to 100 percent of statutory net income will necessarily impair capital, in every case where actual net earnings are smaller—unless, of course,

the corporation has an accumulated surplus from prior years. It will similarly impair capital in the event that the directors have been sanguine in their estimate of current year earnings.

If the present bill is enacted into law, directors of many corporations will inevitably find themselves in a difficult position, impelled to increase dividend distributions for the purpose of minimizing Federal taxes and, at the same time, incurring the danger of personal liability under State enactments for the declaration of excessive dividends.

CONTRACTS

In addition to restrictions upon dividend payment created by State statutes, particular corporations may be subject to a variety of restrictions arising from contractual obligations enforceable under State law. It is true the present bill—section 15—contains one "relief" provision which provides that "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", then a tax of 22½ percent shall be levied in place of the tax provided by section 13, upon such part of the earnings as are controlled by the contract. Waiving the question of whether a tax rate of 22½ percent can be called "relief", even so the relief provided by this section is at best partial. I understand that the Reconstruction Finance Corporation has imposed a condition precedent to the granting of many of its loans to corporations limiting or prohibiting the payments of dividends until loan requirements are met. Doubtless contracts in this form meet the requirements of the relief provision just referred to.

A much more common form of contract, however, is that between a corporation and its bondholders, preferred stockholders or particular creditors not specifically prohibiting dividend payments but requiring the building up of sinking funds, the maintenance of a specified percentage of current assets to current liabilities, and so on. It is at least doubtful whether these contractual obligations come within the scope of "contracts not to pay dividends", but they may nevertheless effectively prevent corporations from paying dividends.

Moreover, if there is any reason for granting relief to a corporation whose contractual obligations entered into before March 3, 1936, prevent it from paying dividends, upon what fair basis can relief be denied to other corporations subject to identical contractual restrictions coming into existence after March 3, 1936? The contract will be equally binding although entered into after that date, and moreover, corporations do not commonly place such restrictions upon their financial freedom unless compelled to do so. There is no reason to assume that after the enactment of this bill a corporation will be able to avoid becoming subject to the same sort of contractual restrictions as heretofore. Its prospective creditors and bondholders will doubtless continue to demand the same safeguards deemed necessary in the past, the more so in view of the tendency of this tax bill to penalize the accumulations of surpluses which would protect such creditors. I suggest that such contractual restrictions upon dividend payment may become more common in the future, if this bill is enacted, than they have been in the past. I doubt, for exam-

ple, that the Reconstruction Finance Corporation will lessen its protective requirements in respect to retention of income by borrowers as a means of assuring orderly and speedy liquidation of its loans.

How will dividends be paid where corporate earnings are accrued?

The obstacles to dividend declarations already considered arise out of State law and contracts enforceable under State laws. In addition, existing Federal tax law itself contains provisions which may in practical effect bar dividend distributions. For example, from my study of the bill, I fail to find relief for the corporation that reports earnings on an accrual basis. There are a great many corporations engaged in one kind of business or another that of necessity must accrue their earnings. An illustration is offered:

Assume a corporation engaged in subdividing real estate which it proposes to sell on an installment basis. The corporation purchases acreage, agreeing to pay for that acreage as the lots are sold. Under the provisions of the existing act, if the first year's payments do not exceed 40 percent of the sale price, it may spread the profits resulting from sales throughout the years in which those profits are subsequently received, and be taxed only upon profits realized. However, if the taxpayer sells a lot and during the first year receives payments in excess of 40 percent, it then must accrue all the profit and pay a tax thereon for the year during which the lot was sold. Bear in mind, the corporation has agreed to pay to the party from whom it acquired the acreage a considerable part of the money it receives from sales. It will therefore have little cash for distribution to stockholders, although possessed of large taxable income in the form of accrued but unrealized profits.

A simple mathematical illustration will reflect the foregoing. The corporation purchases acreage from A for $50,000. This acreage is divided into 100 lots which cost $500 each. The purchase price is to be paid to A as the lots are sold. The first year the corporation sells 40 lots for $1,500 each, or a total sale price of $60,000. Let us assume, however, that the corporation receives on these sales only $700 a lot as down payment, or a total of $28,000. Let us suppose further that it must liquidate its original debt for the acreage to A to the extent of $500 for each lot sold, or $20,000. The corporation's profit for tax purposes will be $40,000, or $1,000 on each of the 40 lots sold. But its available cash will amount to $8,000 only. If the corporation pays the $8,000 in dividends, its tax, under schedule 2–A, would be 32½ percent of $40,000, or $13,000. But the corporation will have no cash in its treasury to pay any tax. If, on the other hand, it does not distribute the $8,000 in dividends, its tax, under schedul 2–A, will be 42½ percent of $40,000, or $17,000, which payment it will have to make out of the $8,000. This is the absurd result of the application of the schedules to a corporation compelled to report its earnings on an accrual basis.

I have another case in mind of a corporation which deals in securities which has regularly inventoried its securities at market value with the permission of the Commissioner of Internal Revenue. Having adopted this accounting method, it is not permitted to make a change except with the Commissioner's approval. Suppose, now, such a corporation finds at the end of the year that it has a net income of $100,000, three-fourths of which represents

unrealized appreciation of the securities in its inventory over their original cost. Such a dealer would have available for distribution in cash dividends not more than $25,000 or 25 percent of its taxable income. If it distributed all its cash, the tax would be $30,000 with nothing to pay it from. If it distributed nothing, the tax would be $42,500 with $25,000 to pay it from; thus, the corporation would be forced to liquidate its stock-in-trade for the purpose either of declaring additional dividends or meeting its tax liability. If it did make a dividend distribution of securities in kind, this procedure would deplete its stock in trade.

These are only two of the many examples that might be cited of situations where, because of the application of the accrual method of reporting income, or because the earning of income will involve obligations for current debt repayment, or for other reasons, corporations will find themselves with substantial incomes subject to tax but no cash or little or no possibility of securing cash, except by liquidation, from which to declare dividends or to pay the tax provided by this act.

SCRIP

The possibility of a declaration of dividends in the form of scrip, bonds, or other corporate obligations has been suggested as a means of meeting the criticism that the effect of the bill will be to prevent corporations from retaining in their businesses necessary amounts of earnings. It has been suggested that small corporations might bring together a group of their stockholders and arrange for the stockholders to reinvest cash dividends distributed to them in the purchase of new securities, thus permitting the corporation to augment its capital and at the same time take advantage of the dividend credit. Large corporations, it is suggested, might resort to scrip dividends or accomplish much the same purpose by the issuance of rights to subscribe to new securities.

The term "dividend", when used in the bill, means "any distribution made by a corporation to its stockholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913." (Sec. 115 (a)).

Section 27 (e) provides:

> 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 payment, whichever is the lower * * *.

The first-quoted section is the same as appeared in the existing act. The second section just quoted above is a new provision not appearing in prior acts which apparently contemplated a new method of distributing corporate earnings by the use of dividend scrip or some other newly-coined method of distributing earnings in order to secure the benefit of a maximum dividend credit.

There are more difficulties in these procedures than have apparently been realized. In the first place, many corporate managements will find it easier to pay out dividends to stockholders than to secure the agreement of the latter to the reinvestment of those dividends in the corporation. Moreover, even if the stockholders should prove to be generally willing to immediately reinvest their

dividends for the purpose of providing their corporations with necessary capital, it should not be overlooked that these dividends, under the new bill, are subject to both normal and surtax rates and their recipients will by no means be able to reinvest the full amount received by them. Out of that amount must come the individual income taxes due from the stockholders with respect to the dividend payments which, in the case of some stockholders, may easily amount to half of the dividends.

On the other hand, if the corporation attempts to pay a dividend in some form of its own obligations, such as bonds or scrip, it will face numerous difficulties. Suppose the corporation estimates, along in December, that it will have a net income of $100,000 and, because of its need for capital, determines to issue scrip dividends—substantially its own I. O. U.'s—for that amount. The scrip is received by the stockholders, let us say, sometime in January after the books of the corporation have closed for the year in question. Up to this point, of course, the stockholders have received no actual cash. Some of them will attempt to dispose of their scrip. In the case of a large corporation an active market might develop with a readily determinable fair market value, once the scrip was actually in the hands of its recipients. On the other hand, in the case of a small corporation a half dozen stockholders might sell scrip at widely varying prices. Now, it is to be noted that the dividend credit of the corporation, as above recited, is not the $100,000 of par value of scrip issued, but the fair market value of the scrip at the time of payment to the stockholders. With a half dozen isolated sales at different prices, what is the market value? How is the corporation to determine, when the issue is planned, what that fair market value will be when the scrip is actually paid out? In our assumed case, it may well happen that the corporation will find that its dividend credit is only fifty or sixty thousand dollars instead of one hundred thousand, leaving it with 40 percent or 50 percent of undistributed income upon which to pay the taxes provided by this bill.

But, even if this is the case, the corporation, by its action, has incurred $100,000 of liabilities. These liabilities will have to be met some time, and it is to be noted that when they are met, the corporation will have to pay them out of earnings, for which, of course, it will receive no dividend credit, and will find merely that meeting its obligations will again result in a higher percent of undistributed income and a heavy tax under this bill.

STOCK RIGHTS

The financing of additional capital requirements through the issuance of rights to subscribe to new stock has also been suggested as offering an avenue of relief to corporations deprived of their traditional practice of plowing a portion of their earnings back into the business. Examination of this idea leads to the following conclusion: Large and well-established corporations with accumulated surpluses and stock selling at high market value may be able to finance themselves through the issuance of rights. They would likewise probably be able to finance themselves through the direct sale of their securities or in a variety of other ways. Small concerns

without a well-established financial position whose stock is possibly selling at depressed prices—concerns, that is, which will be most seriously affected by heavy tax on reinvested earnings—will probably find the issuance of rights impossible.

In the first place, a majority of the States prohibit the sale of par-value stock at a price less than par. The Michigan statutes, for example, provide as follows: "Shares with par value must be issued for a consideration not less than the par value thereof." The statutory provisions of most other States are similar. But it is quite clear that to offer stockholders the privilege of subscribing at par, for stock which is selling on the market at substantially less than par, is not to hold out to them an opportunity which will be anxiously grasped. In effect, therefore, the laws of a majority of States would prevent a majority of our smaller corporations from financing by means of stock rights at all. Even if these legal restrictions could be waived, it would still remain true that it is the existence of a substantial surplus and a buoyant value of existing stock which creates the attraction for new stock subscription under any plan of stock-right issuance.

RIGHTS—BLUE-SKY LAWS

Moreover the statutes of most States contain a provision designed to regulate the issuance of corporate securities. These laws are commonly referred to as the blue-sky laws. Under such laws before a corporation may issue additional securities it must first obtain the approval and authorization of the securities commission of the State. Any plan to issue corporate securities in lieu of cash dividends, or to obtain new capital in lieu of reinvesting earnings, must be carried out in conformity with the State requirements.

FEDERAL RESTRICTIONS

Furthermore the Securities Act of 1933 is designed to regulate the public sale of securities in interstate commerce. In general the act provides that securities offered for sale through interstate commerce channels must be registered with the Commission. There will be many instances where the plans of corporations for minimizing their tax liability under this bill through the issuance of rights, scrip dividends, debentures, or other forms of corporate obligations will come into conflict with the provisions of the Securities Act and regulations of the Securities Commission. Thus it may very well be found, that one form of relief contemplated under this bill may be taken away from corporations by another Federal statute.

I wish to reiterate that my remarks are intended solely to bring to your attention certain legal restrictions surrounding the declaration and payment of dividends, together with certain practical effects arising out of said payments. There are many other provisions of the bill that in my opinion are objectionable and upon which I would like to comment, but my time is too limited.

In conclusion, I urge that if a bill of this general type is enacted into law at least the effective date be deferred to January 1, 1937, in order that corporations may make such readjustments in their financial and accounting affairs as are necessary to synchronize them

with the act. In connection with this suggestion please bear in mind that 4 months of the present year have already elapsed. Undoubtedly many transactions have been consummated in reliance upon the existing revenue act and it seems only equitable that the Government should carry through this year under the present act and defer the application of a new and untried form of revenue legislation which contains so many impractical provisions.

The CHAIRMAN. Mr. Garrison.

STATEMENT OF FLINT GARRISON, NEW YORK CITY, REPRESENTING THE WHOLESALE DRY GOODS INSTITUTE

The CHAIRMAN. Mr. Garrison, you represent the Wholesale Dry Goods Institute?

Mr. GARRISON. Yes, sir.

Senator BARKLEY. Mr. Garrison, I notice that the program for tomorrow shows that we will have a representative of the National Retail Dry Goods Association who will appear before the committee. What is the relationship between the two?

Mr. GARRISON. They are two entirely different lines, Senator. Their interests may overlap; they may have something in common.

Mr. Chairman and gentlemen: My name is Flint Garrison. I am the managing director of the Wholesale Dry Goods Institute, 40 Worth Street, New York. I appear in behalf of dry-goods wholesalers to ask for a simplification in the proposed legislation providing for refunds of processing taxes on floor stocks of goods processed from agricultural products. We have been assured by administration officials that it is the wish of the administration to equitably make such refunds. The bill to provide revenue and equalize taxation, now before you for consideration, contains a provision for such refunds. It is the prevailing belief in the wholesale dry goods trade, as well as in the industries with which we come in contact, that, under the procedure set up in that legislation, it may be years before wholesalers of floor stocks secure a final adjudication and payment of their claims, whereas circumstances now prevailing call for prompt action, if the textile industries and trades are to be relieved from harassments, exasperations, and financial hazards perhaps unprecedented in their history.

The circumstances which prompt this statement are these:

Early in the summer of 1935, it became apparent that original processors of cotton were generally withholding the payment of processing taxes. Cotton goods on which no proceeding taxes had been paid began moving into commerce, exposing the holders of such goods to serious loss in case the tax were terminated or invalidated, inasmuch as the Agricultural Adjustment Act, as amended, provided for refunds only on goods on which the processing tax had been paid. The realization of this hazard caused a widespread suspension of buying in the cotton-goods field until an operating basis could be established. This basis was established with first processors by a processing-tax clause attached to all sales contracts, under which the processor agreed to rebate to the purchaser the amount of the processing tax represented in the goods covered by the contract, in case the processor were relieved from the payment of the tax by the invalidation of the act.

This clause limited refunds to those goods invoiced within a specified period, usually 90 days, preceding such invalidation.

This clause established a clear basis of operation between buyers and first processors. As cotton goods moved on to secondary, tertiary, and subsequent processors, their selling clauses became necessarily less specific and usually limited their guaranty to an equitable distribution to buyers of refunds received by the seller from preceding processors less the amount which the seller retained to cover his own inventories.

Immediately following the invalidation of the Agricultural Adjustment Act, a general movement was undertaken to effect settlements under these various purchase clauses. As a general thing, in transactions with primary processors, settlement has been promptly and fairly effected. With secondary and subsequent processors, however, contract settlement has not been effected in a single instance which has been brought to our attention, although literally hundreds of thousands of transactions are involved and negotiations have been in progress for 3½ months. These unsettled contracts are now the subject of bitter dispute and, in a high percentage of cases, will probably lead to litigation.

Meanwhile, the general level of the primary market for cotton goods has declined to a degree which represents the full amount of the processing tax and, under the highly competitive conditions which prevail in the cotton-goods trade, wholesalers have necessarily followed the primary market in their own quotations. In addition to this, wholesalers have, in many instances, rebated to their customers the amount of the processing tax represented in certain items invoiced prior to January 6, 1936.

The processing tax on cotton roughly approximates 10 percent of the wholesale price of most items of staple cotton goods. This is, in many instances, more than the gross profits of wholesalers on this class of merchandise. Goods processed wholly or in chief value from cotton will constitute anywhere from 25 percent to 100 percent of the inventories of dry-goods wholesalers. These inventories all declined fully 10 percent in value as a result of the invalidation of the Agricultural Adjustment Act.

It is obvious that, unless adequate recovery is received by wholesalers, they will be subjected to exceedingly heavy losses. In an effort to protect themselves against loss, wholesalers have taken three steps:

First, they have filed claims on their manufacturers for refunds of processing taxes provided under their purchase clauses.

Second, they have filed claims against the Federal Government for a rebate on floor stocks held on January 6, 1936, under the provisions of the Agricultural Adjustment Act, as amended.

Third, they have filed claims against the Federal Government for a refund of the floor-stock tax paid in 1933 on the ground that it was a tax illegally collected.

For the recovery of floor-stock taxes paid to the Federal Government in 1933 suit has already been filed in some instances, and it seems probable that extensive and extended litigation and much rancor will develop from this cause alone unless prompt adjustment is effected of the inequities of the present conditions.

Title IV of the pending revenue act, "Refunds under Agricultural Act and Floor-Stock Adjustment", is designed to adjust these inequities. The conditions imposed by this section as a prerequisite to such adjustment seem to us to preclude the possibility of a prompt settlement of such refund claims.

Title IV, section 602, of the act provides for a payment to a person who, on the first moment of January 6, 1936, held for sale or other disposition articles processed wholly or in chief value from a commodity subject to a processing tax, of an amount equivalent to the amount of the processing tax on such commodity, but not in excess of (1) the amount of the burden of the processing tax which had been shifted to the claimant in the price he paid for the article, to the extent the claimant has not received and will not receive reimbursements for such burden from the vendor; and not in excess of (2) the amount by which the claimant reduced the sale price of the article on account of the invalidation of the taxes under the Agricultural Adjustment Act, as amended.

This section further provides that—

> No payment shall be made under this section unless the claimant * * * establishes to the satisfaction of the Commissioner the facts on which such claim is based.

And further provides that—

> The findings of fact and the decisions of the Commissioner * * * shall not be subject to review by any other administrative or accounting officer, employees, or agent of the United States—

And further provides that—

> The determination of the Commissioner shall be final * * * and no court shall have jurisdiction to review such determination.

The wholesale dry-goods trade views with the gravest apprehension the prospect of attempting to secure its floor-stock refunds under these provisions of law. For one thing, it is humanly impossible for a claimant to determine at this time what amount of money he will receive as reimbursement from his vendors. It will most certainly be many months and may be several years before this fact could be determined. Under the proposed law the claimant must await the determination of this fact before his claim can be allowed.

For another thing, it will be mathematically impossible to demonstrate with precision what part of any reductions in prices made by a claimant since January 6 have been due to the invalidation of the taxes under the Agricultural Adjustment Act and what part may have been due to other market influences. The effort to even approximate the determination of this point will require the auditing of thousands of transactions in every establishment, in the aggregate representing an audit of billions of transactions, before these facts can be established in all instances. This will obviously occasion great delay in the settlement of claims besides imposing a heavy burden of expense upon claimants and Government alike.

Under the proposed law, all findings and decisions of the Commissioner are made final, not subject to review of any other Government agency. This arbitrary authority granted to the Commissioner in the law will of necessity be delegated to subordinates, for it will be mathematically impossible for the Commis-

sioner to pass on the merits of more than half a million claims which may be filed under this provisions. This will leave each claimant literally dependent upon the arbitrary decision of a subordinate departmental employee. Under N. R. A., the wholesale-dry-goods trade suffered an experience with arbitrary authority delegated to subordinates. Any prospect of a repetition of that experience can be viewed only with dismay. Based on that experience, the members of the wholesale-dry-goods trade believe it to be not unreasonable to respectfully request that, in all cases where their rights are to be established, provision be made to establish those rights by statutory law rather than by arbitrary, personal decree.

In view of the circumstances now prevailing in the textile trades and industries and of the provisions contained in the proposed law, providing for the refunds of floor stocks, the opinion has been soberly expressed by many thinking people in the textile industries and dry-goods trades that such claims would not all be settled during the lifetime of the present generation and that such adjudication will be subject to much rancor, as well as extended litigation, based on constitutional grounds.

The suggestion has been made that these difficulties would be obviated in more than 95 percent of all claims if the law, as now proposed, were amended by a provision allowing a claimant the option of accepting in settlement of all his claims against the Federal Government, on account of the Agricultural Adjustment Act, of an amount equivalent to the floor-stock tax paid by him in 1933. This proposal has been widely discussed in various branches of the cotton-goods trade and has been widely commended. The brief investigation of the facts which we have been able to make within the past few days in our own field leads us to the conclusion that such a settlement would be advantageous to the Government as well as to claimants for floor-stock refunds.

These are our primary reasons for this conclusion:

First. Most claims for refunds on floor stocks held on January 6, 1936, will exceed the floor-stock tax paid in 1933 by such claimants. This is occasioned by the fact that cotton-goods stocks generally were heavier on January 6, 1936, than they were on August 1, 1933, and by the further fact that the conversion factors employed for computing the processing tax refunds applicable to various classes of merchandise are higher than the conversion factor employed in 1933 for computing the floor-stock tax.

It is further occasioned by the fact that, in filing his floor-stock tax return in 1933, the taxpayer gave himself the benefit of every doubt and will follow the same course in making his claim for refund in 1936. The figures which we have been able to collect within the past few days show that the amount of processing-tax refund due wholesalers will, in approximately 75 percent of all cases, exceed the amount of the floor-stock tax paid in 1933 by anywhere from 25 percent to 200 percent of the amount paid in 1933.

Second. Most claimants—it is believed more than 95 percent and possibly 99 percent of all claimants—will probably accept the settlement of their claims on the suggested basis, even though it represents a smaller amount than their estimated claim, their acceptance being influenced by their desire to secure a prompt settlement of a smaller amount rather than a long-drawn-out adjudication of a

larger amount which may be due them. This will effect not alone a saving in the amount of refund actually made to claimants, but will also save the Government an enormous expense in auditing more than a half million claims involving an incalculable number of transactions.

Third. The proposed basis of settlement would undoubtedly forestall litigation against the Federal Government, which litigation may assume grave proportions.

Fourth. While inequities would arise under the proposed basis of settlement, such inequities would be fewer than would arise under the proposed law.

Fifth. The prompt settlement of claims under the proposed option would be of enormous benefit to general business sentiment. In place of the irritations and resentments which now prevail generally all throughout the textile trades and industries because of the unprecedented disturbances, harassments, and hazards to which they have been subjected, there would immediately be established a feeling of satisfaction and relief. The settlement of claims under the procedure now specified in the proposed law may require years of adjudication, and possibly ending in widespread litigation.

Sixth. In all cases where claims against the Government require negotiation, the small claimant is hopelessly handicapped. He is financially unable to employ the experts which the larger claimant can employ to follow through with his claim, argue its merits, see that it is not held up and lost sight of in routine departmental procedure. Because of this disadvantage to the small claimant and overwhelming advantage to the large claimant, the law, as drawn in section 602 would result in the prompt settlement of the claims of large establishments and the indefinite postponement of the vast majority of claims of the smaller business concerns. The amendment we suggest would put big and little claimants on an equal footing.

Seventh. It will relieve the Members of Congress from political pressure to which they should not be exposed. You gentlemen may rest assured that, should overzealous departmental employees, in their desire to protect the Government's interests under the arbitrary powers granted to the Commissioner in the proposed act and necessarily delegated to them for practical administration, disallow claims to which claimants felt they were legitimately entitled, or unduly delay the adjudication of their claims, your intervention would immediately be sought. You may look forward not merely to hundreds, but literally to thousands of requests for the exercise of your influence unless the plan for its adjustment of these claims is simplified.

For the reasons here briefly enumerated, the wholesale dry-goods trade sincerely requests that you embody in the contemplated revenue act a provision giving any claimant entitled to a refund of processing taxes on floor stocks held on January 6, 1936, the option of accepting in prompt settlement in full of all his claims against the Government arising from the Agricultural Adjustment Act of an amount equivalent to the floor-stock tax paid by such claimant in 1933.

The CHAIRMAN. Mr. Garrison, may I ask you whether this Wholesale Dry Goods Institute is made up of wholesale people throughout the country?

Mr. GARRISON. Yes, sir.

The CHAIRMAN. Are those the views of the executive committee of this institute?

Mr. GARRISON. Yes, sir.

The CHAIRMAN. What do you estimate that would amount to in refunds, according to that suggestion?

Mr. GARRISON. I have the figure.

The CHAIRMAN. Just in round numbers.

Mr. GARRISON. Twenty-seven houses have sent me their figures, out of the total of two hundred and some odd who are members of the institute, and they have a total membership of 1,200 houses in the United States. These 27 houses are of course much larger than the average, and they paid $847,583 in floor-stock tax in 1933. Now, not all of those houses have completed the figures of what their refunds would amount to for adjustment on their inventories of January 6, but the comparison of 23 houses who have made both computations is this: The houses who paid $472,000 in 1933 will have aggregate claims of $563,000 in 1936, the aggregate claims being $91,000 more than the floor-stock tax paid in 1933. Among those are 5 houses whose claim in 1936 would be less than the payment made in 1933.

The CHAIRMAN. Mr. Kent, I think, testified that the whole floor tax at the time the processing tax went on was substantially $98,000,000.

Mr. GARRISON. Was that on cotton goods?

The CHAIRMAN. That is everything. That floor tax was imposed at the time the processing tax went on, and they collected substantially about $98,000,000.

Senator GEORGE. That did not include the floor tax through the first process?

The CHAIRMAN. That included all, did it not, Mr. Kent?

Mr. KENT. Yes. I may say there is a break-down in those figures in the course of preparation into miscellaneous taxing units, in the Bureau. I hope in a day or two we will have the figure showing just how the floor-stock tax was paid in 1933 by processors, by retailers, and so forth.

Senator GEORGE. But the $98,000,000 did include the floor-stock tax paid on the first process?

Mr. KENT. Yes.

The CHAIRMAN. Mr. Garrison, you asked for an option; that is, your executive committee did. If you did not get an option, which would you prefer? Would you prefer the option or the present plan?

Mr. GARRISON. You mean prefer it to nothing?

The CHAIRMAN. The present plan or the option.

Mr. GARRISON. We prefer the present plan with its suggested option. If we cannot get the suggested option, then we must accept the present plan. We must have something. It is inconceivable that we will not get anything.

Senator GEORGE. Your suggested solution could not apply to businesses coming into existence, since you would have to have an exception there.

Mr. GARRISON. Don't you see we wish to follow the procedure indicated in that law, but this was suggested as a method of simplifying.

the settlement of the claims in the vast majority of cases and would cover houses who were in existence in 1936.

Senator CONNALLY. Your plan, in short, is to offset the claims for refunds by the fact that they paid a lot of floor-stock taxes in 1933?

Mr. GARRISON. The plan would be simply this: To permit the claimant to accept as payment in full of his claim the amount of the floor-stock tax he paid in 1933. He is due a refund now, but to arrive at the amount of that refund will occasion an enormous amount of auditing, and we have all wondered how that is to be accomplished. We do not know, particularly when you have two provisions in there, one that will require a demonstration of the amount of refund the claimant is to receive from his vendors, which no one now knows, and the other is to demonstrate what part of his reduction in prices was due to the invalidation of the Agricultural Adjustment Act. We do not see how those two things can be demonstrated at this time.

Senator BLACK. What other organizations, if any, that are interested in this subject have adopted this same idea—do you know?

Mr. GARRISON. Well, there was a discussion in New York last week by several of the groups which are what we call secondary processors, if it is clear to you gentlemen just what it means, and it was the feeling of all the people in that group that that would be the happiest solution of a difficult problem. That included converters, who are secondary processors of cotton goods, and cotton-garment manufacturers; in fact, two or three divisions, dress manufacturers, shirt manufacturers, and others, and that was the feeling of all who were there, that although the amount of the tax paid in 1933 was, on the average, considerably more than the amount of the claims which will be filed in 1936, they would be perfectly willing to accept a settlement on that basis in order to effect a settlement promptly.

Senator BLACK. Did any of that group file injunctions and get part of the money back that was held in court?

Mr. GARRISON. No; because those people were not originally processors.

Senator BLACK. That was only the original processors?

Mr. GARRISON. That was only the original processors.

The CHAIRMAN. We are glad to get your views, Mr. Garrison.

Mr. T. G. Strange, of Columbus, Ga.?

(No response.)

The CHAIRMAN. Is Mr. T. G. Strange, of Columbus, Ga., present?

(No response.)

The CHAIRMAN. Mr. John J. Watson, New York City.

Mr. WATSON. Yes; Mr. Chairman.

STATEMENT OF JOHN J. WATSON, NEW YORK CITY, PRESIDENT, INTERNATIONAL AGRICULTURAL CORPORATION

Mr. WATSON. I will only take a very few moments of your time. I want to address myself particularly to the effect of the tax on a corporation such as the corporation that I happen to be president of, the International Agricultural Corporation, which is a manufacturer of plant foods, fertilizers, phosphate, rock mining, and many other articles, where we deal directly with the farmer or with the dealers.

We have factories scattered in 13 States, 29 factories, all small units, and the picture that is presented in our operations is so closely associated with the prosperity of the farmer that I want to call your particular attention to the effect of a tax like this on undistributed earnings.

Senator BARKLEY. Your twenty-odd factories are separately incorporated in each State?

Mr. WATSON. Senator, some of them are small corporations that we acquired when the company was formed and are run under the original name by the local people for the sake of holding the trade mark of that particular brand of fertilizer which they made.

Right in that respect comes the importance of the making of a consolidated return, because those corporations are simply an incorporated department of our business. We would be put to some considerable expense if we should be forced to take over the fee of those companies and liquidate them. We would lose the valuable trade mark which we have paid for, and there is no reason why, in general, that that should be forced upon us.

Senator BARKLEY. You maintain a separate corporate entity and the name, but the stock is owned by your company?

Mr. WATSON. The stock is all owned by International Agricultural Corporation.

Senator BARKLEY. Where is it incorporated?

Mr. WATSON. It is incorporated under the laws of New York. We have 1 factory in New York, and we have 28 factories scattered throughout 12 other States of the Union.

Senator CONNALLY. Does this holding company own all of the stock of these subordinate companies?

Mr. WATSON. It owns all the stock. We do have some few corporations in addition where we own a 50-percent interest and where the local people own a 50-percent interest.

Senator CONNALLY. Do you import a lot of your material for making fertilizer?

Mr. WATSON. We import some sulphate of ammonia, and we import some potash from Germany and France.

Senator CONNALLY. Nitrates?

Mr. WATSON. Sulphate and ammonia. Nitrate and soda from Chile; yes; but with the production now in this country of nitrate and of sulphate, it is ample to take care of our requirements, and in potash it is ample to take care of our requirements with the exception of the sulphate and the nitrate which is not produced now in New Mexico or out in Searles Lake, Calif., where we have our production.

The CHAIRMAN. We have made great progress in the production of those raw materials?

Mr. WATSON. Yes, sir.

Senator CONNALLY. Your main point is about the consolidated return. Is that what you are concerned about?

Mr. WATSON. I want to speak on two subjects. First is the consolidated return.

One thing I think that you gentlemen in considering this bill should give very careful consideration to is differentiating between the company which has incorporated departments for the reason

that we have ours, and where they could just as well be run under the name of the parent company except that they would lose the old established trade mark accepted by the farmers in that community, if we did liquidate; as against the corporation which is just a holding corporation doing an investment business or something of that character.

Senator BLACK. Could you not continue the trade mark if you consolidated?

Mr. WATSON. I imagine we could continue the trade mark, Senator, by calling it the—well, we will say the Cherokee Brand of the International Agricultural Corporation, or something of that sort. But there is a local pride on the part of these people who are partners or are associates in these localities where we have acquired their properties, and there is a decided goodwill that we would lose.

Senator CONNALLY. You can file a consolidated return now by paying a little higher tax, can you not?

Mr. WATSON. Well, to be perfectly frank with you, I feel that just as the president of a manufacturing corporation after hearing the details of this discussion on the intricacies of this bill—that I am hardly qualified to discuss the general tax bill except just as it affects us. I do not think we can file a consolidated return.

Senator CONNALLY. Railroads, I believe, are the only ones.

Mr. WATSON. Another particular thing which I want to call attention to as affecting our company is this: For the last 5 years and 8 months our profits have been very small. In the year 1931 we had earnings of $60,000. The capital of our company is 10 millions preferred; 430,000 shares of nonpar-value capital stock; five million nine hundred thousand-odd dollars in bonds outstanding; and at a certain period, the peak period of the year, we have a bank debt, a small bank debt of somewhere around $2,000,000; $60,000 was our earnings for 1931. You must bear in mind when I give you these earnings that we are in a seasonal business, dependent and governed very largely by the success of the farmer, and we have to buy our materials because of their expert chemical analysis; they have to be manufactured to give the farmer the satisfaction, some considerable time in advance. In many cases we buy our materials a year before we sell them, and in many cases we do not get paid for them for a year after we have sold them; in fact, the regular terms in the fertilizer business used to be to sell in the spring of the year payable when the crop was harvested. Because of the disastrous effects on fertilizer earnings of the companies they were forced to go closer to a cash basis—because of that.

The next year, 1932, we had a loss of $847,000; in 1933 we had a loss of $1,060,000; the following year we had a profit—that was in 1934——

Senator CONNALLY (interposing). Those losses were principally write-off?

Mr. WATSON. No, sir; these were actual operating losses. In these figures there are no write-offs.

In 1935 we had a profit of $269,000, but in that year we had a write-off of $400,000 in that particular year.

Senator CONNALLY. What was that write-off for?

Mr. WATSON. It was a write-off for——

Senator CONNALLY (interrupting). Stock? Inventory?

Mr. WATSON. No; of accounts; uncollectible accounts. The situation in Aroostook County, Maine—potatoes got to a very low price, and we had a very heavy amount of money outstanding in that territory; and in Florida there was a large amount of money that could not be collected from the farmers.

Senator BLACK. What year was that?

Mr. WATSON. In 1935.

Senator BLACK. That is when potatoes went down?

Mr. WATSON. Potatoes sold as low as 35 or 40 cents a barrel up there, you may remember.

Senator BLACK. What was your 1934 figure? You did not give it?

Mr. WATSON. A profit of $400,000 in 1934. Eight months this year up to March 31—and here I can give you just an estimate of my controller—we have a loss of $275,000.

The point I want to make is this—that in a business that is actually highly seasonable such as our business is, we feel that we should have some relief in practically restoring the losses that we make in a year before we have to pay thes heavy taxes of 40 percent. You will see by the figures which I have given you that there is a $1,847,000 net loss up to 1933. The next year we make $400,000.

Is it fair that we should have to pay a heavy tax on that $400,000? Should we not be permitted to make some earnings to restore to our treasury the working capital that we have lost in those years?

Then again, the following year, $269,000 loss. Again, is it not fair that we should restore and recoup our capital up to that amount that we have lost before we have to pay such a very heavy tax?

That is the point that I make, that we be permitted in giving consideration to this bill that you gentlemen give consideration to the fact that we should be able to replenish our working capital or restore that after years of disaster.

Senator BARKLEY. In those years where you had a net loss, you paid no corporation tax?

Mr. WATSON. No; we paid no corporation tax, but we lost largely of our capital.

Senator BARKLEY. You would have to average a tax rate over a period of years, say, take a 5-year period, and determine whether you made profits over that period before the Government would ever know whether to collect any tax from you. Of course, all income taxes are based upon the income for the year, that is, the taxable year's business. That is true not only of corporations but of individuals. I may lose $10,000 this year and next year I may make $10,000. I cannot offset next year my loss this year in order to cut down my tax as an individual.

Mr. WATSON. No; but we used to.

Senator BARKLEY. We stopped up that loophole.

Mr. WATSON. I think it is only fair that the corporation should be permitted to do that. We have over 3,000 stockholders. I am a trustee representing about 3,000 people, small owners of this company. We have also at stake the people that we have employed. We have about 4,000 people employed on our pay rolls, and that does not count the people employed in transportation in moving over a million tons of goods a year by railroad, by truck, by various methods,

because we are dealing with a product that is a very low-priced product. We are dealing with phosphates that sell for two or three dollars a ton at the mines, and oftentimes there is two or three times that in freight in the cost of the product when delivered on the farm. We are selling, of course, many other low-priced materials.

Senator BLACK. You say you have 3,000 stockholders?

Mr. WATSON. Yes.

Senator BLACK. Do you have any very large stockholders, or are they all small?

Mr. WATSON. We have one large stockholder, I am very sorry to say, Senator.

Senator BLACK. What percentage of the stock does he hold?

Mr. WATSON. That stockholder I can tell you about. He owns about one-ninth of the capital stock of the company.

Senator BARKLEY. I am trying to get at your viewpoint. Under your theory, if the company lost in any one year, in 1931 more money than they made in 1932, 1933, 1934, and 1935, then what you want the bill to do is to permit you to offset your losses in 1931 against your profits for the subsequent 4 years so that you would not pay any taxes unless the combined profits for the 4 years was more than your losses?

Mr. WATSON. I think that is only fair, otherwise where do we arrive at? We may find ourselves in a position where we would lose our capital and we would face bankruptcy, and I assume that it is not the desire of the Government to force any corporations into that position. You will readily see that it would be impossible under those conditions to get new capital.

Senator LONERGAN. Who are the owners of your bonds?

Mr. WATSON. They are owned generally, Senator.

Senator LONERGAN. And they are sold in the open market?

Mr. WATSON. They are sold in the open market. All of our securities are listed on the New York Stock Exchange.

Senator LONERGAN. Your bonded indebtedness and your stock represent about $15,000,000 in investment?

Mr. WATSON. The bond issue of $13,000,000—that is what it was. The bond issue now is $5,900,000. I can give it to you exactly if you would like to have it.

Senator BARKLEY. Would that not be the same as reenacting the law that was in existence sometime ago—I do not wish to mention this—but there was a lot of publicity, unpleasant publicity, due to the fact that in the investigation held by the Banking and Currency Committee of the stock market a few years ago, it turned out that the firm of Morgan & Co. were able to escape taxes altogether because they could project a loss over into another year, and inasmuch as they changed their firm not on the 31st of December but on the 1st of January when they took in a new partner, which gave them an additional year, would that not reenact that very situation except in a worse form?

Mr. WATSON. I do not think so in corporation finance. It may be of interest to you to know that in 1923 I was called into the management of this company to effect a reclassification of its securities, where we had to write off $9,000,000 losses, $9,000,000 because of bad credits extended. We had $9,000,000 of securities, notes due from

the farmers that we had to write off as worthless, and nothing has been collected from them.

Senator BARKLEY. Was that due to the deflation following the war?

Mr. WATSON. You see, in 1921 after the World War, there came such a spiral decline in all chemical materials and raw materials that that caught up with us and hit us in the back of the head about 1923, and we were forced to receivership or to reclassify, and our security owners and stockholders felt that it was cheaper to have it go through a reclassification under the New York State laws than to go through bankruptcy where we have to pay very heavy fees.

Senator LONERGAN. Can you tell us what your gross and net business is in a normal year?

Mr. WATSON. In a normal year it is about $12,000,000.

Senator LONERGAN. Gross or net?

Mr. WATSON. Gross.

Senator LONERGAN. What is your net on that?

Mr. WATSON. Our net profits on that?

Senator LONERGAN. On the $12,000,000.

Mr. WATSON. What do you call "net profits"? After interest on bonds, and all charges, depreciation?

Senator LONERGAN. Yes.

Mr. WATSON. I have given you the figures. It is these figures I have given you, which are after interest charges, interest on borrowed money and depreciation charges.

Senator LONERGAN. And you call that a normal year?

Mr. WATSON. I call them abnormal years, unfortunately. We surely would not like to face years of that sort.

Senator LONERGAN. Let us go back 8 or 10 years.

Mr. WATSON. I will be glad to do that. In the year 1924, this was the year after our reclassification of our corporation, where we charged off $9,000,000, we extended our bonds, and the creditors, bank creditors, $13,000,000, took preferred stock on the basis of 90 cents on the dollar for their debts, so we got rid of our bank debt, or largely got rid of it. We converted our preferred stock which had been paid for 100 cents on the dollar back in 1909, and they were given 1½ shares of common stock which now is worth about $5 a share, the market value would be $7.50 for what they had paid in 1909 $100 for, and the common stock received one-sixth of a share for each share of stock. Some of that was given in various contracts and given with properties that were acquired, such as I mentioned where we had local plants.

Senator LONERGAN. What would you estimate the physical value of your property?

Mr. WATSON. I think about $15,000,000 or $18,000,000, figuring the phosphate rock deposits which we have, and the plants. Of course, that is the large value, the phosphate in the ground.

Senator BARKLEY. To what extent would the application of your suggestion encourage inefficiency in the management of a plant? Would not the tax saved by paper losses or actual losses over a period of 3 or 4 years be sufficient to cause a management to be more or less careless on the ground that they would not have to pay any tax anyhow even though they made a profit some year if the losses were sufficient to absorb them?

Mr. WATSON. I would not think so, Senator. I know in my own case, I can only answer for myself, that would be about the last thing I would do in managing a corporation.

Senator CONNALLY. You say among the most valuable assets you have are these rock deposits?

Mr. WATSON. Yes.

Senator CONNALLY. What rate of depletion do you get on that?

Mr. WATSON. We get 20 cents a ton for the rock on the ground.

Senator CONNALLY. You take that off each year?

Mr. WATSON. Yes, sir.

Senator CONNALLY. Twenty cents a ton?

Mr. WATSON. Yes. In the Tennessee fields—in some cases we pay a royalty to the farmers where we mine on their property.

Senator CONNALLY. You are not restricted on depletion to recouping your capital investment on the rock? You might have already paid yourself the depletion and you can keep on under the present law doing that?

Mr. WATSON. We would have to go, Senator, 30 or 40 years on that basis with the biggest years we have ever seen to take care of ourselves.

Senator CONNALLY. I am not talking of your losses outside; I am speaking of rock on the ground.

Mr. WATSON. $13,000,000 was paid by the company for the rock properties. This company when it was formed paid $13,000,000 for it.

Senator CONNALLY. On your income tax you take depletion on each ton of material that you have sold?

Mr. WATSON. Each ton as it is sold.

Senator CONNALLY. Twenty cents a ton?

Mr. WATSON. Yes, sir.

The CHAIRMAN. Is there anything else? Have you covered it?

Mr. WATSON. The Senator asked me for the figures to go back 10 years.

Senator LONERGAN. I just wanted any one year out of the 10.

Mr. WATSON. Perhaps just to clear this up, because the year I gave would not be fair, Senator Harrison. The profits in 1925 were $1,025,000; in 1926, $1,400,000; losses in 1927 were $352,000; profits in 1928 were $1,400,000; profits in 1929 were $1,100,000; and the profits in 1930 were $1,500,000.

I have given you the other profits.

But to answer your question, it is perfectly reasonable to expect that we would only go through 1 or 2 years of a loss to recoup the capital, but we have this bonded indebtedness of $5,900,000 coming due in 6 years, in 1942, and, mind you, we have not paid a dividend to any of our stockholders since 1931. Not a shareholder in our company has received a dividend, and then they did not receive the full dividend. They have received $2,800,000 in dividends in 12½ years, and by the terms of the reorganization, they were entitled to a 7-percent cumulative stock. The stock was taken in lieu of bank debts, so it was all money that was all paid in, and there is 60 percent per share accumulated on it now.

So I am just pleading for some relief on that sort of an accumulation of losses so that we can restore our company's capital.

Senator CONNALLY. Under this bill you would only be taxed 22.5 percent if you qualify under the tax.

Mr. WATSON. Yes; 22.5 percent, but we would favor a flat tax.

Senator CONNALLY. That is flat. You mean flatter?

Mr. WATSON. Yes.

The CHAIRMAN. Thank you very much. The next witness is Harry H. Gerrity.

STATEMENT OF HARRY J. GERRITY, WASHINGTON, D. C., REPRESENTING THE NATIONAL ASSOCIATION OF BUILDING OWNERS AND MANAGERS, AND THE UNION PACIFIC RAILROAD CO.

Mr. GERRITY. Senator, I have a dual statement. My first statement is on behalf of the Union Pacific Railroad. It will only take me a few minutes to read.

The CHAIRMAN. How much time, Mr. Gerrity?

Mr. GERRITY. Fifteen minutes.

The CHAIRMAN. For both?

Mr. GERRITY. Yes, sir.

The CHAIRMAN. Why do you not just put it in the record and state briefly what your proposition is, and we can ask you questions about it. I understood that you want to talk on the rental proposition in section 102.

Mr. GERRITY. My statement on behalf of the National Association of Building Owners and Managers is in regard to the definition of personal holding companies in section 102 which includes the word "rents."

STATEMENT ON BEHALF OF THE NATIONAL ASSOCIATION OF BUILDING OWNERS AND MANAGERS

I am appearing to suggest a change in the provisions of section 102 of the tax bill, H. R. 12395, as passed by the House on April 29. I represent the National Association of Building Owners and Managers, which is composed of 46 local associations in larger cities of the country, and associate members in some 90 of the smaller cities, having a membership of approximately 1,714 and representing more than 2,125 office buildings as of January 1, 1936, and, in addition, substantial holdings in apartment, loft, and other commercial properties.

We appeared here in 1928, and again in 1934, for the same purpose, namely, to oppose the definition of "personal holding company" as contained in section 102 (b) (1) of the bill. This section covers "Surtax on Corporations Improperly Accumulating Surplus." It is expressly made applicable only to six classes of corporation: (1) Banks, (2) insurance companies, (3) foreign corporations, (4) corporations organized under the China Trade Act of 1922, (5) corporations deriving income from sources within possessions of the United States, and, finally, (6) personal holding companies. Banks are defined in section 104, but a personal holding company is defined in subsection (b) (1) of section 102 of the bill to mean—

any corporation if (A) at least 80 percetnum of its gross income for the taxable year is derived from royalties, dividends, interest, rents, annuities, and (except in the case of regular dealers in stock or securities) gains from the

sale of stock or securities, and (B) at any time during the last half of the taxable year more than 50 percentum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

It is provided in the bill that stock owned directly or indirectly by a corporation, partnership, estate, or trust shall be considered as being owned proportionately by the shareholders, partners, or beneficiaries, and an individual shall be considered as owning the stock owned by his family in such a manner as to produce the smallest possible number of individuals owning more than 50 percentum in value of the outstanding stock.

The CHAIRMAN. Do you think that the law has been changed in that respect?

Mr. GERRITY. Yes, sir; I think it has.

The CHAIRMAN. Under the present law, it applies to all corporations whether they are in the real-estate business or what not, section 102, and in this it restricts it; is that right?

Mr. GERRITY. Yes; but section 351 of the present law defines "personal holding companies" and does not include the word "rents" in that class of income.

The CHAIRMAN. That has been eliminated, you understand?

Mr. GERRITY. Yes, I understand; but still under this section, an office building corporation deriving 100 percent of its income from rents, which is more than 80 percent, would be, ipso facto, a personal holding company, because under paragraph (d) of section 102 it says that there is a presumption that any corporation—if I may proceed with my statement, I do cover the point a little further down.

I think the law is being changed, and would suggest that the word "rents" be eliminated as it will affect a great many of these building corporations which are not holding companies but operating companies.

The surtax imposed under section 102 is 25 percent of the amount of the "retained net income" up to $100,000, and 35 percent of the retained net income in excess of $100,000. The "retained net income" is defined to mean the net income, less the dividend credit. Hence, all six classes of corporations mentioned in section 102 (a) of the bill are entitled to the dividend credit provided in section 27, but only one class—personal holding companies—is subject to a higher rate of what might be called the normal tax on corporations, as imposed under section 13. By section 104 (b) a bank or trust company will pay, in lieu of the tax imposed by section 13, a flat so-called normal tax of 15 percent, and a like rate of tax is applied to insurance companies in section 201 (b), to foreign corporations in section 231, to corporations deriving income from United States possessions in section 251 (c), and to China trade corporations in section 261. We earnestly request that real-estate corporations be accorded the flat 15 percent tax rate, just the same as banks and insurance corporations, and the other three classes of corporations mentioned in section 102 (a).

However, the unfairness of section 102, as applying to small corporations owning and operating commercial buildings, is further evidenced in subsection (d) of section 102, which provides that "the fact that any corporation is a mere holding or investment company, * * * shall be prima-facie evidence of a purpose to avoid surtax." This would bring all small corporations owning and

operating office and apartment buildings, having five or less stockholders (as defined and limited in the bill), and whose gross income was derived from rents, within the surtax rate of 25 percent, over and above the ordinary corporation tax rate which the bill provides for in section 13. For example, if an office building had gross income from rents of 80 percent or more, and the stock was owned by a single stockholder, the net income not distributed in dividends would be subject to the tax imposed by section 13, plus a surtax of 25 percent on the first $100,000 undistributed, and 35 percent on any excess thereof that might be retained by the corporation in each taxable year. The total tax on the retained or adjusted net income might easily amount to 67.5 percent under schedule II of section 13, in the case of a corporation with an income in excess of $10,000.

Of course, section 102 applies the surtax to corporations, such as personal holding companies, provided, however, that such corporation 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. But, as I have already said, a small real-estate corporation owning and operating commercial properties, with five or less stockholders, would be presumed, under the bill as it passed the House, to be availed of for the purpose to avoid surtax and would be subject to the drastic penalty provisions of section 102, and this would be decidedly harsh and unjust in practically every instance, because the corporate form of ownership is used for convenience only and is not adopted or availed of for the purpose of tax avoidance, which is basically the aim of section 102 to prevent.

The CHAIRMAN. Section 102 would apply. It does not mention rents in there, but it applies to all corporations that are trying to evade their taxes.

Mr. GERRITY. Corporations which have improperly accumulated surplus beyond the needs of the business.

The CHAIRMAN. That is right.

Mr. GERRITY. But that is not in the section as drafted in the bill. The words "beyond the reasonable needs of the business" is not in the bill.

The CHAIRMAN. You are at variance with all of our experts who say that it is.

Mr. GERRITY. I have quoted from section 102 (d), which says:

> The fact that any corporation is a mere holding or investment company shall be prima facie evidence——

The CHAIRMAN. (interposing). I would suggest to you that you talk to the committee's expert on the proposition, file your brief for the record, and if there is any question about it we will take it into consideration.

Mr. GERRITY. The statute is very short.

Senator COUZENS. There is no use reading it.

Mr. GERRITY. I would like to point out the fact that real estate carries 80 or 90 percent of the burden of local taxation.

The CHAIRMAN. If there is anything in this proposition, it will be looked into thoroughly.

Mr. GERRITY. It is a well known fact that real estate is still heavily burdened with taxation, although in recent years other sources for revenue have been resorted to by municipal governments. According to the Statistical Abstract of the United States for 1935, prepared by the Department of Commerce, the total assessed valuation of real property subject to the general property tax was $124,706,000,000 in 1932, and the States, counties, and minor civil divisions levied in real-estate taxes in that year $5,026,763,000, which amounted to $40.37 per capita. Of the total receipts of local tax bodies, including school districts, townships, and other civil divisions, $4,361,307,000 was derived from real-estate taxes, or 92.48 percent of the total receipts. The counties received in real-estate taxes $877,142,000, or 85.92 percent of the total receipts, and the cities, towns, villages, and boroughs received $2,007,495,000 in real-estate taxes, or 91.39 percent of the total received from general property taxes. These statistics bear out the assertion which is frequently made, that about 80 percent of the cost of running our local government comes from real-estate taxes. In Pittsburgh, I am told, real estate pays 90 percent of all the taxes, and doubtless this is true in many other large cities. Everyone will admit that real estate is still bearing the greatest part of the load of local taxation. For 15 years our association has been getting out office building experience exchange reports, and the latest report, for the year 1934, covers 319 buildings in 63 cities throughout the United States. It is shown that the relative cost of taxes to income has increased from 14 percent in 1930 to 19.6 percent in 1934. In a great number of cities property taxes actually decreased in 1934, but while this is true, the ratio of local property taxes to income has materially increased. In relation to rentable area in office buildings real-estate taxes in 1934 averaged 28.4 cents per square foot, and 17½ cents of the rental dollar from these 319 office buildings is allocable to property taxes of course, as many as 319 office buildings may have had taxable income, but there are still many hundreds of office buildings which, because of the vacancies and lack of tenants, have operated without any net income in recent years and will continue to do so for some years to come. Federal income taxes are of no concern to many corporations operating office buildings, and I was told recently about a building which was put through a reorganization, that in 14 years the corporation paid only $1,600 in Federal taxes, while in the same period of time over $400,000 was paid in local taxes. This $400,000 of local taxes really meant the difference between ownership and receivership of the property.

Our latest vacancy survey, as of January 1, 1936, covering 2,126 buildings in 52 of the larger cities shows a vacancy of 24.11 percent, or 46,595,409 square feet out of a total rentable area of 193,251,490 square feet. Of course, many office buildings throughout the country, except in Washington, have a large amount of vacancy, and some are still in receivership or required by contract to apply the greater part of their net income to the amortization of mortgage indebtedness from year to year. In the case of bondholders' reorganizations there are requirements that no dividends can be declared until the bonds have been partly retired, and undoubtedly there will be hundreds of cases where it will be absolutely impossible for the directors

of the corporation to declare any of the net income in dividends to stockholders. In this connection, the bill provides a flat rate of 15 percent (1) on that part of the adjusted net income which is needed to make up prior year deficits, and (2) a flat rate of 22½ percent on that part of the adjusted net income which cannot be distributed due to a prohibitory written contract executed by the corporation prior to March 3, 1936, and (3) a flat rate of 22½ percent on that part of the adjusted net income required to amortize certain types of indebtedness such as mortgages. (See secs. 14, 15, and 16.)

The complexity of these varying rates as applied to corporations owning, leasing, or operating commercial properties might be illustrated by considering the four large office buildings at any street intersection in a typical American metropolis. The corporation owning the office building on the northwest corner would be subject to a flat rate of 15 percent, if it was in receivership, under section 105. The corporation owning the building on the northeast corner would be subject to a flat rate of 22½ percent if it had gone through reorganization and was required by contract between itself and the bondholders to apply the net income to the partial retirement of the bonded indebtedness, whilst the corporation owning the building on the southwest corner might have more than five stockholders and be subject to the downward graduated tax rate beginning at 42½ percent on the undistributed net income under schedule II of section 13, and the corporation owning the office building on the southeast corner, having less than five stockholders, would be subject to the personal holding-company provisions of the bill and might have to pay a normal tax at the downward graduated rate on undistributed net income, plus a surtax under section 102 of 25 percent on the first $100,000 of retained net income and 35-percent tax on the remainder. All four corporations are engaged in the same kind of business, operating commercial properties and leasing space therein. Although they might be differently situated in respect to mortgage indebtedness and have different financial structures, there would seem to be no valid distinction for varying tax classifications based upon the relationship of the number of persons owning the stock in the corporation.

The provisions of section 102 of the bill would work an injustice to real-estate corporations which are engaged in the active business of operating and managing office and apartment-house buildings. A great majority of all large commercial buildings are owned by corporations, and they would come under the definition of "personal holding company" as contained in section 102, because all of the income received is in the form of rents, and the stock in a great many is held by five persons or less. These are operating companies engaged in a legitimate business, and they are not holding companies in the ordinary sense, and should not be so designated. We feel that they should not be penalized by the additional surtaxes which are threatened under section 102, or forced to change their present method of conducting business in order to escape them.

Office-building corporations are no different from other business corporations whose stock is closely held, and whose income is derived from manufacturing or trading, for example. The risks inherent in the ownership and operation of commercial real estate are just

as great as in other lines of industry. When it is realized that corporations owning buildings must, in many instances, use all of their available earnings toward the amortization of mortgages, or toward providing sinking funds to meet mortgage maturities, and for reconditioning, replacements, and other unusual but essential purposes, it is clear that the inflexible provisions of section 102 of the bill are singularly harsh in their application to such corporations.

The prudent office-building corporation must retain part of its annual net income, if any, for replacements, betterments, or new installations, and these expenditures are nondeductible under the existing income-tax law. Because buildings are long-lived assets the annual depreciation rate is low, so that the depreciation reserve is not sufficient in amount or otherwise available for contingencies. The relief provided by section 16 of the bill, granting a flat rate of 22½ percent on the adjusted net income in excess of the amount required to amortize outstanding indebtedness, is clearly insufficient, and likewise discriminatory, in that a corporation with a large mortgage debt greatly in excess of its adjusted net income, to amortize over 5 or 10 years, would be favored to the detriment of a corporation which had a small mortgage indebtedness less than its adjusted net income for the taxable year, both competing in the same line of business. More capital is required to be invested in office buildings in proportion to the gross return than in any other business or industry. The ratio is about 10 to 1—that is, for every $10 invested there is a gross return of but $1 in income, and the net return is much less than this as measured by the capital invested. Corporations of this class are not, and never have been, regarded as holding corporations in any sense. If they are at any time availed of to prevent the imposition of surtaxes upon their stockholders, they can readily be reached under section 102 of the existing law, which can be continued in the present bill by the elimination of personal holding companies from section 102 and reenacting section 351 of the Revenue Act of 1934, which specifically applies to personal holding companies without including the term "rents" in the definition of the classes of income to be taxed thereunder.

When this committee considered the matter 2 years ago there was a storm of protest from real-estate interests all over the country. The data presented at that time is covered on pages 159 to 174 of the Senate hearings on H. R. 7835. In preparing its report (S. Rept. No. 558) on the House bill, 2 years ago, this committee included therein the following statement:

> The House bill includes in the income within the 80-percent clause income from rents. A great part of real-estate business is done by small family corporations. These partake more of the nature of operating companies than mere holding companies. Your committee is of the opinion that it is unwise to include such companies within the category of personal-holding companies. Therefore, the word "rents" is omitted from the definition.

We believe that that is a fair and accurate statement and applies equally today as it did 2 years ago. These commercial building corporations are in reality operating companies rather than mere holding companies. We hope that the committee will reach the same conclusion at this time, in respect of the provisions of section 102 of the House bill, and we urge that it is unwise, as well as unnecessary, to include real-estate corporations within the category of so-called

personal holding companies. A simple correction of the matter would be by eliminating the word "rents" in the definition of personal holding companies in section 102 (b) (1) of the bill. We have no objection to the provisions of the law as they exist today, but it is felt quite generally throughout the country that if special treatment is given to banks and insurance companies by a flat 15-percent tax rate, as now provided in the bill, similar treatment should be given to corporations owning, leasing, and operating real estate.

We are quite willing to carry our fair share of the burden of Federal income taxes, whenever there is net income upon which the tax can be levied, but considering the tremendous load which real estate carries in the form of local taxes, it is not unreasonable to suggest that in drafting a new tax bill at this time some special provisions should be made for a flat 15-percent rate on all real-estate corporations, which are just as much entitled to favorable treatment of this kind as are banks and insurance companies. In the larger cities of the country real-estate bonds are widely held by persons of small means, and the preservation of their existing investment in these large commercial buildings through reasonable taxation rates is as of much public concern as the protection of the stockholders or depositors of banks and the policyholders of insurance companies. We feel that there should be no discrimination in rates as between real-estate corporations and banks and insurance companies.

The provisions of section 102 of the bill tend to weaken the existing law as contained in sections 102 and 351 of the Revenue Act of 1934. It is better to retain section 351 as it exists than to combine personal holding companies within the scope of section 102, which is thereby limited as a practical matter, merely to personal holding companies which are availed of for the purpose of preventing the imposition of surtax upon their shareholders by the accumulation of surplus beyond the reasonable needs of the business. The enforcement of the provisions of the existing law is endangered by the amendments made in the pending bill.

In regard to the other statement I have, it is in connection with section 143 of the bill.

STATEMENT ON BEHALF OF THE UNION PACIFIC RAILROAD CO.

In the President's message of March 3, 1936, he stated that the recommendations which he was making "would effect great simplification in tax procedure, in corporate accounting, and in the understanding of the whole subject by the citizens of the Nation." If you will give me 5 minutes, I would like to present the gist of this statement.

The CHAIRMAN. We will give you time, but if we are in agreement on a proposition there is no use taking up the time of the committee.

Mr. GERRITY. This is on an entirely different matter. This is entirely different. The personal-holding company definition was adjusted in 1934, to the satisfaction of the real-estate people, and all that we ask is that the present law be continued.

In regard to this other matter, as I said, I represent the Union Pacific Railroad.

I appear to suggest the elimination from section 143 of the bill of the provisions relating to withholding of tax at the source on so-

called tax-free covenant bonds. The elimination of these provisions would simplify the administration and public understanding of the law, in accordance with the thought expressed by the President in his message, and there is great need for some measure of simplification in our present tax structure. If my suggestion is adopted, there would be no loss of revenue to the Government; in fact the expense in administering the provision, both by corporations and the Government, would be a clear saving, and an increase in revenue would result as a consequence.

The 1934 bill, considered 2 years ago, did make an amendment to section 143 by providing that it should apply to bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, *issued before January 1, 1934*. In other words, the withholding of tax at the source on tax-free covenant bonds does ont apply to bonds issued since January 1, 1934. In view of the 1934 amendment, the retention of these withholding provisions is unjustified, as the amendment makes the provisions practically useless at the present time as to new bonds, and an entire abandonment of the tax-free covenant provisions in the law is justified and advisable in furtherance of simplicity, if for no other reason.

Under the general scope of the bill not only surtaxes, but also normal taxes will be paid upon dividends received by stockholders. There is no valid reason why bondholders should not pay the entire tax on the interest received by them, rather than to impose 2 percent of the tax on such interest upon the obligor corporation, and the balance of the normal and surtaxes on such interest upon the individual bondholder subject to income taxes.

The subject which I am discussing was first brought to the public attention in the report of the subcommittee of the House Ways and Means Committee, on December 4, 1933, in considering methods of preventing the avoidance and evasion of the internal-revenue laws, together with suggestions for the simplification and improvement thereof. In its report the subcommittee stated:

(21) WITHHOLDING TAX-FREE COVENANT BONDS

Section 143 (a) provides for the withholding by a corporation or other obligor of an amount equal to 2 percent of the amount of interest paid on bonds or other obligations which contain a provision by which the obligor agrees to pay any portion of the tax imposed upon the obligee. The tax is not required to be withheld at the source where the obligee files with the obligor a statement that he is not taxable under the income tax on account of his income being less than the amount of his personal exemption. The bondholder is entitled to a credit against his tax where there has been withheld a tax at the source on his account.

Your subcommittee recommends that this system of withholding a tax on tax-free covenant bonds be entirely discontinued. The system originated in the 1913 act, where general withholding was employed to collect a large portion of the tax. The withholding policy has now been abandoned and the withholding on tax-free covenant bonds is an exception to the general rule. It is an administrative nuisance and requires the payment of many small refunds. Simplification and reduction in administrative expense can be secured by the elimination of this section. No loss in revenue will result from the change.

During the consideration of the 1934 bill, the following discussion was had by members of the Ways and Means Committee with Dr. Magill, representing the Treasury Department. This appears on pages 144 to 146 of the House hearings, as follows:

The CHAIRMAN. Now let us take up the next subject.

Mr. MAGILL (reading):

"(21) *Withholding tax-free covenant bonds.*—The Department submits that the present provision of the statute relating to withholding of tax at the source in the case of tax-free covenant bonds, as contained in section 143 (a). (1), (2), and (3), should not be eliminated. Many bonds, now outstanding, contain this provision. The elimination of this section of the statute would result in much confusion, and would remove a useful check upon the accuracy of returns."

What the subcommittee proposes in substance is this: That the present practice of permitting a taxpayer to have a credit on his return for an amount of tax paid at the source by the corporation on tax-free covenant bonds should be stopped. Although we do not say so in the reports, I believe that the Department would agree with you that it would be desirable to end this practice with respect to bonds issued in the future, which could be done by appropriate legislation. Our only question lies in this respect: That bonds now outstanding do contain this provision for the corporation paying the tax at the source, and if you do not have this crediting provision the corporation will necessarily have to make a multitude of arrangements with its various bondholders in order to pay them directly the small amounts of taxes which are involved.

It is quite true, as I dare say the subcommittee had in mind, that the Government is acting in this respect as an intermediary on behalf of the two parties, and is putting itself to some inconvenience and some expense in that connection, and I think that might well be eliminated as to the future.

Mr. COOPER. I think that is substantially the view the subcommittee had of it. We were inclined to think that as the situation now stands it is rather an administrative nuisance, and considerable personnel is necessary to administer this, when it might just as effectively be done some other way, certainly for the future.

Mr. MAGILL. I think that is entirely true for the future. I was told by the section in the Bureau that they regarded this as giving them a check upon the accuracy of returns of interest on taxpayers' returns. I do not myself see where it can be of much advantage to them in that connection.

Mr. COOPER. And we also had the impression that it involved a great number of small tax refunds.

Mr. MAGILL. It does.

Mr. VINSON. What is your personal view in regard to the recommendation of the subcommittee?

Mr. MAGILL. I would be inclined to put in the statute something which would eliminate this provision as to the future, but let it go as regards the past. I think the practice will soon end if you take a step of that kind.

Mr. HILL. Do you consider some obligation, implied or direct, on the part of the Government to carry out this provision so far as it exists?

Mr. MAGILL. No; I do not think there is. I do not think there is any legal difficulty or constitutional difficulty. What it would mean is simply this: I own a $1,000 bond with a 6-percent coupon. The corporation has agreed to pay 2-percent tax at the source. That means that the corporation has in effect obligated itself to pay $1.20 each year on my account. If this withholding and tax-free covenant provision is taken out, the corporation, in order to live up to its obligation, ought to arrange to pay me $1.20 directly that is what it amounts to instead of doing it in this roundabout way.

Mr. VINSON. As I understand you, you think that it is feasible and practical and the proper thing to do to dispense with this provision so far as future bond issues are concerned?

Mr. MAGILL. Yes, sir.

Mr. VINSON. Of course, at the present time some of the money withheld does not reach the source to which it was directed, does it?

Mr. MAGILL. Of course, the fact is, it is not a real withholding. Take the case that I just spoke of, the corporation pays me the $60 which the coupons call for, and then pays in addition $1.20 to the Government. Now, the corporation may pay more than it should, owing to the fact that I am really exempt from the tax.

Mr. VINSON. You do not pay it unless you are subject to the tax, do you?

Mr. MAGILL. Well, that all depends on what check-up is made with respect to the information returns.

Mr. VINSON. In other words, unless the taxpayer files an exemption certificate, the corporation does pay?

Mr. MAGILL. Yes; that is true. The difficulty will come in this: Although the person who is collecting the interest is not, in fact, subject to the income tax, he may not know at the time he collects the interest from the bond that that is going to be true, and hence he may not file the notice in writing, indicating that the company should not pay the 2-percent tax, although actually it will prove to be true that it is not due. That leads to this matter of refunds which the subcommittee has spoken of.

It should be noted that Dr. Magill stated that he was in favor of putting in the law something which would eliminate this provision as to the future, and that he did not consider there was any obligation on the part of the Government to carry out this provision so far as it then existed. There is further testimony on this same subject in the House hearings on pages 299–302, in December 1938, and before the Senate Finance Committee, as shown on pages 138–143 of the Senate hearings on H. R. 7835, in March 1934. Under the law as it exists today the rates of withholding required by section 143 (a) (1) on obligations of corporations containing a tax-free covenant and issued before January 1, 1934, are as follows:

Owner	Tax-free unlimited	Tax-free limited to 2 percent
	Percent	Percent
Citizen or resident of the United States (individual or fiduciary) or a partnership other than a nonresident partnership composed in whole or in part of nonresident aliens	2	2
Nonresident alien individual and fiduciary, or a nonresident partnership composed in whole or in part of nonresident aliens	2	1 4
Nonresident foreign corporation	2	1[1]4
Unknown	2	1 4

[1] Two percent assumed by debtor corporation; balance deducted from owners' interest.

I submit herewith a copy of T. D. 4460 and T. D. 4478, which discloses the present operation and administration of section 143 (a) (1) of the existing law and ask that it be printed as an appendix to my remarks.

Senator CONNALLY. Let me ask you a question. This tax on tax-free covenant bonds are bonds in which the issuing corporation includes a clause that they are free of tax?

Mr. GERRITY. Yes; Senator. Some specifically state that the obligor would assume to pay a certain percentage of the Federal income tax, but most of them issued prior to 1918 and which come under this section are bonds which did not make a statement like that. It said that the obligor agrees to pay the interest without deduction for any tax, before there was any Federal income tax law at all; consequently the point we make is unless Congress imposed the tax on the obligor corporation, they will be fulfilling the obligation of the bond by paying the interest in full without any deduction of the tax.

Senator CONNALLY. Exactly; but the obligor assumed that liability when it issued those bonds, and why should it not carry it out?

Mr. GERRITY. Not as to the bonds of railroad corporations issued prior to 1918. I think the brief I have here will probably convince you on that point. This is an anomaly in the Federal income-tax law. It is the only withholding at the source provision that has been retained, and as I say it is not effective as to bonds issued after January 1, 1934, and it requires the filing of about 6 million

of these small information slips throughout the year and requires a lot of small refunds by the Commissioner of Internal Revenue.

Senator BLACK. Do you mean refunds to the individual?

Mr. GERRITY. Sometimes to the individual and sometimes to the corporation. In other words, the individual might file a slip saying that he is liable for the tax when as a matter of fact the chances are that he is not liable for any tax. The corporation will have to pay the tax, and then they will be entitled to this refund of 2 percent which they pay on behalf of the individual.

Senator CONNALLY. They would not be doing anything except that which they covenanted in the bond to do?

Mr. GERRITY. I should like to quote from the Senate Finance Committee report.

Senator CONNALLY. I do not care who it is from. The same theory applies.

The CHAIRMAN. Won't you put this into the record? We will take that into consideration.

Mr. GERRITY. When the tax bill passed the Senate 2 years ago, the Senate adopted an amendment striking out the withholding provisions regarding tax-free covenant bonds, but the Senate amendment was not adopted in conference. I recommend that when the pending bill is reported to the Senate, section 143 be amended so as to conform with the 1934 bill as passed by the Senate 2 years ago. A letter from the Treasury Department was placed in the testimony before this committee 2 years ago, in which it was stated that there are approximately 6,000,000 forms 1000 and 1000–A, filed each year for individuals residing in practically every locality in the country; that these forms are executed by approximately 2,000,000 bondholders, resulting in numerous types of handwriting of varying degrees of legibility; that of these 2,000,000 bondholders a certain proportion change their addresses often from one collection district to another, and that the results are obvious: First, in the case of illegible certificates, precision in sorting is impossible, and in the second case, where the address is changed, transmission of the certificates to the collection district where the return of the individual is filed cannot always be effected. The Treasury Department stated that the result of these two conditions makes a partially incomplete file of ownership certificates for many taxpayers, and when it is realized that the income tax returns of nearly all individuals are finally audited and closed in the collection district where they are filed, the burden of administering this withholding section of the law is more than warranted or justified.

In my opinion, the change made by the committee 2 years ago was not sufficient. In reporting the 1934 bill the Finance Committee report stated (p. 40):

SEC. 143. WITHHOLDING OF TAX AT SOURCE

The present law provides for withholding by a corporation or other obligor of an amount equal to 2 percent of the amount of interest paid on bonds or other obligations which contain a tax-free covenant. The tax withheld is paid over to the Government, and the obligee on furnishing proof is credited with the amount of tax withheld. The House bill discontinued the requirement of withholding as to bonds issued after January 1, 1934. Other minor changes were made in this section to effectuate the policy adopted in the House bill in section 11.

From the Government viewpoint there seems no more reason for withholding in the case of bond interest than in the cases of salaries, dividends, and other items. The change made in the House bill is in the interest of simplicity and is approved. On the other hand, the withholding provision should be retained as to bonds now outstanding, as the House bill provides, in order that the corporate obligors may not reap a profit at the expense of their bondholders. However, your committee recommends the date of discontinuance of such provision should be set forward to July 1, 1934, so as to avoid any confusion in the marketing of present issues.

The above statement that the corporate obligors might reap a profit at the expense of their bondholders is entirely unfair and not justified by the facts. Insofar as there are outstanding bonds in which the corporate obligors have agreed to pay any portion or all of the bondholders' income taxes the holders of such bonds will continue to receive all that their contract calls for, notwithstanding the abolition of withholding tax at the source. The principal class of bonds which are unfairly dealt with under section 143 were issued prior to 1913, and most of them many years prior thereto, and they contained no covenant to pay the bondholders' income taxes whatever, but merely agreed to pay the interest in full without deduction.

In order that the committee and its experts may have full information, I attach also as an appendix to my remarks two memorandums on the subject which I think will be helpful.

It is believed that the amendment made by the 1934 law, limiting the withholding provision solely to bonds issued prior to 1954, has created greater confusion in the administration of these provisions, and that the sensible and fair thing to do, is to eliminate entirely the portion of section 143 which applies to tax-free covenant bonds. The amendment did not help to simplify, but rather to complicate the situation. The nuisance feature of withholding tax in the case of bond interest has existed since 1917. Corporations are burdened with the enormous amount of red tape in making monthly and annual returns—the banks and other financial institutions are continually annoyed with millions of small slips (form 1000) and the administrative expense of the Treasury, corporations, banks, and others, would be reduced if this onerous method of collecting tax on bond interest is abandoned in the 1936 revenue act. The total amount of taxes collected in this fashion is about $10,000,000 each year. The number of annual withholding returns (by corporations) average about 12,000. The number of exemption (or ownership) certificates required to be printed and supplied by the Treasury is now about 6,000,000 a year.

The tax is that of the individual bondholder. He reports the interest received as income, and then takes a credit for the tax paid by the corporation. The payment of the tax is a gain to him—but he is not taxed on it. The collection of the tax from the corporation is, in reality, additional interest on the bond. Of course, some corporations agreed to pay the income tax—but most of them did not. This is especially true of bonds issued prior to 1918. They only agreed to pay the interest without deduction for tax. This they would continue to do if Congress should eliminate section 143. This section actually imposes on the corporation the tax which the individual is supposed to pay, in most instances. It is merely incidental that corporations will save some tax by the suggested change. The Treasury revenues will not suffer—rather, an administrative

nuisance (which adds to the Government expense) will be abolished; and millions of taxpayers will be less annoyed by their Federal tax problem. The shifting of so small an amount of tax to individual bondholders would be so widely distributed as to make the additional tax liability of little consequence—and most of such bonds are held by persons of some wealth who have "ability to pay" and who would not feel any burden from the proposed change of method in collection. There would be less duplication of work and effort; needless bookkeeping would be avoided, and a great deal of wasted labor and expense would be saved to individuals and corporate taxpayers, and the Treasury as well. All such costs are an economic waste.

APPENDIX A

(T. D. 4460)

WITHHOLDING OF INCOME TAX UNDER THE REVENUE ACT OF 1934—OWNERSHIP CERTIFICATES REQUIRED IN CONNECTION WITH INTEREST ON BONDS OF CORPORATIONS

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

Collectors of Internal Revenue and Others Concerned:

The Revenue Act of 1934 was approved by the President at 11:40 a. m., May 10, 1934. Subsections (a) (1) and (b) of section 143 of the act provide:

"(a) *Tax-free covenant bonds.*—(1) Requirement of withholding: In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, issued before January 1, 1934, contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods, if payable to an individual, a partnership, or a foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein: *Provided*, That if the liability assumed by the obligor does not exceed 2 per centum of the interest, then the deduction and withholding shall be at the following rates: (A) 4 per centum in the case of a nonresident alien individual, or of any partnership not engaged in trade or business within the United States and not having any office or place of business therein and composed in whole or in part of nonresident aliens, (B) 13¾ per centum in the case of such a foreign corporation, and (C) 2 per centum in the case of other individuals and partnerships; *Provided further*, That if the owners of such obligations are not known to the withholding agent the Commissioner may authorize such deduction and withholding to be at the rate of 2 per centum, or, if the liability assumed by the obligor does not exceed 2 per centum of the interest, then at the rate of 4 per centum.

"(b) *Nonresident aliens.*—All persons, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States, having the control, receipt, custody, disposal, or payment of interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having an office or place of business therein), rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any nonresident alien individual, or of any partnership not engaged in trade or business within the United States and not having any office or place of business therein and composed in whole or in part of nonresident aliens (other than income received as dividends of the class allowed as a credit by section 25 (a)) shall (except in the cases provided for in subsection (a) of this section and except as otherwise provided in regulations prescribed by the Commissioner under section 214) deduct and withhold from such annual or

periodical gains, profits, and income a tax equal to 4 per centum thereof: *Provided*, That the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent."

Section 144 of the act, relating to withholding tax on income paid to foreign corporations, provides:

"In case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withthheld at the source in the same manner and upon the same items of income as is provided in section 143 a tax equal to 15% per centum, and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section: *Provided*, That in the case of interest described in subsection (a) of that section (relating to tax-free covenant bonds) the deduction and withholding shall be at the rate specified in such subsection."

Subsection (b) of section 147 of the act, relating to returns of information at the source, provides:

"(b) *Returns, regardless of amount of payment.*—Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by persons undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange."

The withholding provisions of section 143 (a) (1) are applicable only to bonds, mortgages, or deeds of trust, or other similar obligations of a corporation which were issued before January 1, 1934, and which contain a tax-free covenant. For the purpose of section 143 (a) (1), bonds, mortgages, or deeds of trust, or other similar obligations of a corporation are issued when delivered. Where a broker or other person acts as selling agent of the obligor the obligation is issued when delivered by the agent to the purchaser. Where a broker or other person purchases the obligation outright for the purpose of holding or reselling it the obligation is issued when delivered to such broker or other person.

For the purpose of this Treasury decision, a domestic corporation or partnership is one organized or created in the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, or under the law of the United States or of any State or Territory, and a foreign corporation or partnership is one which is not domestic. A foreign corporation engaged in trade or business within the United States or having an office or place of business therein is referred to in this Treasury decision as a resident foreign corporation; and a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein, as a nonresident foreign corporation. A partnership engaged in trade or business within the United States or having an office or place of business therein is referred to in this Treasury decision as a resident partnership; and a partnership not engaged in trade or business within the United States and not having any office or place of business therein, as a nonresident partnership.

The rates of withholding required by section 143 (a) (1) on obligations of corporations containing a tax-free covenant and issued before January 1, 1934, are as follows:

Owner	Tax-free, unlimited	Tax-free, limited to 2 per cent
	Percent	*Percent*
Citizen or resident of the United States (individual or fiduciary) or a partnership other than a nonresident partnership composed in whole or in part of nonresident aliens	2	2
Nonresident alien individual and fiduciary, or a nonresident partnership composed in whole or in part of nonresident aliens	2	1 4
Nonresident foreign corporation	2	1 1½
Unknown	3	1 4

1 2 percent assumed by debtor corporation; balance deducted from owner's interest.

The withholding provisions of section 143 (b) and section 144 are applicable to bonds, mortgages, or deeds of trust, or other similar obligations of corporations issued before January 1, 1934, which do not contain a tax-free covenant and to such obligations of corporations issued on or after January 1, 1934, whether or not they contain a tax-free covenant, as well as to the other items of income specified in section 143 (b). The rates of tax required by those sections to be deducted and withheld are 4 percent if the owner is a nonresident alien individual or fiduciary, or a nonresident partnership composed in whole or in part of nonresident aliens, or if the owner is unknown, and 13¾ percent if the owner is a nonresident foreign corporation.

The portion of the tax withheld from interest on bonds, mortgages, or deeds of trust, or other similar obligations of corporations paid on or after January 1, 1934, and before 11:40 a. m., May 10, 1934, under the Revenue Act of 1932, which is in excess of the tax required to be withheld under the Revenue Act of 1934, shall be retained by the withholding agent and reported on the annual withholding return, form 1018, for 1934, which shall be filed on or before March 15, 1935, and the tax shall be paid over to the appropriate collector of internal revenue on or before June 15, 1935, except in those cases where by reason of the approval of exemption certificates, form 1002, filed by the owners, the corporation is authorized to release the tax to the owners.

The portion of the tax withheld on other classes of income paid on or after January 1, 1934, and before 11:40 a. m., May 10, 1934, under the Revenue Act of 1932, which is in excess of the tax required to be withheld under the Revenue Act of 1934, shall be retained by the withholding agent and reported on the annual withholding return, form 1042, which shall be filed on or before March 15, 1935, and the tax shall be paid to the collector of internal revenue on or before June 15, 1935, except in those cases where an alien employee files with his employer a properly executed claim on form 1115. Upon receipt of form 1115, for 1934, by an employer, or if such a form has already been received, the employer may release and pay over to the employee or his proper representative the excess tax withheld from compensation for labor or services performed in the United States.

In those cases where the payee from whom tax has been withheld is not eligible to file an exemption certificate on form 1002, or a claim on form 1115, refund of any excess tax withheld shall be made only by the Bureau of Internal Revenue. Such payee may file a claim for refund on form 843 accompanied by an individual income-tax return on form 1040B.

In accordance with the provisions of section 147 (b), citizens and resident individuals and fiduciaries, owning bonds, mortgages, or deeds of trust, or other similar obligations issued by a domestic corporation, a resident foreign corporation, or a nonresident foreign corporation having a fiscal agent or a paying agent in the United States, when presenting interest coupons for payment shall file ownership certificates where (a) the obligations do not contain a tax-free covenant or contain a tax-free covenant but were issued on or after January 1, 1934, and the amount of the coupons is $20 or more for each issue of such obligations; (b) the obligations contain a tax-free covenant and were issued before January 1, 1934, and the amount of the coupons is $20 or more for each issue and the net income does not exceed the personal exemption and credit for dependents allowed by section 25 (b); and (c) the obligations contain a tax-free covenant and were issued before January 1, 1934, and the net income of the owner exceeds the personal exemption and credit for dependents allowed by section 25 (b), regardless of the amount of the coupons. A resident partnership, or a nonresident partnership all of the members of which are citizens or residents, owning such obligations when presenting interest coupons for payment shall file ownership certificates where (a) the obligations do not contain a tax-free covenant or were issued on or after January 1, 1934, and the amount of the coupons is $20 or more for each issue; and (b) the obligations contain a tax-free covenant and were issued before January 1, 1934, regardless of the amount of the coupons.

In all cases where the owner of bonds, mortgages, or deeds of trust, or other similar obligations of a corporation is a nonresident alien (individual or fiduciary), nonresident partnership composed in whole or in part of nonresident aliens, nonresident foreign corporation, or where the owner is unknown, an ownership certificate for each issue of such obligations shall be filed when interest coupons for any amount are presented for payment. The ownership certificate shall show the name and address of the debtor corporation, the name and address of the owner of the obligations, a description of the obligations, the amount of interest and its due date, the rate at which tax is to be

withheld, and the date upon which the interest coupons were presented for payment. The ownership certificate is required whether or not the obligation contains a tax-free covenant. However, ownership certificates need not be filed by a nonresident alien, a partnership composed in whole of nonresident aliens, or a nonresident foreign corporation in connection with interest payments on such bonds, mortgages, or deeds of trust, or other similar obligations of a domestic or resident foreign corporation qualifying under section 119 (a) (1) (B) of the Revenue Act of 1934, or of a nonresident foreign corporation. Ownership certificates need not be filed in the case of interest payments on obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or obligations of a corporation organized under act of Congress, if such corporation is an instrumentality of the United States; or the obligations of the United States or its possessions. (See sec. 22 (b) (4) of the act.) Ownership certificates are not required to be filed in connection with interest payments on bonds, mortgages, or deeds of trust, or other similar obligations issued by an individual or a partnership. Also, ownership certificates are not required where the owner is a domestic corporation, a resident foreign corporation, or a foreign government.

When interest coupons detached from corporate bonds are received unaccompanied by ownership certificates, unless the owner of the bonds is known to the first bank to which the coupons are presented for payment, and the bank is satisfied that the owner is a person who is not required to file an ownership certificate, the bank shall require of the payee a statement showing the name and address of the person from whom the coupons were received by the payee, and alleging that the owner of the bonds is unknown to the payee. Such statement shall be forwarded to the Commissioner with the monthly return on form 1012, revised July 1934. The bank shall also require the payee to prepare a certificate on form 1001, revised July 1934, crossing out "owner" and inserting "payee" and entering the amount of the interest on line 3, and shall stamp or write across the face of the certificate "Statement furnished", adding the name of the bank.

Ownership certificates are required in connection with interest payments on registered bonds as in the case of coupon bonds of corporations, except that if ownership certificates are not furnished by the owner of such bonds, ownership certificates must be prepared by the withholding agent.

For the purpose of this Treasury decision, form 1000, revised July 1934, shall be used in preparing ownership certificates of citizens or residents of the United States (individual or fiduciary), resident partnerships, and nonresident partnerships all of the members of which are citizens or residents. If the obligations are issued by a nonresident foreign corporation having a fiscal or paying agent in the United States, form 1000, revised July 1934, should be modified to show the name and address of the fiscal agent or the paying agent in addition to the name and address of the debtor corporation. Form 1001, revised July 1934, shall be used in preparing ownership certificates (a) of nonresident aliens (individual or fiduciary), (b) of nonresident partnerships composed in whole or in part of nonresident aliens, (c) of nonresident foreign corporations, and (d) where the owner is unknown.

Form 1912, revised July 1934, shall be used by withholding agents in making returns of income tax paid at the source for the month of July 1934 and succeeding months.

In order that the date of issue of bonds, mortgages, or deeds of trust, or similar other obligations of corporations, containing a tax-free covenant may be readily determined by the owner, for the purpose of preparing the ownership certificates required by this Treasury decision, the issuing or debtor corporation shall indicate, by an appropriate notation, the date of issue or use the phrase, "Issued on or after January 1, 1934", on each such obligation issued hereafter, or in a statement accompanying the delivery of such obligation.

WRIGHT MATTHEWS,
Acting Commissioner.

Approved August 4, 1934.

L. W. ROBERT, Jr.,
Acting Secretary.

APPENDIX B

(T. D. 4478)

WITHHOLDING OF INCOME TAX UNDER THE REVENUE ACT OF 1934—OWNERSHIP CERTIFICATES REQUIRED IN CONNECTION WITH INTEREST ON BONDS OF CORPORATIONS

T. D. 4460 AMENDED

TREASURY DEPARTMENT,
OFFICE OF COMMISSION OF INTERNAL REVENUE,
Washington, D. C.

Collectors of Internal Revenue and Others Concerned:

Treasury Decision 4460 (Internal Revenue Bulletin, vol. XIII-33, p. 3), approved August 4, 1934, is hereby amended by eliminating the paragraph reading:

"In accordance with the provisions of section 147 (b) citizens and resident individuals and fiduciaries, owning bonds, mortgages, or deeds of trust, or other similar obligations issued by a domestic corporation, a resident foreign corporation, or a nonresident foreign corporation having a fiscal agent or a paying agent in the United States, when presenting interest coupons for payment shall file ownership certificates where (*a*) the obligations do not contain a tax-free covenant or contain a tax-free covenant but were issued on or after January 1, 1934, and the amount of the coupons is $20 or more for each issue of such obligations; (*b*) the obligations contain a tax-free covenant and were issued before January 1, 1934, and the amount of the coupons is $20 or more for each issue and the net income does not exceed the personal exemption and credit for dependents allowed by section 25 (b); and (*c*) the obligations contain a tax-free covenant and were issued before January 1, 1934, and the net income of the owner exceeds the personal exemption and credit for dependents allowed by section 25 (b), regardless of the amount of the coupons. A resident partnership, or a nonresident partnership all of the members of which are citizens or residents, owning such obligations when presenting interest coupons for payment shall file ownership certificates where (*a*) the obligations do not contain a tax-free covenant or were issued on or after January 1, 1934, and the amount of the coupons is $20 or more for each issue; and (*b*) the obligations contain a tax-free covenant and were issued before January 1, 1934, regardless of the amount of the coupons."

And substituting therefor a paragraph reading as follows:

"In accordance with the provisions of section 147 (b), citizens, resident individuals, and fiduciaries, resident partnerships and nonresident partnerships all of the members of which are citizens or residents, owning bonds, mortgage, or deeds of trust, or other similar obligations issued by a domestic corporation, a resident foreign corporation, or a nonresident foreign corporation having a fiscal agent or a paying agent in the United States, when presenting interest coupons for payment prior to January 1, 1935, shall file ownership certificates where the obligations contain a tax-free covenant and were issued before January 1, 1934, regardless of the amount of the coupons. The amount of interest received on such bonds shall be entered on line 3 of form 1000, revised July 1934 (or line 2 of form 1000, revised June 1932), except in the case of a citizen or resident the interest shall be entered on line 2 of form 1000, revised July 1934 (or line 1 of form 1000, revised June 1932), if the net income of such citizen or resident does not exceed the personal exemption and credit for dependents allowed by section 25 (b). On and after January 1, 1935, citizens and resident individuals and fiduciaries, owning bonds, mortgages, or deeds of trust, or other similar obligations issued by a domestic corporation, a resident foreign corporation, or a nonresident foreign corporation having a fiscal agent or a paying agent in the United States, when presenting interest coupons for payment shall file ownership certificates where (*a*) the obligations do not contain a tax-free covenant or contain a tax-free covenant but were issued on or after January 1, 1934, and the amount of the coupons is $20 or more for each issue of such obligations; (*b*) the obligations contain a tax-free covenant and were issued before January 1, 1934, and the amount of coupons is $20 or more for each issue and the net income does not exceed the personal exemption and credit for dependents allowed by section 25 (b); and (*c*) the obligations contain a tax-free covenant and were issued before January 1, 1934, and the net income of the owner

exceeds the personal exemption and credit for dependents allowed by section 25 (b), regardless of the amount of the coupons. On and after January 1, 1935, a resident partnership, or a nonresident partnership all of the members of which are citizens or residents, owning such obligations when presenting interest coupons for payment shall file ownership certificates where (a) the obligations do not contain a tax-free covenant or were issued on or after January 1, 1934, and the amount of the coupons is $20 or more for each issue; and (b) the obligations contain a tax-free covenant and were issued before January 1, 1934, regardless of the amount of the coupons."

Treasury Decision 4430 is further amended by eliminating the paragraph reading:

"For the purpose of this Treasury decision, form 1000, revised July 1934, shall be used in preparing ownership certificates of citizens or residents of the United States (individual or fiduciary), resident partnerships, and nonresident partnerships all of the members of which are citizens or residents. If the obligations are issued by a nonresident foreign corporation having a fiscal or paying agent in the United States, form 1000, revised July 1934, should be modified to show the name and address of the fiscal agent or the paying agent in addition to the name and address of the debtor corporation. Form 1001, revised July 1934, shall be used in preparing ownership certificates (a) of nonresident aliens (individual or fiduciary), (b) of nonresident partnerships composed in whole or in part of nonresident aliens, (c) of nonresident foreign corporations, and (d) where the owner is unknown."

And substituting therefor a paragraph reading as follows:

"For the purpose of this Treasury decision, form 1000, revised July 1934, shall be used in preparing ownership certificates of citizens or residents of the United States (individual or fiduciary), resident partnerships, and nonresident partnerships all of the members of which are citizens or residents, except that prior to January 1, 1935, either form 1000, revised June 1932, or form 1000, revised July 1934, may be used. If the obligations are issued by a nonresident foreign corporation having a fiscal or paying agent in the United States, form 1000 should be modified to show the name and address of the fiscal agent or the paying agent in addition to the name and address of the debtor corporation. Form 1001, revised July 1934, shall be used in preparing ownership certificates (a) of nonresident aliens (individual or fiduciary) (b) of nonresident partnerships composed in whole or in part of nonresident aliens, (c) of nonresident foreign corporations, and (d) where the owner is unknown.

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved September 29, 1934.

T. J. COOLIDGE,
Acting Secretary of the Treasury.

APPENDIX C

MEMORANDUM SUPPLEMENTING ORAL PRESENTATION MADE TO FINANCE COMMITTEE OF UNITED STATES SENATE ON BEHALF OF RAILWAY TREASURY OFFICERS' ASSOCIATION (REPRESENTING OVER 90 PERCENT OF THE RAILROAD MILEAGE IN THE UNITED STATES) ON WITHHOLDING OF TAX AT SOURCE ON SO-CALLED TAX-FREE COVENANT BONDS, SECTION 143, H. R. 7835

PROPOSAL

The subsection (a) of section 143, page 109, of H. R. 7835, be eliminated. Such proposal, if adopted, will require also elimination in lines 1, 2, and 3 of page 112 of the following words: "Except in the cases provided for in subsection (a) of this section", and further elimination commencing in line 24 of page 113 of the following words: "Provided that in the case of interest described in subsection (a) of that section (relating to tax-free covenant bonds) the deduction and withholding shall be at the rate specified in such subsection."

The foregoing proposal will not reduce Government revenue lawfully collected, but on the contrary should substantially increase such revenue. The proposal in no way affects collection or withholding at the source from nonresident aliens, but deals only with citizen or resident individuals and partnerships.

HISTORY

The 1913 Revenue Act required withholding of payment at the source on many classes of income, including interest on the so-called tax-free covenant bonds. The purpose was, of course, to insure collection of taxes from those persons from whose incomes the withholding took place. The withholding provisions result in so many different forms, such a mass of regulations, and such general confusion that Congress, in the Revenue Act of 1917, wiped out (insofar as citizens and residents of the United States were concerned) all of the withholding except as to interest on the so-called tax-free covenant bonds owned by individuals, partnerships, and fiduciaries. The withholding was discontinued even as to domestic corporations.

The 1917 act passed the House retaining withholding features, but the Senate in that year undertook to abolish all of them. In conference committee compromise was reached by retaining the one item here under discussion, and that particular remnant of what had proved to be a general nuisance has been continued in effect in the subsequent revenue acts. In principle there was no good reason why one class of bond interest should be separately dealt with, and the action taken with respect thereto was purely anomalous and arbitrary, particularly so when we bear in mind that the purpose of the withholding provisions in the first instance was to insure collection of taxes and not to shift to the corporations issuing the bonds the burden of paying the bondholders' taxes.

1934 ACT

H. R. 7835 as passed by the House retains the nuisance remnant above mentioned. The subcommittee of the Ways and Means Committee reported in favor of the proposal we are now urging in language as follows:

"(21) WITHHOLDING TAX-FREE COVENANT BONDS

"Section 143 (a) provides for the withholding by a corporation or other obligor of an amount equal to 2 percent of the amount of interest paid on bonds or other obligations which contain a provision by which the obligor agrees to pay any portion of the tax imposed upon the obligee. The tax is not required to be withheld at the source where the obligee files with the income tax on account of his income being less than the amount of his personal exemption. The bondholder is entitled to a credit against his tax where there has been withheld a tax at the source on his account.

"Your subcommittee recommends that this system of withholding a tax on tax-free covenant bonds be entirely discontinued. The system originated in the 1913 act, where general withholding was employed to collect a large portion of the tax. The withholding policy has now been abandoned and the withholding on tax-free covenant bonds is an exception to the general rule. It is an administrative nuisance and requires the payment of many small refunds. Simplification and reduction in administrative expense can be secured by the elimination of this section. No loss in revenue will result from the change."

In view of the foregoing report of the subcommittee no attempt was made by us to present the subject to the full Ways and Means Committee, and so far as we are advised, no serious effort was made by anyone to put a complete statement of facts before that committee.

The Treasury Department, in commenting upon the recommendation of the House subcommittee, stated (p. 16 of the printed statement of Acting Secretary of Treasury) as follows:

"(21) Withholding tax-free covenant bonds.—The Department submits that the present provision of the statute relating to withholding of tax at the source in the case of tax-free covenant bonds, as contained in section 143 (a) (1), (2), and (3), should not be eliminated. Many bonds, now outstanding contain this provision. The elimination of this section of the statute would result in much confusion, and would remove a useful check upon the accuracy of the returns.

We will hereinafter comment further upon the Department's above-quoted statement.

AMENDMENT OF PRESENT LAW BY H. R. 7835 CREATES NEW CONFUSION

The Ways and Means Committee did not follow the recommendation of the subcommittee. It retained the provision of the present law except that it compromised to the extent of having the withholding or payment at the source apply only to bonds issued prior to January 1, 1934. The insertion thus made piles confusion upon confusion. No railroad company to our knowledge and few, if any, other corporations, have since 1913 brought out new bond issues containing the so-called tax-free covenant to which the present law applies, and it is not to be expected that there will be such issues in the future. The date of January 1, 1934, inserted in the pending bill is therefore of no value. It is highly objectionable and will lead to widespread confusion in respect to the bonds hereafter to be issued under so-called open-end mortgages. Many railroad companies have several outstanding mortgages in connection with which bonds containing the so-called tax-free covenant were issued prior to 1913. Those mortgages provide for the issuance from time to time during the life of the mortgage of additional bonds. Such subsequent issues take place fairly frequently under railroad mortgages, but the bonds, under the mortgage provisions, are all of the same tenor and bear the same date as those of the original issue. It will be impossible in the future (should the bill as now drawn be enacted) for a bond owner, a banker, or broker, except after considerable investigation, to know whether tax should be paid on the interest thereon by the owner of the bond or whether it should be paid by the corporation, because there is nothing on the bond to inform him as to whether it was actually issued prior or subsequent to January 1, 1934. Even now the great majority of bondholders cannot correctly fill out the required ownership certificate (hereinafter discussed in detail), and the change in the law as now proposed, will complete their bewilderment.

PRACTICAL OPERATION OF PAYMENT-AT-SOURCE PROVISION OF PRESENT LAW

In practice, the provision of the present law which we seek to have stricken from the 1934 act, has accomplished nothing of benefit. It has been a general nuisance and heavy expense to the banks, to the corporations, and to the Government. If the full facts had ever been brought before the congressional committees, the withholding provision would have long since disappeared. The existing nuisance is shown in part by the following quotation from a letter written October 31, 1927, by the Treasury Department to Southern Pacific Co. in answer to a request by that company that refund be made to it of payments unlawfully exacted. The department, although conceding the errors, offered as a reason for failure to refund, statement in part as follows:

"In the correspondence referred to you have consistently contended that the bureau should prepare voluntary certificates of overassessment in the ordinary course of examination of ownership certificates with respective personal returns when it is found that debtor corporations having paid tax, as evidenced by the form of ownership certificate used, in behalf of an individual for whom the total amount paid was not required to offset his tax, or when such individual was subject to no tax without the benefit of any credit. This you claim is mandatory upon the office in view of the provisions of section 284 of the act.

"In this connection your attention is invited to some of the administrative problems confronting the office in pursuing the policy requested by you. There are approximately 6,000,000 certificates, forms 1000 and 1000-A, filed each calendar year for individuals residing in practically every locality of the country. These forms are executed by approximately 2,000,000 bondholders, resulting in numerous types of handwriting of varying degrees of legibility. Of these 2,000,000 bondholders a certain proportion change their addresses often from one collection district to another. The results are obvious; first in the case of illegible certificates, precision in sorting is impossible and in the second case, where address is changed, transmission of the certificates to the collection district where the return of the individual is filed cannot always be effected. The result of these two conditions makes a partially incomplete file of ownership certificates for many taxpayers. Were a voluntary refund attempted in such cases some of the debtor corporations involved would not receive the benefit of the proportion to which they were entitled."

Perhaps the best way to acquaint your committee with what actually occurs annually in connection with the 0,000,000 ownership certificates mentioned in the above quoted letter, is to follow one of the certificates on its journey from the bondholder until it has passed through the Bureau of Internal Revenue. The form is no. 1000, and a sample thereof follows:

Ownership certificate

To be used by a citizen or resident individual, fiduciary, or partnership in connection with interest on bonds of a domestic or resident corporation containing a tax-free covenant.

Debtor corporation

Name _____
Address _____
Name of bond _____
Date interest was due on above bond _____ Date paid _____

I certify that to the best of my knowledge and belief the information entered hereon is correct.

(Signature of owner, trustee, or agent.)
(Address of trustee or agent.)
(A fiduciary must disclose the name of the estate or trust for which he acts.)

Owner or bonds (print name)

Name _____
Street _____
City _____ State _____

Classes of bond owners according to net income	*Amount of interest received*
1. Individual or fiduciary whose net income does not exceed the personal exemption and other credits.	no tax paid by corporation
2. Individual or fiduciary whose net income exceeds the personal exemption and other credits, or a partnership.	2-percent tax paid by corporation

[NOTE]. If you discover at the close of the year that the interest was not entered on the proper line, you should prepare on or before February 1 of the following year an amended certificate on this form and forward it to the corporation which issued the bonds.

With few exceptions, the 2,000,000 bondholders mentioned in the Department's letter do not have a supply of the ownership certificate forms. They cut their coupons and take them to the receiving teller of a bank to deposit for collection. The bank has the supply of forms. The bondholder or his messenger is informed of and is presented with form 1000, which is required to be filled out and signed by all owners of so-called tax-free covenant bonds, provided such owners have a net income above the exemption allowed by law. The ownership certificate is not required in connection with bonds which do not have the covenant. In the case of Southern Pacific Co., for instance, its $671,000,000 of outstanding bonds are about equally divided between the two classes.

Some of the causes for error follow:

First. The bond owner does not know whether his coupons were clipped from bonds containing the covenant. There is nothing on the coupons to show it. He could find out by returning to where his bond is kept and search through the fine print on the face of the bond, but, of course, he does not go to that trouble, but merely signs his name on the line pointed out by the bank clerk.

Second. The bondholder, as often as not, does not know at the time the certificate is filled out whether or not he will have a taxable income at the end of the year, so he takes the safe course and states that he will, thereby throwing the tax on the corporation in thousands of instances where no tax should under the law accrue against anyone.

Third. Most forms are, except for the owner's signature, filled out by the bank clerks who rarely ask the tax status of the owner, and if the question were asked, he could not say until the end of the tax year. The bank clerk habitually fills out the form so as to require the corporation to pay, thereby taking the safe course for the customer of the bank.

Fourth. The bank clerk, not knowing whether the coupons presented are from bonds subject to the law, must, if he be diligent in correctly filling out the form, refer to Poor's Manual or Moody's Manual or other books of the bank's financial library. That he does not always bother to investigate at all, and that in doing so he often makes mistakes, is evident from the fact that a single corporation, Southern Pacific Co., whose outstanding bonds are as above stated about evenly divided between the two clauses, receives several thousand ownership certificates each year (sometimes close to 3,000 in a single month) accompanying coupons from bonds not having the tax-free clause, and therefore not requiring any ownership certificate nor any withholding nor assumption of tax at the source. Such certificates must, of course, be sorted out by the corporation and destroyed--a process consuming time and money.

Fifth. In some instances, where corporations have merged subsequent to the issuance of the bonds, a certificate cannot easily be correctly supplied because the corporation that issued the bond is not the one that will pay the interest or withhold the tax.

Sixth. The ownership certificate, while appearing to be simple at first glance, is extremely difficult to understand, particularly the tabulation in the lower right-hand corner. Even when the bondholder or the bank clerk knows that the interest has accrued on a bond subject to the withholding, and further knows that the owner will have a taxable income for the year, he frequently fails to enter the correct amount in the right space on the form.

Seventh. Finally, the illegibility of the completed certificate is such, as pointed out in the Department's above-quoted letter, that they fall short of constituting a basis for accurate record.

The certificates (when completed with much inaccuracy and at substantial trouble to the banks) and the accompanying coupons are transmitted to the treasury departments of the respective corporations. There they are examined and sorted according to respective issues, etc. The many which relate to bonds as to which no tax is payable at the source are kept for a limited period and destroyed. The others aggregating, according to the Treasury Department, some 6,000,000 per year are, after classification, required to be listed on form 1012, which calls for much detail including the name of the bond, the name of the bond owner, his address, the nature of the interest paid, the amount of tax withheld, etc. The volume of typewriting and clerical work required in the preparation of form 1012 is tremendous. The many resulting sheets of closely typewritten matter are bound together, and under the regulations must be forwarded each month along with the ownership certificates to the sorting section of the Bureau of Internal Revenue at Washington. For the year 1933 Southern Pacific Co. prepared and filed forms 1012 listing approximately 35,000 separate ownership certificates setting forth the above-described detail as to each one of them. The total made up four large volumes of legal-size paper having an aggregate depth of about 1 foot.

When we attempt to visualize the total bulk of this material that is trucked into the Bureau each year and allowed to accumulate there, we are impressed that the mere matter of storage must in itself present a problem.

On reaching the sorting section the 6,000,000 ownership certificates are no doubt checked again against the information shown on form 1012 and the following year when the income-tax returns are filed, they are again checked against such returns. Assuming that 1 clerk can take from the files and carefully check 20 income-tax returns per day against a like or greater number of ownership certificates (form 1000) and against the books submitted by the corporations (form 1012) it would require 1,000 clerks working steadily during the entire 300 workings days of the year to cover the task. Accurate information on this phase of the subject can, of course, readily be obtained from the Bureau.

In addition to the foregoing, corporations are required to prepare and file annually with the collectors of internal revenue form 1013 showing by months the tax to be paid at the source by the corporation.

RECOMMENDATION OF TREASURY DEPARTMENT

Hereinabove we have quoted the comment of the Department against the recommendation by the House subcommittee that this nuisance provision be eliminated from the act. Two reasons are offered:

First. The "elimination would result in much confusion." In what respect? Beyond the probable necessary readjustment of personnel in the sorting section and the transfer thereof to some useful work, we are unable to perceive any resulting confusion; but, to the contrary, the elimination of a monumental amount of confusion, annoyance, and expense now placed upon the bondholders, the banks, the railroads, and the other corporations with similar outstanding bonds, and upon the Government itself. We are suggesting no change with respect to withholding and payment at the source on the income of aliens, which involves somewhat similar forms, records, and procedure to that above described, and in connection with which there will continue to be much work for the personnel of the sorting section of the Bureau, and if more work for the sorting section is required out of consideration for the personnel, we suggest that the Department take over, under appropriate regulations, the innumerable small refund claims filed by aliens, and which are now handled through the corporations.

Second. The Department says elimination of the nuisance provision "would remove a useful check upon the accuracy of returns." In view of the Department's own statements in the letter above quoted, and in view of the inaccuracies in connection with the ownership certificates, we think this particular suggestion calls for no further discussion. That there is any substantial value from a checking standpoint we doubt. But if there is, then why not adopt the same method employed with respect to the interest accruing and paid on so-called non tax free bonds, of which there are probably more in the hands of the public than there are of the so-called tax-free bonds, to which the nuisance provision applies. On the non-tax-free bonds the banks are required by Department regulations to report the interest collections to the Bureau. In such reports the interest payment on both classes of bonds can be included for each customer or depositor of the bank with less annoyance than under the present practice, because no ownership certificate is required and no segregation of the two classes of bond interest would be involved. In any event, the Bureau now deals with income from bonds probably greater in both number and amount than the class of bonds affected by our proposal, and whatever method is followed with respect thereto may be applied to all bonds, thereby doing away with an expense and annoyance of large proportions. Surely this one remnant of payment at the source for citizen and resident individuals and partnerships can be of no value commensurate with the economic waste it creates.

SUBSTANTIAL UNLAWFUL EXACTIONS UNDER PRESENT PROVISION AND EFFORTS TO SALVAGE THEM

We have pointed out above that both bondholders and banks acting for them in filling out ownership certificates shift onto the corporations a large tax burden that the law never contemplated should be borne by anyone. The extent of these unlawful exactions is shown by many check-ups carried on from time to time by the corporations themselves. A corporation has no way to protect itself in the amount of tax it pays directly from the source to the Government. It must file returns and pay the tax on the basis of the erroneous ownership certificates. It cannot check against income-tax returns because those are confidential. The only possible avenue open is a circularization of the bondholders who signed the ownership certificates. Obviously such procedure is expensive and is never complete in result because a large proportion of those receiving requests for amended certificates, even though they have found that they had no taxable income for the year, are sufficiently interested to furnish a corrected certificate and thereby assist the corporation in obtaining refund.

As the note at the end of the certificate states, the bondholder may at the close of the year file an amended certificate exempting the corporation from liability if he finds that he has no taxable income for the year. The number of amended certificates voluntarily filed is and always has been negligible.

Knowing that they were being subjected to tax liability at the source on bond interest in many cases in which the bondholders themselves had no tax liability, some railroad companies have undertaken annual canvasses of bondholders as shown by ownership certificates presented with coupons.

For instance, the Union Pacific Railroad Co. in its 1931 canvass sent a communication to each of 3,500 individual bondholders in the United States whose personal addresses were disclosed by the ownership certificates. Of these

2,310 respondent and of that number 558 signed the form to the effect that they had no tax liability for 1931 and the balance requested payment of the tax at the source by the corporation. As the result of the 558 exemption certificates the Union Pacific System corporations were relieved of 14 percent of the tax paid for the 8,560 bondholders addressed. This demonstrated that to this extent at least the corporation's liability as shown by the original ownership certificates was excessive.

One of the difficulties inherent in making such a canvass is the fact that many bondholders keep their securities in so-called custody accounts with banks. In such cases the banks make out the ownership certificates and sign them as agents for the bondholders. Their invariable practice is to so fill out the certificates as to require the 2-percent tax payment at the source, without any attempt to ascertain from the bondholders their actual income-tax status. Personal solicitation of such bank custodians in the Union Pacific canvass for 1931 was addressed to 1,132 custodians, of which less than half responded at all, and of those who did respond the majority merely used a rubber stamp requiring the tax to be paid at the source, and only 100 relieved the corporation of the payment of the tax.

By letter dated January 18, 1934, the Union Pacific has been advised by the Bureau that its unverified statements from bondholders for 1931 will be accepted as the basis for refunds to the corporations, but that for the future claims of this character must be supported by sworn statements of the bondholders and conform to certain specified requirements. This new regulation involving a notary fee and otherwise adding difficulties, of course, makes wholly impracticable the continuance of the canvass which the Union Pacific and some others have conducted in past years. It also leaves the company with its accumulated evidence from bondholders resulting from its canvass for 1932 entirely unusable and nullifies the labor and expense of that canvass.

Similar canvasses have been made from time to time by a few other railroad companies with similar results, all clearly indicating that 14 percent or more of taxes paid from the source are unlawful exactions and that an inescapable and continuing fraud is worked upon the corporations to that extent. As suggested above and as shown by the quoted letter from the Bureau to the Southern Pacific Co., the Bureau will not voluntarily refund the overcollections which it discovers and by new and recent ruling makes it impossible for the corporations to apply for and obtain just refunds on information obtained by their own investigations.

THE TAX-FREE COVENANT—COMMON IMPRESSION AS TO CORPORATION'S OBLIGATION ERRONEOUS

There exists a somewhat common but entirely erroneous impression that elimination of the tax-at-the-source provision would enable corporations to avoid a contractual obligation. First, if there be any bonds in which the issuing corporation has agreed absolutely to pay a portion or all of the income tax on the bondholder's interest income the corporation will still have to account to the bondholder therefor, notwithstanding the adoption of our proposal. Second, the covenant we are dealing with and the one commonly found in so-called tax-free bonds creates no such obligation. Typical wording of such covenant, taken from a Southern Pacific bond, is as follows:

"The railroad company further agrees (insofar as it lawfully may do so) that both the principal and interest of this bond shall be paid without deduction for any tax or taxes which the railroad company may be required to pay thereon or to retain therefrom under any present or future law of the United States of America or of any State, county, or municipality therein."

This covenant was put in many railroad and other bonds issued prior to 1913. Its clear intent was to insure payment to the bondholder of the full 4 percent or other rate of interest called for by the bond. There was not even an intimation that the corporation would protect the bondholder against an income-tax levy by the Government on the interest so paid. Once the full interest was paid into the hands of the bondholder it rested upon him to respond to the Government for whatever rate of tax might be levied thereon and why not? It is his income—not the corporation's income. Why should the corporation pay a tax on the bondholder's income any more than on the salaries paid to its officers and employees or on the many rents it pays or on the income of manufacturers or others to whom it pays money? It is

essentially the bondholder's income and why should he have his tax thereon shifted to someone else? What the corporation agreed to do was to pay the full interest to the bondholder in whose hands it would be subject to tax to be paid by him and only in the event that the corporation, after having paid the full interest, should be required by law to make a payment thereon directly to the Government it would pay that also. In the absence of action by Congress the covenant was ineffective. It took a law to make it operative—to shift the tax from the actual recipient of the income to the shoulders of the debtor corporation. If the 1913 and subsequent acts had not contained the withholding provision and the provision allowing the bondholder credit for what the corporation paid, the burden would not have shifted from the one who receives the income and who ought to pay the tax.

We should not overlook the original purpose of the withholding provision. It was intended to avoid tax evasion and applied to many forms of income. It was not intended to make operative bond covenants which otherwise would have had no effect. When it was repealed in 1917 as to all other forms of income it should in principle have been wiped out entirely, as its original purpose as to all forms of income was abandoned. The net result of what has happened is that the corporation is required to pay (not because of a covenant in the bond but rather because of the intervention of law) its own income taxes at present high rates, but in addition must pay on the income of others to whom it has paid its full interest obligation. To further intensify the inequity of the situation the corporation is not allowed a deduction for the taxes thus paid on another's income, but must under present law and regulations pay those taxes and in addition a tax amounting to 13¾ percent thereof. In 1917 when this nuisance remnant was retained against right principle and as a result of illogical compromise the corporation income tax rate did not exceed 2 percent as against the present 13¾ percent or 14¾ percent. If there ever had been any sound reason for shifting the tax of the individual to the corporation at a time when the corporation tax rate was comparatively low, such reason no longer exists because of the present very high rate on corporation income.

We repeat that the tax-free covenants are a promise not to deduct from the bondholder's interest any tax which the Government may require to be paid at the source. There is no more reason for the Government retaining this requirement for payment at the source as to 2 percent than for making the payment at the source requirement apply to the entire tax liability of the bondholders on such interest. Under the 1932 act the normal tax rate runs up to 8 percent and the surtax rates up to 55 percent. Of course it is impractical to apply such a payment at the source provision to the full extent of the tax liability of the bondholder under a graduated tax scale. But with the individual tax rates what they now are it is nothing short of absurd for the Government to insist upon a cumbersome machinery to the end that the corporations shall pay a 2-percent tax for the bondholder. It is not enough to excite any gratitude on the part of the bondholders.

In fact, this tax feature operates to protect a very limited class of the more wealthy investors. In the case of the Union Pacific Railroad system an analysis of 1931 bondholdings and interest payments shows the following:

About 64 percent of the interest on tax-free covenant bond issues of the system was paid to domestic corporations and exempt organizations, as to which interest the 2-percent tax at the source does not apply. The remaining 36 percent of the interest was paid to approximately 19,500 individuals, fiduciaries, and partnerships. The benefit to these bondholders is shown by the following table:

Tax paid at the source:	Number of bondholders
None	6,884
Less than $2 each	5,453
$2 to $3.99 each	1,881
$4 to $5.99 each	2,351
$6 to $9.99 each	1,588
$10 to $19.99 each	873
$20 or more	558
Total tax paid, $68,078.39	19,538

Similar analysis for Southern Pacific System of 1933 bondholdings and interest payments shows the following:

About 80 percent of the interest on tax-free covenant bond issues was paid to domestic corporations and exempt organizations as to which interest the 2-percent tax at the sources does not apply. The remaining 20 percent of the interest was paid to approximately 37,153 citizens (individuals, fiduciaries, and partnerships) and nonresident alien individuals, partnerships, and corporations. The benefit to these bondholders is shown by the following table:

Tax paid at the source:	Number of bondholders
None	11,850
$2 or less	16,806
Over $2 to $20 each	8,450
$20 or more each	547
Total tax paid, $68,316.28	37,153

A tax of $20 at the source means $1,000 of interest collected and at an interest rate of 4 percent this means a holding of $25,000 of bonds. Any individual holder of any such aggregate of either Union Pacific or Southern Pacific bonds is bound to have, for reasons of diversification of investment, similar amounts of bonds in many other corporations. Therefore, the limited class of individual bondholders (558 out of 19,600) in the case of the Union Pacific and (547 out of 37,153 in the case of the Southern Pacific) for whose benefit the railroad company paid a tax at the source of as much as $20 are persons of such great wealth that they hardly require and probably do not appreciate the assistance of the Government in protecting them from such a comparatively small amount of tax payment.

GOVERNMENT REVENUES CONTEMPLATED BY LAW WILL NOT BE REDUCED BUT INCREASED

Adoption of our proposal will not decrease the revenues to which the Government is entitled under the law. That fact is so reported by the subcommittee of the House. The Treasury Department makes no claim to the contrary. The same amount of lawful taxes on the same income will be paid in the future by the bondholders instead of by the corporation and without hardship to any of them as hereinbefore pointed out. The Government will lose only the unlawful exaction it now receives as a result of the complex procedure and the general abuses in the making and handling of ownership of certificates, but even that loss will be largely offset and the lawful revenues substantially increased by the saving of hundreds of thousands of dollars heretofore wasted by the corporations and by the Government itself in administrative expense. For every dollar saved by the corporations their net taxable incomes will be correspondingly increased, and from each $100 of such increased net taxable income the Government will receive 13¾ or 14¾ percent, or at least $13.75.

PROPOSAL WILL SIMPLIFY TAX-RETURN FORMS

A minor advantage in the proposal and one much to be desired by all taxpayers is simplification of tax-return blanks (forms 1040 and 1040-A) by the elimination of two items from each form. Such elimination will result in less computations and in no longer requiring the taxpayer to segregate and state separately the two classes of bond interest. The abatement of these nuisances, together with abolishment of the ownership certificate should fairly well compensate the bondholder for accepting the trivial increased burden involved in the quite just requirement that he pay his own income taxes on his own income.

Respectfully submitted.

BEN C. DEY,
General Counsel, Southern Pacific Co.,
Appearing for Railway Treasury Officers' Association.

APPENDIX D

UNION PACIFIC SYSTEM,
October 29, 1927.

Hon. WILLIAM R. GREEN,
Chairman, Joint Congressional Committee
on Internal Revenue Taxation,
House Office Building, Washington, D. C.

DEAR SIR: I transmit herewith original and nine copies of a memorandum submitting for consideration of the joint committee a proposal to repeal the taxation at the source on tax-free-covenant bond interest.

This proposal is not of interest peculiarly to the Union Pacific Railroad Co. or to the railroads generally. It is of interest to all corporations having outstanding bonds subject to the so-called tax-free covenant.

We regret very much that this submission is made so late in the deliberations of the joint committee. This submission was not made earlier by my associates and myself as officers of the Union Pacific Railroad Co. because of our hope that the repeal of these provisions would be advocated by some organization representing corporations generally. As this hope has not been realized, we have concluded to make the submission in the name of the Union Pacific Railroad Co. alone.

We earnestly request the joint committee's consideration of our memorandum.

Very truly yours,

_____,

NEW YORK CITY, *October 29, 1927.*

To the JOINT CONGRESSIONAL COMMITTEE ON INTERNAL REVENUE TAXATION:

WITHHOLDING AT THE SOURCE AS TO BOND INTEREST

We respectfully urge the committee's consideration of the desirability and expediency of amending the Revenue Act of 1926 to abolish (1) "withholding at the source" as to "tax-free covenant" bond interest paid to citizen and resident individuals and partnerships, and also (2) "withholding at the source" as to bond interest paid to nonresident alien individuals, partnerships, and corporations, whether subject to "tax-free covenant" or not.

It is asserted with confidence that, aside from the proposal to reduce the rate of corporation income tax, no more meritorious or important amendments have been proposed to the committee. The two propositions are independent of each other and subject to entirely different considerations. We do no more in the case of proposition numbered (2) than submit the question for consideration. The necessity or expediency of collecting at the source the tax upon interest paid to alien holders must be determined by the views of the Treasury and of bankers familiar with the marketing of bond issues. But as to the adoption of proposition numbered (1) there is hardly room for difference of opinion. Tested by every pertinent consideration, the taxation at the source of "tax-free-covenant" bond interest paid to citizens and residents is indefensible and should be abolished.

DISCUSSION

(1) *Tax-free-covenant interest paid citizens and residents.*—This subject matter is covered by section 221 (b) of the present statute. It is a requirement that corporations "deduct and withhold" a 2-percent tax from all interest on bonds containing a "tax-free covenant" when paid to an individual citizen or resident of the United States or to a nonresident alien individual or to a partnership. It is the sole remaining provision for withholding from income of citizen and resident individuals. While the expression used in the law is "deduct and withhold", it is well understood that the tax is imposed on the corporation, for the requirement is limited to interest on bonds in which the corporation has covenanted not to deduct any tax, and it was the intent of the law that the corporations should bear this 2-percent tax. This branch of our recommendation is limited to the elimination of so much of the requirement as applies in the case of citizen and resident individuals and domestic partnerships.

(a) The provision is anomalous, arbitrary, and inconsistent with the general policy of the income tax law.

The income-tax laws of 1913 and 1916 contained requirements for withholding at the source not only from bond interest but from other forms of fixed and determinable income when paid to individuals. Withholding at the source was the general policy of those laws. The requirements were originally police measures designed to prevent large-scale evasion of income taxes. Withholding was not required from income paid to domestic corporations whose taxes could be otherwise policed. The policy was abandoned in the 1917 revision. By that revision the requirement of a general withholding from all income was repealed. Withholding was continued as to all income paid nonresident aliens. But as to income paid citizen and resident individuals and partnerships no withholding was required except in the case of bond interest subject to a tax-free covenant. And the law has continued in this form through all the subsequent revisions. The normal tax was increased to 4 percent by the 1917 act but the tax at the source on tax-free covenant bond interest was made 2 percent. It was felt that to leave the corporations liable under their tax-free covenant bonds for the increased rate of normal tax would be unduly burdensome and unfair. But on the other hand, it was argued that the corporations had generally issued bonds with covenants to pay the interest without deduction for taxes and that they ought to stand some of the burden of the bondholders under these covenants? The taxes on individuals were being increased to the supposed limit of capacity to pay. The selection of the 2-percent rate for tax-free covenant bond interest was purely arbitrary. As far as we know the principle which dictated this disposition of the matter has not been given serious consideration in the subsequent revisions of the law.

Nothing could be more anomalous or arbitrary than a tax provision invented to apply only to one single class of bond interest, a class determined by the presence in the bonds of a particular covenant. Its origin represented an intervention on the part of Congress in a certain class of private contracts. The policy of the former laws to collect taxes at the source of income wherever practicable was being abandoned. With that abandonment, if consistently carried out, the covenants in corporate bonds, to pay without deduction of tax, would no longer leave upon the corporation the burden of the tax on the interest. But Congress provided that taxation at the source should be retained to the extent of one-half the normal rate in the case of bond interest subject to such a covenant. The individual normal rates under the 1926 act are 1½ percent on the first $4,000 of taxable income, 3 percent upon the next $4,000, and 5 percent upon the remainder, but the tax-free covenant bond interest still bears 2 percent. With all deference, this tax provision was based upon a consideration which deserved no recognition in a tax law. It was nothing less than a penalty. It had defensible aspect in the 1917 act in that the taxation of individuals was being raised to the limit and it was perhaps fair that some of this burden should be shifted to the corporations. We submit, however, that the provision has served its purpose and that the reason for this provision has been satisfied. It has now been in force in its penalty form for 10 years. The corporations as the result of the intervening revisions of the law are bearing a share of the income taxes disproportionate to the share borne by individuals. Thus the situation existing when this provision was first enacted has been reversed.

What the tax-free covenants undertake is that the corporation will pay the interest in full without deduction of any tax required to be paid at the source. During the period in which payment at the source was the policy of the law as to income generally, there was no question that these covenants should operate. The situation was precisely such a situation as they contemplated. But when that policy was abandoned as to rents, salaries, and other classes of income, the tax-free covenants should have ceased to have any application.

Even from the standpoint of form section 221 (b) is a curiosity in legislation. Although the sole purpose of the provision was to impose the 2-percent tax on the corporations, the section in express words commands the corporation to "deduct and withhold" the tax in case it has covenanted with the bondholder to pay the interest without tax deduction, the only case in which the section applies at all. It might well be construed as intended to nullify the covenant since it commands the corporation to deduct and withhold notwithstanding it has covenanted not to deduct. In other words, the natural meaning of the language of the section is the direct opposite of its real intent.

Since 1913 corporations have omitted in new bond issues any covenant which might render them liable for the Federal income taxes on the interest. Only those corporations are now affected by the tax provision in question which had outstanding in 1913 long-term bond issues which have not yet matured. With the maturity of the old issues the amount of tax-free covenant bond interest is lessening year by year. These facts emphasize the arbitrary and discriminatory character of this tax in its present application.

(b) The repeal of this tax would be a step toward equalization of taxes as between corporations and individuals. It would give the corporations substantial relief without increasing materially the tax of each individual bondholder.

The tendency so far in tax revision has been to reduce the tax on individuals, both by decreasing the rates and by increasing the exemption. On the other hand, the corporation income taxes have been increased. In the recent discussion of tax revision much stress has been laid upon this inequality of treatment. In theory no loss of Government revenue would be involved in this amendment, since the theory of section 221 (b) and (d) is that the corporation pays 2 percent on such bond interest tax liability of the bondholder and the bondholder takes credit therefor in his return. The proposed amendment would merely shift the liability to the bondholder.

The aggregate money relief to the corporations would be substantial.

It is demonstrated that the total taxes so shifted from the corporations to the bondholders would be so widely distributed that the tax increase of the individuals, severally, would be negligible.

According to newspaper report, an analysis of income-tax returns for 1926 has been recently made by the Treasury for the Ways and Means Committee which discloses some 30,000 individuals returning net income of more than $50,000. According to this analysis, the average net income of this group of 30,000 taxpayers was $122,000, of which total bond interest averaged $8,000. Assuming that all such bond interest was subject to tax-free covenant, the 2-percent tax shifted from the corporations to the bondholders having $8,000 of bond interest would amount to $160. The normal and surtaxes on a net income of $122,000 would be around $20,000, without allowing for exemption of dividend income from normal tax. A question of a tax increase of $160 to an individual already subject to a tax liability of $20,000 may fairly be regarded as immaterial.

An analysis made in the case of the outstanding bonds of the Union Pacific Railroad Co., all of which are subject to the "tax-free" covenant, discloses that about 60 percent of the bond interest is paid to domestic corporations which, of course, are not interested in this obligation since the present law imposes the obligation on the source only when the interest is paid to individuals and partnerships. The remaining 40 percent of the interest is paid to some 24,000 individuals and partnerships. One-half of these bondholders collect less than $100 in interest a year and consequently are relieved of less than $2 in tax. Less than 600 bondholders, other than corporations, are relieved by this covenant of tax to the extent of $20 or more. To be affected to the extent of $20 by this 2-percent tax obligation, the interest must be $1,000, indicating a holding of about $25,000 of bonds. An individual who owns so large an amount of bonds of the Union Pacific is, in most cases, the holder of similar blocks of bonds in a number of other companies and is indicated as a person of such wealth that the amount of tax at the source involved would constitute an insignificant portion of his entire tax. This conclusion is consistent with the result shown above on the basis of the Treasury analysis of larger taxpayers. On the other hand, it need not be assumed that the large body of bondholders who collect less than $100 a year in interest have similar holdings in many other companies; the inference is rather that such a small holder is not an owner of bonds of more than two or three, if any, other companies. The bondholders between the two classes mentioned (i. e., those collecting less than $100 of interest and those collecting $1,000 or more) will many of them fall in the class of holders of such small amounts that the relief from the tax-free covenant is too small in amount to be a matter of consequence, and many others will fall in the class of such great wealth that the amount of tax relief is relatively too small, when compared with their whole tax liability, to be of moment. Midway in the list there may be a class of bondholders of comparatively small means to whom the amount of tax relief is of consequence, but this class

must be exceedingly small. Therefore, the conclusion seems justified that very few, if any, bondholders would attach any importance to the continuance of the obligation to pay 2-percent tax at the source.

(c) The repeal would relieve corporations of a tax which they now bear in cases where the bondholder is exempt.

The theory of the present withholding provision is very definitely that the debtor corporation is to pay the tax on behalf of the bondholder. The debtor corporation is supposed to be informed of the taxable status of its bondholders by the bondholders themselves, either by means of the ownership-certificates required to be filed with the debtor corporation at the time of the payment of interest or by written notice before February 1 of the following calendar year, so that it need not pay a tax unless the bondholder has taxable income in excess of the exemptions to which he is entitled. This is the theory of the law and the regulations. But the theory does not work out in practice. Different forms of certificate are prescribed by the regulations to accompany coupons when deposited or transmitted for collection. By one form (form 1001) the bondholder may apply the personnel exemption to which he is entitled against that bond interest; this will relieve the corporation of any tax. Another form (form 1000) waives any claim to apply the personal exemption against the interest, and when this form is filed the corporation becomes liable for the tax. It is practically impossible to give the average bondholder any clear understanding of the system of ownership-certificates prescribed by the regulations but in the course of time bondholders generally have learned that the safe certificate for them to file is form 1000 which waives any claim of exemption. Even those bondholders who understand the ownership-certificates, realize that there is no advantage to them in giving the corporation the benefit of any part of their personal exemption. The banks throughout the country, we are satisfied, encourage the practice of using form 1000, without inquiry as to the taxable status of the bondholders.

A recent instance was reported to us by a bondholder who on depositing coupons with her bank was unable to secure a copy of form 1001, as the bank provided itself only with a supply of form 1000. There are, of course, many bondholders of moderate means whose personal exemptions exceed their entire income and for whom therefore the corporations should not pay any tax at the source. Nevertheless, a very large number of such bondholders, entitled to exemption, file ownership-certificate form 1000 with the debtor corporations and thereby render the corporations liable for the tax. In other words there is no practical way for the corporations to get the benefit of the personal exemptions to which the bondholders are entitled, unless the bondholders disclose their exemptions in their ownership-certificates and this disclosure bondholders now very generally omit to make. Thus as a practical result to a considerable extent corporations are paying taxes under the withholding provision which are not due to the Government and which are not contemplated by law.

(d) The repeal would relieve the corporations of a great expense which they now incur in complying with the withholding provision of the law.

Monthly returns of interest payments are required consisting of the names and addresses of the persons to whom interest is paid, the amounts of the payments and the tax on each payment. This requires the listing of the names and addresses taken from the ownership-certificates. The labor involved is enormous. When it is considered that in case of the Union Pacific Railroad Co. there are some 24,000 bondholders, exclusive of corporations, and that interest payments are made twice a year, the extent of the task of listing the names and addresses may be readily appreciated.

Further, the necessary handling of the vast number of ownership-certificates filed with the coupons, and their periodical transmission to the sorting section of the Internal Revenue involve a very considerable labor and expense.

(e) The repeal would be of great advantage to the Bureau of Internal Revenue in simplifying the administration of the law and saving expense.

The administration of this branch of the law is unduly burdensome from the standpoint of the Bureau of Internal Revenue. The volume of monthly returns and of ownership certificates poured into the Bureau by all the corporations of the country is enormous. The storage of this material alone presents a grave problem and a considerable expense. The certificates must be sorted and the returns audited. We will not attempt to elaborate upon this feature of the matter, since the Bureau can, if desired, furnish reliable estimates of the cost of administering this branch of the law.

The requirement of ownership certificates in connection with the collection of coupons results in a complicated procedure which is annoying to the mass of bondholders and to banks handling coupons, as well as burdensome to the corporations and to the Bureau. When the law was revised, eliminating the requirement for withholding from bond interest not containing a tax-free covenant, the regulations were changed to eliminate the necessity for citizens and residents to file ownership certificates when collecting their bond interest on that class of bonds. Substantially all bond interest is collected by individuals through their banks of deposit and the Commissioner by regulation constituted the banks of deposit the source for reporting information concerning the amount of interest collected by their customers on non-tax-free bonds. Thus at the present time there are two sources of information in respect of the amount of bond interest collected by a bondholder. The debtor corporation is under the regulations the source for tax-free covenant interest and the bondholder's bank is the source for all other bond interest. The amendment of the law now recommended would enable the Commissioner to completely abolish the ownership-certificate procedure as to citizens and residents and in its place to constitute the banks of deposit as the one source of such information as he thought desirable for all bond interest. It would seem that the bank is a much better source of information than the debtor corporation. The bank, at the end of the year, can give information as to the total amount of interest collected by a customer on all his owned bonds, whereas as long as the debtor corporations are the source, the Commissioner must collate the information returns of all corporations to ascertain the aggregate bond-interest income of any individual.

(*f*) The cost to the Government and the corporations of administering this withholding tax is an economic waste. It is not incurred for the purpose of securing more revenue but solely to the end that a part of the bondholder's tax shall be borne by the corporation.

The cost to the debtor corporations of compiling withholding returns, etc., to the collecting banks of handling the ownership certificates and examining them, and to the Bureau of filing, sorting, and checking, etc., the ownership certificates and the withholding returns, amounts to a very considerable sum of money. This sum must not be compared with the total amount of tax collected but rather with the difference between the amount the Government now collects and the amount it would collect if there were no withholding provision. The Government would lose the revenue included in this tax now collected from the corporations in cases where the bondholder was not liable for any tax and possibly some taxes paid in duplication by the bondholder. But the revenue so lost is revenue which the law does not intend to collect. Substantially the bondholders would pay the tax which is now collected at the source. Therefore, the whole cost of administering this withholding provision and the annoyance caused to the public are attributable solely to the desire of Congress in 1917 to make the corporations pay something because of their tax-free covenants, however inconsistent such a result might be with the general policy and structure of the tax law.

(*g*) While the tax liability would be shifted to the bondholders, even they would derive some advantage from the repeal.

Many individuals would pay no more tax as the result of the repeal of the withholding provisions than they pay now. It is believed that a considerable number of bondholders since they collect their interest in full, without actual deduction for the tax, do not understand, or else pay no attention to, the provisions of the law permitting them to take credit for the amount of the tax to be paid at the source in computing their own income-tax liability. Therefore, to some extent the tax is paid by both the corporation and the bondholder.

But even those bondholders whose taxes would be actually increased in the small amount which would result from the repeal, would benefit through the relief from the annoyance of the ownership-certificate system. To the mass of bondholders who collect less than $100 a year in interest it is doubtful if the $2, or less, in tax saved them by this provision of the law would be deemed worth the attendant bother of making out and filing ownership certificate twice a year in collecting their coupons.

(2) *All bond interest paid nonresident aliens.*—Section 221 (b) imposes a tax of 2 percent at the source on bond interest subject to a tax-free covenant when paid to nonresident alien individuals or partnerships, as well as when paid to citizens and residents. Under section 221 (a) withholding at the source (which is an actual withholding) is required of the whole normal tax of 5 percent in

the case of income generally when paid to nonresident alien individuals, except tax-free covenant bond interest. By section 237 withholding at the source of the 13½ percent tax (which again is actual withholding) is required in the case of income generally when paid to alien corporations, except tax-free covenant bond interest.

This branch of our recommendation is that the abolition of withholding be extended to all bond interest, whether tax free or not, and even when paid to nonresident alien individuals, partnerships and corporations. This would mean (1) the repeal of section 221 (b) so far as it applies the 2 percent tax to "tax-free" covenant bond interest paid nonresident alien individuals and alien partnerships; (2) the amendment of section 221 (a) so that it would not require withholding of 5 percent tax from nontax-free bond interest paid such alien individuals and partnerships; and (3) the amendment of section 237 so that it would not require withholding of 13½ percent from the nontax-free bond interest paid alien corporations.

The debtor corporations have no interest in the amendment of section 221 (a) and section 237. These provisions involve actual withholding, so the tax is not borne by the source. And so few interest payments fall within these provisions that the labor and expense of administering them are inconsiderable.

The reasons in favor of the repeal of the tax under section 221 (b) so far as it applies to payments made aliens are the same as those advanced for the repeal of the tax on payments made to citizens and residents.

The reasons for the amendment of section 221 (a) and section 237 are simplification of the law and the removal of a tax which discourages foreign investment in bonds of United States corporations.

We believe that an association of bankers has urged the wisdom of exempting the interest on foreign-owned bonds on the ground of public policy and we will not elaborate the general point.

So far as concerns the repeal of section 221 (b) as affecting interest paid alien holders, it is sufficient to say that probably only a very small amount of the 2-percent tax paid by the corporations for alien holders represents tax due under the law. A nonresident alien of course collects his interest in full without actual deduction. Assuming that his total income from sources within the United States is less than $1,500, there is no income tax due the United States, if the bondholder claims this personal exemption. As a practical matter he is not interested in claiming the exemption because it means nothing to him in dollars and cents, and it is, therefore, practically impossible for the debtor corporation to induce him to execute an exemption certificate in order to save the corporation from paying the tax.

Respectfully submitted.

UNION PACIFIC RAILROAD CO.,
By F. W. CRARSEN, *Vice President*,
E. G. SMITH, *Treasurer*,
HENRY W. CLARK, *General Counsel*.

The CHAIRMAN. Is Senator Hardwick in the room?

Will you come forward and make your statement?

STATEMENT OF HON. THOMAS W. HARDWICK, WASHINGTON, D. C.

Mr. HARDWICK. I represent four of the largest manufacturers of cosmetics, the Pond Extract Co., Andrew Jergens Co., John H. Woodbury, Inc., and Northam-Warren Corporation.

I am pretty familiar with the limitations under which you gentlemen labor, and I won't worry you with reading papers. I am going to try to present my proposition just as fairly and briefly as possible. I have been where you are many a time and I know how to sympathize with you. It happened to be my luck to participate in the enactment of the first three or four income-tax laws that this country ever passed. First, as a Member of the House of Representatives for the very first one, and for the next three as a Member of the Senate.

Not immediately but early in the development of the Federal income-tax system, the necessity was impressed upon Congress, in order to be fair to the taxpayer as well as to the Government in disputes about deficiencies where the Government would claim that the taxpayer had not returned enough or had not paid something which he should have, that the Commissioner of Internal Revenue should be given the power to assert and collect deficiencies, but, as I say, very early in the development of the system it became evident that somebody must have the right to pass on the controversies that arose between the taxpayer and the Government on that question.

Senator KING. You want the intercession of the Board of Tax Appeals in——

Mr. HARDWICK (interposing). I want to include a class of people who have not that right that should have it. Beginning in 1924 the Congress adopted that attitude that it was not fair under Anglo-Saxon jurisprudence that it permit the same authority to prosecute the case, to sit as judge and jury in determining it, and finally as executioner, in executing the decree, so that they set up the Board of Tax Appeals, an independent agency appointed directly by the President to pass on these contentions, and they gradually put every single important group of taxpayers except one—and I will come to that—within this legislation, giving to every such taxpayer the right of appeal to that board under the provisions of the law, and finally, of course, to the courts from the board.

The same provision was not included when the manufacturers' excise tax in 1932 was enacted to the people who were required to pay that tax. Why, I do not know. We had some representations from the Bureau of Internal Revenue coming from the Secretary of the Treasury, initialed by the Secretary but of course not his work—and there are three reasons that have been given as near as I can figure them out. I will put all of these things in the record so that you can have them to see what these contentions are.

First they say that these excise taxes are collected by the month and not by the year as in other cases, and that makes a difference, and yet we pointed out in answer to that, that they have never claimed a deficiency. We suggest that if it is important that that provision be put in the law that the Bureau be not allowed to levy deficiencies on these people except by the year. I do not think it makes any difference, because the Bureau does not do it in any other way except by the year now. Second, they said, now, if we did that, we would be overburdening the Board of Tax Appeals. I do not think that is in accordance with the exact facts. There are many of these cases there where deficiencies are asserted, but there are not many that go to the point of appeal, because it is expensive, it costs money to make these tax appeals.

The deficiencies claimed now have amounted to so much that they are just as much entitled to consideration as anybody else in this country. For instance, two of my clients have deficiencies of more than half a million dollars claimed against them now, and they are among the very best people in this country, like Pond's Extract people and all these other people who are good folks.

Senator KING. May I ask you a question?

Mr. HARDWICK. Certainly.

Senator KING. Do you not see a line of differentiation between taxes that might be called temporary taxes and permanent taxes?

Mr. HARDWICK. The trouble with that is that these are permanent. They are extending them for 2 years more, but every time the time runs out, they extend it. It does not seem at all probable that these taxes will be soon remitted. Now, what are you going to do? We have people here with more than a half a million dollars claimed——

Senator CONNALLY (interposing). May I ask you a question?

Mr. HARDWICK. Certainly.

Senator CONNALLY. Were these taxes paid by stamp taxes, or how?

Mr. HARDWICK. No; they return it once a month and pay right into the Internal Revenue Bureau.

Senator CONNALLY. On their gross sales?

Mr. HARDWICK. On what they call the fair selling price. I do not know whether you gentlemen remember the controversy that developed on that, but in levying this tax on the manufacturers, it was provided in section 603 and section 619, that they should pay on a fair selling price, and Congress went on to provide that for the purposes of this title, in determining the price for which the article is sold, there shall be included in any charge, coverings or containers of any nature and any charge incident to placing the article in condition taxed ready for shipment, but there shall be excluded the amount of the tax imposed by this title whether stated as a separate charge, transportation, delivery, insurance, installation, or any other charge not required by the foregoing sentence to be included, which shall be excluded from the price only if the amount thereof is established to the satisfaction of the Commissioner in accordance with the regulations.

The CHAIRMAN. That is in a different category from gasoline and other items?

Mr. HARDWICK. Yes.

The CHAIRMAN. That will go out with 1937.

Mr. HARDWICK. Yes, unless these taxes are again renewed; this one was extended for 2 years. These deficiencies amount to such large sums in some cases that it does not seem fair not to have the same rights as the other taxpayers. Many concerns might be absolutely ruined, and it is not right to take six or seven hundred thousand dollars out of a taxpayer's pocket when there is an honest difference of opinion and an honest controversy growing out of these provisions I have read, before you give some impartial tribunal the right to pass upon them.

The CHAIRMAN. What do you suggest?

Mr. HARDWICK. I would give the right of appeal to the Board where the deficiency is in excess of $25,000.

The CHAIRMAN. A wrong is just as great a wrong from a moral standpoint if it involves $25,000 or $2,500,000.

Mr. HARDWICK. Exactly. There are instances where probably great harm would be wrought to some of these smaller people by putting a limitation like that on it. That is the reason I did not originally suggest it.

As far as my clients are concerned, we could put a limitation of $100,000 on the amount and it would not make any difference. Some amounts are so trivial you might not want to give the right of appeal. You do not do that in other cases, however.

In this bill you have three sections in which you provide an elaborate system by which these corporations that pay this tax that you have provided in this act shall have the right of appeal. Why should there be any discrimination against the payment of the manufacturers' excise tax in this respect? Why not also say exactly that the same right of appeal that you already allow everyone of the others, be granted to them? It would not make any difference.

Senator KING. You have your right of appeal, but you have to pay the tax in advance?

Senator GEORGE. You have a right to sue for a refund.

Mr. HARDWICK. But we must pay out our money, six or seven hundred thousand dollars, and we do not get a determination by an impartial authority.

The CHAIRMAN. Would you want the law retroactive?

Mr. HARDWICK. No.

Senator CONNALLY. If you do not make it retroactive, how does it help the people who already have assessments against them?

Mr. HARDWICK. Well, they have not been where they are pending in the Bureau. They are claiming them, and if they do make that ruling, we would like the right to appeal before we pay out a million dollars.

Senator BLACK. What is the nature of the dispute?

Mr. HARDWICK. Well, take Pond's Extract Co., to illustrate, and that will make the whole thing plain. Pond's Extract Co. is one of the largest concerns of the kind in America. For many years it had an arrangement with another corporation—I have forgotten the name of that other corporation—by which that other corporation acts as its selling agent, in other words, the manufacturing concern which is Pond's, sells to this other concern, which is the distributing concern. Ponds Extract Co. gets a certain price from them.

Senator BLACK. Is it a subsidiary?

Mr. HARDWICK. I will come to that in just a moment. They get a certain price. The selling concern that hires all the salesmen and does the advertising and stands the distribution costs, of course gets a higher price from the wholesaler and retailer than is paid to the manufacturing concern. The selling concern and the manufacturing concern are not identically owned, but there are interlocking interests. There is a strong minority of the stock in each corporation that has no interest at all in the other corporation, and the legal situation is such that an appeal could be made to a court of equity, and a bill in equity could be maintained if these corporations dealt with one another unfairly.

The Bureau is inclined to contend, because there is some common ownership of stock, the selling corporation, that the price they get from the folks that sell it ought to be the price taxed. We say that is not true, that they have their own profits, they pay part of them, and there are stockholders in the selling concern who have no interest in the manufacturing concern.

Just such controversies as that. The cost of hiring salesmen, of getting out advertising and all like that, is a matter between them and the Government. We get from them what our manufacturer's selling price is, but our article is the business of manufacturing.

As I say, you have these three sections already in this bill providing an elaborate system, sections 270, 271, and 278—an elaborate

system for appeal to the Board of Tax Appeals by people in this bill. By a very few words which Mr. Parker can readily add or you can instruct him to add to this bill, you can include this particular class of people within the right to take appeals to the Board of Tax Appeals.

I said I was not going to read a paper, and I am not, but I would suggest it in this form:

Jurisdiction is hereby conferred on the United States Board of Tax Appeals in respect to manufacturer's excise taxes imposed by title IV of the Revenue Act of June 6, 1932, as amended, in the same manner and subject to the same procedure, including the right of appeal, and the same limitations with respect to assessment and collection as is provided in the Revenue Act of ——, 1934, with respect to income taxes.

Jurisdiction is hereby conferred on the United States Board of Tax Appeals in respect to deficiencies amounting to $25,000.00 or more per annum upon manufacturers' excise taxes imposed by title IV of the Revenue Act of June 6, 1932, as amended, in the same manner and subject to the same procedure, including the right of appeal, and the same limitations with respect to assessment and collection as is provided in the Revenue Act of 1932 with respect to income taxes; provided deficiencies with respect to such manufacturers' excise taxes shall not be claimed and asserted by the Commissioner of Internal Revenue, except in cases of jeopardy, for a period of less than one year, instead of by the month.

Then if you want to do it, if you are afraid of the argument that it won't do, give the little fellow a right to appeal in these cases as well as the larger one. Personally if I were a member of the committee I would not put any limitation as to the amount. I do not think the little fellows can stand the expense of appealing. But I do not like the proposition of giving the big man a right that you deny to the little man.

Senator CONNALLY. That 1 year business, is that vital? I do not mind giving you the right to go to the Board of Tax Appeals, but I think the Commissioner should be allowed to do it month by month.

Mr. HARDWICK. That is immaterial to us. The Bureau suggested that sort of objection to it; hence we included it.

Senator CONNALLY. Because otherwise you might have to wait until the end of the year, which might impair or hamper the collection of the tax and the accounting and all that sort of business.

Mr. HARDWICK. I would be perfectly willing. As a matter of fact my understanding is that they have never levied except in the cases of fly-by-night people or people who wanted to beat them for a period of less than a year.

Senator CONNALLY. I would not want to tie their hands.

The CHAIRMAN. Put that in the record, Senator, and the committee will give consideration to your suggestion.

Mr. HARDWICK. There is only one thing that I want to add, if there is any member of the committee that does not understand——

The CHAIRMAN. I think you have made very plain what you want.

Senator CONNALLY. Colonel Garwood is here from Houston, and I would prefer if the committee would let him appear in the morning. He has just gotten here and he has a lot of these hearings to read. Will it be agreeable to have him come on the first thing in the morning?

The CHAIRMAN. Yes; if that will suit his convenience better.

Then we will hear from Mr. Digges.

STATEMENT OF ISAAC W. DIGGES, NEW YORK CITY, REPRESENTING TRANSRADIO PRESS SERVICE, INC.

Mr. DIGGES. Mr. Chairman, my name is Isaac W. Digges, an attorney of New York City. I represent Transradio Press Service, Inc., and I appear to request a slight amendment to section 701 (b) of the Revenue Act of 1932. That section presently exempts from taxation telephone and telegraph facilities utilized in the collection of news for the public press or in the dissemination of news through the public press. The proposed amendment would likewise exempt news collected for radio broadcast or the dissemination of news through radio broadcast.

Transradio Press Service, incorporated in 1934, is engaged in the business of collecting news in the United States and foreign countries, through its own press bureaus, correspondents, and affiliations with other press associations. The news so gathered is disseminated principally to radio broadcasting stations, and to a much lesser degree to daily newspapers. In practice the news is principally sent over leased telephone wires to radio broadcast stations and to newspapers. Transradio Press Service is in competition with the other major press services of the United States. It differs from those services only in that the largest number of its subscribers are radio broadcast stations; other press associations serve newspapers principally although the principal competitors of Transradio also serve a large number of radio stations.

The latter are exempt under the present law; Transradio is not. This matter was investigated last summer by the chief of staff of the Joint Committee on Internal Revenue Taxation, who reported to the chairman of this committee in part, as follows:

> Radio news agencies of the type of Transradio Press Service, Inc., I am informed, are enterprises developed in news field since the passage of the Revenue Act of 1932. There seems to be considerable merit in the contention that they perform a service in the public interest equally meritorious with the agencies collecting news for the press and that the present law is somewhat discriminatory against them.

The CHAIRMAN. Was this brought to the attention of the Ways and Means Committee?

Mr. DIGGES. It was not, sir.

The amount of the tax is infinitesimal from the viewpoint of the Government, amounting in the case of Transradio to less than $10,000 per year, and Transradio is the largest of the companies in its field. That sum, however, represents a serious burden upon a company which pays out for transmission facilities more than 50 percent of its gross income. It also represents an inevitable discrimination against a company which has performed a meritorious service in getting quickly and accurately to the public timely news of world happenings.

The specific recommendation which I have to make is that the words "or for radio broadcasting stations" be inserted after the words "collection of news for the public press" and that the words "or by radio" be inserted after the words "the dissemination of news through the public press."

Senator BLACK. Let me ask you one question. Is there any other class of business that runs for profit that is exempted from the payment of this tax?

Mr. DIGGS. Not that I know of, except that it has been the policy of Congress, I think, since 1918, to exempt from taxation news dispatches.

Senator BLACK. You have looked at the bill, and there is no other exemption from payment of that tax by any other business that operates for profit except the one you have mentioned?

Mr. DIGGS. This is an excise tax, Senator, which does not have anything to do with the income-tax provisions of the act.

Senator BLACK. But it is a tax that the citizen has to pay?

Mr. DIGGS. Yes; that is correct.

Senator CONNALLY. Let me ask you about your service. What do you do? You wire this out to other radio broadcasts and then they announce the news over the radio?

Mr. DIGGS. That is correct. We operate just as any other press association.

Senator CONNALLY. You beat the newspapers to it as a rule?

Mr. DIGGS. On some occasions.

The CHAIRMAN. Thank you very much. The next witness is Mr. Lazo.

STATEMENT OF HECTOR LAZO, WASHINGTON, D. C., REPRESENTING COOPERATIVE FOOD DISTRIBUTORS OF AMERICA

Mr. LAZO. I will file my statement and tell you briefly the thing that is bothering us. We represent really small business, and by small business I mean concerns that do $30,000 a year or less, who are grouped together in cooperatives in order to be able to compete with the large corporations.

Senator KING. You mean that is your gross sales?

Mr. LAZO. The gross business of these individuals, and we have about 21,000 of these individuals that are grouped together in 98 cooperatives. They are necessarily forced by the cooperative laws of the States and of the Union to restrict the sale of their stock to their individual members. They cannot go to the public to sell stock. Therefore, they are operating in a manner that their operating capital necessarily comes from individual members, and they must depend upon the earnings of these cooperatives that are left by the members with the cooperative itself for operating capital.

I am not sufficiently well versed to know whether that would be 22 percent or 42 percent, but from the statements made by the experts on it, they are enough to scare any cooperative, and the farm cooperatives, you know, are now exempt under section 101 of the Revenue Act of 1934.

Mr. CONNALLY. Are these concerns all corporations?

Mr. LAZO. Yes, sir; they are all corporations, incorporated cooperatives, and operating now in about 37 States of the Union with 21,000 retail members.

Senator GEORGE. Dealing in what?

Mr. LAZO. Dealing in food and grocery products. They must depend upon the earnings of the members which are left in there, for their operating capital. Any serious tax upon that would be necessarily a result in hampering of their ability, of small independent business to meet the competition of the large corporation against whom they are organized on a cooperative basis.

The CHAIRMAN. You have your brief there.

Mr. LAZO. Yes, sir; it is filed.

The CHAIRMAN. Thank you very much.

(The brief referred to is as follows:)

In behalf of 21,000 small merchants, banded together in 96 cooperative wholesale groups in 37 States, I offer you a respectful plea that you give serious consideration to the proposed so-called corporate surplus tax, which may easily be the undoing of many small corporations and quite probably prove a downfall tax to hundreds of cooperatives.

In addition to the already mentioned dangers to small corporations in general, we as cooperatives are faced with the additional threat to the only means that true cooperatives have of building up, namely, undistributed savings from operations. Of course, technically speaking, they are not "surpluses", since cooperatives do not make profits but merely effect savings. But thus far only farm, fruit grower, and similar organizations are exempt under the existing revenue laws (in the Revenue Act of 1934, sec. 101, par. 12). A proposed House bill (H. R. 11775), introduced by Representative Scott, would extend this same exemption to all bona-fide cooperatives. But, in the meantime, we who are by charter and by law restricted in the sale of stock for operating capital to our own limited membership, therefore, must depend upon the unselfishness of these same members in foregoing immediate and full participation in all savings and earnings from operations, in order to provide for adequate working capital and for growth.

The cooperatives have provided small independent business in this country the only means of escape from economic extinction brought about by the vast changes which have followed mass production, mass concentration of population, and, in direct consequence, mass distribution. The economic forces which have altered methods of transportation, the passing of the corner blacksmith shop, and the extinction of the little red schoolhouse have also ordained that unless independent business can meet the challenge of change, it, too, must pass out, not only (although this is important) because of the abuses that mass production and mass distribution have brought about but also, and primarily, because of the economic changes and vastly increased needs of distribution at low cost. In this the consumer is the deciding factor—what the consumer can pay.

Independent business has grouped itself together in various organizations. We are convinced that the cooperatives of our type afford independent retail business their solution. But in order to be able to protect small independent business under the cooperative system, we, who are restricted in the sale of stock, and therefore in the source of capital for operations, must have the right to retain certain amounts of the savings effected as undivided, although it may be allocated, overcharge. The individual members who receive the earnings in patronage dividends, of course, pay taxes on them now; the cooperative itself does not make a profit, because it is not permitted to make a profit. It is strictly a nonprofit organization. Surpluses are not undivided profits; they are savings effected, which the members leave in there as a liability or charge on the house in order that small independent business may, through collective action, meet the challenge of the large corporation.

The new and highly disturbing, discouraging threat to careful management and building up of these cooperatives through this type of taxation will not only work a tremendous hardship upon these small corporations but a double and unfair hardship upon cooperatives of all types who cannot turn to the public for additional capital, whose assets are quite often limited, and who have great difficulty borrowing at the bank, and who must satisfy also statutory requirements, such as in the State of Iowa, where by law it is required that cooperatives set aside a portion of their savings every year until these withdrawals reach 80 percent of the total capital paid in stock plus all unpaid patronage dividends, plus all certificates of indebtedness payable upon liquidation; that is a requirement of the law in Iowa. There are other State laws with similar requirements.

May I, therefore, respectfully suggest that as a measure of protection of small business and the ever downtrodden consumer, with all realization of the need for revenue for carrying on the Government of the United States, that your committee consider H. R. 11775, amending section 101, paragraph 12, of the revenue act, for otherwise you will be imposing upon cooperatives a double penalty; and that means a double penalty upon small independent business which cannot survive alone; and on the consumer who is footing the entire bill anyway.

Respectfully submitted.

HECTOR LAZO.

Senator KING. Mr. Chairman, we are receiving valuable information from both the Treasury Department and various witnesses who have appeared. For the purpose of getting all the information that we can to draft a new bill, I should like to insert in the record an editorial that the New York Times has in this morning's issue, a very excellent editorial, and by that I do not mean to give my approval to it in all respects, as to the terms of a bill. I think the suggestions therein contained are so valuable and informative that it should go into the record.

The CHAIRMAN. Very well; it may be inserted in the record.

(The matter referred to is as follows:)

A COMPROMISE TAX BILL

The prospective deficit for the current fiscal year, charging the entire veterans' bonus to the year, reaches the enormous sum of $5,906,000,000. The estimated deficit for the next fiscal year is $2,675,000,000. It would not be difficult to show that not all the expenditures that help to produce these deficits are necessary. Very substantial reductions, in fact, are easily possible. But it would be unrealistic to suppose that Congress—any Congress—could wipe out these deficits by slashing expenditures enough to do that in one fell blow and in an election year. The gap must be partly closed by an increase in taxes.

The President has suggested that taxes be raised at least to the extent necessary to repair the damage done by events subsequent to the official Budget estimates he presented in January. This required new revenues running not far from a billion dollars. The President had not only the courage to recommend that taxes be imposed to raise these revenues, but the still greater courage to recommend the particular taxes by which this might be done. In doing this, especially in an election year, he answered the charges of many of his critics that he is concerned only with extravagant spending and gives no thought to paying the bill.

II

His main proposal, however, for a corporation tax solely on undistributed profits happens to be one that is likely to do great economic injury to the country. This is not because the tax burden it imposes would in itself be excessive. It is because the tax is of such a nature that it would act either to bribe or coerce corporations into following a policy that would injure their credit, increase the number of bankruptcies, aggravate the violence of the up-and-down swings of business (and of Treasury income) and, worst of all, tend to stunt the industrial growth of the country and the opportunities it offers for employment. One of the most ironic aspects of the whole matter is that, proposing a revolution in our form of corporate taxation, the Treasury recklessly gives up assured revenues of about $1,000,000,000 for the merely speculative chance that it can get $620,000,000 additional out of the new tax.

The chief argument for the new tax proposal is that it will bring "equality of taxation" as between individuals. Even if it could be shown that it would do this, the argument would be far from conclusive. There are more important economic objectives than an academic "equality of taxation" among individuals. One of them is to increase the production of goods and satisfactions for our people, another to increase the opportunities for employment. If we prevent or retard the achievement of either of the last two objectives in impatient efforts to secure the first, we shall have made a sorry exchange.

III

But would the new tax necessary bring a more just taxation of personal incomes? In certain circumstances it could easily bring the opposite. The maximum tax imposed on a corporation's net income under the new measure is 42½ percent when the corporation fails to pay any dividend at all. This is approximately the tax rate paid on personal incomes of about $75,000. Suppose the controlling stockholders and directors of a given corporation have incomes greatly in excess of $75,000? If their dividend policy were primarily dependent on their prospective income tax (as the new bill in principle assumes), they might still pay no dividends because they would

save money by paying only 42½ percent instead of possibly 50, 60, or 75 percent. But what of the small stockholders in that corporation—men and women who might ordinarily not have to pay more than the normal income tax of 4 percent on their incomes? They, too, because of the new measure, would have to pay an income tax of 42½ percent on that part of their income earned by the corporation. Here the new tax would drastically hurt the small stockholder in an unsuccessful effort to get the big stockholder.

IV

The criticisms that have been made of the present tax bill have for the most part protested against its nature, not against the added tax burden that it would impose. This means that business in the main accepts the necessity for new tax legislation and expects to pay its fair share. The Senate is in a position to take advantage of that mood by writing a proper tax bill. Many Senators have shown by their questions and comments that they are in grave doubt regarding the wisdom of the present measure and would welcome substitute suggestions.

Such suggestions must be made with a full recognition of political realities. The most desirable tax measure would be one to spread the personal income tax. At present only about 4 or 5 voters in every 100 pay such a tax. Not until the base of the income tax is broadened can really adequate revenues be raised. Not until we do this will we bring home to the masses of the voters what Federal spending means. But it would be naive to expect this to be done in an election year.

Fortunately, the added amount that it is proposed to raise through the new tax on undistributed corporation profits can be obtained by taxes that would work comparatively little harm. In imposing these taxes certain features of the measure passed by the House might profitably be retained. For example, the Senate would do well to follow the House in dropping the capital stock and excess profits taxes. These levies have not been very productive and they depend more upon the success of the guesses of corporation directors than upon ability to pay. But the 15-percent tax on corporation net incomes should be kept. This is the backbone of our corporation tax system. Secretary Morgenthau has estimated that the yield on it from 1936 earnings would be $964,000,000—hardly a sum to be thrown away. It would simplify matters, as well as bear more equitably on individual stockholders, if a flat tax of 15 percent were imposed instead of the present graduated from 12½ to 15 percent. If there is to be any graduation, it should be confined to corporation incomes of $20,000 or less. It is not until the income of an individual rises above $20,000 that it is taxed as high as 15 percent. Corporation incomes of less than $20,000 might, therefore, reasonably be taxed at no higher rates than individual incomes of the corresponding amounts.

V

In addition to this, the Senate might also, following the House, impose the normal tax of 4 percent on dividends paid to individuals. The Treasury has estimated that this alone would yield about $300,000,000. This is already nearly half of the added amount needed.

A tax of 4 percent might then be imposed on undistributed corporation profits without exceptions. Such a tax should raise substantial revenue at the same time as it would be likely to have very little effect on dividend policy, for it would penalize even the relatively low-income stockholders no more to retain these profits than to pay them out. If the Treasury is correct in its estimate that "$4,500,000,000 of corporation income in the calendar year 1936 will be withheld from stockholders", then it is not difficult to figure the yield of this tax. It would be $180,000,000. This already gives us $480,000,000 of the needed additional amount. Congress, therefore, would be under no pressure to impose drastic and injurious taxes to raise the remainder.

In the boom period from 1922 to 1929, inclusive, during every year of which the corporations were earning more than they paid out in dividends, the average ratio of dividends to earnings was about 77 percent. Whatever may be true of personal holding companies and isolated instances, it seems foolish to assume that the dividend policies of corporations as a whole were then materially influenced by income-tax considerations. Though every corporation is in a special position, we may for tax purposes consider this average figure as a rough index of "normal" dividend policy.

The Senate should allow, therefore, the retention of at least 20 and preferably 35 percent of earnings with no more than a 4-percent tax on the amount retained. This would contrast with a proposed tax of 45 to 48 percent of such a retention in the present bill. The Senate might then cautiously apply a graduated tax to retentions above that. Certainly it should allow every exception that the House measure already allows, but it should not stop there. One vitally important exception, among others, should be added. No surplus tax should be imposed on earnings explicitly retained for the purchase of new machinery, the building of added plants, or the creation of tangible facilities for enlarging the productivity of a company or the employment that it will provide. A surplus tax designed ostensibly merely to stop "tax avoidance" should not imperil genuine industrial expansion.

When these exceptions have been made, surtaxes might be imposed on other earnings undistributed. If the corporation's income is divided for tax purposes into fifths, and the first fifth retained as surplus bears only the 4-percent tax, the four succeeding fifths might be subjected to surtaxes of certainly not more than 5, 10, 15, and 20 percent.

Certainly such a plan would raise as much income as the present proposed bill. It might not be an ideal measure; the burden it placed upon corporations might still be excessive; but it would satisfy those who insist upon the principle of an undistributed profits tax, and it would give opportunity for studying the effects of that tax without working too sudden and dangerous a revolution in our tax structure.

The CHAIRMAN. Tomorrow morning we meet at 9:30 at the Finance Committee room. Mr. Garwood will be the first witness.

We will now recess until tomorrow morning.

(Whereupon, at 4:30 p. m., the committee recessed until tomorrow, May 5, 1936, at 9:30 a. m.)

REVENUE ACT, 1936

TUESDAY, MAY 5, 1936

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

The committee met, pursuant to adjournment, at 9:30 a. m., in the committee room, Senate Office Building, Senator Pat Harrison presiding.

Present: Senators Harrison (chairman), King, George, Walsh, Barkley, Connally, Bailey, Byrd, Gerry, Couzens, LaFollette, Hastings, and Capper.

The CHAIRMAN. Is Mr. T. G. Strange present?

(No response.)

The CHAIRMAN. Mr. Harold R. Young?

Mr. YOUNG. Yes, sir.

STATEMENT OF HAROLD R. YOUNG, WASHINGTON, D. C., REPRESENTING THE NATIONAL RETAIL DRY GOODS ASSOCIATION

Mr. YOUNG. Senator, I should like to ask before I begin my statement, if you are disposed to hear one proposition that is not involved in the bill as it passed the House?

The CHAIRMAN. I think you should confine yourself to the bill.

Mr. YOUNG. I will be glad to conform to that suggestion. I should have liked, however, to have presented one matter that is not in the bill.

The CHAIRMAN. You might have ingenuity enough to shift it in.

Mr. YOUNG. The National Retail Dry Goods Association, for which I am appearing, has just completed its twenty-fifth year of service to retailers and the consuming public, and has in its membership more than 5,600 retail dry goods and department stores located in every State in the Union, the total membership of which does an annual volume of approximately $4,000,000,000.

In addition to the National Retail Dry Goods Association, I have been requested to state for the record that the following national retail organizations are in hearty accord with the proposals we are about to make.

National Retail Furniture Association.

National Association of Retail Grocers of the United States.

National Association of Retail Clothiers and Furnishers.

These associations are a part of the Retailers' National Council, an organization composed of 12 national retail associations, with a combined membership of 200,000 stores, employing 1,500,000 people, and doing a total annual volume of $10,000,000,000.

I am going to confine my presentation here to the proposed title IV of the Revenue Act of 1936 because the attitude of our association toward the proposed legislation generally was fully stated by me in my appearance before the Ways and Means Committee of the House on the second day of April 1936, and I have nothing to add to that statement; and further, because upward of 849,000 retailers, large and small, who paid more than $14,700,000 into the Treasury of the United States in July, August, and September 1933 in floor stocks taxes have a special interest in title IV of the proposed act. This huge number of retailers is anxiously awaiting the action of Congress with respect to the method by which this tax is to be returned to them, as contemplated by section 16 of the Agricultural Adjustment Act.

The amendment to the Agricultural Adjustment Act of 1935 provides that the tax content of the taxable commodities in the inventory of dealers at the termination of the tax will be refunded to dealers. The subcommittee of the Ways and Means Committee has recommended that this refund be made contingent upon the showing by the claimant that (1) claimant's demand for refund does not exceed the amount of the burden of the tax which was shifted to the claimant by the seller, nor (2) does it exceed the amount which the claimant has received from the seller or that the claimant will receive from the seller, and what is more important, (3) that the amount claimed does not exceed the amount by which the claimant reduced the sale price of the article on account of the invalidation of the tax under the Agricultural Adjustment Act as amended. Paragraph (e) of section 602 specifically eliminates all claims of an amount less than $10.

Let us analyze the possibility and probability of the dealer being able to qualify under this restriction. The members of the Supreme Court of the United States, in the *Rickel Rice Mills case* recognized that the statutory condition precedent to recovery of the tax, to wit, proof that the taxes had not been passed on to the buyers was a condition impossible of performance. The members of your committee, probably likewise will realize that the Supreme Court was quite correct and that unless the tax happened to be billed separately from the merchandise, and this was seldom the case, there would be absolutely no way in which the buyer of merchandise could show that the tax had been passed on to him by a processor, or whether or not he was passing the tax on to the ultimate consumer because of the tremendous variation in prices from time to time of the commodities affected and the variations in the original margin of gross profit or markon. A simple example is that of merchandise manufactured of cotton the cost of which was carefully figured, including the tax after which the selling price was determined upon, at $2 per dozen. Changes in the competitive situation and market conditions, when the merchandise was offered for sale, made it necessary to reduce the price of that merchandise to $1.75 per dozen. Is the tax passed on under these circumstances when the producer wholly failed to receive the price to which he originally felt he was entitled and to which in the normal course of business he probably was entitled? I should say here that it would be very difficult, if not impossible, to establish that the tax was or was not passed on. Variations of this example are too numerous to cite.

Retailers may possibly receive some refund from processors, but up to the present time all processors have stated that there will be a limitation on any refund and that such refund, if any, will be solely on merchandise purchased within a period of 90 days prior to the decision of the Supreme Court. There is no way for the average retailer to determine whether or not the merchandise which he had on hand on January 6, 1936, was the merchandise upon which he may receive a refund from the processor or manufacturer, and certainly no retailer is clairvoyant enough to determine whether or not he will receive any reimbursement from a vendor in the future.

Since under the bill before you any claim must be filed prior to January 1, 1937, and there will be a great deal of dispute as to the reimbursement which a taxpayer is entitled to from his vendor, it will be difficult enough for the large taxpayer with his accounting and legal forces to determine this question, but absolutely impossible for the small retailer who will naturally be given very little consideration by the processor particularly since such small retailers buy largely through wholesalers, and they would have to await the completion of any proceedings by which the wholesaler might obtain a refund from the processor, and then await any distribution of this refund by the wholesaler to the retailers.

The second requirement that the amount of refund shall be limited to the amount by which the claimant reduced the sale price of the article on account of the invalidation of the taxes is decidedly unfair and would probably result in no reimbursement at all to the majority of retailers, for the following reasons: The merchandise, the taxable content of which was subject to the processing tax, consists largely of a tremendous number of small low-priced items such as handkerchiefs, towels, sheets, and pillow cases, shirts, blouses, house dresses, aprons, cotton underwear, and so forth. When the floor-stock tax was paid the retailer, he of course would have been absolutely justified if he had increased the selling price of his merchandise accordingly, but as a practical matter he found it impossible to do so. In the first place as far as each individual item was concerned the amount of tax was to a great extent a fraction of a cent, and the retailer had to continue to sell a 5-cent handkerchief for 5 cents, a 10-cent handkerchief for 10 cents, and a dollar shirt for a dollar. He could not logically add a fraction of a cent to a handkerchief, nor could he logically change the price line of his shirts from $1 to $1.02, because it was not worth while to reestablish price lines, particularly such illogical ones as would have been necessary in order to recover the tax, nor would it have been worth while or practical for the retailer to remark his entire stock of merchandise, as in modern retailing each individual item is carefully price-marked usually with a gum label, pin or string price ticket, and the cost of handling and remarking the tremendous number of items in the average stock would have been prohibitive.

I can unhesitatingly say that practically no increase in prices were made in 1933 because of the payment of the floor tax for the reason heretofore stated and for the further reason that competitive conditions would not permit it.

By the same token, then, retailers found it just as impossible and just as impractical to reduce prices subsequent to the invalidation of

the Agricultural Adjustment Act. There are too many factors involved in the buying and selling of merchandise to permit of any calculation as to what elements of costs are passed on to a consumer. If a cotton-goods department of a store, for example, found at the end of the year that it had lost money, even though there was a desire and a determination to pass the tax on to the consumer, it was quite obvious that the tax actually was not passed on to consumer and was paid by the retailer. The Supreme Court rightly held that proof of the nature required for the refund of these taxes is a condition precedent impossible of performance.

Paragraph (e) of section 602 provides that no claim shall be allowed on an amount less than $10. To the large taxpayer $10 is insignificant, to countless thousands of small taxpayers the sum of $8 or $9 is a considerable amount. Obviously the small taxpayer will make every effort to calculate his inventory and the taxable content thereof at a sufficient amount so that his claim may be upwards of $10, and since at best the taxable content is a matter of inexact calculation or guess it will then remain for the Commissioner of Internal Revenue, under section (e) of title IV, to determine whether or not the amount is correctly arrived at, and whether or not he will make the refund. Since the recommendation—probably from the Commissioner himself—"that a minimum of $10 be established" was based on the fact that the cost of administering the claims of lesser amounts is disproportionate to the effort involved, he must either pay without question or investigate at considerable cost. At best this is rather a poor reason to give to a small retailer to whom any number of dollars, under $10, is by no means a small amount, and from the number of retailers who paid this tax—over 849,000—compared with the amount paid of $14,700,000, it is quite apparent that there must have been a vast number of retailers who did pay less than $10 and whose floor stock on January 6, 1936, would total less than $10.

We are likewise going to assume that the Congress of the United States has no desire nor intention to offer to make an equitable adjustment with taxpayers and at the same time make it impossible for the taxpayer to enjoy such adjustment. We are likewise going to assume that the Congress of the United States having enacted a law by which it compelled retailers to make a certain tax payment to the Government, and thereafter in 1935 having enacted an amendment to that law by which a refund was to be made to retailers under certain conditions that the Congress has no desire to deprive these retailers of an opportunity to actual recovery of this tax, and with this firm conviction in mind we have the following suggestion to make: That section 602 be amended to provide for a refund to retailers of the exact amount of the floor tax paid by such retailer under the floor tax levied in July and August 1933 without limitation as to minimum amount.

This is wholly equitable, simple of administration and would, of course, be highly satisfactory to the many thousands of retailers who under the provisions of section 602, as presently constituted, would receive no refund at all. It is exact and the cost of determining the amount and of completing the reimbursement, as far as the Government is concerned, would be an absolute minimum cost.

Further, the tendency undoubtedly in 1933, as is the tendency of all taxpayers, was to pay as little as possible. The tendency under the present proposed provision—section 602—would be to obtain as large a refund as is possible, so that it would be necessary for the Commissioner of Internal Revenue to check and calculate millions of inventories since many claimants would have inventories of several types of merchandise.

The CHAIRMAN. What do you estimate the cost of that?

Mr. YOUNG. Do you mean the cost to the Bureau of Internal Revenue?

The CHAIRMAN. If the amendment is carried out according to your suggestion.

Mr. YOUNG. The amount, Senator Harrison, that was paid by retailers in the floor stock taxes in 1933, according to the records of the Bureau of Internal Revenue was $14,726,826.55.

Senator GEORGE. How many retailers were there?

Mr. YOUNG. Eight hundred and forty-nine thousand, according to the records of the Bureau.

Senator GEORGE. Many of them carried different types of merchandise?

Mr. YOUNG. I should say all of them did.

Should our recommendation, made herein, be adopted, and we earnestly request its careful consideration, it will be necessary that the repayment of the tax paid in 1933 be actual and not merely figurative, and for that reason it would be necessary to amend title III of the proposed act so that it shall not apply to any refund of tax made under title IV, but that such refund shall be considered as income either for the year 1933 in which the tax was paid, or for the year in which the reimbursement of the tax is received.

To summarize we would say that the Government has everything to gain and nothing to lose by the amendment herein proposed. The taxpayer would have the satisfaction of knowing that the tax which was taken from him, illegally, according to the decision of the Supreme Court, has been returned to him in full, and instead of countless thousands of dissatisfied taxpayers there will be an equal number of grateful ones.

Mr. Chairman, at the convention of the National Retail Dry Goods Association in January 1936 the following two resolutions—and they are short—were adopted, and I should respectfully ask the consideration of them if any other subjects are given consideration by your committee.

Whereas section 148 (d) of the Federal Revenue Act of 1934 provides that the Secretary of the Treasury shall submit annually to the Congress a report containing the names, addresses, amounts of compensation, and the names of paying corporations on all individual compensation in excess of $15,000 per year; and that this information may be made public at the discretion of the Congress, and

Whereas this publicity of individual compensation violates the personal and private rights of citizens and may make them the prey of countless unscrupulous and nefarious schemes; Be it

Resolved, That the National Retail Dry Goods Association in convention assembled vigorously protest this unwarranted publicity of income-tax returns, and urge its members to recommend to the Congress that section 148 (d) of the

Federal Revenue Act of 1934 be amended to the end that such publicity be prohibited.

I thank you.

The CHAIRMAN. Mr. Benjamin C. Marsh?

(No response.)

The CHAIRMAN. Mr. C. T. Murchison. I notice that there are three representatives of the Cotton Textile Institute here; Mr. Murchison, Mr. Dorr, and Mr. Russell. Are those three gentlemen in the room?

Mr. MURCHISON. Yes, sir.

The CHAIRMAN. We are trying to avoid as much repetition as we can. May I suggest to you three gentlemen representing the Cotton Textile Institute, do you want to have one speaker, or do you want to have three?

Mr. MURCHISON. There are three of us, Mr. Chairman, but we have arranged our statements in such a way as to avoid duplication. Each one has a special phase of the subject to discuss.

The CHAIRMAN. How long would it take each of you?

Mr. MURCHISON. I think the average statement would not be more than 20 minutes.

The CHAIRMAN. Try to get through in less time if you can.

Mr. MURCHISON. Our entire group would not take more than an hour, Senator.

The CHAIRMAN. There are just three of you, are there? There are no more that represent the Cotton Textile Institute?

Mr. MURCHISON. No; just three of us. Mr. Dorr follows me. I will come first, and Mr. Dorr, and then Mr. Scott Russell.

STATEMENT OF C. T. MURCHISON, NEW YORK CITY, REPRESENTING THE COTTON TEXTILE INSTITUTE

Mr. MURCHISON. My statement is addressed exclusively to title III of the pending revenue bill having to do with the proposed windfall tax.

Upon the invalidation of the processing taxes by the Supreme Court decision of January 6, there immediately arose a flood of rumors and conjectures pertaining to the extent of the profits which would accrue to certain industries as a result of that decision. The press gave wide circulation to these spectacular statements and the general public was led to believe that the alleged profits were fantastic in their proportions. Those industries which had been subjected to processing taxes were by implication placed in the position of having received what was tantamount to stolen goods and having fattened at the expense of the general public. From one highly conspicuous source the return of unpaid tax money to the industries in question was described as the greatest legalized steal in American history.

Title III of the present revenue bill, unintentionally of course, gives continuing vitality to this concept by providing for a tax which is referred to as a tax on unjust enrichment. In the discussion of that portion of the tax bill which falls under this heading, I shall confine myself entirely to its incidence upon the cotton textile industry or, more specifically, that portion of the industry consisting of processors and shall not presume to discuss its applicability to other industries which may come within the scope of the provisions.

The processing tax on cotton became effective on August 1, 1933, and was assessed upon first processors at the rate of 4.2 cents per pound on the theory that the burden of the tax would be passed on to the purchasers of processed goods and by them in turn upon the consuming public. An elaborate scale of so-called conversion factors was set up and approved by the Treasury Department as a practical means of determining the allocation of the tax to the various classifications of finished goods which were sold to the public. Presumably these conversion factors were adopted by the trade as a whole and it became customary to specify in contracts of sale that the price included the tax, although this was not universally done.

In the spring of 1935, the greater part of the industry had become convinced, from nearly 2 years of experience, that the processing tax constituted an element of cost too heavy to be passed on to the public if normal consumption volume was to be restored and maintained. Competing fibers and materials, such as rayon, silk, wool, jute, paper, and leather, not being subject to processing taxes or any form of excise tax equivalent to that being paid on cotton, were giving increasing evidence in the markets of the advantage which they held. Moreover, there was a steadily growing conviction that the processing tax was unconstitutional. For these two reasons the great bulk of cotton processors, through the use of court injunctions or otherwise, terminated their tax payments to the Government on bale openings of April 1935 and in all subsequent months to January 6 of the current year.

On July 16, 1935, the decision in the *Hoosac case*, rendered by the Massachusetts Court of Appeals, so definitely confirmed the opinion of the industry as to the constitutionality of the processing tax as to become the dominant factor in the cloth markets. In general the processing tax represented from 15 to 20 percent of cloth values in the primary market. Since second and third processors and wholesale distributors normally carry inventories equivalent to from one-quarter to one-third of the total annual volume of business, and since these goods are normally purchased on long-time forward contracts, the prospect that so large a percentage of their value would be instantaneously wiped out by the invalidation of the tax became a danger of the first magnitude. Buyers of cotton goods immediately shifted to a hand-to-mouth basis. Garment manufacturers, household furnishers, industrial consumers, retailers, all turned in panic toward a policy of cutting inventories to an absolute minimum, thus definitely destroying the initiative in the promotion of consumption and intensifying the advantage held by competing fibers and materials.

This crisis in the industry was overcome in August by joint arrangement between sellers and buyers in the form of a system of qualified sales contracts which, in general, allowed for the continuance of the tax as a portion of the invoiced price, but which also provided for the refund of the tax portion of the sales price to the customer on all shipments within certain specified periods prior to the expected Supreme Court decision in case the decision invalidated the tax.

In the instance of converters and other secondary processors who absorbed approximately one-half of the industry's production, the clause providing for refunds was applicable to all invoices made during the 120 days prior to the decision. In the instance of knitters,

garment cutters, and other secondary manufacturers, wholesalers, mail-order houses, and certain large chains, who absorb about one-third of the industry's production, the clause ran for 90 days. In the instance of retailers and consumers, the clause ran for 30 days. In addition, there were certain private agreements of similar nature entered into before the clauses were drafted and covering production antedating the clauses. The chief factor determining the duration of these various periods was the average inventory of each group or, in other words, the customary rate of turnover. These qualified contracts to which I refer provided that if and when the processing tax should be invalidated, the sales price contained in the contract on undelivered portions should be immediately reduced by the amount of the tax as measured by the Treasury conversion factors.

In view of these agreements, anticipatory of the Supreme Court decision, all cloth prices in existing sales contracts were automatically reduced by the equivalent of the tax on January 6 and prices on new contracts after January 6 were also reduced by the same differential. Thus, all existing inventories of finished goods and goods in process, whether in the hands of first or subsequent processors, diminished by the amount of the accrued tax. Simultaneously with this writing down of its inventory, the industry became automatically liable to the purchasers of its goods under the refund clauses to an amount roughly approximately $35,000,000. This introductory explanation provides the background which gives vivid meaning to a brief statistical summary.

From August 1, 1933, to January 4, 1936, American consumption of cotton amounted to 13,548,000 bales, averaging 476 pounds per bale. At $20 per bale the aggregate processing taxes paid and accrued amounted to $272,000,000. Of this amount the Internal Revenue Bureau recorded as actually paid $182,913,000. An additional portion, amounting to about 1 percent, or $2,720,000, may be regarded as uncollectible due to insolvencies in the industry and should therefore be completely eliminated from our picture. These two items, the amount actually paid and the amount uncollected, when deducted from the gross amount due, leave $86,367,000 as the approximate amount still potentially payable as of January 5, 1936. But this $86,000,000 plus is subject to a considerable offset in the form of Government refunds, drawbacks, and allowances on account of export goods and goods sold for charitable and Government purposes. The best available estimate of this amount is slightly in excess of $6,000,000, allowance for which leaves only about $80,000,000 net due the Government on January 5. From this amount must now be deducted the customer refunds, the history and explanation of which I have already given and also those refunds made under agreement antedating the clauses adopted by the industry as a whole. These two allowances amount roughly to $37,000,000, and reduce the maximum potential windfall to approximately $43,000,000. But we are not yet through with our computation of deductions.

As already explained, the effect of the Supreme Court decision was to reduce the value of goods in process and on hand by an amount equal to the accrued tax. This amount was reliably estimated to be about $20,000,000 and now the potential windfall is reduced to not

more than $23,000,000. From this amount there are properly deductible, in accordance with principles already set forth in the revenue bill, two additional items:

First, the amount of the income tax paid by processors on collection of tax moneys from their customers in 1935; second, the current costs and other legal fees incident to the withholding or impounding of processing tax payments to the Government pending the Supreme Court decision. The aggregate of these two items is variously estimated from 3 to 4 million dollars and in consequence we now find the potential windfall to be something less than $20,000,000 for the industry as a whole.

To present this picture in a somewhat different manner, and in a way which arrives at the same result in a nonstatistical fashion, we may regard the total of tax payments withheld from the Government as having accrued over the 9 months' period from April 1935 to January 4, 1936.

Senator KING. I assume you did not make any computations with respect to any other commodities except cotton?

Mr. MURCHISON. Only cotton.

The CHAIRMAN. Have you any idea of what percentage cotton bears to all of the industries upon which the processing tax was paid?

Mr. MURCHISON. My offhand guess would be, approximately one-third. There may be a wide margin of error in that, Senator.

The CHAIRMAN. Under that, there would be $60,000,000 due from the windfall?

Mr. MURCHISON. No; I was thinking of the gross payments which the industry has made. I would not with to imply that the deductions which are proper in our computation would also be applicable to other industries.

Senator KING. If you follow those figures and that statistical data, you will bring the Government in debt to your industry. Proceed; excuse me.

Mr. MURCHISON. These points which I am making are all matters of record and of history and are unique in their origin and explanation.

The CHAIRMAN. So that we may keep straight in our minds a little bit, you estimate now 20 million under the cotton proposition?

Mr. MURCHISON. Something slightly less than 20 million.

The CHAIRMAN. May I ask in that connection, what is the estimate, Mr. Murphy?

Mr. MURPHY. I could not give the estimate of the commodities. I would like to point out that Mr. Murchison is talking about the amount which might be recovered from the cotton processors. One of the deductions is the reimbursement which they have made to their consumers, which reimbursement might be of course taxable to those consumers under this bill.

Mr. MURCHISON. That is correct, Mr. Senator.

Senator KING. You would have some difficulty, would you not, in pursuing the tax to various consumers throughout the United States?

Mr. MURPHY. Undoubtedly; yes, sir.

Senator KING. It would be a fantastic scheme to attempt it, would it not?

Mr. MURPHY. I would not want to say fantastic.

Senator KING. It would be an unreal one, then.

Mr. MURCHISON. To present this picture in a somewhat different manner, and in a way which arrives at the same result in nonstatistical fashion, we may regard the total of tax payments withheld from the Government as having accrued over the 9-month period from April 1935 to January 4, 1936. The final 2 months of this 9-month period were required to produce the inventories or stocks of goods on hand at the end of the period. In other words, the total stocks on hand and uninvoiced are equivalent to 2-month output and on this 2-month output no taxes were collected or could be collected from customers which automatically offsets the failure to pay to the Government taxes on these same goods. Hence our picture is narrowed to 7 months' operations.

The refund clauses applied to a volume of output equivalent roughly to 105 days' operations, this figure being a weighted average of the periods within the scope of the refund clauses. Thus from our original 9 months we knock off an additional 3½ months, reducing the maximum period from which unjust enrichment might be derived to less than 4 months. But those items of expense representing export and charitable goods refunds, legal expenses, and refund obligations of an individual character, aggregate an amount of tax equal to still another month's accruals, thus reducing still further the maximum period of enrichment to less than 3 months, or more exactly about 10 weeks.

This analysis brings vividly to the front a very striking contrast which is, that the industry, over a period of 20 months, paid to the Government nearly $183,000,000, and yet is being charged with unjust enrichment for withholding taxes payable on not more than 10 weeks' activities and representing less than $20,000,000 for the entire industry whose capital investment is 1¼ billions and which gives employment to approximately 450,000 people.

Although we cannot state precisely the correct amount of that residue called the windfall, after the various allowances are made as above indicated, nevertheless, we can estimate it with sufficient exactness for the purposes of the present discussion. The exact amount probably lies between $18,000,000 and $20,000,000. But this residue is a windfall only in a technical sense. It is a figure derived from accounting operations which are confined within a narrow range of legal requirements. If we are concerned with the equities in the present problem, we shall wish to give attention to the true incidence of the processing tax and ascertain whether in reality the industry profited from the manner of its passing. Whether there is in existence any real windfall from the standpoint of equity depends on whether the industry actually shifted the amount of the tax in whole or in part upon its customers.

Senator KING. Pardon me. When you speak of the industry, you mean all of those industries including the tire manufacturers who purchased and consumed cotton in the manufacture of commodities, or is it limited only to those who manufactured garments?

Mr. MURCHISON. No; I am limiting this to the cotton mills, those who actually processed the cotton; and, of course, that would include the mills making tire fabrics.

It is theoretically possible, therefore, that the possession of $19,000,000 more or less as a technical windfall would collide with the

sterner fact that the industry's losses from this self-same tax may amount to an offsetting figure greater in amount than the $19,000,000. The fact that the contracts of sale in general use specified a tax-included price is no evidence of a real shift. The common practice of declaring that the price included the tax was due to the legal issues involved. Only by that means could purchasers know the extent of their own possible obligations to the Government in the case of export operations or sales to charitable institutions or how the termination of the tax might affect their floor stocks. In actuality sellers accepted whatever price they were able to wring from an unwilling market and in the invoicing of the shipments arbitrarily allocated to the price the particular cost element which presumably represented the tax according to the appropriate conversion factor.

Owing to the highly competitive situation existing in the cotton-textile industry and the general cost variations from mill to mill and from State to State, and also to the complete absence of reliable cost-accounting systems from a large number of mills, it was manifestly impossible for the processing tax to be reflected equally for each mill, in the cloth markets. According to economic theory the addition of a uniform cost to production would tend to bring about a uniform addition to price without destroying the differentials previously existing among the producing units. But it is important to note that a uniform addition to price is not necessarily an addition which is equivalent to the increase in cost.

According to further economic reasoning, the imposition of a processing tax would tend to drive down the cost of the material processed by an amount equal to the tax, thus leaving the processor in the same cost position which he originally occupied. This principle, however, was not permitted to operate in the case of cotton, in view of the pegging of the price through Government credit operations. Unable to compensate for the processing tax through the purchase of raw material at a correspondingly lower price, the only hope of shifting the tax lay in a corresponding increase in the price of the finished articles.

In his attempt to follow this recourse, the processor was greatly handicapped by the concurrent inauguration of the National Recovery Act which, by increase in wages and shortening of hours, served to increase labor costs by approximately 80 percent. Thus within the period of a single month, cotton processors were called upon to adjust finished-goods prices to meet increase costs from two directions—the A. A. A. and the N. R. A. Obviously, production economies on a sufficient scale to offset appreciably an increase of 80 percent in labor costs and an increase of one-third in material costs were impossible. For a short period the devastating effects of this tremendous expansion in the cost of manufacture were cloaked by the speculative buying induced by the anticipation of still higher prices. After a few months a swollen inventory situation abruptly halted both production activities and the price advance, and the subsequent behavior of the cloth markets reflected nothing more than a blind struggle of sellers and buyers to adjust themselves to a situation which, in the aggregate, was novel and confusing, with results that were tragic to the industry. The market for cloth did not have the sustaining influence enjoyed by the market for raw cotton.

The prices that were obtained were those which had to be accepted in accordance with the law of supply and demand, and in the textile industry, this law did not prove useful in enabling the mills to shift the burden of the tax to their customers. That deplorable condition is one which cannot be dismissed lightly by saying that there was lacking the will to shift the tax. It is more correct to say that the lacking element was the means to exercise the will. Had it been possible to sustain prices at a level covering the costs in full of N. R. A. and A. A. A., the ultimate results might still have been disastrous in that the higher prices would have forced a reduced consumption and so aggravated still further the problems of the cotton farmer and the millworker. As it was, the volume of business which the industry did obtain during that portion of the processing-tax period which followed the first few months of speculation was purchased very dearly. The period was one of loss for a great majority of the mills. The tangible evidence was not only consisting in the actual profit and loss figures of the industry as reported by the Bureau of Internal Revenue and more lately by the Federal Trade Commission, but is also apparent in the narrowing differential between selling prices and production costs.

If we take the figures prepared by Mr. Alston H. Garside, economist of the New York Cotton Exchange, who for many years has been regarded as one of the most authoritative statisticians in the field of textiles, we find that from January to July 1933 the period immediately preceding the processing tax, the average margin between actual production costs and selling prices of 4 yarns and 10 cloths was 9.72 cents per pound. From August to December 1933, the analagous figure was 9.1 cents per pound; in 1934 it dropped to 7.26 cents; in 1935 to 6.78 cents. In these computations the most representative products are used and the cost of production includes the cost of the raw material, labor costs, and the processing tax. The evidence is unmistakable, whether we depend upon Government sources or private sources, that the industry was failing to pass to the consumer the production costs of its goods in which was included the processing tax.

Senator KING. I suppose that that cost represented the average cotton consumed by the textile trade?

Mr. MURCHISON. Cotton during that period averaged around 12 cents a pound. If you add to that the labor cost item and the processing tax item and then deduct that total from the selling price, then you get what we call this margin we are speaking of, and out of that margin, of course, had to come overhead and selling expenses and other taxes.

I am quite well aware that in the discussion of this point there are those who are disposed to evade the real issue by saying that the industry failed to pass on its labor cost or its overhead cost and that no reason exists, therefore, why the processing tax should be singled out as the one element of cost which could not be passed on. From a careful study of the records of the industry for the past 10 years and from a knowledge of its organization and business practices, which is far more than casual, my belief is that this attempted distinction between the various items of cost is mere quibbling. The question

whether the processing tax was shifted is too serious to be dealt with by resorting to sheer casuistry.

In the decade since 1925, the industry has had only four profitable years. Of these four, only one—1927—was one of substantial profit. In that year the industry as a whole made in round numbers $75,800,000. In 1928 the profit was only 10½ millions; in 1929, 22 millions; in 1933, the fourth profitable year, the figure was $31,800,000, largely the result of the great activity and rising prices immediately preceding and following the inauguration of N. R. A. and A. A. A. In 1927 the relatively high profits coincided with the period of rapidly rising prices of raw cotton; the price of raw cotton in that year rising from 13 cents a pound to 24 cents a pound in December. At that time, therefore, as in 1933, the profits were largely accidental and transient in character. For the period as a whole, losses far exceeded the profits.

For the decade the industry shows a net loss in excess of $100,000,000. In other words, it has given to the public that much more than it has received in return. In terms of its benevolence, in providing the American people with essential goods at prices below the actual cost of production, it takes rank as the leading charitable institution of all times. It will no doubt be brought to the attention of this committee that the industry in 1930 suffered a loss of $90,000,000 which was a loss accruing either before the N. R. A. or the A. A. A. were ever heard of. That year was one of intense liquidation and confusion as was the case in most industries. The heavy losses continued through 1931 and 1932; there were also heavy losses in 1926.

The only safe conclusion which can be drawn from this record is merely this—the cotton textile industry is an industry which cannot be relied upon to incorporate in its price structure any arbitrarily selected item of cost. When it does succeed in doing so, it is not by design but by a fortuitous combination of circumstances. It is not, therefore, inherently an agency which can serve the function of acting as an intermediary for the collection of any established schedule of taxes.

The program, therefore, adopted by the Government for the relief of agriculture, however laudable in purpose, was impossible of realization insofar as it attempted, through the use of the textile industry, to pass on to the general public the burden of relief for the cotton farmer.

In the aftermath of that experience it is regretable that to the many ills which the industry suffers should be added the additional one of unjust enrichment at the expense of the consumers whom it has served far better than its own stockholders. The industry does not oppose this contemplated windfall tax in the sense that it has ill-gotten gains which it dislikes to surrender, but only in the sense that the yardstick of equity fails to reveal any measurable windfall.

That completes my statement.

Senator KING. May I ask you one question? Was there any distinction in losses so far as you could institute a comparison that would have any justice, between the cotton mills of the New England States

and the cotton mills of the South, or the cotton industry of the South and the cotton industry of the North; in other words, did they both suffer alike?

Mr. MURCHISON. Both have suffered. There may be some slight difference in degree, but the exact figures have not been made because the Federal Trade Commission and the Bureau of Internal Revenue do not classify according to regions. They classify according to types of manufacture.

Senator WALSH. It is the one subject on which the northern mills and the southern mills agree. On all others, they differ.

Senator KING. Do you think there has been an overproduction in the industry?

Mr. MURCHISON. That is true, Mr. Senator; and of course that is one of the reasons for this present problem, and that is one of the reasons why the industry could not pass on the processing tax, because the production capacity was so great as to tend to create always a surplus of commodities which deprived the industry of its power to control the price situation.

Senator KING. Has there been any diminution in exports of cotton goods during the past 6 or 7 or 8 years?

Mr. MURCHISON. Oh, yes; a tremendous diminution. I would say we have lost over two-thirds of that business; more nearly three-quarters.

Senator WALSH. And an increase of imports from Japan.

Mr. MURCHISON. Concurrently, yes. The imports from Japan were negligible 2 years ago, and now they are coming in at the rate of around 80,000,000 yards a year, and pretty well concentrated on bleached goods, and in certain types of manufacture they now consist of about 40 percent of the total domestic production.

Senator KING. What is the yardage of all of the mills of the United States?

Mr. MURCHISON. I think around 7,000,000,000 yards.

Senator KING. A great many billions, is it not? I have just read a book on the imports from Japan, and I was astonished that they were so small in view of the complaints which I had heard.

Mr. MURCHISON. The rate of increase is very, very rapid.

Senator KING. This book has only been published within the past few months. Have you finished your statement?

Mr. MURCHISON. I have finished my statement, Mr. Senator; and I would like now to introduce to the committee, if I may, Mr. Dorr.

STATEMENT OF G. H. DORR, NEW YORK CITY, REPRESENTING THE COTTON TEXTILE INSTITUTE

Senator KING (presiding). I will ask you to present your case as expeditiously as you can, without however sacrificing the presentation of what you desire to present.

Mr. DORR. I wish to address my remarks to certain features of the bill as framed as it has come to you from the House.

The first point I wish to add is this, or the first question that arises with regard to this windfall tax is whether the provisions do not go the length of laying a so-called income tax on a deficit. I think they do.

It seems to us that the first step that should be taken in determining whether or not any such tax should be laid with respect to income

from a taxable year is to find out whether there was any income during that taxable year, and if there were no income from the taxable year, then this tax should not be applied.

But the act as drawn or the bill as it comes to you, does not contain that limitation. What it does is to segregate certain transactions on particular goods which were scattered throughout the taxable year, try to figure out whether there was a net income on those, and wholly disregarding the transactions for the year as a whole, attempts to lay the tax with regard to those particular transactions, with the result that say, there has been no income whatever but a deficit on the years' operations, nevertheless that deficit may be increased, and it will undoubtedly in the case of a number of cotton mills, if the provisions of this bill stand as they are, that deficit will be increased by the proposed tax.

Senator KING. Do you assent to the conclusion reached by the previous witness, that taking into account the losses and the deductions, and so on, in any event the amount of the windfall could not exceed between 18 and 20 million dollars?

Mr. DORR. Yes, absolutely. If you take into consideration whether there has in fact been a shifting and whether there has been any unjust enrichment, I think you gentlemen will find the ultimate result will show that there is not any unjust enrichment whatever.

The effect of the provision then as drawn would be not to take any tax on a part of the mill's profits of the year, but would be to impose a tax out of many which would actually increase the existing deficit, or turn a profit into a deficit.

And it seems to us for that reason the provisions of the bill should be changed to provide that unless there is some net income for a taxable year, there should be no windfall tax imposed, and that that tax should in no event exceed the net profits for the taxable year. Further, it seems to us difficult to see that there can properly be any unjust enrichment if a mill is not making an income which is more than ordinary return on the capital which it is putting to the service of the public it serves.

Senator BARKLEY. Looking at the windfall tax purely as a windfall tax and disconnected with the ordinary operating expenses and profits or losses of the concern for the year, do you think it is fair to tax those that do make a profit outside of windfall, on their profit and the windfall, and those who do not make a profit outside of the windfall, to tax them on nothing? Is that really quite a fair way to put it?

Mr. DORR. I cannot see that there is any justice in laying an income tax on a person who has earned a deficit during the taxable year. It seems to me that that is contrary to the principle of the income-tax provision of the Constitution.

Senator BARKLEY. I agree with you as to ordinary income, but this is extraordinary income and treated as such.

Mr. DORR. All it does is to go into—it becomes part of the income of the mill for the taxable year. If he has not got any income and has earned a deficit, I cannot see that there is any unjust enrichment out of his operations from the public in that year. He has used his capital in the service of the public. They have gotten the benefit of it.

Senator BARKLEY. If it is an unjust enrichment, it is unjust because he is collecting something which he has not gone out of pocket in.

Mr. DORR. Is it unjust? Has he dealt with his customers unjustly if he has furnished his goods to them at a price which yields him no return whatever on his capital invested for that year?

Senator BARKLEY. But in which is calculated a tax which he has passed on to the public, and which he proposes now to collect back from the Government.

Mr. DORR. Which he proposes to collect back from the Government?

Senator BARKLEY. I mean the windfall, whether it comes from the Government or whether it comes from any other source, it is an unexpected income that he did not take into calculation when he fixed the price of his goods, and in such cases where he passed the tax on to the public, do you think that the taxpayer ought not to be required to pay an extraordinary tax on that if it is what it proposes to be, an unjust enrichment? There may be some dispute as to whether it is an unjust enrichment, depending on the viewpoint and the interest of those who discuss it.

Mr. DORR. I would say this, Senator, that I just cannot see that a mill which during a taxable year has sold its goods at a loss on the whole transaction, in other words, furnished its goods to its customers on terms which has given them the benefit of the use of his mill and has actually devoted to them part of his working capital as the net result for the year, I cannot see as a result of that year's transaction that he has been unjustly enriched in any sense of the word.

Senator BARKLEY. The loss is not greater because of the tax; it may have been less. In some cases there may have been more passed on than is collected.

Mr. DORR. It does not seem to me that it is sound under the principles of the income-tax amendment or under the principles of justice to lay an income tax on a loss out of the business of the year.

Senator KING. We tax the consumption of gasoline regardless of whether the corporation that uses the gasoline in its manufacturing plant makes a profit or not. Would there be any analogy between that case and this?

Mr. DORR. I do not think so. In the first place, that is not an income tax. You are dealing here now with the provision of a constitutional amendment which gave the power to tax income. The other power is the power to lay an excise tax and which is laid irrespective of whether or not—well, that you have the power to lay.

Senator KING. You differentiate between an income tax and an excise tax?

Mr. DORR. Yes. You are under no limitation there.

Senator KING. The reason I ask whether there was any analogy between excise and income——

Mr. DORR. Yes, of course there is a distinction.

Senator KING. Proceed.

Mr. DORR. The bill as it comes to you from the House seems to recognize the doubtful constitutionality of that, because it provides that if the provisions for laying the tax where there is no income for

the taxable year is unconstitutional, then the tax shall be laid the other way. It does not seem to me that it is sound to proceed with a tax of that doubtful constitutionality.

Senator BARKLEY. Congress has the power to classify incomes for the purposes of taxation. Suppose that a concern is engaged in the dry goods business as a corporation, and it is also engaged in the coal business or in the oil business, do you doubt the power of Congress to levy a tax on the net profits of that part of its business which is in the dry-goods business, although there may be a loss in the coal business or the oil business?

Mr. DORR. Of course there is the power of classification. Whether you can classify between a sale today, or we will say have a half a man's sale of goods on which he has paid a tax, and half of that same delivery he has not paid a tax, which is constantly the situation, whether you can tear apart a single business transaction and classify a thousand yards of the same transaction on the one hand and a thousand yards on the other, I would question whether that is a reasonable classification.

Senator BARKLEY. I am not urging that viewpoint.

Mr. DORR. No.

Senator BARKLEY. I am not saying that you could split up a sale of dry goods into a thousand yards and if you make a profit on that thousand yards you should tax it as an individual transaction. What I had in mind is a corporation that is engaged in different kinds of business that are not related at all——

Mr. DORR (interrupting). I would agree with you there; that is another story.

Senator BARKLEY. It is not related to the coal business, the oil business, or the automobile business. Congress could undoubtedly classify those profits if there was loss in one and a profit in the other.

Mr. DORR. On most of these deliveries on which this question will arise you have a single sale. Part of those goods were goods on which a tax was in fact paid, and a part on which the tax was not paid, and you have to tear apart that invoice and try to classify them as entirely different businesses, and it does not seem to me that that is real or would seem to a court real.

The next question which I have, which has to be met here, is what transactions are you going to take into consideration in making your computation? What the bill as it comes to you does is to take all of the transactions on which no tax was paid, figure out the sales price of all of those articles, and then figure out and attempt to allocate the particular costs of those particular articles, deduct the costs from the sales price, and get a net income; then take those same articles, and take the margin between the raw material which went into those articles and the selling price, and compare that margin with similar articles selected from a representative 5-year period, then compare those margins, and if the margin in the latter period is larger, then to assume that the tax has been shifted and apply that shift to any net income which has come on those particular articles.

The idea being that if goods have been sold on which no tax has been paid and there has been a shift arrived at by this rather complicated process, then there has been unjust enrichment on the goods so sold, and that that ought to be recovered, or 80 percent of it ought to be recovered to the Government.

Let us see whether you should even on that theory take all of the goods on which no tax has been paid. We are immediately confronted by this situation. As to the goods which the cotton textile industry was delivering for months prior to January 6, 1936, it was delivering them under the qualifying contracts which Dr. Murchison has spoken of, under which if it got a refund of taxes, it would refund that amount to its customer. If it had not paid a tax, it would pay over that amount to its customer.

Consequently as to that great area of goods on which millions of dollars have now been refunded or credited to the customers, there could in fact be no shift because the tax has—the contract provided and the contract has been carried out, to the effect that the amount of that tax if it had not been paid would be paid over to the customer, and yet this bill requires the taxpayer to include those articles on which there cannot have been any shift, in his return, go through the laborious and expensive task of segregating them out, finding out what the sales price was, allocating the costs, labor and all other costs to those sales to determine whether there has been any net income on them; then go through the laborious process of comparing the margin between the raw material price and sales price on those goods, picking out similar goods 5 years back over a 5-year period, in similar amounts, calculating the margin on that, and then comparing the margin—and to what purpose?

You know at the start that there has not been any shift. If the presumption provided by this act is an accurate presumption, all that process would do would be to show that fact. If it is inaccurate, as we believe it to be, it might and it in many cases would indicate that there has been a shift; but as a matter of fact, there could have been no shift, because the amount of the tax would have been repaid to the customer.

It seems to us clearly that taking the theory of the bill, that it is idle and mischievous and burdensome to the Government and to a mill alike to include in the base for computation of this windfall tax, goods on which there could have been no possibility of a windfall, because they were delivered under contracts under which the amount of the tax has been refunded to the customer.

I do not know whether I make myself clear on that. It is a little complicated; but it seems to me that the inclusion or the failure to exclude those sales from computation is not to be justified from any standpoint.

Coming now to the next question—how about these goods which Dr. Murchison has described, which were in the hands of the mills at the time the tax was terminated by the decision of the Supreme Court? What ought to be done about those? Those goods are of two classes.

First, goods on which a tax has actually been paid, and there were substantial amounts of those goods still in inventory in a number of mills on January 6, 1936. What are we going to do about those? The tax has been paid on those.

I think the answer as to what we ought to do about them is to be found in what Congress proposed to do about them in the Agricultural Adjustment Act. What did Congress then propose to do about them when the tax was terminated?

It proposed to make a refund of the amount of the tax. And why? Because Congress recognized perfectly well the obvious fact that just as soon as the tax was terminated, it ceased to be an element to influence price. There was bound to be a drop in inventory value or bound to be an effect on the market downward, a downward effect, and when that occurred, when that tax had gone out, then if a tax had been paid on any goods in inventory, it ought to be promptly refunded by the Government.

And that was what Congress provided in the Agricultural Adjustment Act in the event that the tax was terminated either by the expiration of the act or by the promulgation of the Secretary.

Now, it seems to us that that action of Congress was sound and it seems to us there is absolutely no reason for not applying the same rule here where the tax has been terminated by the Supreme Court. The business effects of the two situations, the two methods of termination are precisely the same.

Senator KING. You are dealing now only with those stocks on hand when the decision was announced?

Mr. DORR. Yes, sir.

Senator KING. Have you any idea as to the amount?

Mr. DORR. I cannot give you an estimate of that, Senator. I would like to, but I do not think any statistics are available. We know that in the case of some mills, particularly in those mills which had been closed down for quite a period, and particularly where there are seasonal goods, we know that there were substantial stocks still on hand on which a tax had actually been paid.

Senator KING. I suppose the books of the various mills would indicate the stocks on hand?

Mr. DORR. They show that; yes, indeed. The inventories were taken at that time, and that is a matter which is readily ascertainable.

It may be said that the law at the present time does provide some such remedy. It may be that section 21 (g) as amended in last August provides such a remedy, but the Treasury does not seem yet to have recognized that. It is 3 months since this happened, and so far as I am advised, no regulation has been adopted or put into effect for providing for such refunds, and it seems to me that this bill should deal clearly with that matter and should deal with it on the same principle and in the same language that it was dealt with in the original act which Congress passed for a similar situation.

So much for the goods we have on hand where the tax has actually been paid. Now, how about the goods we have on hand, and, of course, there is an enormous amount in the cotton-textile industry because cotton goes through slowly as you know, through our plants—and we have quite a lot of stocks always on hand. As a matter of fact, cotton on which the tax was theoretically levied prior to January 6 or on January 5, we will say, would not actually result in manufactured goods in many cases until February or in some cases even later would become manufactured goods. How about those goods?

There again, I think we ought to turn to the way Congress dealt with a similar situation when the Agricultural Adjustment Act was passed. It recognizes that because of the lag between the opening and the time when the tax would actually become payable, that mills

would have on hand when the tax expired by the proclamation of the Secretary or by the expiration of the act, that the mills would have on hand not merely goods on which they had paid a tax, but also goods on which a tax had technically become due because of the earlier opening of the cotton bale, but on which no tax had been paid.

What did Congress say with regard to that? Did it say that those taxes would have to be paid afterwards? Not a bit. It was recognized by it that inevitably there would be the same effect on those inventories as on the other, that once your tax was gone it would have no effect on the market price, that the market price would then be governed by the new costs of goods currently manufactured and by supply and demand, and consequently Congress in the Agricultural Adjustment Act provided that those unpaid taxes should be abated.

It seems to us that that principle was sound and should be applied to this same situation. Here we have our inventories. Here we have the wiping out of that element of cost with the inevitable result and effect on the market, and Congress recognized that by providing that any taxes which at that time had been levied and unpaid, should be abated.

Senator KING. Mr. Commissioner, I understood that some phases of this question being discussed by the witness were under consideration by the House Committee of Ways and Means when this bill was before them, but that sufficient data were not available and investigation had not been sufficiently made, and it was anticipated that the Treasury Department would submit another bill?

Mr. HELVERING. That is true.

Senator KING. I do not want to be inquisitive, but may not that bill be submitted to the Ways and Means Committee and may we not have the advantage of it in the consideration of this bill before we have concluded our investigations?

Mr. HELVERING. We hope to have that worked out fully within a day or two, Senator, for their consideration and perhaps get it to you in time to incorporate it in the bill. It is a simplification of 21 (d).

Mr. DORR. I was asked the question a minute or two ago as to what amount of goods, stock on hand on January 6, was tax-paid. I am handed the experience of one particular mill, the Texas Textile Mill, in which 20 percent of the stock on hand on January 6 had actually had taxes paid.

I am not suggesting these things, gentlemen, because they seem to me to be things which cannot be remedied or won't be remedied. It seems to me that they are things which are bound to be remedied in the actual development of a bill. No bill when first framed can possibly take account of all contingencies. It is a matter of hammering it out, and naturally with all of the pressure in the House it was impossible to work it out in all of these situations and realize them. I have no doubt before the bill is finally enacted, these matters will be given weight and consideration.

What happened in the cotton-textile industry illustrates the soundness of the rule adopted by Congress in the Agricultural Adjustment Act. Gentlemen, the Supreme Court had hardly finished reading its opinion invalidating the act, when the people who were active in the cotton industry market in New York were in session, and on that same afternoon determined, without waiting to see

whether there would be any reargument or anything of that kind, that they were obligated under their contracts on goods which they were delivering that very day to their customers to write off the amount of the tax on the price of the goods they were delivering. It happened that promptly, and that was put into effect. Of course, they had to. People would not have accepted deliveries. That element of cost had gone out of the market.

I give you that as illustrating how promptly just those factors which Congress had in mind when it first passed the Agricultural Adjustment Act did in fact work in our industry.

So it seems to us that there should be excluded from consideration in the computation of the tax all of those goods which were not invoiced on January 6. That should be the end of the period. If there has been any unjust enrichment, it has been on the goods delivered prior to that time.

Some of the actual complexities of applying the formulas which the law outlines will be touched on in a succeeding statement, and I won't go into those, but there is just one thing that I do want to point out with regard to the representative period chosen for comparison in determining whether or not there is or has not been a shift of this tax. The representative period which has been selected is the 5 years preceding the imposition of the processing tax. I want to call you attention——

Senator KING (interposing). You think it should be 10 years, do you?

Mr. DORR. I think 10 years may be better from one standpoint, because it would be more representative, but from another standpoint it would add greatly to the perfectly fearful mechanical task of working the thing out, and I think it would be better if it could be confined to, we will say, 2 years that were really representative, or something of that sort. That would lessen the mechanical burden of working it out, and at the same time it would be fairer; but let me point out the results you get in the cotton textile industry from the period suggested.

If we assume that we will say in December on the goods delivered in December and November, and the market was a little better and prices were a little better at that time and the average mill at that time was breaking even, exclusive of any question of tax being included in the price. On deliveries during that period, they were making a refund of the tax if they did not pay it to their customer. Assuming that they were breaking even, we know that they were not shifting the tax because they were refunding it, and yet if you apply the presumption laid down in this act, those mills would be presumed to have shifted at least I would say on the average mill, 2.5 cents a pound of the tax, and if by any chance they were making any net income, all of that net income up to the amount of the tax would be taxable and they would have to pay it over if the presumption were applied even though, as I say, they had refunded the amount of the tax to the customer.

Now, how does that come about? That arises from certain peculiarities of the situation in this representative period as provided, from our standpoint, it is not a representative period.

Of the 5 years, the 3 immediately preceding were the extraordinary years of the depression; years in which the industry lost $53,000,000, $63,000,000 and $90,000,000 respectively. The 2 years, 1928 and

1929, which are also included, were not for the cotton textile industry, normal years. They made $10,000,000 and $22,000,000 respectively, which was a little less than—about 1 percent on their $1,250,000,000 capital.

The first normal year was 1927 when they made about 4½ percent on their invested capital, but that year is excluded from the calculations; it is not taken as one of the representative years.

Taking the 5 years, that means a loss of $170,000,000, and that is an actual loss to the industry. That means on about 12,700,000,000 pounds which were sold during those years, that means a loss of 1.4 cents a pound on every pound they sold during that period, and consequently if they were breaking even in December and November and October 1935, if the mill was breaking even, then there would be a shift to that extent shown in applying the presumption created by the statute.

But that is not the only distortion. As you know, at the present time the industry is paying a very much higher manufacturing cost due to the N. R. A. The industry has sought, has earnestly sought and successfully sought, to maintain the advances in labor standards which occurred at that time. As Dr. Murchison said, those advances were very heavy and very extreme. Consequently when you go back to the earlier years and use the formula of merely deducting the raw material from the sales price in the two periods, you are ignoring the factor of a change in labor costs and all other manufacturing costs. Those changes, as we have figured them out from the Government figures, amount to at least 1.2 cents a pound. Adding that 1.2 cents a pound to the loss of 1.4, you get the difference between the margin in the representative period and the margin in the period of the present time of at least 2.5 cents which is there but cannot possibly be attributed to a shift of the tax burden, and which under the presumption created by the act, that 2.5 cents change, increase in margin, would be attributed to a shift in the tax.

As I see, the net result would be that if you simply apply the presumption, even though the whole tax has been refunded to the customer, if the mill did make any net income during that period, it would have to be subject to a windfall tax.

It does not seem to us that much, under those circumstances, can be said in favor of that presumption, certainly not as applied to the cotton textile industry. Nor does it seem to us a sound answer to say "Well, the mill can go ahead and after it has made all of these computations, gone through all of this labor, it can then go in and establish before the Commission that the presumption was not accurate and there could not have been any shift because the tax was refunded."

All of that means an interminable amount of expense and labor not merely to the mill but to the Government, because the auditing of these returns, making them up, is going to be a task which is going to put a tremendous expense and a tremendous labor on the Government as well as on the mills.

There is just one other thing that I want to say a word on. It may seem a minor matter to you, and yet it is an important matter to a number of mills and is a situation that I think you will feel you want to take care of.

Under the act as framed the tax adjustments with customers which we have been describing can only be taken account of in the

event that they were either made before March 3, 1936, or made pursuant to a written contract entered into before that date. Now, while it is true that, by and large, through the industry there were written contracts which governed that matter entered into prior to that date, nevertheless there was a practice, to a considerable extent, in many mills to simply tell the customer, "We will do the right thing by you," and there was confidence by the customer that the mill would do the right thing by it, if the act was declared invalid.

There was also the pressure of competition among customers who felt that they ought to be put into the same situation as other customers, with the result that as soon as the act was declared invalid it was fairly generally recognized that there would be many tax adjustments made, and should be made, where there was no formal written contract, and there being no date in mind before which they would have to be made, and it being a matter of considerable work to determine on just what invoices such adjustments ought to be made, that work had, by no means, been completed by such mills on March 3. Consequently they were caught in the situation of being under moral commitments to their purchasers which they felt that they would in any event have to carry out. Having to make those adjustments they clearly negative the possibility of any unjust enrichment as to the transactions being left in the air and would be in the situation where they might have to pay 80 percent tax on the amount of unpaid taxes in regard to those goods, and yet at the same time pay the whole amount of it over to the customer. That is the situation which we are quite sure the Congress will not want to put those mills in, and therefore we would suggest that either the date of March 3 be eliminated, that no time limit be set, or if it is necessary, for administrative reasons, to set a date that it be advanced, say, to July 1, 1936, when all of that work could have been completed.

I think that is all I have.

Senator BAILEY. Mr. Dorr, I wish to get some information about the textile industry. Can you tell me how many textile mills are in debt?

Mr. DORR. There have been a very considerable number of receiverships and bankruptcies. There are a number of mills that were in such a situation that the tax which had been levied, I think Dr. Murchison estimated the amount to be several million, which never can be paid.

Senator BAILEY. Could we get the statistics in tabular form of the number of debts and the amounts of the debts? The taxation under this bill is related directly to debts.

Mr. DORR. I think we can endeavor to get that for the committee, Senator.

Senator BAILEY. Could you then give me how many textile mills have liquid surpluses?

Mr. DORR. There is a good deal of information of that sort which was returned to the mills by the Federal Trade Commission in the investigations which they made into profits and losses recently. Some of that material the institute has, but not all of it.

Senator BAILEY. Could you give me a statement as to how many mills have old machinery; that is, machinery that is not up to date?

Mr. DORR. Well, that is a thing which there is about as much dispute about in the industry as anything that there is.

Senator BAILEY. Let us put it this way: How many mills are in a bad position in the matter of competition on account of the difference between their machinery and so-called modern machinery? Could we get that information? I am assuming that the mills that have old machinery would have to buy new machinery.

Mr. DORR. Why, there is a constant effort on the part of the mills to keep themselves up to date, and if they haven't got working capital, they haven't got credit.

Senator KING. Does not the institute keep up with the trade? Pardon me, Senator Bailey. I do not want to interrupt you.

Senator BAILEY. I had one more question.

Senator KING. It seems to me if you have an institute it is not functioning properly unless it assembles the data which the question of the Senator would seem to require.

Mr. DORR. Senator, the mills are somewhat reluctant to expose their sores in public, so to speak.

Senator KING. I see.

Mr. DORR. They have their banks from which they are trying to get loans, and they are not particularly anxious to expose their difficulties.

Senator BAILEY. In view of this legislation, whether they are reluctant or not, the facts must come out.

Mr. DORR. Yes.

Senator BAILEY. Now, let me ask you another question. I wonder if you can get the information for us, not now, but before the hearing is over, as to how many mills have impaired capital-stock structures?

Mr. DORR. It may be possible to obtain that, as to a certain group of mills.

Senator BAILEY. Now, I have just one other question. I have in mind two mills in North Carolina, one has a deficit of $290,000, not in the form of bonds, just a running deficit, and its capital is impaired. Now, if it should make $100,000 this year, under the law as we have it, it would pay 42 percent of that $100,000 on its profits without paying more taxes than it is paying; that is, it will pay the 16 percent rate, but the remaining $58,000 would have to be carried to the capital account, it could not be declared in dividends, because that is against the law, just as the force and effect of the law is to drive that $58,000 into the tax bracket, and that would be into the higher brackets.

Mr. DORR. I think unquestionably if there is not some provision made for taking care of those situations the operation of the law would be to drive out the smaller and weaker mills.

Senator BAILEY. Let us see what your answer is to this: The capital structure of a corporation is based on the credit. If the capital structure is impaired and the Government imposes a tax, it prevents the earnings from going into repairing the credit, and it interferes not only with the textile mills but with the credit.

Mr. DORR. Yes.

Senator BAILEY. Well, just in the matter of this particular bill it postpones, at any rate, the payment of their debt.

Mr. DORR. Yes, and it makes it more difficult for a mill in that situation to get credit.

Senator BAILEY. Now, compare that with a competitive mill that has an unimpaired capital and has a liquid surplus say of $10,000,000, and new machinery, it can declare all of its dividends and pay no

taxes. Now, what is the effect with respect to competition as between two institutions of that type?

Mr. DORR. As I suggested, unless the bill takes care of those situations it is going to be very hard on the smaller mill and the weaker mill.

Senator BAILEY. Would not the strong mill eat up the small mill, if they are in direct competition under those circumstances?

Mr. DORR. It would have a very definite advantage. It would have that result. That is, it presents a very serious situation to undoubtedly a great number of mills in the industry. You see, our industry is not an industry of large units. Ours is one of the few American industries which has maintained a large number of relatively small independent units. Our largest aggregations do not do more than 3 percent, I believe, of the total business.

It would give a very definite advantage to the stronger and tend to get away from what we regard as a rather happy characteristic of our industry.

Senator BAILEY. It is not necessary for a stronger mill to pay it out of its earnings.

Mr. DORR. Yes, it could do it.

Senator BAILEY. The weak mill would not even be permitted to pay its debt.

Mr. DORR. No, it would not be able to take those steps which are necessary to preserve the credit.

Senator BAILEY. Now, if you and Dr. Murchison can supply it approximately, not absolutely, I will be very glad to put those figures into the record.

Mr. DORR. We will do that.

Senator BARKLEY. To what extent is the cotton textile industry overexpanded?

Mr. DORR. Overcapacitated?

Senator BARKLEY. Yes.

Mr. DORR. That all depends on how you regard this factor. If our industry operated on a one-shift basis, the way which it historically did, and the way, for instance, that it does in England, why then we would not be overcapacitated at all. If we ran 24 hours a day, we would be tremendously overcapacitated. As it is we run one shift in a certain number of mills and two shifts in a large number of others in most of the industry, and on that basis we are quite a little overcapacitated.

Senator BARKLEY. And the uneconomic condition of the textile industry, as a whole, is due, in part, to the uneconomic way in which it has been managed over a period of years. I mean by that that at first it was established in certain sections of the country far from the raw material which it utilized in the production of its goods. Now, more recently, factories are beginning to go into the territory where the cotton is produced, and they save a lot of freight rates, they save a lot of labor costs, and they are supposed to be more economically operated in the territory where they are close to the raw material, which leaves those in the former region somewhat in the lurch, and all those things taken into consideration over a long period of time has contributed considerably to the present difficulties of the cotton textile industry, is that not true?

Mr. DORR. That has undoubtedly been a factor; that is, that shift in the place of operation, but I think that, to a large extent, has already been liquidated out.

Senator BARKLEY. That may be.

Mr. DORR. I think our real difficulty is in the operating period, through the very unfortunate tendency, we believe, from every standpoint, to go to, we will say, 24-hour operation. It is not an industry that ought to work all night. That tends to very great overcapacity.

Senator BARKLEY. That is not the normal way to operate the plant in England, is it?

Mr. DORR. You mean to operate all night?

Senator BARKLEY. Yes.

Mr. DORR. No; nor in any other country in the world, except perhaps one or two, have they installed all-night operation.

Senator KING. Moreover, there has been a loss of exports in commodities, has there not?

Mr. DORR. Yes.

Senator KING. If we had a reasonable export market, such as has been attempted by Secretary Hull and by other statesmen in the same category, then there would be a greater prosperity in the textile industry?

Mr. DORR. I wish we could induce the State Department to help us on some of our exports.

That is all I have. Thank you.

The CHAIRMAN. Thank you, Mr. Dorr. Mr. Russell.

STATEMENT OF SCOTT RUSSELL, MACON, GA., REPRESENTING THE COTTON TEXTILE INSTITUTE

Mr. RUSSELL. Mr. Chairman and members of the committee, I wish to deal solely with certain administrative features of the bill as drawn in an effort to propose some more simple method, both from the standpoint of the processor and of the Government, of obtaining approximately the same results that the bill seeks to attain.

The present plan provides that the mill must determine its net income from the sale of articles with respect to which the tax was not paid. It must then determine the amount of the shift of that tax burden. It gives a prima-facie presumption by which that shift is to be determined. To have that presumption you take the average profit margin on similar goods and bear in mind particularly the classification of similar goods during the preceding 5 years. That margin is determined by taking the difference between the cost of raw materials and the selling price on those goods.

The same computation is made with reference to the tax-free goods. Certain deductions or refunds are made in regard to the tax-free goods, and after those deductions are made the average margin for the 5 years is deducted from the margin on the tax-free goods.

It is possible to rebut that presumption by various things set out in the bill. You can show a change in the cost of the manufacture; you can show a change in the price to reflect the tax; you can show a refund of the amount of the tax, but we start out at least with a presumption that the margin is the difference between the raw material and the selling price.

Now, it may be possible for some processors who manufacture one item, or two items, to compute that tax, but the average textile mill which makes a thousand different items simply cannot do it.

To substantiate that statement I would like to briefly point out to the committee the process through which the textile mills have to go. Beginning in early September of each year, when the new crop comes in, the textile mills begin to buy. From early September until late December they purchase practically their year's requirements. The purchases that are made after that time are made to meet unexpected contingencies. Most of those mills undertake to hedge in futures their long or short position as between their inventories and their orders. That hedge is insurance, pure and simple. Theoretically, at least, they make no profit on their futures and they have no loss on the inventory if they succeed in their hedges. However, the hedging is not exact. They do not do it every day. They do not succeed in hedging so that they have an exact balance between their long and short position, but theoretically they undertake to carry it out. If a mill has 50,000 bales of cotton, more than it has orders for, it undertakes to hedge that 50,000 bales.

They buy this cotton, of course, in various grades and various staple lengths, but grading it is not an exact science. Its moisture content varies. The normal moisture content of raw cotton is about 9 percent, but it fluctuates from 6 to 11 percent. The waste varies by reason of variations in the uniformity of the staple. One bale of cotton of exactly the same grade may produce 5 percent more yarn than another bale simply because the staple is not uniform and does not go through the spinning machinery with the minimum amount of waste. Thus a bale of cotton that has a very low moisture content and a uniform staple may produce 10 percent more yarn than another bale that is bought on exactly the same grade.

All of these bales are not earmarked as to price. The bales in the various grades are put together and the prices averaged, and they are carried on the books at so much in dollars and cents. A mill will take 50 to 100 bales of this cotton, open it, mix it, and blend it, and start it through the mill.

The first process that it is subjected to is the preparation of the fibers for spinning. Now, there are three such processes and each of them produce a different amount of waste. Each of them makes a little better grade as they progressively produce more waste, because they lay the fibers more evenly and more smoothly, but to keep those three processes moving it is almost impossible to determine, from day to day, from week to week, or from month to month, just exactly how much difference there is in the waste that each of them produces.

That cotton starts through the mill. Some of it is simply spun into yarn. It may be sold as a single strand. Some of it is twisted and sold as cabled yarn in from 2 to 80 strands. Some of it goes on until it is made into finished cloth, and some of it even into finished wearing apparel in some mills. The waste that this processing occasions varies from 10 to 35 percent, depending upon the grade of the cotton, the length and uniformity of the staple, the character and extent of the processing to which it is subjected, its original moisture content, whether or not it is dyed, and whether or not it is bleached, and various other factors.

Senator KING. Cannot the mill recoup for that loss of 35 percent?

Mr. RUSSELL. It sells this waste for something, Senator. Some of the mills have a reclaiming plant and they work that waste back into low-priced goods.

Senator KING. Yes.

Mr. RUSSELL. But my point is they cannot determine how much waste is occasioned by any one of these particular operations with any degree of accuracy, and we are dealing here with an 80 percent tax, so that a minor variation in accuracy runs into a great deal of money very quickly.

Senator KING. And some of the yarn might be utilized in a fabric upon which there was a profit, and some of it might be utilized in a fabric of a lower grade, or a higher grade, upon which there is a loss?

Mr. RUSSELL. Exactly. They start the cotton through the mill from the same mixing and some of it may be taken out as yarn and sold. That may bring 20 cents a pound. Some of it goes on until it is processed into a product that brings 30 cents a pound. Some of it may go still further. But those differences have to be balanced to meet the market, of course, and the accurate determination of how much waste they have, or how much manufacturing cost they have for each of those steps is an almost impossible proposition.

Senator KING. You could not then, by any uniform formula, determine just what you had passed on to any purchaser, as to the cost of the processing tax?

Mr. RUSSELL. Exactly. After that cotton is manufactured it is put in a warehouse generally. The heat of the machinery has taken most of the moisture out of it. If it is shipped immediately, it is weighed on 100 pounds, it is shipped for 100 pounds. If it stays in a dry warehouse that moisture decreases and the mill may have to ship it as 97 pounds or 98 pounds. If it is put in a moist warehouse it may be 102 pounds when they get it out of there.

Now, section 501 (b) of the act requires that the gross income from the sale of articles with respect to which a Federal excise tax was imposed upon the taxpayer but not paid be computed. Apparently this means the gross profit on each separate invoice. I understand that the Treasury has so construed it.

Senator GERRY. What section is that?

Mr. RUSSELL. Section 501 (b), Senator. The mill would then have to take each of the invoices that it had rendered during this period and its first step would have to be to ascertain the cost of the raw cotton that was contained in that finished article. Well now the variation in moisture content and in waste content could vary that as much as 10 percent. Ten percent variation in an article that has 12-cent cotton in it is 1.2 cents, and an 80-percent tax on that is nearly a cent a pound arising solely from inaccuracy of computation. Now, it may work against the Government just as effectually as it works in favor of it. I do not mean it necessarily penalizes the processor, but it necessarily is inaccurate.

If the mill has the record of the particular bale it may be possible to get the price that it paid for it, but it probably has not. It may have had a hedge against that cotton, or the market may have gone up so that it had a larger spread, but it may have had that spread hedged and it may not have had it hedged. It does not have a calculation of its hedges against each bale because it has to buy its hedges in 100-bale lots.

Now, "gross income" apparently means the difference between the cost of raw materials and the selling price, and if it does the next step would be to deduct the cost of the raw cotton from the selling price. As I have just said, the market might have changed so that the spread would be reflected as very much greater than if the market had not changed, or very much less, as the case might be, and it would be necessary then to go back to your hedging operations and take those hedging operations into consideration to see whether you had actually had that profit or had actually suffered that loss.

You then have to ascertain net income. You have to, in doing this, compute the cost of manufacture of that particular article. You have got to allocate to it the fixed charges, including interest, taxes, overhead, depreciation, and selling cost. Every mill that operates with any efficiency has a cost-accounting system. They have worked out that cost-accounting system on averages over a long period of years. Over a long period of years it gives them figures that are sufficiently accurate to enable them to make prices to their customers and have some idea of where they are coming out.

Senator CONNALLY. Let me ask you right there: In your cost-accounting system do you not take into account all the factors that you are discussing, such as waste, moisture, and all those elements?

Mr. RUSSELL. In making an average over a 10-year period, yes; but in dealing with any shorter period, while we still use our averages, they do not accurately reflect.

Now, let me illustrate it this way: One of the mills for whom I am general counsel underteakes under this cost-accounting system to estimate each month the result of its operations. During its fiscal year ending August 31, 1935, it estimated that it had lost $600,000. When it took its inventories and made its income-tax return it found it had lost $250,000, so that its computation was $350,000 off, or approximately 60 percent. Now, 60 percent tax on that $350,000, which would have to be the basis for computation under this bill, would be approximately $280,000, purely because those cost-accounting figures did not balance in that year. Over a 10-year period, as I say, the mill can average the thing up and they are willing to sell goods on that basis, because it is the best basis they can get, but it does not balance out when the matter is completed.

Senator CONNALLY. Well, of course, no accounting system is 100 percent accurate, even in normal times. You have to have averages.

Mr. RUSSELL. Undoubtedly that is true.

Senator CONNALLY. Like any statistics, you have to base it on averages, do you not?

Mr. RUSSELL. That is undoubtedly true, and I am going to suggest a plan of using averages that will avoid all of this tremendous amount of work, if the Senator will indulge me until I get to that point.

Senator KING. Let me ask you one question right there, if I may: Have you any system by which you may determine, in the transitory condition through which we passed, with the fluctuation in prices during the past 2 or 6 years, since the processing tax was imposed, on any particular fabric that you have manufactured and shipped, whether or not you passed the tax on on that fabric?

Mr. RUSSELL. We have not.

Senator KING. It seems to me where you manufacture, as you say, a thousand grades under different conditions, where the prices fluctuate from day to day, there is no standard of prices at all in the community, or in the market, it would be impossible for you to determine whether you passed on the tax in any particular fabric or not, or any particular order tht came to your mill.

Mr. RUSSELL. Senator, I did not have much difficulty in convincing the Federal court that it was utterly impossible. The Bureau of Internal Revenue has had 4 months since the Hoosac decision to issue regulations, to at least tell us how to do it under 21 (d), they had carte blanche, and so far they are reopening claims that were filed prior to the Hoosac decision, with the statement that they were to be considered under 21 (b); but they have not yet evolved a method of considering them, and I do not think they will ever be able to evolve a regulation that will, with any degree of accuracy, determine that fact, in fairness to the Government or to the manufacturer.

Senator CONNALLY. In fixing the price for resale, under your cost-accounting system, do not you take into consideration the processing tax?

Mr. RUSSELL. We did our best, but we never, during the year 1935, were able to get a price for our goods that reflected both the tax and the profit. It showed, when we got through, that we had not taken into consideration all of the factors.

Now, we may have taken the tax or we may have taken the N. R. A. costs, or we may have taken something else, but we did not take everything.

Senator CONNALLY. If you did not do that then you did not have any net income.

Mr. RUSSELL. Exactly; but this bill does not propose to tax us on net income; it proposes to tax us on the net income from these particular goods, regardless of whether we lost on other goods. The allocation of the manufacturing costs, of course, varies by the percentage of time that the mill is operating. If it is operating full time, its depreciation and all of those fixed charges are spread over a great many more pounds of cotton. It is just utterly impossible, in any given period, to make those averages balance.

Now, let me illustrate the mechanics involved. This same mill about whom I have been talking made refunds to its customers on 17,000 invoices. The only thing they had to do with those invoices was to use the Treasury sheet with the conversion factors on it and compute on each invoice how much the tax was, and send the customer a check for it. It took the accounting department of that mill more than 30 days, working day and night, to make those computations on 17,000 invoices.

They have 45,000 invoices during a 9 months' period on which they have to make this much more tremendously complicated computation, which, when it is finished, would be merely an estimate, and conservatively it would take at least five times as long on each invoice; so that if 1 month was taken on 17,000 invoices in making refunds it will take at least a year to make the first step under this bill. For the 5 years they had approximately 300,000 invoices. Now, their records are not in as good shape for those 5 years, naturally. Their ability to identify the cotton and the materials is not in as good shape; but they would have to go further, they would have to take the

45,000 invoices and classify them into groups, because they have got to get their margin on similar articles in the 5-year period. In other words, a certain number of yarn has got to be put in this group and another number in this other group, and when they get through they have got 1,000 classifications that they have got to examine. Their accounting department told me that that second step would require, at an absolute minimum, 7 years of their time, working just as constantly as they possibly could, and when they got through all they would have would be an estimate. Then a Government auditor would come down there and he would spend 8 years there, and then after he got through and it came back to the Treasury we would probably have a lawsuit about it. So that the net result would be that most of us would not have to worry about whether the tax was ever paid or not, because very few of us would survive long enough to see the termination of it.

Senator KING. The company might be bankrupt in the meantime.

Mr. RUSSELL. Exactly; and it is entirely possible that the Government would spend $20,000,000 trying to get this $20,000,000 from the textile industry, and when they got through the courts would decide that they had just spent $20,000,000.

The CHAIRMAN. Now, will you give us your suggestions?

Mr. RUSSELL. Yes, sir. May I, Senator, just indulge in one more statement with reference to this question? The Treasury Department has always recognized, and now incorporates in regulation 86, article 22, the statement that no mill, no business in which the manufacture of goods is an income-producing factor, can possibly show a correct income without the use of inventories. This bill does not take into consideration the use of inventories when we deal with separate individual items.

Now, my suggestion is this—and it is frankly merely an estimate—it is just as accurate as the method proposed; it may produce more money, and it may produce less, and nobody on earth can tell whether it will do one or the other, but it, at least, has the virtue of simplicity. If instead of taking the separate invoices we would simply say that the net income of the taxpayer for the year derived from these goods was the proportion that these tax-free goods bore to the whole number of goods, the proportion of the net income that the tax-free goods bore to all the goods shipped, we would have our first step. Now, in doing that they ought to eliminate all processing taxes, paid or unpaid, so that all the goods shipped during the year would stand on a parity and you would have a reasonably fair basis.

If a mill shipped 12,000,000 pounds during the year, 5,000,000 pounds of it was tax free, with processing tax eliminated on the whole thing, we would simply say that the net income derived from those goods was five-twelfths of the whole.

That would be the first step. It might cost the mills more money, and it might cost them less. Whether it would cost them more or less would depend on whether the profits were relatively higher in the tax-free periods or the other periods, but you would find one had one experience and someone else had another. I think you would find, however, that all of them would adopt it, because of the utter impossibility of the other method, if it were made alternative.

Then to determine the shift. Take the average cost per pound of raw materials going into all goods and the average manufacturing cost going into all goods during the tax-free period and deduct it from the selling price for your margin during the tax-free period; do exactly the same thing for the 5-year period, on an average, and say that that is the amount of the shift. Now, it has been suggested that that is arbitrary because it takes into consideration goods that were not within the tax-free period. That may be; but if it is, then make it optional. If the taxpayer adopts the optional method he certainly cannot be heard to say that it was more arbitrary than the other method, and in a few minutes any accounting department in the country can make that computation. In a single day, a Treasury agent can check it, and, aside from any litigation that may follow, the matter is closed up and forgotten, if the mill can pay.

That is the plan. I think it is a plan that this committee ought to give most careful consideration, because it will avoid 99 percent of all the administrative difficulties. It may produce just as much money, it may produce more, and it may produce less, but until all these computations are made nobody can tell whether it will produce more or produce less.

I would like to call your attention also to section 501 (d) and 501 (e) (2) which fixes the cost of raw materials as a presumptive cost. You start us off with a cost and a presumption that everybody knows is untrue. Everybody knows that the N. R. A. costs have greatly increased the cost of manufacture of cotton textiles between the representative periods and the period under consideration. The net result is that we have a presumption, prima facie. We tear it down immediately by showing those costs. We then have no presumption, and we again are left in hopeless confusion.

Just before I came into the committee room one of the manufacturers in Georgia called my attention to three matters that he asked me to call to the attention of the committee, or four matters.

First, under this bill these computations may go on through the years 1937 and 1938, and maybe 1939, because goods in inventory will be shipped on over periods later than that. That amount will be negligible, and he asked me to bring to the committee's consideration the proposition of limiting it to the year 1936. It will cost the Government possibly some small amount of money, but it will save them the tremendous administrative efforts involved in it.

Secondly, in section 602 (g) it is provided that where the vendee—that is, dealing with refunds—that where the vendee has agreed to pay a price that includes the processing tax, that the goods bought on that order will be considered as a part of his inventory.

Senator KING. Part of the vendees' inventory?

Mr. RUSSELL. Part of the vendee's inventory. There seems to be some question as to whether "agreed to pay" gives due consideration to the clauses that were put into the contracts under which those prices were reduced. I have thought it was clear that he did not agree to pay it if we had a clause which reduced it, but his suggestion is that the word "paid" would do substantial justice and would obviate that question.

Now, in section 601 (b) he calls my attention to the fact that processors are denied refunds for exports, large cotton bags, and charitable shipments. A number of first processors did export and did sell to

charities and did make large cotton bags. The scheme of this bill is that 21 (d) takes care of the first processor's refund on floor stocks, which is probably true, though it causes some accounting difficulty; but it does not take care of it on the other items, because t does not necessarily prove that the tax was not passed on, and it should be made clear that the processor who exported is entitled to the refund on that export just the same as the second man is entitled to it.

Senator KING. Have you a suggested amendment?

Mr. RUSSELL. I have not prepared one, Senator, because it was called to my attention just as I came into the room.

Senator BARKLEY. Let me ask you right there: Are you suggesting substitute language for what you are criticizing?

Mr. RUSSELL. Not on these propositions that I have suggested, Senator. As I said, they were simply called to my attention just as I came in. I have suggested no substitute language but a substitute plan in my main statement. I would be very glad to submit substitute language if the Senator desires.

There is one thing in this bill that was not comprehended in my statement, dealing with administrative matters, that I would like to call the committee's attention to.

Section 502 makes a processor who earned a net income during the taxable year pay 65 percent windfall tax, and makes a processor who has no net income pay 80 percent. If he lost money but still had a windfall he has to pay 80 percent on it. If he made money and had a windfall he pays 80 percent on it, but he saves the 15 percent that he would have had to pay on his ordinary income. Now, I do not think that is a condition that anybody ever intended to exist, and I simply want to call that to the committee's attention.

The CHAIRMAN. Mr. Russell, the committee thanks you, and if you gentlemen want to discuss this with Mr. Turnery, the Treasury expert, you can retire out there and do so.

STATEMENT OF LAURENCE A. TANZER, NEW YORK CITY, CHAIRMAN, COMMITTEE ON TAXATION, MERCHANTS ASSOCIATION OF NEW YORK

Mr. TANZER. Mr. Chairman and gentlemen, I appear here as chairman of the committee on taxation and public revenue of the Merchants Association of New York. The Merchants Association is a chamber of commerce with about 4,000 members, representing the business life of the city, large and small businesses, professions and trades, and in fact a cross section of the business life of the city.

Senator BARKLEY. You have the New York Board of Trade and the Merchants Association, and you also have a chamber of commerce?

Mr. TANZER. The chamber of commerce is the Chamber of Commerce of the State of New York. That is a different organization.

Senator BARKLEY. Is there an overlapping of the membership of all these trade organizations?

Mr. TANZER. They have some members in common, yes; but they are different organizations, and the Merchants Association, I think, is the most comprehensive of all. It has, if I am rightly informed, the largest membership and the most comprehensive membership.

This bill was studied by the committee on taxation and public revenue of the association, composed of 17 lawyers, accountants, and

businessmen, all familiar with the subject of taxation, and they made their report to the board of directors of the association, consisting of 28 representatives of all varieties of business in the city, and after careful study by the committee on taxation and the board of directors, the association came to the conclusion that this bill—I have reference particularly to the proposed tax on the undistributed income of corporations—was so serious and dangerous in its effect on business and on the country at large, on the prosperity of the country, that they have sent Mr. Ballantine and myself here to lay their views before this committee.

Mr. Ballantine, who is a member of our committee, has made a close study of the bill, and I shall ask the committee to permit Mr. Ballantine to present the specific reasons why the association is opposed to the bill; and when he has concluded, if there is any time available, I would like to make a few remarks.

The CHAIRMAN. You better finish your remarks at this time rather than after Mr. Ballantine makes his remarks.

Mr. TANZER. All I had in mind, Mr. Chairman, was that after Mr. Ballantine had concluded I would present some general observations, depending upon his presentation. I am particularly anxious that the committee shall hear Mr. Ballantine's presentation of the specific grounds of our opposition to the bill.

The CHAIRMAN. One of the members of the committee wanted to be here when Mr. Ballantine testifies. He is not here, so we can take Mr. Ballantine the first thing after noon, and we will meet a little bit earlier than usual, we will meet in the afternoon at 1:30.

Mr. TANZER. Very well, Mr. Chairman.

The CHAIRMAN. We will finish up with you, Mr. Marsh, now.

STATEMENT OF BENJAMIN C. MARSH, WASHINGTON, D. C., REPRESENTING THE PEOPLE'S LOBBY

Mr. MARSH. Mr. Chairman and gentlemen, my name is Benjamin C. Marsh, I appear as executive secretary of the People's Lobby, with offices here in Washington.

Senator BAILEY. Mr. Marsh, for the record, what is the People's Lobby?

Mr. MARSH. The People's Lobby is an incorporated, nongovernment organization, with a membership all over the country. I can give you a list of some of the important members. There are about 3,700 members and subscribers to our Bulletin. It is working on a specific program of legislation. I do not know whether it is going to be subject to the attention of the O. G. P. U. about which Mr. Bone spoke yesterday or not. I trust not.

I would like to read a very brief statement outlining our position, then give some facts and figures to indicate our reasons for it.

We should not allow election year to become a lethal chamber for economic sense and honest taxation. At least $1,000,000,000 of Federal consumption taxes should be repealed, and no new ones added, and the total revenues of the Federal Government from taxation increased by about $2,000,000,000, raised by taxes which will increase consumption and reduce costs of production.

These taxes must be direct and nonshiftable to consumers, since regardless of theory, consumption, not production, must be subsidized to stimulate recovery and raise standards of living.

One of the witnesses this morning talked about corporations which were in receivership. Well, 20,000,000 in America of whom at least seven or eight million could or should be working, are in receivership and constitute the greatest drawback to prosperity, because they are not allowed to produce. They are going to find a way before long to get ownership of the means of production unless the present owners are increasing their employment.

I do not know how much you want to have to go into this record, but I should like very much to read an article by Mr. John T. Flynn entitled "Men Out of Work", in Collier's for May 9, in which Mr. Flynn points out that the Government has got to employ those whom private industry will not employ or take care of, and it is an army that is a good deal larger than the largest army we had in uniform during the World War. It is going to cost several billions of dollars.

(The article referred to is as follows:)

MEN OUT OF WORK

(By John T. Flynn)

For politicians, at this feverish moment, the man of the hour is none other than our old friend, the man without a job.

There is such a lot of him. About 10½ million, and most of him of age and eligible to vote. And when, next November, the freedman's ballots flutter down on the hill and dale and farm and town, for him who'll wear our kingless crown, why this legion of the jobless will be very handy to have around the polling places for somebody.

For the businessman, however, there is another army, far more numerous, about 40 million strong—better known as the "employed", who are just as handy to have around the shopping district not just 1 day in 4 years, but 6 days a week. And if the businessman will do a little simple arithmetic he will find out to his surprise that, back in March 1929, when we were all supposed to be prosperous and happy, there were just about 45 million at work; and that now there are 40 million at work for private business and about 5 million more on Uncle Sam's relief or works pay rolls. Which means that there are almost as many on somebody's pay rolls now as there were in the days of plenty. There's a fly or two in this stein, of course, but I know more than one businessman who has kept the dividends flowing because he kept this important fact in mind.

These 40 million at work for private business are the doughnut. The more than 10 million who are not privately employed are the hole in the doughnut. Two years ago the hole was 50 percent larger than it is today. Now there is more doughnut and less hole. But, of course, the hole is still there, with this difference: That 2 years ago that hole was a depression problem, while now it is being recognized as a problem of prosperity.

People have begun to ask themselves this question, Can it be that prosperity can come back and unemployment linger along with us too? Can it be that, even if a boom develops, there are a large number of jobless people for whom no jobs will come back?

The answer, and it is important, is, Yes.

One industry may be prosperous, another in a depression. In 1929 the automobile industry was prosperous, the textile industry was depressed. One man has a job. He is prosperous. Another is out of work. He is a little individual depression. The Nation may have a very large collection of prosperities, numerous industries doing well. But a few may be in trouble. A year from now we may, perhaps, have 45 million individual prosperities and 5 million depressions. We may actually develop a boom in this country and leave 5 million or more people out of it entirely.

You, Mr. Reader, are a businessman and a citizen. As a businessman, you will do business with the doughnut and not the hole. You will trade with the employed, but not the unemployed. You will flourish with the boom and not the depressed fraction left out of it. As a businessman you will keep your eye on that doughnut.

But as a citizen you have also got to keep your eye on that hole.

This permanent unemployment army constitutes just about the biggest question in this campaign. But singularly enough, all of the candidates, Democratic or Republican, keep pretty quiet about it.

As a matter of fact, all other questions are important chiefly because they bear on this one. All the clatter and clamor about the Constitution and the Supreme Court, about the budget, extravagance, Government borrowing, and inflation and money and gold is bunking in our ears principally because here are 10 million people out of work and no one knows what to do about it. Isn't it about time we found out?

SOME THINGS WE OUGHT TO KNOW

A good way to begin is to know just where we stand now. There are enough statistics published in newspapers about this to puzzle Einstein. But the facts are really not hard to grasp. How many are really still out of work? How many we put back to work? How many can we put back? How many will be left unemployed when we have exhausted our efforts? How many will remain in the permanent "Not-so-Grand Army of the Republic?" How many are on relief? How much is it costing and who is paying the bill?

Well, here is just about the way things stand: The United States, when you look at it, turns out to be a bewilderingly big place. You just can't see around it. If you want to describe it you have got to talk in millions and billions. And nobody knows what a billion is.

So in order to get a clearer picture of what has happened to these men out of work, let's take just a wee little slice of it. In 1929 there were supposed to be over 48 million people able to work. Now, instead of looking at the whole 48 million, let's look at just 100 of them. Imagine a community with just a hundred workers in it, but which represents in camera precisely what the Nation as a whole is. Then imagine all of them employed in one enterprise.

Well, if we look at them in March 1929 we will see there are 94 of these workers on the inside of this great plant and 6 outside not working. So even in the prosperous period of March 1929 there were 6 persons out of the 100 who were unemployed. Either they were shiftless, or were too old to work, or had been fired because they were incompetent or the work gave out, or they quit to find some other employment. But one thing seems fairly clear to us now. If we could get back to a stage where 94 of us were working and only 6 were idle, it would be no tremendous burden on the 94 to make some sort of provision for at least some of the 6.

AN UNWELCOME FOURSOME

But then came the depression and things began to happen to this community. By March 1930 there were only 91 working instead of 94 and three more had joined the ranks of the unemployed. The score now stood 91 to 9 in favor of employment.

Then in March 1932 the score was 77 to 23. But by this time something else had happened. Two people in that town had suddenly become of working age. There were two more now looking for a job. That really means the score now stood at 77 to 25. Instead of just 100 workers, we have 102. And by 1935 we had 104. The population doesn't remain stationary. The number of employable keeps on increasing.

So with this understanding we can follow the history of these eventful years in a simple column of very small figures which will mean something to us. Here it is:

	Employed	Unemployed	Newcomers		Employed	Unemployed	Newcomers
March—				March—Con.			
1929	94	6	.....	1933	73	25	3
1930	91	9	.....	1934	80	20	3
1931	85	13	1	1935	79	21	4
1932	77	23	2	November 1935	83	15	4

Now, if we will look at this table carefully we will be able to see some interesting facts. First, the storm did its work between March 1929 and March 1933.

Of these 100 workers in 1929, 94 were at work and 6 were idle.

But by March 1933 only 72 were at work. That is, 22 had been let out. So the idle comprised the original 6 unemployed, plus the 22 who were fired.

But there were three more—an addition to the working population which was now, through normal growth, three larger than it was in 1929. So instead of 28 idle, there were 31 idle, because now there were 103 workers instead of 100.

Pickup in employment began in 1933. Contrast the figures:

	Total workers	Employed	Unemployed	New workers
March 1933	103	72	26	3
November 1935	104	83	18	4

The New Deal—or something—has put 10 back to work in these 3 years, 10 out of 28 unemployed. But there are still 18 of those 28 idle and 4 newcomers in the field of industry.

This is one reason why, in spite of putting many back to work, the number of unemployed fails to decrease correspondingly.

It was in March 1933 that the New Deal stepped in. There have been all sorts of claims for and against it. But in these small figures we can see what has happened, as we can see the temperature on a thermometer.

Here is the story of what happened to those original 100 workers:

	Employed	Unemployed
March 1929	94	6
March 1933	72	28
November 1935	83	17

But there are more than 18 unemployed because there are 4 more added to the working population since 1929. There are now 22 out of work.

And so the New Deal has put 10 back to work in the last 3 years. But 22 still remain on the outside of industry. To get back to where we were in 1929 we would have to put, not 22, but 16 more back to work, leaving us with the original 6 idle. That's plenty, but it is not unmanageable.

Unfortunately our little country has more than 100 workers. This is just a picture of what has happened to a representative hundred. But from this we can see what has happened to the Nation as a whole. Just translate this little story into the necessary big figures, which ought to be a little easier to grasp now.

Back there in 1929 there were 48,479,000 employables. Of these, 45,619,000 were at work and 2,860,000 were not.

By March 1933 of these workers, 34,716,000 were at work and 13,763,000 were not.

By November 1935 the number of these original workers employed was 39,921,000. But there were 8,558,000 idle. This is what we would have today if our working population had stood still. But it has grown in these eventful 6½ years. In that time, 2,177,000 possible workers have been added to the population. That is why the number of unemployed has decreased less than employment has increased.

GRAY HAIRS FOR OUR POLITICIANS

To get back to where we were in 1929, therefore, we have to find jobs not only for those who were at work then, but also for all of those who have come into the great army of workers since—2,177,000 of them.

This is the great problem of the day. This widespread army of over 10 million souls—"dole souls", as someone has called them—are going to put some white strands into the heads of our politicians, however carefree they are.

But where do all these figures about unemployment come from? They are, of course, estimates. But they are based on fairly reliable data. In 1930 the Census Bureau made a Nation-wide house-to-house census of unemployment. That is the very thing everybody has been demanding now. This census may not have

been conducted in sufficient detail, but it gave us a pretty good and reliable figure on the unemployment at that time.

Since that time four agencies have attempted to keep this unemployment figure up to date. They are the American Federation of Labor, the National Industrial Conference Board, the National Research League, and Mr. Robert R. Nathan, of the United States Department of Commerce.

Now, when you get into the field of statistics—particularly unemployment statistics—you can do wonderful things with figures, depending on what you wish to prove. If you want to make unemployment look big you will adopt one method. If you want to make it seem small you will adopt another. You may be perfectly honest, but you may be at the mercy of your own bias.

In keeping this census figure up to date, the statistician has to consider many factors. There is the increase in the population. There is the very question of what you mean by unemployment.

For instance, there can be little doubt as to how much the population has increased since 1930. There is an official figure for that. The increase in population would seem to make an increase in the number of persons looking for jobs. However, one statistician uses the increase in the population as a whole; another uses the increase in that part of the population of working age—which happens to give a different figure.

Then, what is an unemployed person? In 1929 a large number of young people, as soon as they got to working age, went after jobs. In 1936 there are not so many jobs for them. So they stay in school. If the jobs appeared they would rush for them. Meantime, are they to be counted as unemployed? Then a lot of young people, when times got hard and the city jobs disappeared, went back to the farm to dad. There they remained. They do chores and get shelter and board. If jobs appeared freely again in town they would rush back to get them. But meantime are they unemployed? These and a dozen other questions have got to be settled by the statistician before he makes his estimates. Depending on how he settles these points, his estimate of unemployment will be high or low. And as statisticians are like the rest of us, swayed by their emotions and their philosophies, they are apt to settle these questions in accordance with the point they want to prove.

It is for this reason that these different agencies arrive at different estimates of unemployment now. Here are the estimates of these four agencies for the beginning of December 1935:

National Research League	13,000,000
American Federation of Labor	11,600,000
Robert R. Nathan	10,735,000
National Industrial Conference Board	9,092,000

These differences are explained almost entirely by the differing answers which the different agencies made to the questions I outlined above.

I went carefully over the figures of each group, spent some time asking explanations of how their various statistical points were settled and decided to adopt the figures of Mr. Nathan as perhaps being less open to criticism than the others.

He was loaned to the President's commission named to study unemployment as a preliminary to the Social Security Act. He had an adequate staff. He is an able statistician and he seemed to be least interested in arriving at any pet conclusion. He was objective and seemed to make the most sensible and cautious allowances for all the points which arise in such a study. His figure is a little over a million more than that of the National Research League and a million less than that of the American Federation of Labor. On the whole, I think it is the most reliable.

CAMPED IN THE TREASURY

The figures I was least interested in were those which came from politicians of any party—extreme radicals or extreme conservatives, administration officials anxious to prove how much Mr. Roosevelt had accomplished, or political enemies anxious to prove how signally he had failed.

But one question pops up. Back in 1932, when unemployment was about the same, the streets were filled with panhandlers, the cities were defaced with long queues of men in bread lines, the presence of the unemployed was everywhere visible. Of course, things are not as bad as they were in 1933, but they are about what they were in 1932. But where are the bread lines? Where are the panhandlers? Where are the soup kitchens? Where are the pitiful tales of

starvation and family disaster? There are no evidences of this vast unemployed army. Where is it camped?

The answer is that most of it is camped in the United States Treasury.

There are 6,000,000 people on relief, in one way or another. This does not mean there are that many actually receiving direct payments. Relief is given, in the case of families, not to any individual, but to the family. And there may be two or three or even more employable persons out of work in the family. The Relief Administration estimates that the average number of employable workers in each relief family is one and a half. However, it is computed, it will be seen that as of December, 1935, there were 6,000,000 workers who were directly or indirectly the objects of aid from the Government.

This leaves 4,700,000 who are not getting relief. What are they doing? That is a little bit of a mystery. First, there are a lot of people of working age who do not work—don't have to or don't want to. Then there is a very great number of young people who are normally employables who are now in school because there is no work. They would probably go to work in a hurry if there were any. Then there is a large number of men and women who are not working, who are living at home with parents or relatives, whose shelter and subsistence is assured and who do not have to resort to relief. When there is a large group who have gone from the city to the farm back to the old homestead to remain with dad for the period of the depression, who would come flocking back to town at the first sign of good times.

NO SOUP KITCHENS, NO BREAD LINES

But it is clear from this that the severe pressure of the depression is mitigated by the relief rolls and their 6,000,000 victims or beneficiaries. That is why there are no soup kitchens, no bread lines, no evidences of disaster and want such as we saw in other years.

But it enables us to realize what would happen if these 6,000,000 people were to be turned loose upon the world.

Well, what's the bill for all this? And who, by the way, is paying it?

It's pretty hard to tell just what the damages are. Some of these accounting officers of ours have been pulling some fast ones in the way of bookkeeping. Uncle Sam has been making funny little marks all over his ledgers and as for the State fiscal reports—most of them are about as unreliable as an income-tax return.

Uncle Sam has been spending rather freely and a lot of economical businessmen whose knees, as one columnist put it, were shaking in 1933, are now shaking their fists at the Federal Government for throwing the money around. But just how much of this spending has been for relief and the jobless and how much for other purposes it is very difficult to tell.

From July 1, 1933, to December 31, 1935, the dear old Uncle has spent on what he calls emergency purposes $9,333,533,806. He will spend at least another three billions this year. But a lot of this money has gone to farmers as subsidies, to railroads for loans, to banks as loans and for preferred stock and in various other ways. Of course it could be contended that all these outlays helped to restore confidence and to restart business, and that made work and provided jobs. There could be, and of course there are, two sides to that, as you can tell any night by listening on the radio. But there aren't two sides to some other figures—figures of what is spent directly on relief and work projects. If we isolate these sums from all other Government emergency spendings, to find that since July 1, 1933, up to October 1, 1935, the United States Government spent $4,726,015,731.14.

But the States and cities and counties have also spent some money for relief. How much, there is simply no way to tell. We can guess from the amounts they have borrowed and from the income taxes levied. These have been mostly for relief. The States have borrowed on bond issues from January 1, 1933, to October 1, 1935, some $461,665,918. The local governments have borrowed in the same time $521,206,115.

Then they have raised funds by means of sales taxes. About $109,000,000 of the sales taxes collected by the States since June 1933 have gone for relief. Hence it would be a fair estimate to say that all our governments have spent something in the neighborhood of 6 billion dollars on doles and "made work" for the jobless in the last 3 years.

This is what it has cost. But who has paid for it? Who, indeed? The answer is surprising. No one has paid for it. With the exception of that tiny fraction collected in sales taxes, it has all been financed with borrowed funds. We

have handled the bills with I. O. U's. Some day, we imagine, someone will pay these bills. Perhaps our children or our grandchildren. Obviously we cannot go on doing this indefinitely. Even if we could swing it--which of course we can't--it would be a foolish thing to do.

THE TURN-OVER IN RELIEF

That is why we haven't dealt with the problem--because we haven't been paying the bills. One hears of a great burden on the taxpayers. But we have laid no taxes to pay for relief. We haven't raised enough in taxes to pay the ordinary costs of the Government these last 4 or 5 years. When we get around to dealing with the problem of unemployment, we will have to stop borrowing and start taxing. That is why politicians prefer to keep silent about the subject.

But we'll have to get down to brass tacks sooner or later. And hence, while the Honorable Silas Q. Blather is floating around spouting from the rear of his campaign truck, this is a good time to ask him what he intends to do about this piece of business. But before we do that--that is, before we give the Honorable Silas a chance to fog up the picture there are one or two popular misconceptions about this whole thing which ought to be cleared up.

First, there are a lot of people--and particularly a lot of businessmen--who think that the whole relief outlay is just a big racket; that these people on the relief rolls are for the most part a flock of congenital will-nots and that they can be depended on to squat on the Treasury as long as the dole holds out.

Of course this is one of those statements very easily made and those believe it who would like to believe it. But it just isn't a fact.

First of all, there are over four million workers who are not on the relief roll. They can't be accused of being dole grafters. But as to the six million who are the beneficiaries of relief or Government "made work", of course there are a lot who will never get off of relief; there are ne'er-do-wells among them. And there are, by now, people whose morale has been broken and still others whose earnings when working are so slender that they are better off on relief. But as to the great mass of relief cases, the facts which are known about them make it perfectly clear that they will go to work gladly and quickly as fast as jobs appear for them. The best evidence of this last is that they do get off.

We perhaps have a notion that those on relief now are the people who have been hanging around the Government's free-lunch counter since it opened for business. But the fact is that of the millions on relief 2 years ago but few of them are still on relief. That is, people are getting off relief all the time and their places being taken by others. There is a complete turn-over of the relief rolls in 2 years.

Of those on relief now, a very large number are people who, despite the depression, have held out until now. Either they have been working these last four or 5 difficult years and have only recently lost jobs or, having lost their jobs earlier, they have held out in spite of hell and high water hoping for a better turn. This seems to me to dispose completely of the fear that these people won't work.

In the next place these people are not a lot of bums. They represent almost every class in the nation. And they include millions of men and women who have been accustomed to making excellent money, many of them, for that matter, as proprietors of their own business. There are, in fact, over eighty thousand proprietors, managers and officials on the relief rolls. There are over nine thousand building contractors.

There is a vast army of professional people--architects, chemists, metallurgists; thousands of draftsmen, over sixty-two thousand engineers and over twenty thousand teachers. You could start practically any kind of enterprise your imagination could conjure up and man it completely, from manager down, from the relief rolls.

Now what can our political and business leaders do about this?

Obviously the best remedy for unemployment is employment. Many businessmen say that the best thing to do is to "let business alone" and it will go ahead and absorb all of this great army that really wants to work.

How many will business be able to reemploy when it is fully recovered? And how many will still be left in the army of the unemployed?

INSPECTING THE JOBLESS ARMY

At present the industry most affected by unemployment is the building industry. In March 1929 the building industry employed about 2¼ million people. Today it employs about 800,000. Most of these are employed on work being

done by the various governments or being financed by the Federal Government. If we have a building boom, it is fair to assume that these 2½ million men will be put back to work. It is also fair to assume that at least another million will find employment in the industries which contribute to building. It is also reasonable to suppose that with the purchasing power of these people revived at least another 2 million people will find work in the great consumers' goods industries. Here is work for 6 million people. As there are now 800,000 employed at building, this means the rehiring of another 5,200,000. But even if this happens there will still be 5,000,000 out of work.

This is a large army. But it ought not to defeat us if we still just recognize it and plan for it. But above all we dare not ignore it. And will anyone assert that any of our political leaders—Democratic or Republican or Socialist—has put his finger on the means of dealing with it? Of course, it is entirely possible that a boom might develop of sufficient proportions to wipe out a large part of this. But of course, after all our lessons, we surely are not going to pin our hopes upon a boom. We don't want too much boom.

Let's see what this jobless army looks like. It is not easy to classify it. But it is possible to divide it into certain fairly well-defined groups.

First, a large number of them—perhaps a million or more—would be made up of men temporarily out of work. In so large a country there cannot be precisely the same number of jobs and men—perfect balance. Men are passing out of their jobs continually for all sorts of good reasons—dissatisfaction with the work, suspension of the work, factories going out of business, seeking better opportunities, fired for good causes, and so on. They are idle for a brief period and then are taken into jobs again.

Second, a large number are young people who are really of school age, but who prefer to work when there is work.

A large number are old men and women over 65. But I do not consider them because in the unemployment estimates those over 65 have not been included.

Third, a good many men who lose their jobs cannot get new ones because of advanced age, even though they are under 65.

Fourth, there is always a large number idle because of sickness, injuries, etc. This number is perhaps as much as half a million.

Fifth, there is a large number who are shiftless people who do not want to work if they can avoid it.

Sixth, there is a large number who do not have to work—either they have sufficient income without work or they get money from Dad.

If we look at it this way, then we can see that if industry, by rehiring, could reduce the jobless load to 5,000,000—the job of dealing with the problem of unemployment might not be unmanageable.

At the beginning I pointed out that in our little community of 100 workers in 1926, there were 94 at work and 6 idle. The same community would now be 104. If we had in a community of 104 workers 95 employed and 9 idle, it certainly would not be impossible to handle the problem of dealing with those 9. That's what it would be if we could reduce unemployment to 5,000,000.

It must be remembered that some of those nine would be professional will-nots, sick people, people temporarily out of a job and looking for another one and hence not public dependents at all and also some would be people who did not have to work.

In this article I have not set out to propose a remedy but merely to state the problem, to get some fairly dependable figures and facts about it, to make a picture of it and for the benefit of those who wish to discuss it. But I can indicate the lines of approach to a solution of it.

First, I am sure we must assume that business can reabsorb all but 5,000,000. If we for once assume that business cannot do this in its process of recovery, then, of course, the problem is more serious and will certainly lead us to search for more radical remedies. And second, it is also plain that achieving this by business is going to depend on the revival of the construction and heavy-machinery industries.

We can divide the unemployed then into two groups. First, those temporarily unemployed—people going through that unpleasant interval between losing one job and finding another. Second, those who form part of the unabsorbable surplus of labor.

JOB INSURANCE AND SHORTER HOURS

The first we can most certainly take care of through a system of unemployment insurance. To that policy we are already committed. Men of all faiths and forward-looking businessmen all endorse this principle.

But we ought not deceive ourselves into believing that we have taken care of the problem in the Social Security Act already passed. So far as unemployment insurance is concerned, the Federal act merely puts the problem up to the States and the States have done very little about it. However, this is one thing we can do for a fairly sizable chunk of those jobless people.

The second group constitutes those who cannot find work over long periods. Unemployment insurance at best can pay only limited benefits for a limited time—8, 10, 12, perhaps 16 weeks or a little more. This gives a man who has lost his job a breathing spell to find another one. But the remaining section of these 5,000,000 out of work will be those who either have no unemployment insurance or who have exhausted its benefits.

One remedy here is shortening of hours. The American Federation of Labor supports the compulsory 30-hour week. Organized industry is opposed to this. But it is not wholly opposed to some adjustment of the work-week to new conditions. How many would we have unemployed if we were still operating on the 10-, 11-, and 12-hour-day of 50 years ago? Perhaps the 30-hour week is too drastic a cut. Maybe the 36-hour week with some provision for flexible schedules would be more practicable and attainable. But there is no doubt that some cutting of the hours would tend to increase the number who would be employed. And a large section of the idle could be absorbed into work that way.

WITHOUT BOONDOGGLING

Then there is the problem of machinery. This is referred to as technological unemployment. Personally I have never believed that this problem has been correctly stated. Technological unemployment must be looked upon in two aspects to be understood. Considered over the long range I do not believe that machinery makes fewer jobs. Looked at in particular cases for brief periods, there can be no doubt that machinery does throw many men out of employment.

The simple fact is that a larger proportion of the population is employed now in normal times than was employed in normal times 100 years ago, when machine production was in its infancy. In other words, there are actually more jobs now than there were then. If we compare normal times now with normal times in the seventies—60 years ago—we find that a larger number of the population is employed. Machinery has not, on the whole and over long periods, reduced the number of jobs. It has increased them.

But while this is true, it does introduce temporary and difficult maladjustments. Put a great crane into a factory yard with two men to operate it and it will displace 100 hard workers. Those 100 men are out of work. They are the unhappy victims of this improvement. We must not put an end to improvements, particularly in the back-breaking work taken over by handling machinery, because of this. But we must try to take care of the temporary dislocation caused by the displacement of men. In the last 2 years of mounting prices of raw materials and wages, it is natural that employers should seek to decrease production costs by improving the efficiency of machinery. This, undoubtedly, accounts for some of the lag in employment. This problem employers and the State have got to deal with.

But when all is said and done, there will still be several million—maybe 3,000,000 over and above those cared for by unemployment insurance, sick benefits, personal independence plus the no'er-do-wells who will have to be considered if we want our system to work. Here is the great problem which is as yet untouched.

Is the Government to give them doles or work?

Work is the answer, in my humble judgment.

What government is to provide it—the State or the Nation? The funds, as I see it, will have to come from the Nation, though perhaps they should be administered through the States or at least through some of them.

Who should administer them? Certainly not the political machines in the States or the Nation. Some sort of personnel unconnected with the political machine will have to be provided.

What kind of work? No useless work, surely; no boondoggling, certainly. I can only indicate the answer. We must survey the field of public needs and find out what are those things which the Nation needs but which private business does not produce because they are not profitable. There, we must find the kind of work which will be provided for the unemployed.

Mr. MARSH. All present direct taxes, including corporation taxes, should be retained—personal income tax rates from $3,000 to $50,000 increased, and exemptions reduced by at least $200.

Perhaps you will see that it is not only simplification that I am suggesting, but I am simply suggesting that when I ought to be paying at least four or five hundred dollars a year more income taxes to the Federal Government, your committee, and most of the Senators, should be paying at least twice as much as my increase.

In addition, the President's proposal for a tax on undistributed corporate surpluses should be tried. How much it will yield nobody knows, unless they are better experts than Dr. Einstein on the relativity of taxes. An emergency tax should be levied on existing large liquid corporation surpluses based on the ratio between actual assets or earnings and surplus, and income from Federal bonds should be taxed as part of all income. I do not say income from the instruments of State, and local bonds, but I say that income on Federal bonds can be taxed as a part of that income. If you will recall, several years ago we had a lawyer here before this committee who made an argument on the constitutionality, which I think is not questioned, of our taxing income from Federal bonds, that is, the Federal income tax on income from Federal bonds, not as a tax on the instruments of the Government but as a part of all income.

There should be, in addition, an excise tax on valuable land holdings based on the value, with an exemption of about $3,000, both to obtain revenue from beneficiaries of Government expenditures and to stimulate housing and general construction and industry.

The present tax system, Federal, State, and local, is perpetuating unemployment and poverty, for nearly two-thirds of Federal revenue is derived from taxes on inability to pay and inability to resist payment.

I would like to read into the record an article entitled "Taxation Now Vital Issue", in which I give a lot of figures which I know you are not going to have time to permit me to give to you personally, but it gives the argument for this sort of taxation which we are advocating. I should like to insert that in the record if there is no objection. It is about 11 or 12 hundred words.

The CHAIRMAN. Let me see that.

Mr. MARSH. It may be dangerous. It is largely based upon Government reports. I wrote it, too. If you will not permit it to go in the record I will read it out loud, if you would rather have me do so, Senator. It is just the one article.

The CHAIRMAN. Just the one article?

Mr. MARSH. Yes.

The CHAIRMAN. I thought you said 12 pages.

Mr. MARSH. No, no. I said it is about 1,100 words.

The CHAIRMAN. You wrote the article yourself, did you?

Mr. MARSH. Yes.

The CHAIRMAN. Let it go into the record.

(The article referred to is as follows:)

TAXATION NOW VITAL ISSUE

Next to restoration of civil liberties throughout the nation—freedom of speech, or assembly, of the press, and of the radio—without which peaceful transition to an intelligent economic system is impossible—taxation is the most vital immediate economic issue in the national capital.

Discussion of whether the national debt can "safely" be $70,000,000,000 is an evasion of the issue of why we compel consumers to pay increasing unearned income to a group of investors, a small proportion of whom hold a major part of

the Federal Government's debt—most of which is tax-exempt, that is, most profitable for those with large incomes.

Interest payments on the national debt this year are about $830,000,000.

Realism compels admission that it would be folly to have the Government take over any major industries at present valuation, and that 5 years of practical but drastic taxation of land values, income, personal and corporate, including liquid surpluses of corporations, i. e., undivided profits, and of estates, would enable the Government to acquire basic industries including of course all natural resources and monopolies, at a fraction of their present selling price.

Such taxation assumes of course repeal of Federal, State, and local consumption taxes, which now cost consumers when pyramided, at least $7,000,000,000, most of it paid by those with incomes under $1,500.

The report of the Bureau of Internal Revenue shows that at the end of 1933—

Corporation assets were	$368, 208, 457, 000
Corporation bonded debt and mortgages were	45, 882, 526, 000
Capital assets, lands, buildings, and equipment, less depreciation, were	104, 958, 383, 000
Non-tax-exempt investments were	70, 478, 850, 000
Capital stock preferred was valued at	18, 893, 841, 000
Capital stock common was valued at	74, 087, 660, 000

This is the summary for the 388,564 corporations which returned balance sheets.

Of these, 591—about one-seventh of 1 percent of the total number—had total assets of $50,000,000 and over.

This small group of corporations had 53 percent of all corporation assets, three-fifths of bonded debt and mortgages, nearly three-fifths of capital assets, nearly two-thirds of non-tax-exempt investments, and nearly half of the preferred stock and of the common stock.

Cash and tax-exempt bonds held by all corporations at the end of 1933 amounted to $28,806,841,000, of which the giants held $15,242,831,000, or considerably over half; and surplus and undivided profits, less depreciation, of all corporations were $35,096,312,000, of which the giants had $21,037,156,000, or about three-fifths.

There are no exact figures on the present holdings of cash and tax-exempt bonds of corporations, nor on their surplus and undivided profits less deficit, but cash and tax-exempt bonds holdings are probably about the same, while on the basis of payments of dividends, interest, and net income of corporations during 1934 and 1935, surplus and undivided profits must be well in excess of $30,000,000,000.

The increase since 1932 of over this amount in the market price of stocks listed on the New York Stock Exchange is strongly confirmatory of this view.

Treasury experts estimate that if all their income were distributed, corporations would pay $4,768,000,000 of extra dividends this year.

It is almost certain that the $30,000,000 total assets group of corporations have about the same proportion of total liquid assets as in 1933.

Congress should at this session not only tax corporate undivided profits as suggested by the President.

Congress should retain present corporation profits taxes, estimated to yield this fiscal year about $475,000,000, substitute $1,000,000,000 of taxes on corporation liquid surpluses for $1,000,000,000 of consumption taxes, and raise at least $2,000,000,000 additional revenue by increased income taxes, surtaxes, and estate taxes.

This would give an additional revenue of $2,000,000,000 which would partly offset the deficit of $2,410,000,000 during the first 8 months of this fiscal year, which will probably be at least $3,200,000,000 for the year.

The President's proposal would increase net Government income by only about $620,000,000.

The Commissioner of Internal Revenue reports that in 1934:

1. That 419,431 persons reporting net incomes over $5,000—

Had a total income of	$5, 976, 859, 000
Were allowed deductions of	1, 005, 597, 000
Had a total net income of	4, 971, 262, 000
Paid in Federal income taxes and surtaxes only	473, 981, 000

Had left after paying all income taxes an average of $10,721.

Got three-fifths of their income from ownership of control of property.

They could have paid at least $1,500,000,000 more in income taxes and surtaxes than they did.

2. The 3,668,766 persons reporting incomes under $5,000—

Had a total income of	$8,731,699,000
Were allowed deductions of	1,246,699,000
Had a total net income of	7,485,000,000
Paid in Federal income taxes	32,500,000

Had left after paying all income taxes an average of $2,038.

Got nearly one-third of their income from ownership or control of property.

They could have paid at least $500,000,000 more in income taxes than they did.

In 1934 the net value of estates filed for probate was $547,022,000, upon which the Federal tax was $95,228,000.

The estate tax should yield at least $100,000,000 additional revenue.

Federal consumption taxes in 1935 yielded the following amounts:

Liquor taxes	$411,022,000
Cigarettes, tobacco taxes	659,179,000
Manufacturers' excise taxes	141,893,000
Customs duties	343,383,000
Miscellaneous taxes	151,709,000
Total	1,707,184,000

These taxes cost consumers at least half as much more than the Government received.

Congress should also enact the Morris bill (H. R. 6026) levying a 1-percent excise tax upon the privilege of holding land, based on the value, with an exemption of $3,000 to an individual. This would yield at least $150,000,000 to $160,000,000, and would save the Government a large part of the price it pays for land, for housing and other public purposes in cities, and for farms.

In 1935 income taxes, personal and corporate, and estate taxes, furnished only about three-tenths of the Federal Government's revenue, and indirect taxes nearly seven-tenths; while in 1920 income and estate taxes furnished three-fifths, and indirect taxes only about two-fifths.

In 1935 the Federal Government paid about $1,360,000,000 for relief, and will have to spend at least $2,000,000,000 for relief, subvention of education, etc., for years.

During the 5 depression years through 1937 fiscal year, interest paid on the national debt is about $3,813,000,000, and the annual payment despite reduction in interest rates is increasing.

Mr. MARSH. A few of the points I would like to bring out that I suggested. First, that you should not only tax accumulated profits, undistributed profits, but that you should tax the liquid surpluses already existing. Now, we haven't access to any figures except those published by the Government, but for the year 1933, according to the Bureau of Internal Revenue, 594 of the great corporations, each having total assets $50,000,000 and over—they were not the little textile mills that you have been hearing about today which seem to be in fear of receiverships, and I am not surprised with that processing tax on cotton—but this little group of corporations had 53 percent of all corporation assets.

The tax-exempt bonds and cash held by all corporations at the end of 1933—that is the liquid surpluses which is somewhat less now—amounted to $28,800,000,000, of which these big corporations, less than 600 of them, held $15,242,000,000, or considerably over half of the cash and tax-exempt bonds.

Now, it is perfectly clear that you could collect at least a billion dollars by an extra tax upon those accumulated liquid surpluses, as well as collecting something, I do not know how much you can get, from the President's very timely suggestion for a tax upon the undistributed surpluses. The fact that there were such large

undistributed surpluses made in 1 year is an indication that prices are altogether too high.

In making this suggestion for taxation of course we do not suggest it as a final remedy, but merely as to the matter which is now before this committee.

Let me show you what is happening. The Federal Government collected in 1935 consumption taxes amounting to about $1,707,000,000. Such taxes usually cost consumers at least half as much again as the Government receives, but conservatively those consumption taxes, most of which are paid by families with incomes under $1,500, cost them $2,000,000,000. That has spelled about $2,000,000,000 of nonconsumption and of nonemployment, which is quite a large proportion of the amount that the Federal Government is paying for relief and for made work which is not allowed to provide what people need, because it would interfere with profiteers who seem to be in control.

In 1934, according to the Commission of Internal Revenue, there were 419,481 persons reporting net incomes over $5,000.

After they paid all their income taxes and surtaxes they had left an average of $10,721. Now, this committee could raise at least $1,500,000,000 more in income taxes and surtaxes than was raised in 1934 by taxing this group of people.

Senator BAILEY. If we tax cumulative surpluses that would be a direct tax.

Senator CONNALLY. That would be a capital levy, would it not?

Mr. MARSH. It might be a levy upon capital, but now you are levying upon consumption.

Senator BAILEY. My point is, it is direct under the Constitution that proceeds should be apportionable to the State pro rata, with widely different rates.

Mr. MARSH. You have already distributed the proceeds that you get from such a tax. As Chief Justice Hughes said when he was Governor of New York, the Constitution is what judges say it is.

Senator BAILEY. If we should apportion our taxes which we collect under your plan by proportion to the States that would not be sufficient to relief the indebtedness of the Government with extreme rates in some States.

Mr. MARSH. It would prevent the increase in the indebtedness of this Government. The Senate was so worried over the Government's running into debt. They should have followed our advice 2 or 3 years ago and you would not have that to worry over.

Senator BAILEY. We were not responsible for that, however, Mr. Marsh. If you did not have that you would have perhaps something much worse.

Mr. MARSH. Much worse than this bill?

Senator BAILEY. Yes.

Mr. MARSH. You are an optimist.

The CHAIRMAN. As I understand you, you approve certain portions of this bill. You believe in the distribution of these surpluses, do you not?

Mr. MARSH. Yes, in the taxation of them. The only way you are going to get money, the only way you are going to know how to raise it and how much you are going to get—that is the Federal Government—is by direct taxes. If I may make a suggestion, if one or

two members of this committee and the House committee would meet with the tax experts, Messrs. Parker and Magill and others, and the Commissioner of Internal Revenue, and draft a bill based on the study of the British system—and you may remember the very memorable report made on that subject by Messrs. Parker, Magill, and one other expert whose name I have forgotten—you will realize how England is taxing personal incomes. I cannot give you the figures, but having about half of our income and wealth, England, raised nearly twice as much from the income tax and inheritance tax as we did in America a year ago. That means with the same rate we should raise approximately four times as much as we do from the individual income tax and the corporation income tax, plus the estate tax. I doubt if we could do that, however, if we repay to the State as large a proportion of the estate tax as is now done under the law.

Senator BAILEY. You would defend then taxing an income as low as $800?

Mr. MARSH. Yes; on condition that you repeal all these consumption taxes. I agree with the raising of the income tax last year; still the great bulk of the increased income has got to be derived from income taxes, from taxing those with incomes from $3,000 to $50,000, $60,000, and $75,000. That is where the great bulk of taxable income is.

In addition to that you should adopt the principles—you should incorporate in this bill the principles of the Moritz bill pending in the House for the Federal excise tax, for the privilege of holding land with an exemption of $3,000 or thereabouts, so you will not hit the little home owner, the little farmer; but frankly, you would hit some members of this committee, you would hit the President, you would hit some of his Cabinet members and their families, and the Vincent Astors.

Senator BAILEY. You would hit everybody.

Mr. MARSH. No; because they would have an exemption of $3,000.

Senator BAILEY. Every farmer that owns land would be hit.

Mr. MARSH. You hit the big plantation owners in the South; you hit the big wheat kings in the North.

Senator CONNALLY. We would hit every home owner in the District of Columbia that had a house and lot that cost over $3,000.

Mr. MARSH. This is just for the land alone, where the land alone is worth $3,000.

Senator CONNALLY. Even with that much you would hit the people in the District.

Mr. MARSH. You would hit very few of the home owners. I could mention some of the people you would hit in the District of Columbia.

Senator CONNALLY. You are disregarding the improvements altogether?

Mr. MARSH. Yes. What we want to do is to encourage production, and the major part, or about one-half, to be accurate, of the revenue the Federal Government is raising today is curtailing production and is making it more expensive and putting a burden upon legitimate production.

Senator CONNALLY. Does not real estate now bear a great load of local and State taxation, and your bill comes along and puts Federal taxation on top of it?

Mr. MARSH. It would not put a tax on "real estate" it would put a tax upon the value of the land. The farmers are getting about as good a hand-out as anybody did; that is, the land-owning farmers. You cannot permanently maintain a Government on the theory of the connivance of the bribed property owners; you have got to get down to honest economics. An officer of the State Farm Bureau Federation of Indianapolis told me the selling price of farm land in Indiana has gone up to $110 and $125 an acre; the average price had gone up about $25 an acre since the A. A. A. went into effect. When I lived on a farm in Iowa I believe a good price for land was $20 to $30, and it has gone up tremendously.

Senator BAILEY. You are in favor of taxing every farmer who owns over $3,000 worth of land?

Mr. MARSH. And every man in the city who owns over $3,000 worth of land.

Senator BAILEY. You are in favor of taxing everybody, particularly the farmer, that owns land.

Mr. MARSH. Yes.

Senator BAILEY. Then you are in favor of direct taxes on surpluses heretofore accumulated?

Mr. MARSH. Not a direct tax. It is an excise tax upon the privilege of holding land, based upon the value thereof, which has been drafted by a very careful constitutional lawyer.

Senator BAILEY. Let that go. I will not worry about that. Your tax on surplus is merely a direct tax on profits.

Mr. MARSH. Then every excise tax is a direct tax.

Senator BAILEY. Excise tax is a tax on transactions. I want to get this before you: How much surplus would be Delaware's for taxation and how much in New York? And how little would Nebraska get out of that? What rate would be imposed upon a State? I would like for you to figure that out.

Mr. MARSH. It would get, if it were distributed on that basis, exactly what they paid.

Senator BAILEY. You tax a surplus where it is. Under the decisions of the Supreme Court you apportion the tax to the State where the surplus is located, and the rate varies with the amount of property available in a State.

Mr. MARSH. If you can guess what the Supreme Court is going to hold constitutional you have got me beaten. If you can show me any authority in the Constitution for the Supreme Court overturning any legislation the Congress wants to make, you are the first lawyer who has discovered it. I hope Congress will not hide behind the Supreme Court. I do not think it is fair to assume they are going to be stupid or weak. I think they are as much concerned over the conditions in America as anybody else. There is no question of the Constitution, or of a fear of the Supreme Court in repealing all the consumption taxes, which the Democratic Party was supposed to do. There is no question of constitutionality or of interference by the Supreme Court in increasing the income-tax rates starting with $3,000 or even $1,000. There is no muddy question there at all. This Congress can do it; and to be very frank, I think it would be very helpful to the Democratic Party if it would face the issue.

Senator CONNALLY. Do you favor reducing the corporation taxes and raising the income taxes?

Mr. MARSH. No; I would retain all the present taxes on corporations, then make a guess as to what you can get through an additional tax upon undistributed surpluses.

The suggestion of the President, of course some of you gentlemen over here will remember, was first made by the late Senator Jones of New Mexico, and he made a very good argument for precisely this principle. We all admit it is a question whether we are going to raise $100,000,000 or $500,000,000 out of it, because, as was suggested by the earlier witness, whenever anybody does not like the tax he takes it to court to hang it up until they pass to their eternal reward, or otherwise.

In the direct tax, such as the income tax, excess-profits tax, and the estate tax, you have none of those problems to face.

The CHAIRMAN. Mr. Marsh, you have had 18 minutes. Are you about finished?

Mr. MARSH. Yes. I would like to ask if you would permit me to read into the record a bulletin of Editorial Research Reports The Deficit and the Public Debt, by Mr. Richard M. Boeckel. It is a short statement.

The CHAIRMAN. How much is it?

Mr. MARSH. It is a book of facts the knowledge of which would not interfere with drafting a wise tax bill. It is not very long. It is about 18 pages.

(The bulletin referred to is as follows:)

EDITORIAL RESEARCH REPORTS—THE DEFICIT AND THE PUBLIC DEBT

(By Richard M. Boeckel)

The public debt of the United States at the end of the present fiscal year, June 30, 1936, will approximate $34,500,000,000.[1] The increase in debt during the year—$5,800,000,000, including bonds and cash to be paid out in connection with the bonus—will be the largest in the peacetime history of the country.

The deficit for the year will also register a new peacetime high. Secretary of the Treasury Morgenthau testified before the Senate Finance Committee, April 30, that the Federal Government's expenditures for the year, including bonus outlays, would exceed its receipts by $5,966,000,000.[2] The deficit for the next fiscal year, he said, would drop to $2,675,000,000 and would be only a little larger than was estimated by the President in his budget message at the opening of the present session of Congress.

Five days before the Secretary appeared before the Finance Committee, the President had spoken of the deficit for the present fiscal year as amounting to $3,000,000,000. In his speech before the National Democratic Club at New York, April 25, the President said:

"People complain to me about the current costs of rebuilding America, about the burden on future generations. I tell them that whereas the deficit of the Federal Government this year is about $3,000,000,000, the national income of the people of the United States has risen from $35,000,000,000 in the year 1932 to $65,000,000,000 in the year 1936, and I tell them further that the only burden we need to fear is the burden our children would have to bear if we failed to take these measures today."

In estimating the deficit at $3,000,000,000 the President failed to take account of bonus payments or of expenditures required by law for retirement of the public debt.

[1] Testimony of Director of the Budget Bell before the House Ways and Means Committee, Apr. 7, 1936.
[2] The largest deficits in American history were $9,083,233,240 in 1918 and $13,370,687,609 in 1919. In January 1934, President Roosevelt estimated a gross deficit of $7,797,249,711 for the fiscal year 1934. The actual deficit on June 30, 1934, was $3,989,406,035.

THE BONUS AND THE FEDERAL DEFICIT FOR 1937

Secretary Morgenthau's estimates of the deficits for 1936 and 1937 were based upon the assumption that all outpayments in connection with the bonus would be made during the last 2 weeks of this fiscal year and that no bonus payments will appear in the Treasury's accounts for the fiscal year 1937. While the greater part of the bonus outlays will certainly be made before June 30, it is wholly unlikely that all bonus transactions will be completed by that date. The Secretary is believed, therefore, to have overestimated this year's deficit by perhaps as much as half a billion dollars and to have underestimated the next year's deficit by a corresponding amount.

The plan of bonus payment announced by the administration when the bonus bill was passed over the President's veto in January called for the mailing of bonds to veterans on or about August 15. This would have thrown the bulk of the bonus expenditure into the fiscal year 1937. In March, however, it was announced that bonds (and checks for odd amounts which could not be covered by bonds in multiples of $50) would be mailed on June 15 to all veterans whose applications had been received and approved by that date. The Treasury, the Veterans' Administration, and the Post Office Department are obviously making every preparation to distribute the bonds and checks with all possible speed. The Post Office Department has announced that it will be possible to make cash payments "on the great majority of these bonds within 1 week of June 15, the first date of payment."[1]

To the extent that bonds and checks are placed in the hands of veterans between June 15 and June 30, the burden of the bonus will fall in this fiscal year. By April 30 applications for bonds in exchange for adjusted service certificates had been received from about 2,000,000 veterans, but applications had not yet been filed by some 800,000 veterans—or nearly 30 percent of the total number to whom payments are to be made.

Secretary Morgenthau estimates the total amount of bonds to be distributed at $1,836,213,950 and the total amount of checks to accompany them at $87,786,050. Assuming that 10 percent of the veterans will not have applied in time to receive their payments before the end of the present fiscal year, expenditures in connection with the bonus up to June 30 will approximate the following amounts:

Bonds to veterans (to June 30, 1936)	$1,652,593,000
Checks to veterans (to June 30, 1936)	79,007,000
Bonds to Government Life Insurance Fund to cancel liens against adjusted-service certificates	507,000,000
Cash to banks to cancel liens against adjusted-service certificates	60,000,000
Administrative expense	10,000,000
Total	2,308,600,000

To meet part of the cost of the bonus about $250,000,000 is available in securities in the adjusted-service certificate fund, so that the net cost of prepayment of the bonus during the current fiscal year will probably be in the neighborhood of $2,058,600,000.

In the Budget submitted by the President in January expenditures for the current year were estimated at $7,645,301,338 and receipts at $4,410,793,946, giving an estimated deficit of $3,234,507,392. This deficit will be increased not only by the amount of bonus payments during the year, but also by the loss of processing taxes resulting from the Supreme Court's decision invalidating the Agricultural Adjustment Act. Processing taxes were estimated in the budget to yield $529,042,000. The actual income from this source for the year will amount only to about $67,300,000[2]—a revenue loss of $461,742,000. Due to the liquidation of the Agricultural Adjustment Administration in January, however, and the fact that payments to farmers under the new Soil Conservation Act will not begin until the autumn, there will be a saving of some $200,000,000 in the fiscal year 1936. Taking these items into account, and assuming that

[1] The payments referred to are those to be made to veterans who wish to cash their bonds at once. On June 13, the statement said, "the Postmaster General will, over a Nation-wide radio hook-up, deliver a special message to the veterans of the Nation in which he will give full and complete information concerning payment of the bonds and what the veterans will be required to do in identifying themselves." The payments will be made from borrowed funds and retirement of the bonds will have no net effect upon the public debt or the deficit.

[2] Refunds of processing taxes appear on the side of expenditures. They amounted to $10,840,572 during the first 10 months of this year as compared with $26,565,490 during the corresponding period of last year.

10 percent of the payments to veterans will not leave the Treasury until after June 30, Government expenditures during the year will approximate $9,503,900,000 and receipts will be about $3,949,050,000, leaving an indicated deficit for the year of some $5,555,000,000.

(If 20 percent of the bonus payments fail to reach the hands of veterans before June 30, the deficit will be in the neighborhood of $5,362,000,000. If 25 percent of the payments remain to be made after June 30, the deficit will be about $5,266,000,000.)

RECENT TRENDS IN FEDERAL REVENUES AND EXPENDITURES

During the first 10 months of the fiscal year 1933 Government expenditures ran slightly below Budget estimates due in part to the stoppage of Agricultural Adjustment Administration expenditures and in part to a lag in expenditures for relief. For the full year an increase of 3.7 percent in expenditures over those of the fiscal year 1935 was estimated in the Budget. Up to April 30, however, expenditures had run only 1.9 percent above those of the corresponding period of last year. The present prospect is that this lag will continue during the two remaining months of the fiscal year and that total expenditures, exclusive of those to be made in connection with the bonus, will run somewhat behind those of last year.

Revenues, on the other hand, have run well ahead of last year. Very striking increases were shown during the first 10 months of this year in collections of income taxes and miscellaneous taxes and in customs receipts. At the same time, the loss of processing taxes caused the increase in total revenues to fall far behind the increase estimated in the Budget for the full fiscal year.

Increases in Federal revenues, estimated and actual

Source of revenue	First 10 months of fiscal year			Increase estimated in Budget for full year (percent)
	1935	1936	Increase (percent)	
Income tax	$822,231,000	$1,081,411,000	31.5	30.5
Miscellaneous taxes	1,282,626,000	1,567,598,000	22.1	13.0
Processing taxes	443,060,000	67,308,000	[1] 84.8	1.5
Customs	284,837,000	324,422,000	13.9	2.9
All other	157,833,000	169,891,000	7.6	23.4
Total	3,090,617,000	3,330,625,000	7.8	16.1

[1] Decrease.

Except for the loss of processing taxes and the passage of the bonus bill over the President's veto, it is evident from the foregoing figures that the Treasury's accounts at the end of the year would have made a considerably better showing than was forecast in the Budget.

REDUCTION OF THE DEFICIT FOR NEXT FISCAL YEAR

Revenues for the fiscal year 1937, beginning July 1, next, were estimated in the Budget at $5,654,217,650. Of this amount, $547,000,000 was to come from the processing taxes which were invalidated by the Supreme Court on the day the Budget was submitted. The President recommended in his tax message of March 3 that this loss be made up by new processing taxes, levied at lower rates on a wider range of agricultural commodities, but this recommendation was not carried out in the new revenue bill as passed by the House.

The House bill is estimated by the Treasury to yield $803,000,000 on a yearly basis. Of this total $623,000,000 is expected to come from increased income-tax payments, but only one-half of these payments will be received during the fiscal year 1937. Unless processing taxes are restored by the Senate, which at present appears unlikely, or the yield of the House bill is increased by other means, the additional revenue brought in will not exceed $500,000,000 during the next fiscal year, and there will be a net loss of $47,000,000 in the Budget's estimate of anticipated receipts.

Expenditures for the fiscal year 1937 were estimated in the Budget at $6,752,600,370, to which there has been added an additional estimate of $1,500,000,000 for relief. Included in the Budget's estimate of expenditures was $620,000,000 for the Agricultural Adjustment Administration. Under the soil-conservation program, enacted as a substitute for the Agricultural Adjustment Administration, expenditures are limited to $500,000,000 a year, so that there will be a net saving on this account of $120,000,000. This saving will be canceled out, however, by the $120,000,000 asked by the President for the fiscal year 1937 (and the 8 ensuing years) to amortize the bonus debt. Assuming that 90 percent of the bonus payments are made to veterans before June 30 of this year, and that the remaining bond and cash payments are completed during the next fiscal year, the budget charge on this account will be $192,400,000, plus about $2,000,000 for administrative expense.

The Budget's estimate of revenues, as modified by the items noted above, amounts to about $5,607,000,000 and its estimate of expenditures to about $5,607,000,000 and its estimate of expenditures to about $8,447,000,000, leaving an indicated gross deficit for the fiscal year 1937 of $2,840,000,000. The indicated deficit may be increased by new appropriations by Congress at its present session for national defense, low-cost housing, flood control and other projects, and by a new appropriation at the next session for relief. Relief needs may be diminished, on the other hand, by payment of the bonus and by acceleration of the pace of business recovery—which would serve at the same time to increase the Government's tax revenues. The Government's income from taxation may be further increased during the last 6 months of the year by additional tax legislation, enacted after the election, to broaden the base of the individual income tax. These considerations, however, are highly speculative, and their possible effects on next year's deficit cannot be determined in advance.

ACCUMULATED DEFICIT OF THE DEPRESSION PERIOD

The year ending June 30, next, will be the sixth successive year in which the expenditures of the Federal Government have exceeded its receipts—the longest period of deficit financing in the peacetime history of the country. After the panic of 1893 there were 6 years of deficits, but expenditures during the last 2 fiscal years of this period included outlays incident to the Spanish-American War.

Including the estimated deficits for the present and the next fiscal years, the accumulated deficit since 1930—the last year in which the Treasury reported a surplus—will amount to $23,072,000,000.

Federal receipts and expenditures, 1930–37

[In millions of dollars]

Fiscal year	Receipts	Expenditures			Gross deficit or surplus
		General	Emergency	Total	
1930	4,178	3,994	.....	3,994	+184
1931	3,199	4,092	.....	4,092	−902
1932	2,006	4,386	768	5,154	−3,148
1933	2,060	3,865	1,277	5,143	−3,083
1934	3,116	2,822	4,283	7,106	−3,989
1935	3,800	3,138	4,247	7,375	−3,575
1936 (estimated)	3,949	[1] 5,685	3,819	9,504	−5,555
1937 (estimated)	5,607	[1] 5,839	[2] 2,608	8,447	−2,840

[1] Estimates of general expenditures for 1936 and 1937 include $3,058,600,000 and $192,400,000, respectively, for the bonus.

[2] In the fiscal year 1937 expenditures for the Civilian Conservation Corps and under the Soil Conservation Act will be classified with general expenditures.

Of the total deficit for the period 1931–37, approximately $17,000,000,000 or 73.7 percent will be accounted for by emergency expenditures. Prepayment of the bonus will account for about 10 percent. The remainder will be accounted for by the failure of Government receipts to cover general operating expenses during the earlier years of the depression.

SURPLUSES AND DEFICITS OF THE PAST

The history of the Federal Government's finances is one of rapidly fluctuating revenues and steadily growing expenditures; long periods of large surpluses followed by comparatively short periods of large deficits. The Federal Budget has seldom been balanced in the sense that revenues and expenditures came out approximately even at the end of the fiscal year.

The last period of substantial deficits in time of peace came during the 4 years preceding the Spanish War when a deficit of about $125,000,000 was accumulated. The years 1837-38 and 1858-61 were also years of large peacetime deficits. Each of these deficit periods followed years of large, and often unwieldy, surpluses; each was due to a sudden falling off in revenue occasioned by sharp declines in economic activity, combined with gradual increases in Government expenditures during the prior surplus years.

SURPLUSES AND DEFICITS OF THE 1830'S

During the 1830's Treasury accounts showed a series of exceptionally large surpluses, due chiefly to sales of public lands in connection with a boom in land speculation. After the Revolutionary War the Federal Government came into possession of an enormous domain through the cession of claims to western lands by eastern States. Between 1810 and 1830 the annual proceeds from the sale of these lands ranged between $1,000,000 and $2,000,000, but beginning in 1830 there was a considerable increase until in 1834 the receipts were nearly $5,000,000. In 1835 they were $14,757,600 and in 1836, $24,877,179. In the latter year revenue from this source exceeded revenue from customs for the first and last time in the history of the country.

In 1835 the entire public debt had been paid off through the purchase of government securities in the open market at a premium and the problem of what to do with the Treasury surpluses thereafter became acute.[1] Thomas Jefferson had foreseen that a policy of economy, coupled with national prosperity, might lead to an overflowing Treasury. In his second inaugural address he advocated a constitutional amendment clearly authorizing the use of government funds for internal improvements, arts, manufactures, and education. It was later proposed that a part of the recurring surpluses be distributed among the States to aid in education and internal improvements.

Henry Clay offered a bill in 1835 to distribute 90 percent of the proceeds of land sales to the States. Other proposals called for reductions in customs duties to cut the Government's revenues, but this course was strongly opposed by protectionists. Finally, on June 23, 1836, Congress approved a bill which provided that all money in the Treasury on January 1, 1837, reserving the sum of $5,000,000, should be "deposited" with the States in proportion to their representation in the House and Senate 4.

"It is in name a deposit; in form a loan; in essential design a distribution [said Senator Benton]. All this verbiage about a deposit is nothing but the device and contrivance of those who have been for years endeavoring to disbribute the revenues, sometimes by the land bill, sometimes by direct propositions, and sometimes by proposed amendments to the Constitution."

The amount available for distribution on January 1, 1837, was about $37,000,000. Of this sum more than $28,000,000 was paid out in three quarterly installments. In May 1837, however, speculation had collapsed and the country had been plunged into deep depression. A dozen years of surpluses came to an end with a large deficit and the fourth installment was never paid to the States. The $28,101,644 previously distributed is still carried on the books of the Treasury as unavailable funds.

DISSIPATION OF SURPLUSES OF THE 1850'S

A series of large surpluses occurred again in the eighties and a large part of the Civil War debt was rapidly paid off. By 1887 all bonds redeemable at par had been retired and during 1888-90, $45,000,000 was expended in premiums on bonds bought in the market in advance of their maturity.

In 1882 Secretary of the Treasury Folger, Republican, [illegible] written in his annual report; "What now perplexes the Secretary is not where [illegible]m he may get revenue and enough for the pressing needs of the Government, b[illegible] whereby he shall turn back into the flow of business the more than enough for those needs that has been

[1] In 1834 the Secretary of the Treasury had suggested that the Government use surplus revenues to make "a temporary investment in some stocks sound and salable."

drawn from the people." He suggested that the surplus might be parceled out among the States or that the terms of the Distribution Act of 1836 might be completed by paying to the States the amounts due on the fourth installment.[4]

In 1883 Congress abolished taxes on matches, patent medicines, perfumery, bank checks and bank capital and deposits, and cut tobacco taxes in half. A tariff act of the same year made reductions in duties on some commodities but gave increases in duties on others. The loss in revenue was not as great as had been anticipated and by 1886 the surplus had again become embarrassing. Efforts of President Cleveland to obtain sharp reductions in the tariff resulted in failure, but mounting expenditures helped to dissipate the large revenues yielded by the customs.

The most notable increase in expenditures was for pensions. Before 1880 the largest expenditure for pensions in any 1 year had been only $35,000,000; after 1880 pension expenditures were never less than $50,000,000. In 1886 the beginning of a steady upward climb was made, pensions reaching $106,937,000 in 1890 and $159,358,000 in 1893. In 1882 President Arthur had vetoed a river and harbor bill authorizing an expenditure of $18,745,000, yet expenditures for rivers and harbors mounted steadily, averaging $9,400,000 during 1881–1890, as compared with $5,800,000 during the preceding decade. Appropriations for the Army and Navy rose about $15,000,000 during this period.

By 1893 increasing expenditures had almost overtaken revenue, and a sudden decline of both customs receipts and the yield of internal taxes following the panic of that year left the Treasury with a deficit of $61,000,000—equal to 16 percent of total expenditures. This was the first of a series of deficits, which, together with inflationary legislation, involved the country in serious currency difficulties and almost forced it off the gold standard by depleting the gold reserve. Expenditures were still further increased by the Spanish War and annual deficits continued until 1900.

POST-WAR SURPLUSES AND TAX REDUCTIONS, 1920–30

During the period from 1900 to 1916 there were 8 scattered years of deficits and 8 years of surpluses. Then came the war deficits of 1917–19, which aggregated $23,257,248,365. They were followed by 11 unbroken years of surpluses.

Treasury surpluses, 1920–30

1920	$212,475,198	1924	$505,366,987	1928	$398,828,281
1921	86,723,772	1925	250,505,239	1929	184,787,035
1922	313,801,651	1926	377,767,816	1930	183,789,215
1923	309,657,461	1927	635,809,921		

Expenditures, which in 1919 had risen above $18,500,000,000, rapidly declined as the war machine was dismantled. By 1923 they had fallen to $3,795,000,000. The first Budget under the Budget and Accounting Act of 1921 was submitted for the fiscal year 1923. The new budget system greatly assisted President Coolidge in his efforts for economy. The budgets submitted by Harding, Coolidge and Hoover for the years from 1923 to 1930 consistently underestimated revenues and overestimated expenditures.

Five tax-reduction bills were enacted during the period 1920–30. The amounts of tax reduction effected by these acts, as estimated in reports of the Secretary of the Treasury, are shown in the following table. The estimates are based upon a comparison of receipts during the last 12 months under the old act with what might have been collected had the new act been effective for that year.

Revenue Act of 1921	$663,000,000
Revenue Act of 1924	519,000,000
Revenue Act of 1926	422,000,000
Revenue Act of 1928	222,000,000
Income-tax reduction of 1929	160,000,000

While reducing income and estate taxes and abolishing most of the excise taxes that had been imposed during the World War, Congress increased customs duties by the Fordney-McCumber tariff of 1922, with the result that receipts from customs rose from about $356,200,000 in that year to more than $600,000,000 in 1929.

[4] In 1833 Virginia sued unsuccessfully in the Supreme Court for payment of the fourth installment due it in the amount of $733,803.

Increases in income tax exemptions reduced the number of individual income-tax payers from 5,518,310 in 1920 to 2,037,645 in 1930. In the latter year the Government was dependent upon the income tax, including the corporation tax, for 58 percent of its total revenues.

In 1895, when the Government depended upon the tariff for approximately one-half its revenues, R. F. Hoxie, a leading American economist, wrote:

"In war the current public income has proved utterly insufficient, unstable, and inflexible; in peace it has shown itself extremely uncertain, fluctuating with every crisis and even with the changes in the policy and condition of foreign nations; in times of prosperity it has forced upon the country embarrassing surpluses, leading to extravagant expenditure, speculation, and crisis; in adversity it has left the Treasury empty, necessitating the lavish use of public credit."

Experience after 1930 demonstrated that dependence upon a narrow-based income tax for over half the Government's revenues had many of the same effects in periods of crisis as the earlier dependence upon customs.

Budget Policies of Roosevelt Administration

President Roosevelt's first important declaration on the state of the Government's finances after taking office on March 4, 1933, was made in a special message to Congress on March 10. At that time the President believed the Budget should be brought into balance as rapidly as possible—chiefly through steep reductions in Government expenditures.

"For three long years [he said] the Federal Government has been on the road toward bankruptcy.

"For the fiscal year 1931 the deficit was $462,000,000.

For the fiscal year 1932 it was $2,472,000,000.

"For the fiscal year 1933 it will probably exceed $1,200,000,000.

"For the fiscal year 1934, based on the appropriation bills passed by the last Congress and the estimated revenues, the deficit will probably exceed $1,000,000,000 unless immediate action is taken.

"Thus we shall have piled up an accumulated deficit of $5,000,000,000."[1]

The unbalanced condition of the Federal Budget, the President said had contributed to the collapse of the banking system; had accentuated the stagnation of the Nation's economic life; had added to the ranks of the unemployed. The government's house was not in order; national recovery depended upon its being put in order at once. "The members of Congress and I am pledged to immediate economy."

He asked sweeping powers to reduce the compensation of Government employees and benefits to veterans. "I give you assurance," he concluded, "that if this is done there is reasonable prospect that within a year the income of the Government will be sufficient to cover the expenditures of the Government." The powers asked by the President were extended by Congress in the act of March 20, 1933, entitled "An act to maintain the credit of the United States Government."

Despite the measures taken by the President under the Economy Act, most of which were later nullified by Congress, the Government's expenditures for the year ended June 30, 1933, were reduced by only about $12,000,000. The President appears thereafter to have lost confidence in the theory that economy in government expenditure was compatible with recovery. His first budget, submitted on January 4, 1934, forecast expenditures of $10,569,000,000 for the fiscal year 1934, then half completed, and a net deficit for the year of $7,309,000,000.

It was later reported that the President had been won over by J. Maynard Keynes, with whom he held conferences at the White House, to the British economist's theory of recovery through inflationary spending. Keynes held that emergency expenditures of $400,000,000 a month, borrowed from the banks, would make themselves felt throughout the economic system and result in quick recovery, accompanied by reabsorption of all the unemployed and an early balancing of the Federal budget.

Emergency expenditures during January–June 1934, averaged $475,000,000 a month. When it became evident that the President wished to continue this program of heavy emergency spending, Lewis W. Douglas submitted his resignation as Director of the Budget. Douglas opposed a continuation of large Federal

[1] The figures used by the President were for the net deficit exclusive of statutory debt retirements.

expenditures for public works and believed that the dollar should be stabilized and the budget brought into balance at the earliest possible date.[1]

Shift of Responsibility for Cutting Relief to Industry

The administration's spending policies were defended by the President in a speech at Boulder Dam, September 30, 1935, but he admitted in the same speech that Government spending alone would not result in giving work to all the jobless.

"It is a simple fact", he said, "that Government spending is already beginning to show definite signs of its effect on consumer spending; that the putting of people to work by the Government has put other people to work through private employment, and that in 2½ years we have come to the point where private industry must bear the principal responsibility of keeping the process of greater employment moving forward with accelerated speed."

This was the first expression of what later became the administration policy of holding industry responsible for bringing about reductions in the Federal Government's recovery and relief expenditures through reabsorption of the unemployed. This policy has recently been emphasized by administration spokesmen in various ways in all their public utterances.

Thus Jesse H. Jones, chairman of the Reconstruction Finance Corporation told the Advertising Club of New York, April 21: "While the depression is over, we still have the unemployed and it will be difficult to bring Government expenditures within Government income until there is work enough for all to make a living. Either industry must provide more work or a better distribution of that which is available." Postmaster General Farley said at Charleston, W. Va., April 22: "Yes, the Government is in business and the Government is going to get out of business as soon as it possibly can. Which means that it will retire from the field as soon as business is able to pay its debts and stand up by itself."

Secretary of Labor Perkins said at Chicago, April 27: "We intend to leave it to private business to work out its own recovery plans until the first of the year, and we expect substantial reemployment by then. If, by that time, the program has not been what we had hoped, we may have to work out a new program." This was taken as a suggestion of a new N. R. A. Secretary of Commerce Roper told the United States Chamber of Commerce, April 28: "There must be reemployment or a longer period of increased taxation. If a substantial measure of increased reemployment does not take place, the taxation for relief purposes will come largely from business earnings."

Ascending Revenues: Descending Relief Expenditures

The President said in his Budget message at the opening of the present session of Congress that the policy followed since March 1933 in the efforts of the administration to promote recovery had been predicated on two independent beliefs: First, that the measures taken would immediately cause a great increase in the annual expenditures of the Government. Second, that as a result of these measures the receipts of the Government would rise definitely and sharply during the following few years, while the need for relief would diminish and thereby reduce Federal expenditures. "The increase in revenues would ultimately meet and pass the declining cost of relief."

"The policy adopted in the spring of 1933 [the President continued] has been confirmed in actual practice by the Treasury figures of 1934, of 1935, and by the estimates for the fiscal years 1936 and 1937. There is today no doubt of the fundamental soundness of the policy of 1933. If we proceed along the path we have followed and with the results attained up to the present time, we shall continue our successful progress during the coming years."

In his Budget message of January 4, 1934, the President had said the Government should plan to bring its 1936 expenditures, including recovery and relief, within the revenues expected in that year. "We should plan to have a definitely balanced Budget for the third year of recovery and from that time on seek a continuing reduction of the national debt." In his Budget message of January 3, 1935, he had said the point had not yet been reached at which a complete balance of the Budget could be obtained.

[1] President Roosevelt, in his Baltimore speech of Apr. 18, 1934, referred to proposals for return to the gold standard and for putting Federal finances in order as "panaceas." "I ask you, what do panacea planks like these offer to you as a way out of the problems you had today and will get up to see tomorrow?"

"I am, however, submitting to the Congress a Budget for the fiscal year 1936 which balances except for expenditures to give work to the unemployed. If this Budget receives the approval of the Congress, the country will henceforth have the assurance that, with the single exception of this item, every current expenditure of whatever nature will be fully covered by our estimates of current receipts."

In this year's Budget message the President again refrained from forecasting the time at which the Budget would be balanced—the point at which rising revenues would overtake declining expenditures. The inference of the Budget was that relief expenditures would continue to be the measure of the deficit in future years, and would continue, as in the past, to be met by Government borrowing.

Expenditures for relief during the present fiscal year now promise to be about $225,000,000 below those of the last fiscal year. The reduction in relief expenditures during the next fiscal year will exceed this amount if Congress refrains from making a new appropriation for relief when it meets in January.

RISE IN GENERAL EXPENDITURES OF FEDERAL GOVERNMENT

While Federal emergency expenditures are showing a declining tendency, the general expenditures of the Government are moving in a contrary direction. General expenditures touched a low of $2,822,000,000 in the fiscal year 1934, and since have been steadily rising.[1] Expenditures for the Civilian Conservation Corps will be classified next year as "general" rather than "emergency" expenditures. Expenditures under the Soil Conservation Act will likewise be classified as "general" expenditures, whereas A. A. A. benefit payments were classified as "emergency."

A large increase in the general expenditures of future years will be occasioned by the Social Security Act. The President on April 23 transmitted to Congress an estimate of $460,800,000 required for expenditure under this act during the next fiscal year. The Railroad Retirement Act and the Bituminous Coal Conservation Act will together require expenditures of about $50,000,000 a year. The bulk of these expenditures will be met from the proceeds of special taxes levied by the acts and will not add to the Federal deficit. While it is possible that some or all of these laws will be invalidated by the Supreme Court, it is virtually certain that substitute legislation will be enacted by Congress, whichever party is in power, and that expenditures under social insurance laws will continue to be a large item in future budgets.

Aside from the items noted above—and the bonus which will be included in the general expenditures of the present and the next fiscal years—the largest increase in general expenditures has been caused by the rapid expansion of appropriations for national defense. National defense expenditures totaled $479,694,308 in 1934. Budget estimates call for expenditures of $937,791,966 for national defense in 1937—an increase of 95 percent. (Actual expenditures promise under the bills now pending in Congress to be $50,000,000 in excess of the latter figure.) Veterans' pensions and benefits totaled $605,573,275 in 1934; in 1937 they will total $790,058,900. The increase in these two items during the 3-year period amounts to $642,583,283.

General expenditures of the Government may be further increased in future years by the payment of pensions to veterans of the World War. The National Tribune which led the agitation for Civil War pensions during the 1880's, said on April 26, 1936, that the fight to obtain service pensions for World War veterans would open in Congress in January 1939.

"In 1890, when the first Civil War general pension bill was enacted, the average age of the men who fought to defend the Union was 46. In 1920 the men who served in the Spanish War had reached the average age of 46 and they were granted pensions. Only a few years must pass before the average age of World War veterans will be 46, and the National Tribune announces here and now that we intend to fight with all our strength to see that pensions are granted to the men who served this country in 1917–18."

The next decade may duplicate the record of the 1880's with a long succession of Treasury surpluses, but the situation will be entirely different from that which prompted Congress to grant pensions to Civil War veterans in 1890. Tax reduction will have first call whenever the Government's receipts exceed its expenditures and the huge debt left by the depression will afford abundant means of getting rid of whatever annual surpluses may be shown by the Treasury's accounts

[1] The low of general expenditures during the period of Coolidge economy was touched in 1925. They were afterward slowly expanded by the increase in Government activities.

THE FUTURE OF THE NATIONAL DEBT

A public debt of $34,500,000,000 on June 30 of this year will be further increased during the next fiscal year by perhaps $2,500,000,000, giving a total debt on June 30, 1937, of about $37,000,000,000.[10] By that time the new tax legislation to be adopted at this session of Congress—and any new revenue legislation adopted at the next session—will have come into full operation. If the experience of the immediate post-war years is duplicated, and the country enjoys a sustained recovery in business, revenue should be brought to the Treasury in flood tide during the fiscal year 1938.

President Roosevelt predicted in his Budget message of January 1934 that the public debt on June 30, 1935, would total $31,834,000,000.[11] (The debt was $408,500,000 below that figure on April 30, 1936.) The Government should plan, he said, to balance its Budget in 1936, with no increase in the public debt, and to undertake a continuous reduction of the debt thereafter.

Changes in the public debt since the United States entered the World War in 1917 and during the Roosevelt administration to date are shown in the following table:

Mar. 31, 1917 (pre-war debt)	$1, 282, 044, 346
Aug. 31, 1919 (highest post-war debt)	26, 596, 701, 648
Mar. 3, 1921	24, 045, 136, 550
Dec. 31, 1930 (lowest post-war debt)	16, 026, 087, 087
Mar. 3, 1933	20, 937, 350, 964
Apr. 30, 1936	31, 425, 440, 396

Secretary Morgenthau, in his testimony before the Senate Finance Committee, April 30, said the Treasury had been able to borrow readily all the amounts necessary to finance the recovery program and had been able to obtain its loans at steadily declining interest rates.

"The continuance of this satisfactory situation, however, will depend upon scrupulous adherence to an orderly program looking to a balance of the Federal Budget just as soon as the needs and abilities of our people make that possible and thereafter upon a steady reduction in the public debt."

Debt requirements required under the sinking-fund provisions of the Victory Loan Act have been regularly made during the depression, but the debt has been increased by new borrowing in amounts far in excess of statutory retirements. The earliest period during which it now appears likely that further debt reduction can be achieved through the sinking fund is the fiscal year 1938.

AMERICAN RECORD OF RAPID DEBT RETIREMENT

The past record of the United States with respect to retirement of indebtedness incurred during war or periods of economic emergency is without parallel among the great powers.

The Federal Government began with a debt of $71,060,000, after the debts of the States had been assumed in 1790. By 1832 the entire Revolutionary debt had been discharged and by 1836 the country was entirely out of debt, having retired in addition to the original debt, the debt resulting from the War of 1812 and debts incurred for the purchase of Florida and the Louisiana Territory.

The Civil War left the country with a national debt of $2,845,000,000. Taxes imposed to raise war revenues began to yield large returns only after hostilities had ceased. As a result, during the first 7 years after the war more than one-fifth of the debt was retired. Steady reductions were effected thereafter until in 1893 the outstanding debt was only $961,432,000. Moderate increases resulted from the depression of 1893, the Spanish War, and the building of the Panama Canal, but the gross debt in 1916 was only $1,225,000,000, the bulk of which was in bonds required to secure national bank note circulation.

During the 14-year period from the end of the fiscal year 1919 to the end of the fiscal year 1930, the debt resulting from the World War was reduced by more than $9,000,000,000, or about 36 percent, at an average exceeding $845,000,000 a year. The sources of funds for debt retirement during this period are shown in the table herewith:

[10] Use of the stabilization fund for debt retirement during the last half of 1937 (see p. 834) would hold the debt to $35,000,000,000.

[11] In a speech at Atlanta, Nov. 20, 1935, the President said he had been told by bankers in March 1933 that "the country could safely stand a national debt of between $55,000,000,000 and $70,000,000,000."

Public debt retirement, 1919–30

	Amount	Percent
Gross debt outstanding, June 30, 1919	$25,482,034,418.49	.....
Debt reduction:		
From Treasury surpluses	5,476,779,404.93	37.40
Sinking fund	5,187,458,800.00	34.29
Debt payments by foreign governments	1,455,720,450.06	16.01
Reduction in balance of general fund	913,282,020.23	9.82
Miscellaneous	230,425,944.15	2.48
Total	9,256,726,112.31	100.00
Gross debt outstanding, June 30, 1930	16,185,307,290.18	.....

It will be seen that the largest amount of debt reduction was accomplished through surpluses resulting from an excess of Government receipts over expenditures. The surpluses were due only in part to collections of taxes in excess of the Treasury's estimates. Included in them were the revenues resulting from liquidation of assets acquired by the Government during the World War. Sales of surplus war supplies alone accounted for $750,700,000 of the Treasury surpluses during this period. An equal amount was obtained through sales and payments of railroad obligations, Federal farm loan bonds, and other securities acquired by the Government during the war period, through liquidation of the accounts of the War Finance Corporation and collections of back taxes levied under the high rates of the war-armistice period.

OFFSETS TO PUBLIC DEBT ACCUMULATED IN DEPRESSION

The Government will emerge from its present period of deficit financing, as it did from the war period, with certain large assets which will bring in funds in future years for reduction of the public debt. These assets—partly acquired during the administration of President Hoover and in earlier administrations—appropriated $4,330,000,000 on March 31, 1936.

Assets of Government corporations and credit agencies

	Proprietary interest of U. S. Government
I. Financed wholly from Government funds:	
Reconstruction Finance Corporation	$1,923,061,804
Commodity Credit Corporation	311,171,926
Export-Import Banks	11,241,640
Public Works Administration	153,496,844
Regional agricultural credit corporations	41,138,620
Production credit corporations	121,304,850
Others [1]	602,373,050
II. Financed partly from Government funds:	
Federal land banks	243,499,386
Federal intermediate credit banks	100,761,705
Federal Farm Mortgage Corporation	202,045,981
Banks for cooperatives	150,796,223
Home loan banks	98,742,311
Home Owners' Loan Corporation	33,931,884
Federal Savings & Loan Insurance Corporation	102,864,641
Federal Savings & Loan Associations	81,533,600
Federal Deposit Insurance Corporation	150,000,000
War Finance Corporation (in liquidation)	70,669
Total	4,328,055,114

[1] In addition to other agencies includes Electric Home and Farm Authority, Federal Housing Administration, Resettlement Administration, Rural Electrification Administration, Tennessee Valley Authority, Inland Waterways Corporation, and crop-production loans.

To what extent, and how rapidly these assets can be liquidated, it is impossible to determine. Some will undoubtedly be held permanently by the Government and others may be liquidated in amounts considerably below the figures at which they are carried on the books of the Treasury. Assuming that one-half can be

liquidated at face value in a relatively few years, there can be a reduction in the public debt by this means of approximately $2,165,000,000.[13]

In the general fund of the Treasury on April 30, there was a balance of $2,441,970,519. In the normal years of the 1920's this balance amounted to only about $250,000,000; when the present administration assumed office it was only $158,000,000. It is obvious that when normal conditions return the balance in the general fund can be sharply reduced, and the reduction can be applied, as it was during the twenties to reduction of the outstanding debt.

Another fund in the Treasury will afford a still more certain contribution of large proportions to public debt reduction. This is the $2,009,000,000 stabilization fund, created out of the gold profit resulting from devaluation of the dollar in January 1934. The life of the stablization fund was extended by the President to January 30, 1937, by a proclamation issued on January 10 of this year under the powers given him by the Gold Reserve Act of 1934. At the end of January next, however, the operations of the fund must come to an end, under existing legislation, and the $2,000,000,000 it contains (less any losses incurred) will become available for reduction of the public debt.[14]

BURDEN OF THE DEBT; A PERPETUAL PUBLIC DEBT

The burden imposed by a nation's debt depends not so much upon the size of the debt as upon the amount of the carrying charges and upon the size and earning power of the population which will meet the carrying charges.

When the United States debt stood at its 1919 peak of $26,600,000,000, the per capita debt was $253.30. A gross debt of $34,500,000,000 on June 30, 1936 will be equal to a per capita debt of $269.75. Thus, while the gross debt will have increased by about 30 percent, the per capita debt will have increased only about 6 percent, due to the increase in population from 1919 to 1936.

The average interest rate borne by the public debt in 1920 was 4.178 percent and interest payments during that year were $1,020,251,622. The average interest rate borne by the public debt during the first 9 months of the present fiscal year was only 2.6 percent. At this rate of interest a public debt of $34,500,000,000 can be carried for $897,000,000 a year.

With a return of prosperity, accompanied by a liquidation of some of the Government's assets, rapid strides will undoubtedly be made in reduction of the public debt. Tax reduction is likely, however, to slow down the rate of debt retirement in later years and it now appears doubtful whether the debt will ever be reduced to the level at which it stood at the beginning of the depression.

A substantial volume of Government securities will be required in the future for bank and insurance company investments,[15] and the new social security legislation of the Federal Government ultimately will demand a very large volume of Government obligations for the investment of reserve funds. The Social Security Act of 1935 provides that the receipts of the States under their unemployment insurance laws shall be paid over to the Secretary of the Treasury to be placed in the unemployment trust fund for investment in securities of the United States. It also sets up an old age reserve account in the Treasury to which an annual appropriation is to be made in an amount sufficient as an annual premium to provide for the payment of old-age pensions under the act. The difference between the amount in this account and the current withdrawals is likewise to be invested in Government securities.

The amount the unemployment trust fund will contain in any year cannot be estimated. It will depend upon the amount of withdrawals by the States to pay unemployment insurance, which presumably will be large in years of depression and small in years of prosperity. It has been estimated, however, that the old-age reserve account by 1940 will contain $1,973,600,000; by 1945, $6,823,900,000; and by 1950, $14,031,700,000.[16] Thereafter the amount in the fund will rise rapidly until by 1980 it will approximate $50,000,000,000.

By 1965 the old-age reserve account, under the provisions of existing law, will have absorbed the whole amount of the national debt as it will exist on June 30,

[13] Some collections may be made also in future years on the $12,000,000,000 of obligations of foreign governments held by the Treasury, on which payment was defaulted during the depression.

[14] The Stabilization Fund is operated in secret and whether it has earned profits or sustained losses is not publicly known. It appears from Treasury accounts, however, that only $200,000,000 has actually been used in stabilization operations, so that the losses cannot exceed that sum.

[15] Reports of the Federal Deposit Insurance Corporation show that on June 30, 1935, the banking system held 49.2 percent of all Government and Government guaranteed obligations outstanding on that date, excluding debt represented by special obligations issued direct to Government trust funds.

[16] Estimates by Paul H. Douglas in Social Security in the United States, p. 167. The estimate for 1965 is $33,898,800,000.

1936—and if an additional debt of large proportions has not been incurred by the Federal Government in the meantime it will have to be created to meet the investment requirements of the social insurance funds.

The CHAIRMAN. Well, you leave that with the committee. We will pass on that later on. I do not want the record encumbered too much.

Mr. MARSH. I would respectfully submit that all of the material that I have asked to put into the record will not take as much space as two witnesses this morning.

The CHAIRMAN. We will pass on that proposition. Turn it over to the clerk. The committee will recess until 1:30 this afternoon.

(Whereupon, at the hour of 12:15 p. m., the committee recessed until 1:30 p. m. of the same day.)

AFTERNOON SESSION

The committee reconvened at 2 o'clock pursuant to the taking of the recess.

The CHAIRMAN. Mr. Arthur A. Ballantine, representing the Merchants Association of New York.

STATEMENT OF ARTHUR A. BALLANTINE, NEW YORK CITY, REPRESENTING THE MERCHANTS ASSOCIATION OF NEW YORK

Mr. BALLANTINE. Mr. Chairman, I appreciate that the committee has a difficult task and you are doing everything to hear patiently the many representatives of diffierent organizations, and therefore I shall try to be as brief as possible.

I am confident that the association of which I am a member and which I represent here, the Merchants Association of New York, finds itself in opposition to the new corporation tax plan in the bill not because it hits the pocketbook, for they expect the pocketbook to be under a great deal of tax strain in these times, but because of a conviction on their part that this tax hurts business, and hence hurts the Government in its receipt of revenue, hurts the security of jobs, and hurts the prospects for employment which is of such deep concern to us all.

The essence of this plan as we see it is to offer very large inducements in the way of savings of new taxes to be imposed by the bill, to the corporation itself, which are conditioned upon the amount of distributions that the corporation makes of its income so that the income will become subject to surtaxes on the part of the stockholders. Those inducements which are offered by the bill run as high as 73.9 percent of the amounts which would otherwise be retained, and it is our fear that that policy of offering very large inducements or premiums upon distributions by corporations of amounts which their managements and directors might feel are needed for the protection and continuance of the business will tend to weaken and even impoverish corporations, and hence to adversely affect the continuance of the Government's revenue and the protection of workers in their jobs, and to deprive them and all of us of the benefits of normal business expansion.

The taxes to be made avoidable under this bill are expressed, of course, in the now familiar 4 schedules, 2 of them using the 8 deci-

mals, and in the 16 mathematical formulae. For our own convenience, we have prepared a little graph to show what this tax is and how it spreads, and I think it may be of some interest to look at that, because it is hard to really get that until one sees it on paper.

(The graph referred to is on file with the committee.)

Basis of proposed tax—Corporations having income of over $10,000

Percent of undistributed income	Percent of tax to total income	Percent of tax to undistributed income	Percent of tax to income less dividends	Dividends	Tax	Undistributed income
10	4	40	28+	$100,000	$0	$0
20	9	45	29+	80,000	4,000	10,000
30	15	50	33⅓	70,000	8,000	20,000
40	25	62½	34	60,000	18,000	30,000
50	35	70	41+	50,000	28,000	40,000
57½	42½	73+	42½	10,000	33,000	50,000
				0	42,500	57,500

This tax, beginning in the lower left-hand corner of this graph, which represents the income of $100,000 of a corporation, is between these two black lines [indicating] which spread away to the upper part of the page, the part above; the upper black line being dividends or the distributed part, and the part below the lower black line [indicating] being the undistributed income, and the tax spreading out between [indicating].

As you will see, the tax fans up by lines which change their angles slightly as they go along; from zero when all is distributed, up to 42.5 percent when 57.5 percent of it is retained.

It would be impossible in our judgment to express that conception other than by schedules and formulae such as are used in this bill. The difficulty is inherent, because you have got the mathematical problem of two mutually interdependable variables, namely, the undistributed income and the tax, each of which depends on the other. When you take the schedules which are expressed as a matter of practical computation for the taxpayer, he has got to begin with his undistributed income or his distributed income—one or the other—to make his tax computation. Neither of those figures does he find from the books. He may find from his books the adjusted net income. He is told how to do that by the statute, but when it comes to undistributed or the distributed that of course must result from a determination by him of how much he means to distribute, and in order to know how much he means to distribute, he must know the tax.

So, as a practical matter, when the taxpayer turns to the use of these schedules, he has got to make several computations to find out what he thinks he had better do.

Usually he must make three or four computations, and if you add in the fact that he may have a deficit or that he may have indebtedness—each one has several branches—he has got to make several, and then find out what is the lowest tax, and in the light of these several schedules, actually go back and determine what he is going to distribute. That can be done, but I have tried it in several cases and it takes a great deal of computing to get the data to really approach this tax. That of course is the method; it has an element of uncertainty in this method of doing it which is somewhat of a deterent, but there is a

stronger difficulty than that. By reason of the fact that if after the determination is made, the taxpayer finds in a later year that the Bureau of Internal Revenue under its able direction and personnel, finds that there is more income than the taxpayer, who may be a little more conservative, thought there was, an additional income is added on for the past year, and then what happens? When you add in say ten or fifty for one hundred thousand dollars additional income for a past year, you cannot go and just figure how much that adds to the tax, as you can now.

Now, if you add $100,000 income in, you figure it is 15 percent ordinarily, or $15,000. Here you cannot do, because the tax is not a percentage of that additional income. The tax is a new percentage of the entire income, including that already tax-paid, and may be a very surprising fraction of any additional amount that is added in.

Now, confronted with that situation under this structure of this law, the taxpayer cannot go back and say, "I will distribute some more of that additional income that you now say I have as the result of this recomputation." Oh, no; the door is closed. The year is passed, the chapter is written for that year, and if that income is added in by reason of a shift from another year, a difference in inventory or anything of that sort, that imposes a large and unknown additional burden which the taxpayer is powerless to deal with by way of a distribution.

Senator COUZENS. Do you mind an interruption?

Mr. BALLANTINE. Certainly not, Senator.

Senator COUZENS. Was that situation that you described true before the bill was amended on the floor of the House, when there was 2½ months right after the close of the year?

Mr. BALLANTINE. That was a very important amendment, Senator, which affects the workability or nonworkability of the bill. It does not touch that point, but it does this. Unless there is a period after the close of the taxable year, the year for which we are determining the income, in which the corporation can determine its distribution, I do not see how this measure could possibly work at all, because at the end of a year there are all kinds of adjustments, in many corporations, which have to be made. Then when they finally take and look at their inventories, they go over their accounts receivable, they look ahead at their problems, and they cannot make an accurate determination within the year. There must be some period in practical experience after the close of the year for any enterprise of any size to determine its income.

Now, this House change abolished the dividend year provision which was made in the original draft, and that, I take it, Senator Couzens, is what you are referring to. That has this effect, that you have got to make your account up before the close of the taxable year of what you distribute so as to win these very great exemptions.

Now, what was said then, that if you distributed too much, you got an extra dividend credit, that applies over on the next year, and that is true under this bill, but suppose you have distributed too much and you did not have that much income, and you had thereby impaired your capital? Then you have not only distributed or tried to distribute, what you did not have, but you may under the laws of my State of New York, for example, have committed a criminal offense, so you are speculating with a very serious matter.

Senator COUZENS. In that connection, may I ask if an administrator or a management analyzes its monthly trial balances from month to month, is the situation as bad as you predict it to be?

Mr. BALLANTINE. Not for all, Senator Couzens, but for some. There are some businesses where you can keep pretty accurate track from month to month. Financial businesses and things of that sort—but when you take a manufacturing business of many types, where inventories fluctuate, the value of the closing inventory at the end of the year makes a great difference.

Senator HASTINGS. Before you leave that subject, I would like to, in order that I may be certain that I have the point in mind that you are illustrating ask you this. Suppose, for instance, you have a net income of $500,000 for the year 1936 according to their account, and therefore pay no tax but distribute $500,000 to your stockholders, and then when the Internal Revenue comes along and discover that they had made a mistake and it was $100,000—they do not discover it for 18 months afterwards, perhaps—that means if I understand you, that the company has to pay to the Government $42,500.

Mr. BALLANTINE. Well, if it distributed $500,000, Senator Hastings, it would have a dividend credit of $500,000.

Senator HASTINGS. I am assuming that the company itself figured $500,000.

Mr. BALLANTINE. And distributed it?

Senator HASTINGS. And distributed it.

Mr. BALLANTINE. Yes, sir.

Senator HASTINGS. But the internal revenue came along afterwards and find that instead of $500,000, it ought to have been $600,000, and they assess them for the extra hundred thousand. It is not possible for them to make that distribution?

Mr. BALLANTINE. That is right.

Senator HASTINGS. And they assess them $42,500.

Senator COUZENS. No.

Mr. BALLANTINE. The tax situation would be this: They then would have a total income of $600,000, against which they had distributed $500,000, and they would have retained 20 percent, and they would pay a tax on that rate.

Senator HASTINGS. That is right.

Mr. BALLANTINE. Your illustration would require the discovery of more income. Suppose it was $500,000 in your case. Then you begin to get into the high figures.

I want to come back just a moment to Senator Couzens' question, because that House amendment does not change the situation with regard to an error discovered after the taxable year is closed and the period of distribution is over. That is, suppose it is a year later; it does not affect that situation. It affects what you do in the taxable year.

Senator COUZENS. Yes, but it does give you 2½ months, the way the Ways and Means Committee reported the bill, to discover any probable errors.

Mr. BALLANTINE. That would be clearly indispensible from the practical standpoint for corporations, many of them if not most of them, to decide intelligently.

Senator COUZENS. I mean that the 2½ months which was originally in the bill did give them an opportunity to straighten out some of those difficulties which you contemplate.

Mr. BALLANTINE. Yes, Senator; that would be a help, but there are corporations that felt that period of 10 weeks was too short for them, but even if you had that, you come into a difference of opinion a year or two later on the question of what your inventory should have been or what your obsolescence allowance was, and then you get the problem that I was first talking about.

Senator HASTINGS. I do not want to interrupt you too much, but I suggested and I was wrong in my calculations, 42.5 percent. As a matter of fact you would pay the Government on the same basis you would be if you had kept $100,000 in reserve.

Mr. BALLANTINE. That is right. It would be just the same.

Senator HASTINGS. And that amounts to $44,000 instead of $42,500.

Mr. BALLANTINE. Well, no——

Senator HASTINGS (interposing). If your total income was $600,000 and you reserved 10 percent on that, it is $40,000 or $24,000; and on the next $40,000, it would be at the rate of 50 percent, or $20,000, making $44,000.

Mr. BALLANTINE. Did I understand you to say you reserved 20 percent of the entire income?

Senator HASTINGS. No; I reserved the first 10 percent on the $600,000, which would be $60,000. On that you would pay 40 percent or $24,000, and on the next $40,000 that you reserve, which is in another bracket, it is at the rate of 50 percent, so that you actually pay 24 and 20 or $44,000.

Mr. BALLANTINE. If you turn to that chart I have, there is the figure of 20 percent and the rate at 20 percent is 9 percent.

Senator HASTINGS. Nine percent of what?

Mr. BALLANTINE. Nine percent of the whole income.

Senator HASTINGS. That is the point.

Mr. BALLANTINE. It would be 9 percent of the whole income. Oh, yes—it would be 9 percent of your entire income; that is right. Or as applied to the $100,000, of course it would be $54,000; yes. I think we are together on that.

Senator HASTINGS. Yes.

Mr. BALLANTINE. As we understand it, the justification for this plan of establishing these new taxes to be avoided by distributions by the corporation is the idea that as corporations retain reported income from distribution, the income so retained and hence not passing under surtax is to be regarded as avoiding the surtaxes, so we must correct this avoidance, and the basic idea it seems to us which underlies this tax, is whether or not it is sound and wise nd just to regard what corporations retain for the protection and preservation and development of business and so much withheld from tax and created avoidance.

Of course, there cannot be any difference of opinion as to the case of corporations that are unnecessarily retaining income which they could distribute for the purpose of escaping the surtaxes. We have always attempted to deal with that problem in the law, and we have the provisions now of section 102 and section 104 which seek to reach that by imposing a penal tax of 35 percent in the case of the ordinary business withhold corporation, and the personal holding company reaching a tax of 40 percent. Those provisions do seem to us to be real weapons to attack the evil of what we regard as real tax evasion.

If they are not strong enough, there is no opposition on our part to strengthen those weapons.

But we believe that the inability to attain perfect enforcement of those provisions, and that admittedly presents difficulty, is far from a justification for treating an ordinary corporation case where it is retaining legitimately as they think, and honestly for purposes of the business, as coming under any kind of penalty on evasion. We say that is a very different thing to do.

When you come to the case of the ordinary corporation, of course it is true that the great bulk of the business of the country by which we all live, and the Government lives, is carried on by corporations, and the use of the corporation medium is open to every individual or every partnership that chooses to take advantage of it. There is no bar whatever against using that corporate form, and the only reason they do not use it is because they do not wish to use it.

Senator COUZENS. Is there not another difference, Mr. Ballantine? If a small corporation has an income of ten or twelve or fifteen thousand dollars a year, as a corporation they pay much higher rates than they would if it were distributed among individuals.

Mr. BALLANTINE. That is true. In paying the flat tax and only getting 4 percent exemption for dividends.

Senator COUZENS. Yes.

Mr. BALLANTINE. But let us look a little further than that. In that case, they would pay more as a corporation; that is true. But the kind of enterprise that is usually incorporated is usually an enterprise that very much passes that point. It is an enterprise that potentially at least may grow large. It is an enterprise that is carrying on some continuous activity which is going to endure from year to year, and which has got to be looked at as a continuing activity. It seems to me that the difficulty here is in failing to distinguish between operations regardless of the corporate form, operations which are of a nature continuing operations which have to be judged and appraised and their productivity determined over a period of time; and operations which are really closed in the particular year in where they do or do not yield income but it is a final chapter in that year.

If there is injustice on business in the individual form or the partnership form, because that is really the kind of business entity that I am talking about, then we say the true relief to that situation if there is no practical relief in all cases by their ability to incorporate, would be to permit the same kind of reserves to be made in that case as are made in the corporation case. We say that they actually have an avenue now through using the corporation form——

Senator HASTINGS (interposing). Mr. Ballantine, just before you leave that subject. I want to see whether there are not some exceptions. You say that the opportunity to incorporate is open for everybody.

Mr. BALLANTINE. Yes.

Senator HASTINGS. We have had some figures here showing how many partnerships are in existence, and the large business they are doing; but is it not true that stockbrokers cannot incorporate?

Mr. BALLANTINE. It is, now.

Senator HASTINGS. So that there is a rather large group that are excepted from your general statement that everybody can incorporate?

Mr. BALLANTINE. Of course, a large number of partnerships included in those returns are undoubtedly professional partnerships, legal partnerships, engineering partnerships, partnerships of that sort where the problem does not fall in the class that I am speaking of at all. When a lawyer gets through the year, he knows what he has had and what his tax-paying ability is. He has not any inventory; he has not got to face new plants or anything of that sort. He may have to learn a little more law, and he certainly does these days, but he has not the same problem that a business has.

That, I imagine, takes a very large segment of those partnerships. I believe that the businesses, the manufacturing, the industrial enterprise, are usually incorporated, and it would be very interesting to see those figures classified by the nature of the activity carried on.

Senator GERRY. The stockholder can incorporate, can he not?

Mr. BALLANTINE. He cannot under the rules of the New York Stock Exchange. A broker cannot be a representative of a corporation. That happens to be true in that case, and no stock exchange firm can incorporate.

Senator HASTINGS. That is a very large group, is it not?

Mr. BALLANTINE. Yes; that is a large group.

Well now, then, looking at the enterprise that I am talking about, which I say economically, regardless of whether it is carried on by the corporation as most of them are, or otherwise, is a continuing thing in business, the annual determination of income which is reported, no matter how carefully you make it up, is not an indication of how much you can presently take out of that business by way of distribution. When you get through the year or approach that business at any particular time, you have got to look first, it is true, at the increase in assets during the year. That is what we really mean by income, the increase in assets. But then you have got to look at the form in which those assets are at that particular time, which is a vital question, because if you are expanding that business and those assets are in the form of a plant addition, or inventory, or accounts receivable, or new machinery, the fact that your assets have increased during the year does not mean that you can take those assets out and make distributions.

Surplus is, of course, a bookkeeping liability entry. The other side of the account, the left side has got to tell the story as to what you have got in the way of cash or things that you can actually distribute to your stockholders.

Now, there is a third element in determining what you can distribute, and that is your look at the future. That is a perfectly indispensable and a perfectly genuine consideration in approaching the problem, because if you have got an inventory that you take at a certain market figure, and we all know how this has been in recent years—how it was in 1921 and again in 1929, when corporations that had large inventories took them at figures at the end of years which were perfectly all right on the basis of the market, but where those of good judgment knew that they were dangerous to that scale of prices, and that in the course of a few months or a year or as a matter of time, that value might fade away, with the result that it would more than wipe out the profit of the year.

And of course they have got to look at the state of their accounts, and they have got to look beyond that, especially in these days when

so many things are changing. They have got to look at the continuance of their processes, their relations to their competitors, the obsolescence of their machinery, the coming in of new trade ways. All of those things come into the picture as to what you can honestly and fairly take out of that business and hand over to your stockholders.

Now, if you take the report then of the business for a particular year, and treat all businesses alike, and say that if it showed so much gain, then we are going to make you distribute in effect or induce you to distribute—because that is what the bill does—it induces you, it does not make you, it induces you to distribute, and I think the mere report of income does not show what you should properly and rightly and justly do. That, we say, puts the corporations and the industries in this country into uneconomic and dangerous practices.

Now, as a matter of fact, this having a corporate reserve, this retention of part of income from year to year, grew up in this country long before there was an income tax or there were any income tax considerations to influence it. It grew up not to avoid taxation but to avoid disaster to the businesses, and if we desert that and place undue stress on mere determinations of income, without prudent judgment of the needs of the business, we are going to put those businesses on the way of disaster again. These surpluses which corporations have accumulated, of course, have not prevented distributions. You have the figures from the Treasury Department, and as I understand if we go back over the years from 1921 up to 1933, 13 years, they show upwards of $10,700,000,000 more distributed in dividends by corporations than corporations earned in that period. They drew to that extent on prior earnings, and the fact that earnings are retained for the time does not mean that they won't be distributed.

Senator KING. Prior earnings or, and in some instances, an invasion of the capital structure?

Mr. BALLANTINE. Oh, yes; that happened particularly for continuing these businesses; those reserves.

And that brings us just to the point—that the reserves which corporations had were powerful aids to the meeting of the depression. I know that it is very easy to say that because we had this policy and because our corporations had the reserves, and we still had the depression, and that that was so terrible, that there is nothing in the reserve idea, because it did not stop the depression. You might just as well say when the ship goes down that there is nothing in the lifeboats because they did not stop the storm. The reserves saved lives in this economic storm.

This compilation [indicating] of the Department of Commerce, the national income produced, published here November 1935—a very interesting compilation, as I understand it, and it shows that all business during the 5 years, 1930 to 1934, paid out 26.5 billion dollars more than was produced by those businesses.

There, Senator King, you were certainly drawing on capital, drawing on reserves; you were perhaps borrowing, but you were also drawing mainly on these reserves which had been accumulated from this past policy. There cannot be any doubt but those reserves cushioned the depression and were a powerful help to employment and

toward recovery, and there cannot be any doubt that we need the creation of just such reserves to guard against future troubles which we cannot be exempt from.

At this very time when under legislation that you have passed, the social security legislation, we are starting out to make and build up great reserves that the Government wants, that may reach fifty billions of dollars, according to the schedules that we have, to protect employment and to protect old age, this measure would stop corporations from the practice of accumulating reserves which have been a practicable and a socially valuable method of dealing with security in the past.

Of course, it is said that it is not the purpose of the measure—and I am not discussing the measure in reference to purpose other than revenue-raising purposes—to check or prevent the accumulation of reserves. It is conceived as a sound and fair revenue measure. We say now that the economic effect of this measure is going to be prejudicial to the regular corporation and industrial activity, and hence to threaten ultimately the source of the revenue and social security.

It is said that corporations can take care of their financial needs by one or both of two ways. In the first place, it is said that they can make reserves to provide for their needs because they could retain up to 30 percent of their income and pay only 15 percent on the total income, which is what they pay now. And it is true. That is the way that the schedule is laid out, but that is not the story as it is going to come up to corporate executives under this plan.

If it were true that corporations could retain as much as they do now but pay no more taxes, it would seem that the bill would accomplish nothing anyway. It changes nothing. The bill does change something, and it changes it vitally, and why?

The percentage of cost, if a corporation saves this 30 percent, is 15 percent of the entire net income. That of course, is 50 percent of the 30 percent that you are saving. In other words, the corporation management has got to say that if we save this 30 percent we are going to pay half as much as that in the form of this tax. It is idle to say that you would have had to pay the 15 percent anyway. Last year's business is over. It does not make any difference if the corporation is paying something now which it did not pay previously. If the man next door is buying something for half of what you are paying now, it certainly is no answer to the proposition that you are paying no more than before, and you are certainly not in an equal competitive position with him. What keeps you in a fair competitive position? What is our business practice under the present rules?

Senator HASTINGS. Mr. Ballantine, have you observed that after you pass the 30 percent, you have called attention to the fact that the first 30 percent costs you 50 percent on what you save; but if you want to run that up to 50 percent, the next 20 costs you 100 percent of what you save—that is, 100 percent of the next 20 percent?

Mr. BALLANTINE. Yes. If you run up to the full 57.5 percent, the percentage that it costs you of the 57.5 percent is 73 percent plus. And you might know that even if you save this little 10 percent down here at the foot, and pay 4 percent on your entire income, that is 40 percent of the 10 percent that you are saving. I am not talking about schedule 1, the ten thousand; but taking those above ten thousand, your premium, the price that you pay for making this saving out of earnings, is from 40 percent of what you save to 73.9.

Senator HASTINGS. It is higher than 73.9. The 73.9 is on your total; but on your first 10 percent, it costs you 40 percent.

Mr. BALLANTINE. That is right.

Senator HASTINGS. On your next 10 percent it costs you 50 percent, on your next 10 percent it costs you 60, and on every 10 percent beyond that it costs you 100 percent. I think I am correct; I checked that over. And while your average may be 73.9, the point I am trying to make is that after you have passed 30 percent and you want to save another 10 percent for reserve, then you have got to give to the Government 10 percent. If you save $10,000 out of your $100,000 income, after you have passed the first $30,000, then when you come to the next $10,000, you have got to give the Government 10 in order to save another 10.

Mr. BALLANTINE. Senator, on the computation of the tax on this, I am going to rely on my chart. When I started to look into this I said, "I have got to get on a chart and ride it", and I have the chart and that shows me what the working basis of the tax is, and I think it is right.

But at any rate, the directors have got to face an answer to their stockholders on the percentage that they are willing to pay the Government for what they save. That is a very onerous question for a board of directors to decide. They may sit around the table and say "Well, we think these inventories may go bad; we do not think that the old no. 2 machine is quite what it ought to be, and this fellow next door has got something that looks pretty good"—but after all, they say, "Can we go out and tell our stockholders that you just have to save this money to the tune of 40 or 50 percent?"

That is how they have to vote, but when you come to a minority stockholder—that is a very popular thing these days—minority stockholders, and some of it is right—but when they check up and we have got to put down and justify as a matter of definite argument the retention against that cost. If they had to say to their stockholders, "We are going out and will get $50,000 of new money for this concern to do some given things and we are going to pay $25,000 to do that—that is what it is going to cost for this piece of financing", what would the stockholders of that concern say to that kind of finance?

So you put to the board of directors a very difficult problem. You put them in the hot spot, and you offer the most powerful inducement to make the determination of questions that may be vital to the life of that corporation and the continuance of its employment turn on this question of tax avoidance and not on the question of general business judgment.

Senator HASTINGS. Mr. Ballantine, I beg your pardon if I interrupt you again. Referring to your own chart, up at the right-hand corner, "Undistributed net income", you have $30,000?

Mr. BALLANTINE. Yes.

Senator HASTINGS. And then over there a $15,000 tax.

Mr. BALLANTINE. That is right.

Senator HASTINGS. You jump from $30,000 to $40,000 in your undistributed income?

Mr. BALLANTINE. Yes.

Senator HASTINGS. That is an increase of $10,000. Your tax jumps from 15 to 25, which is 100 percent. That is the point I was trying to make. In order to increase your reserve from 30 to 40, you have to increase your tax from 15 to 25.

Mr. BALLANTINE. Yes; you do.

Senator HASTINGS. Which, on that 10, is 100 percent.

Mr. BALLANTINE. You do increase it from 15 to 25.

Senator HASTINGS. And the same all the way through the balance of the bill.

Senator COUZENS. It is no more fair to take that percentage of the held reserve than to compute it on the whole income; in other words, it is not fair to figure the percentage based on just what you reserve, but it should be computed on the whole year's income.

Senator HASTINGS. But the point Mr. Ballantine is making and the thing I think ought to be made clear is that the stockholders are going to say that "in order to put in $10,000 more, you have taken from us, and we are in the 4-percent class—we don't care anything about these fellows that pay the 74 percent—we are in the 4-percent class—you have taken $10,000 from us in order to add $10,000 to your reserve." This makes it clear, as I see it.

Mr. BALLANTINE. I wonder, Senator Couzens, as to that suggestion you have just made. Of course, when this was proposed, it was suggested that the tax on corporations would be about 33⅓ percent on income if retained. Then when the bill actually came to be drafted, we had this plan of making the percentages on the whole income vary with the undistributed and we have this result. Now, I believe that has a very practical effect on the actual decision, because as far as the director is concerned, Senator Couzens, I cannot see why he is not faced with the single question on the financial side of it, of such a percentage that he is going to have to pay to the Government against such a saving. It does not make any difference to him whether you figure it on the whole income or how you figure it. It is a question of how many dollars they have to part with to keep so many dollars in the Treasury. And that is all that I am talking about when I used that percentage.

Senator COUZENS. May I distinguish this point, that if you pay the flat corporation tax, it might be up there whether you had any tax on undivided profits or not?

Mr. BALLANTINE. That is true, Senator, but you certainly have eased the position of the director, because he has got that bill to pay the Government anyway, and then he decides as a pure business question what he does with the remainder. Now, what he does with the income determines the Government bill. That is quite a different situation.

Senator GEORGE. Mr. Ballantine, on the point of the minority, won't your trouble be very much more acute when you have a speculative minority holder who buys into a corporation not on the basis of the bona-fide permanent investment, but just merely speculative?

Mr. BALLANTINE. Yes. I think, Senator George, you do touch on a very important point. You change the way stocks are regarded. Someone may acquire stock in the expectation of an immediate division. After that, he does not know. These corporations have to pay out as they go along, and they become inherently very much more of a speculation. All stocks are going to be made more speculative

by this plan of making them clean up as they go along. It does change the picture.

But the other thing that is said that the corporation can take care of itself and provide for its reserves by means of sales of stock; particularly sales of stock; that it pays the dividends to those stockholders and then offers them rights to subscriber, and they exercise these rights, and that brings in the capital that the corporation needs, and, therefore, you have not got a question except between financing out of the retention of earnings of the corporation, and financing by means of sales of stock.

Well, now, let us look at that a little bit and see whether that is truly practicable. Of course no one can underwrite the corporation's ability to sell stocks, and right at the first go-off, if you pay our dividends and substantial parts of them go in taxes to the Government, as they must under this plan, up to the 79 percent that money is gone, and it is not available to come back to the corporation issuing the stock or to any other corporation. That money that was mobilized at the point where these investments were desired in these businesses is disposed of and gone. It has got to be replaced from money from some other source if you really need it.

Well, now, what the stockholder——

Senator GERRY. Can I ask you a question there, Mr. Ballantine?

Mr. BALLANTINE. Yes, sir.

Senator GERRY. In the case of a copartnership, if the partnership pays the tax—the partner—then he has paid it once, whatever he pays on?

Mr. BALLANTINE. That is right.

Senator GERRY. And if he wants to distribute, is there anything in this point—I do not know that I am clear on this—he does not have to pay a tax if he distributes that capital in the future?

Mr. BALLANTINE. There is no tax whatever on the withdrawal from a partnership.

Senator GERRY. In a corporation, if he pays the tax as in this bill here, the corporations have to pay a tax again if it is distributed?

Mr. BALLANTINE. Not the corporation; but the stockholder would I mean, the corporation may retain a certain part——

Senator GERRY (interposing). I am not sure about that.

Mr. BALLANTINE. Let me see if I can say that. The corporation pays a certain tax. It might be 30 percent—let us say it is 15 percent. Then later on, it has got to be distributed to the stockholders. That distribution is subject to the full tax in the hands of the holder. There is no credit as there is now for the normal tax in respect of that distribution, and it does not make any difference either if the corporation paid 42.5 percent on it and it is paid to the stockholder, he still pays the normal and the surtax on that distribution. That does not count—the corporation payment—under this plan, and that is the essence of the plan.

I was talking about the sale of stock and saying first that part of the available investment disappeared. The second consideration is that the aspect of the investment in a corporation is going to assume a different look, because you have got to invest in a corporation that, by and large and generally speaking, and just so far as this bill is effective, is going to be distributing currently as it goes along, and it is going to face the hazards of this new time in which we live.

That looks less attractive as an investment, a corporation which cannot protect itself and make reserves and meet new situations, meet the floods such as they have come up here. The stockholder is going to think twice if he is a true stockholder and an investor, such as Senator George is referring to, about going into that.

Well, what does he do? That is a very practical question. Of course, it makes an added attraction to tax exempt bonds. Perfectly true they are somewhat limited in amount, but they are not totally unavailable. It creates incentives to go into other things.

Besides, there is another very practical question. If you are going to get back capital, you have got to make a definite story to the stockholders. If you are going to build a new factory or acquire some other business or something of that sort, you can go and talk to your stockholders and say, "Here is the plan, and here is the picture of the factory."

But suppose what you are afraid of is that your inventory is not solid. Forgive me, Senator Connally, for saying, the price of cotton is going down, or something of that sort.

Senator CONNALLY. Put it up.

Mr. BALLANTINE. That is not so bad. I would like to see it as much as you would. You are afraid that there is some hazard coming to this business that you do not like to talk about. You cannot go, in prudent management, and make a picture out of it to stockholders and say "Protect against these possible casualties and divers things that may happen to our business; please buy some stock." It just is not the real thing that you can do.

So you take your chances and you do not do this financing, and then this distribution plan works, and then your corporation is left in this weakened position. So it seems to us that you are hurt in the end, that you are hurting in the end the main stream of business income upon which all of us, including the Government, depends.

Now, so far as the sick corporation is concerned, that has got a deficit, coming out of all of the trouble we have had with a deficit, and of course it is hurt. It is perfectly true that there is a provision in the bill for it to build back at the rate of 15 percent the amount of that deficit on its books, but there is no provision for any help to that corporation to build back a healthy surplus or get itself really in the situation that perhaps it used to be in. All it can do is to get even. After that it falls under the full pressure of this distribution policy.

And in the same way with the debt corporation. There is some provision for corporations that have got to take care of debts, but it is a very, very moderate provision. In the first place, you only count debts that exceed the surplus of the corporation. That is as if the surplus which, as I have said, may be in the form of the factory, the inventory, and the accounts, was available to pay the debts if you chose to draw a check on it and pay those debts. Furthermore, even where you have got the debt excess, and the debt excess is all that is dealt with, the debt is only a debt that had a maturity of 3 years for some reason, or if it is a short-term debt, a debt which is determined by the Commissioner to represent an old debt, and his judgment is to be final—and I would be perfectly willing to trust the Commissioner on that particular point; but apart from that, it is a limited provision.

No debt of a maturity for less than 3 years counts unless it is determined by the Commissioner to have been incurred more than 3 years ago. So you have got a very limited debt help provision in this structure. And if you are going out now and borrowing and having your earnings available to help you, of course you are deprived of that. Under this bill the corporation has only 57.5 percent of its earnings at the most to borrow and help itself with and not the former 85 percent. The credit of the corporation is weakened by the fact that they cannot deal with their earnings to pay obligations.

Now, such financing as has been done of late by the banks under some stimulation have been making long-term loans, to go out and help corporations to rebuild and rehabilitate themselves and help the employment problem. And to do that they are looking for payment out of their earnings. But those debts that are incurred now, that kind of transaction is prejudiced if the corporation cannot take that necessity into account and it cannot do it under this bill.

And so far as a new corporation is concerned, one that is coming up, or the old one that is coming back, as compared with the corporation with a large surplus, it is subjected to a great prejudice. A corporation that sits with a large surplus by reason of this policy in this past, can make fuller distributions, it has contingencies provided for; but the new corporation, and the new man who is coming up, whom we need to do new things and always keep the stream of industry going, that factor that is so constantly necessary under our system, has a bar put in his way by being told that he cannot accumulate surplus without having to make all of the distribution called for in this bill. So it tends to keep the small enterprise small and to favor the large and developed industry in holding its position.

When all is said and done, I think it is clear enough why businessmen that look the revenue problem in the face and the economic problem in the face and who are anxious to do their part in meeting these problems want to come and say to you that they fear, they genuinely fear, the broad and lasting effects of this bill, and when it is suggested that all it will gain for a year, the first year, is some $310,000,000, they want to say to you that it is altogether too much risk to take for that immediate revenue. Turn to other and more understandable and more readily available taxes, until at least this measure has been worked out with far more care than was possible in the time which has been at your disposal, and they believe that you ought to get more revenue.

The CHAIRMAN. Now you are getting on the constructive side.

Mr. BALLANTINE. Yes, all right, Senator. They have got the view that you have got to, with a deficit such as we have and such as you have been told of here. Of course more revenue is needed. Of course, reduction in expenditures is vitally needed, and all of you feel that just as much as any of us can possibly feel it, but the mere gaining of more revenue and facing the revenue problem head on is going to help in meeting that vital expenditure problem.

And so we say when so much revenue is specified to be raised, turn first, we have said, to the income tax. It is the belief of this organization that now the upper brackets have been pushed very much beyond the British brackets, and that the lower brackets should be made more productive, as they are in England, and that that is something which

you can turn to, and which could be readily done with benefits to the revenue. If that does not yield enough revenue, they suggest that we use further selective sales taxes to add to the revenue, and that while these things are done as emergency measures, the matter of vitally changing our tax structure, changing the whole basis of corporation taxes, known to be productive, and which has helped the Government so much year after year, be not remade for the sake of a possible 10 percent increase in total revenue; but that that subject, so many-sided, so vital to our economic life be further studied so that we can evolve a sound permanent tax structure that does not involve this experimentation.

Senator COUZENS. Has your association given consideration to the extent that they would be willing to have the corporation tax raised as distinguished between enacting this bill?

Mr. BALLANTINE. No, Senator Couzens, they have not deliberated on that subject of increased corporation-tax rates.

Senator COUZENS. What would you say as an individual and as an ex-Treasury official with respect to that, rather than enacting this bill?

Mr. BALLANTINE. Speaking in that capacity which I am called to do, as long as I am not speaking as representing the association, I would rather see some reasonable increase in the corporation rate which would not bring the hazards that I have been speaking about. I want to say that I do not think you have reason to get all of the additional revenue that you are speaking of here, from the same source. You have not got to turn simply to increasing the flat corporation rates, for example. You can turn to a combination of that with increases in the income tax.

Senator KING. What do you think of this proposition, lower your exemption to $800 for the unmarried, $1,500 for the married man; increase your normal tax from 4 percent to 6 percent, and then have a gradual and harmonious increase in your income tax starting in from those lower brackets on up into the highest, and particularly lifting the rates from this—I was about to say abyss between $20,000 and $50,000, because I think that they are not harmonious in their graduation from the lower to the higher. What would you say to a proposition of that kind which would raise perhaps four or five or six hundred million dollars, in contradistinction to the present bill?

Mr. BALLANTINE. Well, Senator King, I cannot speak for the Merchants Association on that.

Senator KING. I understand that.

Mr. BALLANTINE. On a particular schedule or plan of rates. And I want to get that very clearly of record.

Speaking for myself in the capacity that Senator Couzens spoke of, I feel perfectly certain that we must increase the lower rates of tax. I feel that it is just as sure to come as the sun is to rise, and that we need to do it to get our whole Government structure sound, and the sooner that problem is frankly faced and dealt with, the sounder this Government is going to be.

Senator KING. Would an increase from 4 percent to 6 percent normal, coupled with the other suggestion which I made, present any incongruity or any unharmonious advance?

Mr. BALLANTINE. I think the normal rate can be increased properly. When you come to make the exact schedule, of course you have got

to look at the yields and look at the present pattern, and I would not want to go too far with a personal expression offhand.

Senator KING. I understand.

Mr. BALLANTINE. I think the sort of thing that you are indicating, Senator, is the phase where we can get real help and permanent strength for the income structure which we need.

Senator KING. Perhaps I was a little unfair to ask you when you did not come here as a witness in behalf of the scheme which I have suggested, to divert you from the field which you came here to explore, but I thank you very much.

Senator BARKLEY. Is it not a fact that people who are in the lower brackets subject to Federal income tax are very largely the same people who pay the great bulk of local taxes, State, county, and city, and other local taxes, and that when you add the great mass of local taxes paid by these average property owners and average income earners to the present normal income tax in those brackets, that the amount of tax paid by them in proportion to their earnings is greater than it is, but much greater than it is in some of the higher brackets?

Mr. BALLANTINE. I think it is true, Senator Barkely, that people in the lower brackets do pay local taxes and that their whole tax picture is not indicated merely by having so much income tax. I do not know how the statistics would work out. But while that is an objection, and a difficulty about this, and everybody must recognize it, and it is too bad to put any additional tax on those people, they have got a tremendous stake in the working out of our whole Federal financial problem, and they have got to make sacrifices, and furthermore, I believe they will make them if the people come to understand that they have got to get under this load and do their share, and I believe they will be ready to do their part.

Senator BLACK. Mr. Ballantine, do I understand that the Merchants Association of New York is endorsing the sales tax?

Mr. BALLANTINE. Not the sales tax in the sense of a general sales tax, Senator. They spoke of the selective sales taxes.

Senator BLACK. I thought it was very unusual for a merchants association to favor any kind of sales tax. I was interested in that feature of what you said.

Mr. BALLANTINE. No, they did not endorse the general sales tax. They referred to the selective sales taxes, and those taxes which were recommended, as putting back any kind of sales tax or processing tax, would fall under the head of the sales tax.

Senator BLACK. Did they recommend any items in particular?

Mr. BALLANTINE. No; they did not recommend particular items.

Senator BLACK. May I ask you a question about that lower income tax bracket? From your experience, you will probably be able to answer it. Those who pay in the lower income tax brackets, as a rule pay on all of their income without any deductions for losses from various investments in stocks and bonds and corporations, and so forth, do they not?

Mr. BALLANTINE. Well, those who pay—the less total there is, the less hazard probably there is from their investments, Senator; yes, Senator.

Senator BLACK. Even a smaller percentage of the lower income tax group would probably result in a greater percentage of actual

collection by reason of the fact that they do not have losses in other lines of business activity, such as stocks, bonds, and depreciation?

Mr. BALLANTINE. No; they do not have those factors. Ordinarily it is a salary or wage compensation, and there are not offsetting factors. Of course, those offsetting factors that you referred to actually affect taxpaying ability, but I take it that was not the point you had in mind.

Senator BLACK. No; that was not the point I had in mind. One other question. You live in New York, do you not?

Mr. BALLANTINE. I do.

Senator BLACK. You do not believe that a man can live in New York on $800 a year in such a manner as to encourage the assessment of taxes on him——

Mr. BALLANTINE (interrupting). You need not go ahead with the manner; just leave the manner out and I will answer your question that $800 is a very tough proposition regardless of the manner.

Senator BLACK. You do not claim any tax on an $800 income——

Mr. BALLANTINE (interposing). Of course, that is a single person.

Senator BLACK. If that is all that he made in New York, do you think that he could very well pay an income tax in addition to what he already has to pay?

Mr. BALLANTINE. He is in a very tough situation; there is no question about that, but what has he got to think about? He has got to think——

Senator BLACK (interposing). He has a lot to think about living on $800 a year.

Mr. BALLANTINE. Yes; he has plenty of time to think if he has got only $800. But he has got to think of where New York is going to get off and what is going to happen to that city and to his interests, and so forth, if we do not get this job done. He has got to pay out something, under the general heading of insurance for the financial future of this Government.

Senator BLACK. Would you favor imposing a tax on an $800 income?

Mr. BALLANTINE. Well, the $800 was to be exempt, Senator, to be exact, under the proposition.

Senator BLACK. Would you favor imposing a tax on $801?

Mr. BALLANTINE. It would be a very moderate tax, Senator.

Senator KING. There would not be much tax on $1.

Mr. BALLANTINE. No.

Senator BLACK. There would not be much on it?

Mr. BALLANTINE. No.

Senator KING. The exemption is $1,000 now, is it not?

Mr. BALLANTINE. Yes.

Senator BLACK. If a man were to make actual profits on his investment or from his income of $100,000, do you believe that he ought to pay income tax on that $100,000?

Mr. BALLANTINE. Yes. You mean irrespective——

Senator BLACK (interposing). Irrespective of the way he made the profit. In other words, you think all of the profits he makes should be taxed?

Mr. BALLANTINE. I certainly think all profits should be taxed. Are you asking me whether I think capital gains should be exempt?

Senator BLACK. Should there be any distinction made in the imposition of a tax if a man actually makes a profit?

Mr. BALLANTINE. You mean earned income?

Senator BLACK. If he makes a profit either from his labor or his investments.

Mr. BALLANTINE. I have always had a feeling that earned income was entitled to a differential; that we should properly distinguish, as they do in England and as we do here to a limited extent; between the earned income and what we call the unearned income—the investment or other income. I think there is a sound distinction in favor of the earned income.

Senator BLACK. That is the man who actually works for it?

Mr. BALLANTINE. Yes, sir.

Senator BLACK. Rather than his investments?

Mr. BALLANTINE. Yes. I think that should be favored.

Senator BLACK. If that is true, and a man invests $100,000 in a corporation, and there is a $50,000 profit made on that investment during the year by the corporation, should he pay on the whole $50,000 that year?

Mr. BALLANTINE. Are you assuming a case where he was the sole stockholder?

Senator BLACK. I am assuming a case where he makes the investment. Let us assume he makes two investments; he makes one investment of $100,000 in a partnership and he makes $50,000 on that.

Mr. BALLANTINE. Yes.

Senator BLACK. He invests $100,000 individually and makes $50,000. Those are pretty big profits, but some people make them. And then he invests $100,000 in a corporation and the corporation makes $50,000 on that $100,000. Should he pay a tax on the $100,000 that he made on the individual activities and the partnership, and not pay it on what he makes on the corporation?

Mr. BALLANTINE. If you can tell me how to make such profits on those investments, I would be very much obliged to you.

Senator BLACK. We have had testimony, and I can give you some figures that jumped from $40 to $6,000,000 in a few years, in corporate investments. Let us reduce it then to $5,000——

Mr. BALLANTINE (interposing). I get the problem of what you are asking about, and of course, that goes to a good deal of the heart of this matter. I have tried to say that if the $50,000—let us take the corporation case first. In the case where the big income reported on his share for the year is $50,000 in the corporation, and then we come to face the question of what should be done with that, I do not think that you can appropriately say that because $50,000 is shown there by the accounting, he should pay the tax on that.

Senator BLACK. Even if it is actually true, and the accounting is right?

Mr. BALLANTINE. Now, Senator, when we come to the investment, even though the accountant's report is correct, that does not end the matter yet, because—suppose that it is a rapidly developing thing like rayon.

Senator BLACK. Suppose the partnership was a rayon business.

Mr. BALLANTINE. All right. I will deal with that partnership aspect as soon as I follow this thought, if I may for a moment. If it

is a thing where there is any trouble about the manufacturing and the processes are rapidly changing, and they may have to take new machinery or there is a big unsold inventory of something of that sort, I say you have got to take all of those factors into account before you can tell what he can properly be taxed on as his own income; that it is not automatically his.

Now, turning to your partnership case, I say if he has got exactly the same thing in the partnership form, then my theoretical answer is that that partnership ought, because it is the same kind of a business, it ought to be entitled to make the same kind of reserve that the corporation does. But it is within the power of the people who own that enterprise to go into a corporate form, and I cannot believe that there are many people carrying on operations such as we are talking about that do not incorporate.

Senator BLACK. They ought to have a right to stay as they are and pay the same amount as a corporation.

Mr. BALLANTINE. That seems to me to be the same as if a man has the right to go and eat in a restaurant. If it is across the street, he cannot insist on having Mohamet come to him. He can go there. If it is perfectly open to everybody, as it is, to use the corporation, and somebody does not use it, then for him to come and say that we should change over the whole tax system and change the treatment of the corporations which, by and large, are our vital industries, and which we say are treated right when they are permitted to take out honest reserves—we say that he, with the corporation form open to him, is in no position to ask us to change our whole practice.

Senator BLACK. I just want to be sure that I am right. Then do you think it is just and fair where a man or three different men have investments, one individually, one in a partnership and one through corporations, and they all make exactly the same amount of profit in the year, that much profit made on each investment, do you think it is right to let the tax paid on the profits made through the corporation be either greater or smaller than the tax on the profits made by the individual or partnership?

Mr. BALLANTINE. We are still assuming it is just the same kind of business in each one of the forms?

Senator BLACK. The profit is the same.

Mr. BALLANTINE. And the business is the same? It is the same kind of industry. It is not different?

Senator BLACK. Without saying what kind of business, the profit is the same. Here are three men; one makes $50,000 profit individually; another makes $50,000 profit in a corporation; another makes $50,000 profit in a partnership. Do you think the parties should be equally taxed on each of those profits?

Mr. BALLANTINE. I say, Senator, that you cannot give the answer merely on the amount of the profit; that that does not give you the true answer. I am assuming that the profit is honestly determined by the accountant, and I still say——

Senator BLACK (interposing). And is the same.

Mr. BALLANTINE. Is the same. I am assuming all of those factors, but now what I am saying is not the same. Take the first individual. He may have made that by operating in the market, he may have bought something for $50,000, and he was fortunate enough to sell it

for $100,000. He had the $50,000 and could pay the tax. I say that he ought to pay the full tax.

Senator BLACK. Should we then change the law as to individuals so as to provide that those who make the money by selling stock should pay more than those who do not?

Mr. BALLANTINE. We are taxing that stock profit as full income on that. We do not have to change the law. But I was going on from that case to the case of the man in the business which I think makes it much clearer to regard as a sort of inherent economic unit. I say if a man has got this rayon business or any business that has got a manufacturing process, that you cannot count profit in the terms of a year; that that business has a sort of real economic entity, and what you should rightly tax as to him is the amount that can properly be determined from that as his own usable or spendable income. I would like to make that turn, Senator, on the character of the business, and not on how it happens to be hung up. I agree with you that if that is all the distinction, that one is incorporated and the other is not, there is nothing to the idea that they should not pay the same. There is no answer to that argument.

Senator BLACK. All right; thank you.

Senator HASTINGS. Your answer is that the individual has the opportunity to incorporate?

Mr. BALLANTINE. Yes, sir.

The CHAIRMAN. Thank you very much.

Mr. TANZER. I should like if I may to say just a few words in conclusion.

The CHAIRMAN. Very well, Mr. Tanzer.

STATEMENT OF LAWRENCE A. TANZER—Continued

Mr. TANZER. I should like to sum up in a few words the principles on which the Merchants Association opposes this measure whose workings Mr. Ballantine has expounded.

We oppose it because it rests on the fundamental fallacy that all income of a corporation, however artificially computed for a particular year, ought to be distributed in that year, and that it is contrary to the public interest or to business interest to keep any part of that for the credit of the business. That, we think, is a fundamental fallacy.

We oppose it because being offered with the professed object of removing inequalities and injustices which now exist, it would create greater new inequalities and injustices. Injustice to the weak concern and the new concern as compared with the old and the rich and the powerful concerns. Injustices to the small stockholders whose share in the corporate earnings would be taxed at the same penal rate as the share of the large stockholder.

We oppose it because at a time when there is a greater demand than there ever was before for social security, this measure would destroy the greatest practical means of social security that now exists, namely, the building up of reserves in businesses.

We are opposing it because while one of the professed objects of this bill is to prevent evasion, to penalize and destroy all sound business practices because of occasional evasion is like burning down the house to get rid of the rats.

We oppose it because as a revenue measure it lacks the first elements, certainly, of an emergency revenue measure because of its administrative difficulties and complexities and the impossibility of ascertaining the tax because of the uncertainty of its yield.

And we ask that at a time when revenue is concededly need that Congress turn to known and tried sources of revenue, and leave the question of radical changes in our tax system for further study and deliberation when they can be properly worked out.

The CHAIRMAN. Mr. George T. Evans of Denver, Colo.

STATEMENT OF GEORGE T. EVANS, DENVER, COLO., REPRESENTING THE SHERIDAN FLOURING MILLS, INC., SHERIDAN, WYO.

Mr. Chairman, may I say for the purpose of the record, that my name is George T. Evans. My address is 328 First National Bank Building, Denver, Colo. I appear as attorney for the Sheridan Flouring Mills, Inc. of Sheridan, Wyo. On behalf of my client I wish to thank the committee for this opportunity to be heard. I find myself in a rather unique position. I represent a business organization of a class of which the committee has heard much but from which they have perhaps heard very little. My client is a small corporation.

The purpose of my appearance here is to present, for the consideration of the committee, the question: Is the proposed tax on unjust enrichment constitutional? But before that main question may be answered, other, and subsidiary questions suggest themselves for discussion, and among them are the following:

First. Have economists heretofore been able to agree upon any hard and fast rule for determining the entity which bears the burden of any excise tax?

Second. Have courts heretofore regarded an unjust enrichment the refund of illegal exactions, similar to processing taxes, to the taxpayers upon whom the duty to pay in the beginning was imposed by law?

Third. Does the due process clause of the fifth amendment to the Constitution have any application to tax legislation?

Fourth. Does the proposed tax on unjust enrichment offend the due-process clause of the fifth amendment to the Constitution?

The first inquiry for consideration is: Have economists heretofore been able to agree upon any hard-and-fast rule for determinating the entity which bears the burden of any excise tax? In searching for an answer to this question, a book published many years ago, by a famous authority on taxation, which has been since that time translated into many languages, and which has gone through several editions, may be consulted. The author is Prof. E. R. A. Seligman, of Columbia University, and the title of the work is "The Shifting and Incidence of Taxation." Professor Seligman takes up the question of the shifting of excise taxes historically, and shows that in the seventeenth and eighteenth centuries, various kinds of excise taxes, to which class processing taxes, of course, belong, had been proposed in England and in America; and that for over 100 years pamphleteers flooded both countries with their arguments as to who bore the burden of a general excise tax, among the writers being those of such repute as Alexander Hamilton, De Foe, and Benjamin Franklin. But appar-

ently no very satisfactory general conclusion was reached then, or since, for at page 373 it is said:

> * * * to follow to its remote consequences the ultimate effects of an excise would demand such an accurate acquaintance with all the facts of the particular economic situation as to task the possibilities of the most subtle and minute analysis.

And an eminent jurist, in considering a case involving the shifting of the burden of an excise tax on sales, and refusing to take a purely legalistic view of the matter, made the following comment—citing in his opinion many economic authorities to sustain him:

> * * * it was assumed that the burden of the sales tax involved was so inevitably passed on to the buyer as to require this result. With this assumption economists would not, I believe, generally agree. Many hold that whether the burden of any tax paid by the seller is actually passed on to the buyer, depends upon considerations so various and complex as to preclude the assumption a priori that any particular tax at any particular time is passed on * * * (Mr. Justice Stone, dissenting, in *Indian Motor Cycle Co.* v. *U. S.* 1931, 283 U. S. 570; 75 L. Ed. 1277, 1284).

Senator KING. May I interrupt you. I understood you were challenging, or proposed to discuss the constitutionality of this law.

Mr. EVANS. Yes.

Senator KING. You base it upon the ground that an excise tax may be invalid under the Constitution of the United States?

Mr. EVANS. No; no. I base the challenge to this on the ground that it may be arbitrary and capricious legislation. I am trying to show here the background in economics of what will perhaps be the situation if an excise tax in the form proposed is levied.

Senator GEORGE. Do you regard the windfall tax as an excise tax?

Mr. EVANS. No; I do not. The processing taxes are excise taxes.

Senator GEORGE. I understand that. You are directing your remarks to the windfall taxes, the unjust enrichment?

Mr. EVANS. I am, Senator. I am trying to show here the tax on unjust enrichment may be capricious for the reason that it may be impossible to tell that there has been any unjust enrichment.

Senator GEORGE. I see.

Senator KING. Is not that a question of proof rather than one of a mere legalistic affirmation of a principle?

Mr. EVANS. It is, Senator, and these authorities that I am citing go to show that the question is one that is hardly susceptible of proof.

Senator KING. You may proceed.

Mr. EVANS. Nor did the processing taxes levied under the A. A. A. constitute any exception to this general rule of uncertainty concerning the shifting of the burden of excise taxes, according to the following excerpt from a report by A. A. A. Administrator Davis to Secretary Wallace, dated February 15, 1934. There it was said:

> The question "Who pays the processing tax" cannot be answered by a mere examination of the change in producer, wholesale, and retail prices, and in the final spread between them. It is true that commonly this question is answered in this partial way, without taking into account such facts as the volume of supplies, the rate of consumption, the amounts paid by consumers, the total returns to producers, the benefit payments made to producers from the proceeds of the processing tax, the stimulus to general business activity through increased farm purchasing power, and the improvement in the credit structure of the country through the enhancement of agricultural values. (Agricultural Adjustment, A Report of Administration of the Agricultural Adjustment Act, May 1933 to February 1934, p. 320.)

May we not say, in view of all the foregoing, that, not only have economists been unable to agree upon any hard-and-fast rule for determining the entity which bears the burden of any excise tax, but also that processing taxes, which belong to that class, present no exception to the general rule of uncertainty? And would it not seem to follow that the problem of deciding, from the viewpoint of the economist at least, who was unjustly enriched by the annulment of the processing taxes, is a matter of no less difficulty?

Those are the economic authorities. We submit that they tend to show at least that this problem is hardly susceptible of solution, much less of simple solution, this problem of deciding who did bear the burden of the excise tax, the processing tax.

Senator HASTINGS. Do you propose later to discuss your own situation?

Mr. EVANS. Not in detail, Senator. We feel the detailed situation can be presented by others much more ably than we could. We simply wanted to raise the question of the possible unconstitutionality of the income tax at the rate of 80 percent on these unpaid processing taxes.

The second question for consideration is: Have the courts heretofore regarded as unjust enrichment the refund of illegal exactions, similar to processing taxes, to the taxpayers upon whom the duty to pay in the beginning was imposed by law? We are aided in finding an answer here by several judicial opinions from which the following have been selected. The first decision was handed down in 1927, by Mr. Justice Cardoza, then chief justice of the highest court of New York.

Mr. Justice Cardoza was confronted with a case in which the plaintiff was suing the manufacturer of certain beverages for a share of the Federal excise tax which had been imposed upon the sale to the plaintiff by the manufacturer. On the invoices the selling price of the goods had been stated, and the tax added as a separate item. Recovery by the purchaser was in that case permitted, but Mr. Justice Cardoza was at some pains to distinguish the circumstances and the holding, from what would have been the rule if the tax had been "absorbed" in the selling price—that is to say, if it had been included in the selling price, as processing taxes were in most instances. Said Mr. Justice Cardoza:

> We think the plaintiff must prevail. This is not a case where the item of tax is absorbed in a total composite price to be paid at all events. In such a case the buyer is without remedy, though the annulment of the tax may increase the profits of the seller. (*Wayne County Produce Co. v. Duffy-Mott Co., Inc.*, 1927, 244 N. Y. 351; 155 N. E. 699, 670.)

Processing taxes, except in rare instances, were "absorbed in a total composite price to be paid at all events"; and seem to come squarely within Mr. Justice Cardoza's observation that—

> In such a case the buyer is without remedy, though the annulment of the tax may increase (not unjustly or unfairly be it noted) the profits of the seller.

In another case decided by the Supreme Court of the State of Alabama, Mr. Justice Cardoza's conclusion above cited, was reached in a well-reasoned opinion, where it was said:

> This question should be answered by a determination here of the further question * * *. Was the price paid by the plaintiff the composite price to be

paid at all events for the gasoline and oil? In other words, was the item of tax absorbed in a total price to be paid at all events for the gasoline?

If the tax was absorbed in the total price to be paid at all events, then it would follow, as we see it, that the plaintiff has no right to the money sued for. In other words, if the price charged the plaintiff for the gasoline was placed at such figure as to take care of, or absorb, the tax, and was to be paid at all events as the selling price of the gasoline and oil, the plaintiff is without remedy. His position would be no different than that of any other purchaser of goods who has to pay therefor a price increased by the seller to take care of tariff or other taxes. We take it in such a case, if the tariff or tax should be held illegal, the purchaser would not have a remedy against the seller to recover the amount of the tariff or tax figured by the seller in fixing the price of the commodity (*Texas Co.* v. *Harold*, 1933, Ala. 153, So. 442).

Senator HASTINGS. Suppose in those two instances there had been special statutes in the State of New York and State of Alabama authorizing that particular plant to sue, then the court would not hold that it was without remedy, but would hold, I take it, from your argument, that it was impossible to determine what sort of a verdict to render, and therefore the plaintiff could not prevail; is not that true?

Mr. EVANS. It might be, Senator, but might not this be the view also, that if this tax was absorbed in a price and the customer paid that price, he desired to purchase goods and the seller was willing to sell the goods at a price which admittedly included some kind of an excise tax on the sale, we will say. Might they not take the view that the vendee got what he bargained for at the price that he was willing to pay, a price dictated by the exercise of his careful business judgment in the circumstances? He got what he bargained for at the price he was willing to pay and he must be presumed to be satisfied.

Senator HASTINGS. Yes; but suppose the State should come along——

Mr. EVANS (interrupting). With a statute and then said, "Nevertheless, this tax shall go to the vendee." I assume that is your proposition.

Senator HASTINGS. Yes.

Mr. EVANS. I would depend then, I suppose, on how the challenge was met on the proposition.

Senator HASTINGS. Suppose the vendee put in evidence that the vendor had said time and again that his policy was to include them in the sales price, is there anything then under that kind of statute that would prevent getting it back?

Mr. EVANS. I would think if it were included, as we have outlined, in the selling price by the vendor, the price paid to him, that the payment, including the tax, became his property and it would be unconstitutional for the State, the legislature of the State to say that, according to this rule, he must part with his property. I am speaking of the vendor. I think that would be taking his property away from him without due process of law. That is what I had hoped to show, as I went along.

Still another case, geographically widely separated from the *Alabama case*, but on the facts very close to it, was decided by the Supreme Court of Montana, upon the same theory as that involved in the Texas Co. matter above mentioned. However, in the Montana controversy the State itself was trying to collect the tax that the defendant had incorporated in the selling price of its gasoline; and which

it had not been required to pay over to the State, because the taxing statute had been declared unconstitutional. Said the Montana court:

In the final paragraph of each of the separate causes of action set out in the amended complaint it is, in substance, alleged that the defendant advanced the price of the gasoline and distillate sold by it during the time involved, and gave people who purchased the same from it to understand that when they paid the advanced price, the excess was to be used by the defendant to pay the tax imposed by law; that in this way the defendant has collected the tax involved from dealers and consumers in this State to whom its product was sold; that by this course of conduct the defendant has become trustee of the plaintiff for the amount so collected, and is now stopped from questioning the plaintiff's right to recover in this action.

The plaintiff being the State of Montana.

To support this novel contention, the attorney general invokes the doctrine that when a collector has actually collected taxes by virtue of his office, he must pay the same over to the body politic for which he was acting, and cannot escape liability therefor by setting up the invalidity of the tax and denying the right of such body politic to recover the same * * *.

The rule invoked has no application to the facts alleged. The law does not impose any tax upon the consumer, although in practice it may be that the distributor or dealer passes it on to him by advancing the price of the product sold. (*State of Montana* v. *Sunburst Ref. Co.*, 1926, 76 Mont. 472; 248 Pac. 186.)

So that altogether it seems to be apparent that the courts have not taken the view that an excise tax imposed upon a sale, or imposed in a manner similar to the imposition of the processing taxes, if included in the selling price were necessarily passed on in the sense that recovery was permitted by somebody who purchased from the seller. Of course, those are circumsances where, as the Senator indicated, there was no statute requiring a different view.

Senator HASTINGS. Your contention is no statute could be drawn that would be constitutional?

Mr. EVANS. Yes, sir. That is what I propose to consider next.

In view of what has been shown above, in our search for information on the question of whether or not courts have heretofore regarded as unjust enrichment the refund of illegal exactions, similar to processing taxes, to the taxpayers who paid them in the beginning, it would seem that the question may consistently be answered in the negative. In other words, it seems apparent that in the past, courts have not regarded such refunds as unjust enrichment. May the observation not be indulged in, therefore, that the whole theory of unjust enrichment in such circumstances is one that has apparently not yet been approved by the courts?

The next inquiry is: Does the due-process clause of the fifth amendment have any application to tax legislation? The following excerpts from opinions by the Supreme Court of the United States seem to be in point here.

In a leading case on the Federal income tax, Chief Justice White, after setting forth the doctrine that the fifth amendment does not limit the true taxing power of Congress, said:

* * * this doctrine would have no application in a case where, although there was seeming exercise of the taxing power, the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation, but a confiscation of property * * * (*Brushaber* v. *U. P. Rd. Co.*, 1916, 240 U. S. 1; 60 L. Ed. 493, 504).

Other and later decisions are to the same effect.

But under the guise of reaching something within its powers, Congress may not lay a charge upon what is beyond them. This Court has recognized that a statute, purporting to tax, may be so arbitrary and capricious as to amount of confiscation, and offend the fifth amendment (*Nicholas* v. *Coolidge*, 1927, 274 U. S. 542; 71 L. Ed. 1184, 1192).

Senator KING. The fifth amendment may, in some instances, be made applicable?

Mr. EVANS. Yes, sir; that is the point.

Senator KING. Where it is capricious or arbitrary?

Mr. EVANS. Yes; arbitrary or capricious so as to amount to confiscation.

The possibility that a Federal statute, passed under the taxing power, may be so arbitrary and capricious as to cause it to fall before the fifth amendment must be conceded (*Tyler* v. *U. S.*, 1930, 281 U. S. 497; 74 L. Ed. 991, 999).

That a Federal statute, passed under the taxing power, may be so arbitrary and capricious as to cause it to fall before the fifth amendment is settled (*Keiner* v. *Donnan*, 1932, 285 U. S. 312, 326).

Senator KING. I think we may accept the legal proposition that you have just announced with respect to arbitrary and capricious taxes amounting to confiscation being unconstitutional.

Senator HASTINGS. Before you go on, the situation I put to you awhile ago is not this situation. In the New York and Alabama case I was assuming a statute which authorized the consumer to sue the seller.

Mr. EVANS. I see.

Senator HASTINGS. This is different from that. You are complaining now because the Government is taking this tax. This is not an effort to protect the consumer.

Mr. EVANS. No; that is right, Senator.

In getting to this last point may I review the antecedent situation briefly, I mean by the situation that existed before this proposal.

It will be remembered that by December 31, 1935, about 2,000 processors had been granted injunctive relief from the payment of processing taxes to the Treasury Department. As a condition attached to the granting of injunctions, the various United States courts over the country had ordered, in most cases, that the periodical payments of tax required by law to be made to collectors of Internal Revenue, be made instead into the registry of the courts. Such impounded funds were to be held, in most instances, pending further order of court.

Such was the situation on January 6, 1936, when the Supreme Court declared the A. A. A. unconstitutional in *Butler* v. *United States* (*Hoosac Mills case*), and so it remained until the same court on January 13, 1936, in the case of *Rickert Rice Mills, Inc.* v. *Fontenot* directed the return to the mill of the impounded funds which it had paid into court as a condition of obtaining injunctive relief from payment to the Treasury Department. Following the Rickert Rice Mills decision by the Supreme Court, the various inferior courts over the country quickly released impounded funds to processors who had paid them into court. Then came the tax message of March 3, 1936, and the proposed tax on unjust enrichment.

In considering the constitutionality of any legislation that may be enacted, the purpose of which is to recapture processing taxes that

were not paid because of the invalidity of the act which imposed them, it would seem logical to attach some significance to the implications of the Rickert Rice Mills decision. There the Supreme Court directed the return of the impounded payments to the processor. Conceivably this may be taken as equivalent to a decision that the Government never did, from the beginning, and never could in the future, have any right to such funds. The Court was not unfamiliar with the circumstances, and the decision was unanimous. Even those Justices who would not agree that the A. A. A. was unconstitutional, as held in the *Butler case*, did agree in the *Rickert case*, that if the act imposing the tax was invalid, then that processor was entitled to the money which had been impounded. The Court must be presumed to have been aware of the fact that some 2,000 other processors were in the same circumstances as the Rickert Rice Mills, Inc., and that the decision in the *Rickert case* would be followed by inferior courts in all the other cases. Yet in the Rickert decision the Supreme Court prescribed no conditions that must be met before such funds were returned to those who had paid them into court. It would appear consistent to assume that the *Rickert case*, and its implications, could not have been lightly considered by the Supreme Court. And it may, perhaps, be assumed with equal logic that any legislation that is intended to, and in fact will, practically nullify the Rickert decision runs dangerously close to offending the due-process clause of the fifth amendment to the Constitution.

A possibility seems to exist that, perhaps, the courts over the country might lend a friendly ear to processors who came complaining of legislation which permitted the Government to take away money with one hand, which it had just perviously been required to give back with the other. In other words, it might conceivably be held that such legislation was sufficiently capricious in character to be in excess of the power of Congress to enact tax legislation, and that consequently it must go down before the due process clause of the fifth amendment to the Constitution.

Nor is it likely that the validity of such a measure would, if otherwise unconstitutional, be aided by an alleged necessity. That question is seemingly at rest.

> Rights guaranteed by the Federal Constitution are not to be so lightly treated; they are superior to the supposed necessity. (*Schlesinger* v. *Wisc.*, 1926, 270 U. S. 227; 70 L. Ed. 557, 564).

One more aspect of the situation under examination seems worthy of mention. If the proposed tax on unjust enrichment would become law, and be sustained by the courts, would the door not, perhaps, be opened for abuse of the taxing power at some future time? In other words, it would seem that any time the general Government found itself in need of funds, it could enact any kind of unconstitutional tax legislation, and upon declared invalidity, and refund of the illegal exaction, recapture the refunded amounts, in part or altogether, through the levy of an income tax thereon at the rate of 80, 90, or 100 percent. Once let the principle of recapturing illegal exactions from the taxpayers who paid them in the beginning, by subsequently levying a special income tax thereon, be sanctioned, and it would seem that, altogether apart from the immediate question of unjust enrichment, such procedure could be followed at will.

May we not suggest that courts will perhaps be loath to establish a precedent fraught with such possibilities?

In summarizing and concluding, we suggest that the proposal provides a hard and fast rule for the determination of the amount of the burden of processing taxes which was shifted to others by the processor, thus arbitrarily arriving at a fact which many economists hold cannot be ascertained; and one which the A. A. A. Administration itself, in 1934, said could only be found after consideration of many factors not provided for in the bill; that the theory of unjust enrichment, which the proposed measure presents, is apparently a stranger to the law in circumstances very similar to those contemplated in the proposal; that its effect will be to practically nullify a decision of the Supreme Court of the United States, and make the vindication of their constitutional rights by some two thousand processors a fruitless victory, by permitting the Government to get from them indirectly money that it was held powerless to get directly; and that judicial approval of the proposal may perhaps be taken as doubtful, because of the precedent that would thereby be established and the door opened to possible abuse of the taxing power in the future.

We come to the main question: Is the proposed tax on unjust enrichment constitutional? We respectfully suggest the possibility of a negative answer.

The CHAIRMAN. Thank you, Mr. Evans. Mr. H. B. Powell, Pa., representing the packers.

Mr. POWELL. Mr. Chairman, I am appearing here as representing the packing industry and one of our chief spokesmen would want quite a little time and would like to finish at one time. He has some charts, and one thing and another, that he has to show you.

The CHAIRMAN. Who is he?

Mr. POWELL. Mr. Woods. Then we have Mr. Scully and Mr. Schmidt, who are on your program today.

The CHAIRMAN. Mr. Woods is the gentleman who wrote the letter that was put in the record the other day?

Mr. POWELL. That is correct; yes, sir.

The CHAIRMAN. How many witnesses have you here?

Mr. POWELL. About seven or eight.

The CHAIRMAN. You want them all to be heard?

Mr. POWELL. I would like to have them heard, sir. They will not take long. Mr. Woods would, but the others would not.

The CHAIRMAN. The committee wants to be very patient and reasonable in the matter of hearings, but it is perfectly useless to go over repetition. Do you want all the seven witnesses to be heard or would you rather have an hour given to you and let you have the matter presented by one witness?

Mr. POWELL. I have asked Senator Guffey for 2 hours, Mr. Chairman.

The CHAIRMAN. Well, the committee cannot give you 2 hours.

Mr. POWELL. I understand, but what we would like to do is to have the individual witnesses tell you their own stories as to the sufferings they have been through and will be through.

The CHAIRMAN. The committee will give an hour and a half to the packers. They can arrange it to suit themselves.

Senator HASTINGS. May I inquire, do you propose to discuss all phases of this bill or some particular parts?

Mr. POWELL. Principally the windfall tax, because that is what affects the pork packers whom I represent.

Senator BARKLEY. Why would it not be more logical, more effective, if some one person would go through the whole proposition, making a consecutive statement?

Mr. POWELL. We had an idea, sir, that Mr. Woods would do that; then we would like to follow him up with some individual packers, to show the story of the effect of the processing tax on them, and also the windfall tax.

Senator BARKLEY. In that connection there are a group of packers from Kentucky who are here today. Only one of them will testify, Mr. Wernke, and he is on either tomorrow or Thursday. I would not want him to be shut off because of allowing an hour and a half to the packers today.

The CHAIRMAN. Why would it not be better for the packers to get together? We will give you just so much time and we will let you allocate the time, to save the time of the committee and at the same time give you an opportunity to present your matter.

Senator HASTINGS. Senator Barkley, Mr. Wernke is not on until Thursday.

Mr. POWELL. He is in the room.

Senator BARKLEY. He is on on Thursday. What I wanted to see done was not to have an hour and a half devoted today and here you have a witness for Thursday who may not have a chance to be heard.

Mr. POWELL. We have two or three packers on for Thursday.

The CHAIRMAN. There will be more if they follow the letter that Mr. Woods sent out to everybody.

Mr. POWELL. You will find there are several dozen of them here. They are interested in this bill.

The CHAIRMAN. This committee would never finish if they followed the advice given in that letter.

Mr. POWELL. If the committee will give us the time we will try to work in the witnesses from Thursday in the time you allot us today and perhaps tomorrow morning, so that nobody will be excluded.

Senator KING. I move they have an hour and a half today and 30 minutes tomorrow morning.

Senator HASTINGS. Or Thursday morning.

Mr. POWELL. We are all here, and we would rather go right on with the continuity of the story.

The CHAIRMAN. Could you get along with less time this afternoon? We have two other witnesses who have come here from a distance, New York City and Buffalo, N. Y. The committee likes to accommodate those gentlemen too. Could not you get along with an hour this afternoon and 30 minutes, say, Thursday?

Mr. POWELL. I would much rather go ahead tomorrow, if we could, as we have the witnesses here and they can tell the story.

The CHAIRMAN. We have got a long list tomorrow. Suppose we give you 45 minutes this afternoon and 45 minutes tomorrow?

Mr. POWELL. I think that will be a little short, sir. I really think we will need 2 hours to introduce these witnesses and really give you the story as you should have it.

Senator KING. Mr. Chairman, I think this is an important matter, I move we give them 2 hours, part today and part tomorrow morning.

The CHAIRMAN. I tried to arrange this calendar so that people would come here and be heard. I do not want to disappoint these other people that are here. I want the packers to have plenty of time.

Mr. POWELL. Three of the men, Mr. Chairman, that you have for Thursday are packers, Mr. Wernke, Mr. Taliaferro, and Mr. Jameson.

The CHAIRMAN. Why would not it be better to have all this program come up on Thursday?

Mr. POWELL. We would like at least to get Mr. Woods through today, if we could.

The CHAIRMAN. How long do you want for Mr. Woods?

Mr. POWELL. An hour, sir.

The CHAIRMAN. Let us take Mr. Scully first.

Mr. POWELL. Now, Mr. Scully, sir, is here with us. We would prefer to put Mr. Woods on first.

The CHAIRMAN. He is a packer too, and likewise Mr. Schmidt.

Mr. POWELL. Mr. Schmidt is another member of our group.

The CHAIRMAN. All right, you can take the balance of the afternoon, if you will let us get through with one witness first who is here. I understand he will take about 3 minutes. Mr. Edward F. Howrey.

STATEMENT OF EDWARD F. HOWREY, WASHINGTON, D. C., REPRESENTING THE TEXTILE BAG INDUSTRY

Mr. HOWREY. Mr. Chairman and members of the Finance Committee: My name is Edward F. Howrey of the law firm of Sanders, Childs, Bobb & Westcott. We present this statement on behalf of the textile bag industry, manufacturers of cotton, burlap, and open-mesh paper bags. My remarks will be directed to section 601 (a) and (b) of the House bill.

Section 601 (a), among other things, reenacts section 15 (a) of the Agricultural Adjustment Act, as amended, for the purpose of allowing refunds of taxes paid on cotton used in the manufacture of large cotton bags. The purpose of section 601 (a), according to the committee report, is to remove any doubt as to the legal authority of the commissioner "to continue the making of refunds" under said section. The House committee intended to put the persons entitled to such refunds in the same position as they were prior to the invalidation of the A. A. A. Act.

The House bill, inadvertently we believe, has nullified this intention by providing in section 601 (b), that no refund shall be made to the processor or other person who paid the tax. The committee report incorrectly states that the claims of such persons are within the provisions of section 21 (d) of the A. A. A. Act. Apparently, the House committee overlooked two facts: First, that said section 21 (d) (1) provides, in terms, that its provisions shall not apply to any refunds authorized under section 15 (a) of the A. A. A. Act; and, second, that 21 (d) does not apply to cases where the tax was passed on under an agreement to reimburse the purchaser for the amount of the tax. In addition even if section 21 (d) survived the Hoosac decision, which some doubt, it merely sets up certain procedural requirements and does not constitute an affirmative provision for refunds.

Senator HASTINGS. Let me see if I understand it. As I understand, when your processor broke a bale of cotton the tax immediately applied, and then he made that into threads, or whatever you call it, that goes to make up the bag. Now he has to pay that tax when he breaks the bale of cotton, but if he uses all of that thread, or whatever you make out of cotton, to make bags with, and he later comes and shows that to the Secretary of Agriculture, he is entitled to get back all of that processing tax. That is the way it went before the act was declared unconstitutional.

Mr. HOWREY. That is right.

Senator HASTINGS. What the bag people are interested in now is the right to go to the Secretary of Agriculture and get that money back that they are entitled to under his previous ruling.

Mr. HOWREY. That is right, sir. We are asking to be put back in exactly the same position that we were in prior to the invalidation of the act.

Senator HASTINGS. Is there anything to prevent the Secretary of Agriculture from refunding that now?

Mr. HOWREY. Yes.

Senator HASTINGS. I mean without any law.

Mr. HOWREY. Yes; because section 21 (d), which some thought they came under, specifically prohibits applying the provision of the section to 15 (a) which covered cotton bags.

Senator HASTINGS. You are referring to the House bill?

Mr. HOWREY. I am referring to section 21 (d) of the Agricultural Adjustment Act, as amended.

Senator HASTINGS. I thought that under the orders of the Secretary of Agriculture it was refunded automatically.

Mr. HOWREY. It was prior to the invalidation of the act.

Senator HASTINGS. Now, why was it stopped?

Mr. HOWREY. It was stopped because I assume the Internal Revenue Bureau felt that further refunds were improper.

Senator HASTINGS. All right.

Mr. HOWREY. Anyway, they were stopped on January 6. There are 35 members of the Textile Bag Manufacturers Association. Thirty of them are not processors and will continue to get their refunds under the provisions of the House bill. Five of the members are processors as well as bag manufacturers. These five are discriminated against; their refunds are cut off. If this discrimination is not removed, an unfair competitive situation will result.

Senator KING. Did they pay the tax?

Mr. HOWREY. They paid the tax; yes, sir.

Senator KING. How much is involved?

Mr. HOWREY. I do not know exactly for the whole industry. I think perhaps $3,000,000.

Senator HASTINGS. There is no contention made by the Treasury Department that they ought not to get it back?

Mr. HOWREY. I will come to that later.

Senator HASTINGS. It is just a question of writing it into the law?

Mr. HOWREY. Yes.

Senator KING. Was this matter brought to the attention of the Ways and Means Committee?

Mr. HOWREY. It was not as to processors, because in the old act there was no discrimination against processors in connection with the

tax, and we were very much surprised to find that such a discrimination was included in the new bill. We still think it may have been inadvertence, but we are not entirely sure.

We understand that the Bureau of Internal Revenue is working on a proposed revision of section 21 (d) of the A. A. A. Act, which will take cognizance of the large bag problem. Unfortunately, such a revision would not solve our immediate competitive difficulties. Section 601 (a) of the House bill, as we understand it, contemplates refunds under an established procedure on claims already filed. This would enable 30 bag manufacturers to make prompt settlement with their customers. The other five, who happen to be processors of the cloth used in the bags, would be forced, because of the competitive situation, to make similar settlements out of their own pockets and await reimbursement under a proposed new and complicated section, which may or may not be enacted into law at this session of Congress.

In other words, if section 21 (d) is revised it will not solve our problem on large cotton bags, and we feel section 601 (b) should be amended as to large cotton bags and permit the processors to recover the refund.

Senator KING. Paragraph 601 (b) of the present act?

Mr. HOWREY. Yes.

Senator HASTINGS. I am satisfied the Treasury Department will not object to it.

The CHAIRMAN. They are trying to work it out. There are some difficulties, as I understand it.

Mr. HOWREY. Their objection, as I understand it, is an administrative one. They want it to go into 21 (d). We say that will put a great hardship on us competitively, as to large cotton bags only.

Senator GEORGE. The same thing is true with respect to goods sold to charitable institutions, Government institutions.

Mr. HOWREY. I think so.

Senator GEORGE. And the same thing is true also where they are sold for export, where they happened to be sold by the processors.

Mr. HOWREY. That is true.

Senator GEORGE. There ought not to be any difficulty there, providing the processor paid the tax.

Mr. HOWREY. That is true. The point we are trying to make is that with large cotton bags the administrative difficulties which confront the Internal Revenue Bureau do not exist.

The CHAIRMAN. You have already talked to the counsel?

Mr. HOWREY. Yes; we have.

The CHAIRMAN. All right, Mr. Powell.

Mr. POWELL. Mr. Woods, Mr. Chairman and Senators.

The CHAIRMAN. Mr. William Whitfield Woods.

STATEMENT OF WILLIAM WHITFIELD WOODS, INSTITUTE OF AMERICAN MEAT PACKERS, CHICAGO, ILL.

The CHAIRMAN. You are Mr. William Whitfield Woods?

Mr. WOODS. Yes, sir; my address is 59 East Van Buren Street, Chicago, Ill.

The CHAIRMAN. What position do you hold with the Institute of American Meat Packers?

Mr. WOODS. President.

The CHAIRMAN. All right; proceed.

Mr. WOODS. Mr. Chairman, we are here representing an industry on which the impact of this legislation is somewhat different and somewhat specialized from that involved in the industries represented by these other witnesses who have addressed you. It will be our intention, Mr. Chairman, to avoid repetitive testimony. We should like, however, to place our industry in its setting, if we may, and we offer that as a basis for this claim to rather generous time to which Mr. Powell brought your attention, Mr. Chairman.

In output the packing industry is larger in dollar volume than any other American industry, therefore what happens to it is of concern not only to the meat packers but also to general business and to the progress of recovery.

The CHAIRMAN. These gentlemen who are to be heard this afternoon, including yourself, truly represent the institute view, do they?

Mr. WOODS. I do. The others are speaking as individuals, I think.

The CHAIRMAN. I understand. But the industry will be quite satisfied by us not hearing everyone who may come here at your invitation and further take up the time of the committee, would it not?

Mr. WOODS. I think the industry, sir, would be quite in concurrence with you in the view that there is no point in wearying the committee with repetitive testimony. I think they will be gravely disappointed if the different real points cannot be presented to this committee.

The CHAIRMAN. Well, the committee wants to hear them. The only thing is, you have written a letter, in perfect good faith, representing that institute, asking people to come here from all over the country and call upon the chairman of the committee to get time in which to present their views. Some may not get here until tomorrow, or the day after tomorrow. We have got to close these hearings sometime, and I want the institute to cooperate with the committee and tell them you have had an ample opportunity to be heard.

Mr. WOODS. The industry wants to cooperate with the committee, and so does the institute. It was not our thought at all that all of these men whom we encouraged to come down here to tell the actual facts about their business would be heard, and it was our suggestion when we saw any of them that the committee probably would hear about 10 of the witnesses. Now that was our guess. It was somewhere near the mark, as evidenced by the chairman's disposition of it today.

The CHAIRMAN. You may proceed.

Senator KING. May I ask a question? Do you represent the canners?

Mr. WOODS. The canners?

Senator KING. Yes.

Mr. WOODS. Only the canners of meat.

Senator KING. And do you represent the packers, large and small, throughout the United States?

Mr. WOODS. Yes.

Senator KING. There are some in my State, and some packers in surrounding States. I was wondering if they were members of the institute.

Mr. WOODS. That is true; yes, sir.

The CHAIRMAN. Do the large packers object to this?

Mr. WOODS. I think that all packers object to it. We find less interest in it on the part of the large packers than on the part of the small packers.

The CHAIRMAN. Some of the smaller packers say that the larger packers will be benefited by this.

Mr. WOODS. I have heard that statement made. The smaller packers, Mr. Chairman, regard this legislation as crucial for their business. They regard their businesses as actually in jeopardy.

Senator KING. May I ask whether you speak for the big packers as well as all the others?

Mr. WOODS. Yes, sir. I think, sir, if you will let me proceed I will put that in its exact setting.

Senator BARKLEY. Are you a packer yourself or a lawyer?

Mr. WOODS. No, sir; I am not. I am a paid employee of the trade association in the industry.

Senator BARKLEY. Have you ever been in the packing business?

Mr. WOODS. Never.

Senator BARKLEY. You are not a lawyer either?

Mr. WOODS. No; I am not a lawyer, and I am not a tax expert. I am thoroughly familiar with the business side of the industry.

The CHAIRMAN. You ought to be thoroughly competent to testify before this committee on those questions. I do not speak sarcastically We want to hear from somebody like you.

Mr. WOODS. Mr. Chairman, except for this letter to which you have referred twice I find myself in thorough accord with your view as to these proceedings. I refer to your request of Secretary Morgenthau. My heart went out to you when you said, "I do wish you could get these rates into one column, one set of tables instead of four."

Senator KING. If you accomplish that you will make a contribution to the hearing.

The CHAIRMAN. All right, proceed.

Mr. WOODS. I did want to indicate further that the value of the output of this industry exceeds by $100,000,000 the value of the output of the next largest industry, which is petroleum refining; by $350,000,000 the output of the steel industry, and by $400,000,000 the output of the automobile factories. Now we submit that that entitles us—just in the general picture, not with any glorification of size but with recognition of the importance of this industry to business—to an opportunity here to tell you this story adequately, and we are not going to have that in the time that is remaining before your adjournment.

The CHAIRMAN. Well, you may proceed.

Mr. WOODS. Secondly, we should like to mention that of the total land area in this country about one-half is in farms, substantially a billion acres; and of that one-half, half is devoted to pastureland for livestock, and an additional 200,000,000 acres are used to raise crops and grain largely consumed by livestock.

The meat animals of the country contribute a portion of the farm income, which is approximately equal to the portion contributed by the wheat, rye, oats, corn, and cotton crops combined; and I do not minimize, Senator, being from Mississippi myself, the value of the cotton crop and its importance to the commerce of this country.

Now, consequently, our industry not only has a vital relationship to general business but to general agriculture. We market some of

the crops with which, in general opinion, we are usually not associated. The corn crop marches to market on four legs through our packing plants and through our distributing channels.

It is important to the livestock producer to have an efficient, thriving packing industry, with plenty of competition, plenty of packers widely distributed, varying in size, just as it is important to the packers to have plenty of livestock producers who are satisfied producers and who are thriving and efficient.

Now all packers are interested in the proposals that the committee is considering. The tax on undistributed earnings, the proposed processing taxes which one of the Cabinet officers took for granted, and the so-called tax on "unjust enrichment" are all a matter of interest to all packers.

The pork packers are particularly interested because they have been particularly concerned with title III, which deals with unjust "enrichment."

Now in discussing the tax on undistributed earnings I should like to confine myself as largely as I can to those aspects which are special to this industry, because it is perfectly useless to go over the ground which was covered comprehensively by Mr. Ballantine. In saying that I do not mean to endorse or oppose his testimony, but it does seem to me that his testimony and the questions of the Senators pretty well covered the field. I should like to point out the special relationship of this proposed tax on undistributed earnings to this industry, and that relationship grows out of the situation in which many packers find themselves.

We have in the industry possibly some 800 packers. More than 600 make reports to the Bureau of Animal Industry. Most of them have just come through a period in which they have been greatly weakened.

In 1931 the industry lost $18,000,000. More than one-half of the packers, 55 percent, made losses. In 1932 the industry lost $6,500,000, and 77 percent of the packers made losses. In 1933 the industry made $26,000,000, and three-fifths of the industry made losses.

Senator KING. You mean in numbers?

Mr. WOODS. Yes, sir, in numbers.

In 1934 the industry made $36,000,000, and about one-half lost money. That last figure is an estimate, but we believe it is fairly close. In 1935 the industry made about $30,000,000, and nearly all packers lost money. Some of them had their operating losses offset by inventory profits. Usually that sort of profit is characteristic of the larger packers, those who conduct extensive storage operations. There were few, if any, packers who made an operating profit in the packing industry.

Senator BARKLEY. What is the explanation of that fact, that they made a better showing in 1935 than in 1934?

Mr. WOODS. If I may develop this presentation and then respond to questions, again trying to save the time of the committee, I shall appreciate that very much. I shall cover that very point just a little later.

Senator BARKLEY. All right.

Mr. WOODS. Now those operating losses have continued into 1936, and even the packers who fared the best have not had the offsets in inventory depreciation that some of them had in 1935. However, the retention of their funds which had been impounded, or which had not

been paid in processing taxes has enabled some of the small packers to put their businesses on their feet.

Now these packers believe that if this money is taken away from them they will again be back where they were, and that their businesses are trending very rapidly in that direction. However, I expect to develop that subject in connection with the so-called tax on unjust enrichment.

The background that I would like to get before the committee is that the industry, because of this tax, has been greatly weakened as to most of its operators, if not, indeed, all of them.

Now it seems to me, notwithstanding the explanations that have been made about particular brackets and hypothetical specific cases by some of the taxation experts, that this tax on undistributed earnings does tend to put an obstacle in the way of the growth of the smaller businesses, as previous witnesses have indicated, and it does put an obstacle in the way of a packer recouping his losses so that he can strengthen his business to the extent of the security that it formerly enjoyed.

There are special applications of the danger of this tax on undistributed earnings in our industry. I should like to instance one or two of them.

At the moment, hog supplies are about two-thirds of normal for reasons that we are all familiar with, including the drought and including the Government program.

We also know, those of us who follow those statistics, that this business which has been subnormal in volume for the last 2 years is now at the point where it is trending the other way. These packers who have had their capital impaired, who have used up their borrowing power and who, in many cases, have gone bankrupt and in other cases have been saved from it by this relief from paying the tax any longer, are in a situation where they would like to share in the growth of the business that is coming. They have had their fixed investments, but they haven't had the volume to put through the plant.

The pork packer is operating on, roughly, a two-thirds basis. The pork-packing business is a smaller business than it used to be, but the Department of Agriculture, I believe, has estimated that the hog supply now, or in another year, will show an increase of 25 percent. It will still be subnormal. But it will increase from about 30,000,000 hogs slaughtered under Federal inspection in the marketing year 1936 to about 37,500,000 hogs slaughtered under Federal inspection in the marketing year 1937.

Now everybody would like to get his business back to where it was in volume. Any businessman would like to do that. The fellow who has built up full reserves can do that. The fellow who is bulging with cash and who is in a relatively stronger financial position can take his share of these hogs as they come along and keep his business relatively as large as it was. But what about the fellow who has a pork business two-thirds the size of what it was and has not got the money, particularly if you assess this other tax against him? Must he stand back now and see this normal hog supply as it increases over the next 2 or 3 years until it gets back to normal gobbled up by his competitors who have adequate funds and who can finance that growth without any penalty?

Secondly, there come times when, through fluctuations in prices, an increased amount of money is automatically invested in inventories. There come times when you have got to have more money to finance higher-costing stocks. Now some packer who is large, who has plenty of money, who, over a long period, has built up actual reserves and big surpluses, who is secure, can put out that money and put in just as much stock as he had last year; but if there is some other packer who is not in that situation and who would have to take the earnings of his business—say he made $40,000 and he decides that he wants to keep his business as big as it was, so he is going to have just as big fall inventories as he ever had, and he puts the $40,000 in those inventories—then, as I understand this bill, he must pay a tax of 42.5 percent, whereas his wealthier competitor has paid no tax and can charge himself at the most with a going rate of commercial interest for using his own money. Now say both of those people put hams in storage: One fellow paid 42.5 percent for the privilege and the other fellow paid nothing. Do you think one person can long continue to compete with the other?

Senator KING. Does the packing business require a considerable volume of storage goods, such as hams and sausage?

Mr. WOODS. Yes. I am coming to that too. I do not mean to be discourteous. If you will let me run through this picture it will conserve your time. I do not mean to shy away from any of these questions.

Now suppose that a situation comes where the tax is assessed on the basis that the less prosperous packer somehow has managed to put more of his money in inventories, and on his books he shows paper profits, because the value of the stocks has gone up even though there are no goods there. They are not expendable because he has to maintain his stock at that figure, he has to carry about that much for his trade. The only way he can pay that tax then, unless he has very adequate surplus funds, is to throw some of that stock on the market.

That has two effects. It reduces the size of his business, because the proceeds are then taxed away from him and he cannot replace the goods. He thereby is made smaller and smaller.

Secondly, it damages the market for all the rest of the stuff he has in his cellars as well as the market for all of his competitor's stocks.

Now those are things that are special to the packing industry. I will just touch, without going into them, on one or two of these other points.

It did seem to me the point was reasonably taken that having an inexorable formula here that has to be applied whether the weather is sunshiny or whether it is stormy, whether good management would dictate you plow something back or pay it all out, no matter what the situation is, instead of leaving leeway as to a decision based on good business judgment, that formula must be applied, willy-nilly, and the business straight-jacketed, so far as the protection of its own security is concerned.

I also think that such a tax may result in some pressure to pay dividends when good judgment does not always commend it. However, those are things that affect this industry not greatly differently

from the way they affect other industries, and I would rather leave with you these points that are special to us.

Now the next item which the Committee has been considering and which has been put emphatically before the Committee is the question of processing taxes, and there again I think I can conserve the Committee's time by simply treating that subject in connection with the proposed, so-called unjust enrichment tax, because it is impossible to consider the question of unjust enrichment without considering the processing taxes; and if I may skip now the subject of processing taxes and ask the committee to take from what I say on that topic in connection with the tax on unjust enrichment, the things that are applicable to any processing tax, we shall make a saving on time.

Now this tax on unjust enrichment—and it is not surprising, and I do not say it critically—takes no account of the difference between the packing industry and other industries. It is levelled out in a general way, to apply to all industries.

Well, our industry is peculiar. I know every business man thinks his industry is peculiar, but ours is really peculiar. We handle a perishable product, we handle a live animal, and, oddly enough, we have no control whatsoever over the volume of the industry. We are not like the steel people who, if they think prices are not going to be so good, or for some other reason they do not think it would be justifiable, if they do not think there will be so much steel needed, they do not dig the ore up out of their mines. We cannot help the situation. We do not handle the livestock; we do not determine the supply; we take all that comes.

This bill was drawn with the point of view that an industry buys raw material, adds to the cost of this raw material certain other costs, including taxes, and thus builds up a price; and that the industry can then readily sell at a price which includes all those costs. I think currency has been given to that point of view by the attitude taken by the representatives of some of the other industries. I think it is undoubtedly true of some of the millers. I think it is true of some of the cotton people, although certain witnesses from that group took the opposite view. But we heard that neither of those industries, some portions of them, have been particularly exercised about the tax on unjust enrichment, because under their manner of doing business, where they can make the stuff and store it, where the processing tax was only a minute part of the value of the product as it reached the consumer, some of those people said frankly they could pass it on, and they have even made contracts by which they undertook to pass it on. But as I say, our industry is specialized; our problem is different, and as a consequence packers are firmly and sincerely against it.

Many of them are here. I did encourage them to come. I do hope they tell the Senators the whole story and the actual things that have happened clearly, sincerely and definitely with their own figures, showing the situation of each of these little companies from their own balance sheets.

Now it is impossible to meet this question of whether there has been an unjust enrichment by cutting off one little segment here of something that happened and saying, "This is the whole measure."

We welcome this opportunity to come here and try to meet the challenge: Has there been an unjust enrichment of the pork packer? This tax is presumably both a revenue measure and, in a sense, a moral measure of taxing accretion that in some way was not earned,

that in some way was illicit, and we would like to go into that question fairly and frankly. Has there been an unjust enrichment of the packer?

Now we submit to this committee, as fair-minded, just men, that you cannot, in computing the operation of a program, in viewing an account with a debtor or a creditor, single out one item and say, "This one entry constitutes the whole relationship. On what you made you will be charged for, but what you lost you will not be credited with."

You have got to take everything that happened. Not what happened on January 6, 1935 only, or what happened from May 1935 to January 6, 1935, but to balance those scales justly you have got to put everything in them—you have got to have all the entries in the account.

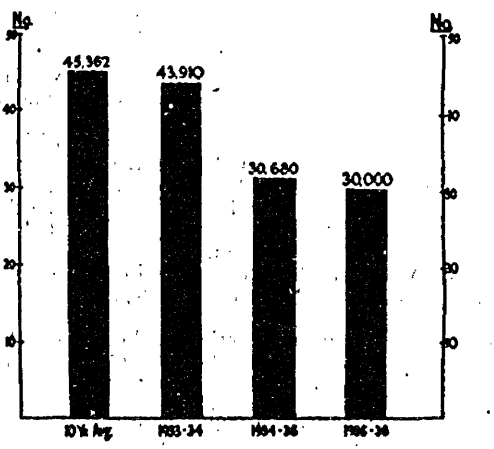
Now this processing tax originally went on November 5, 1933. It went on at a rate of 50 cents a hundredweight. By March it had risen to $2.25 a hundredweight, and I would like to show you as definitely as I can how the balance sheet looks in reference to the pork packer. I do not know how it looks with reference to the miller, and I do not know how it looks with reference to the cotton manufacturer, or anybody else, but I have some material here and it is not technical, it is not hard to understand, Mr. Chairman, it is material that I think will indicate how the blanace sheet stands with the meat packer.

Senator KING. That includes not only pork but all forms of meat?

Mr. WOODS. I was really speaking only of the pork packer, because there is no question of the tax on unjust enrichment in the case of the other packers, Senator.

I will exhibit a number of charts to the committee.

Chart no. 1 is as follows:



Now, gentlemen, will you bear in mind that this processing tax went into effect November 5, 1933, and it was invalidated on January 6, 1936. The use of the processing tax which was collected from the pork packer was as payment to get the farmers to reduce their hog

production. In the first year the program did not have much effect, because although the contracts were signed it takes some time to raise pigs and market them, and so on. That is this year here.

Senator KING. When you said "here" you meant 1933-34 for the purpose of the record?

Mr. WOODS. 1933-34. Here is the 10-year average, roughly. 45,000,000 hogs were killed under Federal inspection.

The best measure we have of a hog supply is the number killed under Federal inspection, because we get such good reports from the Department of Agriculture under that admirable inspection service over there.

You notice in the first year of the program, starting from October 1, 1933, to September 30, 1934—that is what we call the hog marketing year, October to November—there was very little change because you could not get the reduction in supply effected. You have to have contracts in operation for a year before it shows in supplies. Bear in mind that this is the volume that these packers, some of the men sitting in the room here, in their businesses of varying size, were equipped to handle; that they invested their money in plants and equipment to handle about this many hogs: 45,000,000 or more. Now they could not tear the plants down, but the supply was reduced about one-third in the following year, 1934-35. Now that is part of the account that precedes the date of the supposed unjust enrichment. This just played hob with very many packers. Some of them who conduct storing operations could offset some of their operating losses by inventory profits due to higher prices. That profit is not a true profit, however, because, sooner or later, the inventory falls off again in one way or another.

It is just as if you bought a house for $10,000 and you could sell it in a higher market for $20,000, but if the whole market went up you could not do anything about it unless you wanted to stop living in a house. The same thing is true of the inventory. You cannot do anything about it unless you get out of the packing business. Some of them said they did not want to get out, but they were rapidly going out, because with this reduced volume they were paying more for the hogs than the hogs were worth.

The CHAIRMAN. Have you a chart on that proposition?

Mr. WOODS. I have not, but I think the Department of Agriculture can show that. I have the hog prices; yes, sir.

The CHAIRMAN. I thought you had a chart showing the prices that the packers paid for the hogs during this period, and also a chart that was paid for pork sold to the consumers.

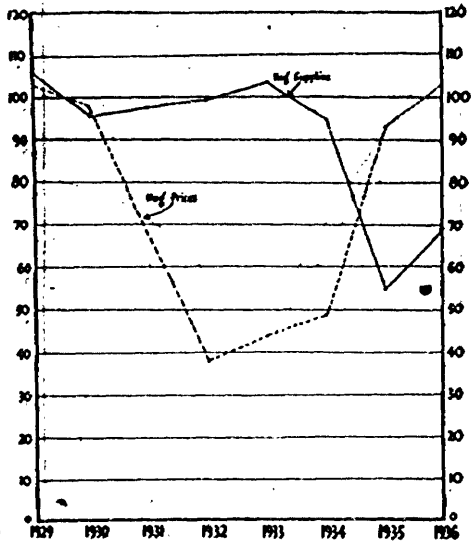
Mr. WOODS. We do not have it exactly in that form, but we have a chart on hog production on an index basis, showing what the result was.

Senator KING. That great reduction in the volume of hog production was caused by the action of the Department of Agriculture in ordering the killing of so many hogs, was it not?

Mr. WOODS. I would say, Senator, that was not the only element. The drought was a big element. The killing of the hogs had something to do with it. Opinions vary on that subject, however. More particularly, they signed up hog farmers—and I am not criticizing or commenting on the policy one way or the other—but they signed up hog farmers to reduce their production 25 percent.

Now, all of those things put together did reduce production. We are not complaining about that. We are not saying anything about that, but we do say that the consequence was that packers had to pay more for their hogs than the hogs were worth, because they were trying to save something out of their investments. They wanted volume to run through their business, because their biggest overhead was still there.

If later on a packer did retain some money that had been demanded as taxes due, and which it was argued, had been passed on in anticipation of those tax payments, it ought fairly to be remembered that in this period which I have mentioned the situation was reverse to the one that is assumed on that theory.



Now that is what I mean about taking the whole account into consideration. This preceded January 6, 1936. We are not out of the effects of that yet.

Bear in mind that all of this was the processing tax program. The opinion of the Supreme Court was only one of the consequences of it. Whatever the economic results were, this situation here was one of the results of it, and we are still having the results of the program.

These packers who were temporarily put on their feet by the retention of those funds are now having an awful time with their operating losses, because hog production, which was curtailed by means of the production control program financed by the processing tax, has still left us short of hogs; we are still doing business on a two-thirds basis; we are like a merchant who has been forced to cut his volume of business.

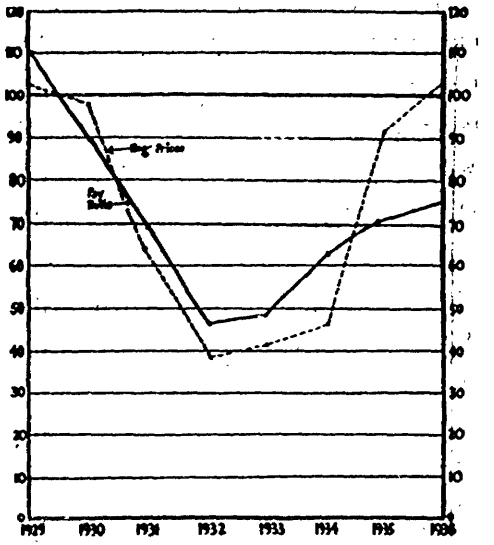
The CHAIRMAN. Was that reduction about the same ratio with respect to the large packers as with respect to the small packers?

Mr. WOODS. Offhand I could not answer that without asking each company, but on the whole it is an average for the industry. If I had to answer the question either way I would say, "Yes."

The CHAIRMAN. I see.

Mr. WOODS. I am just trying to be scrupulously frank with you, Senator.

Chart no. 2 shows the effect that those limited hog supplies naturally had on prices. If you just had one box of grapefruit in the world, of course grapefruit would sell at a very high price. When you have only this small supply of hogs, using the 1929–30 average as 100, as a base, and you find that supply going down to less than three-fifths of



what it was, with hardly more than one-half of the hog supply remaining, obviously prices will go up, and here [indicating] the hog prices which had dropped down to deplorable levels did go up sharply.

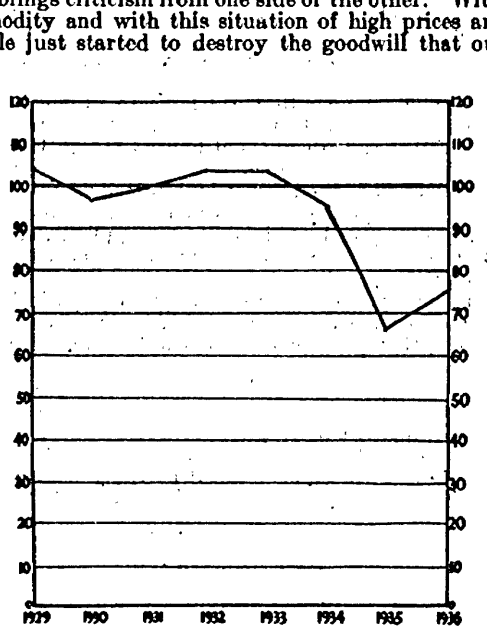
Now the packers, as I have already indicated, were competing almost with voracity for this scarce supply of raw material. I am sure I do not need to belabor that point. Now if there is not enough raw material to go around you will realize, I am sure, that the raw material will be kicked up to artificial levels.

Chart no. 3 shows what we faced on the other end of it. These are factory pay rolls. Again we have taken 1929–30 as 100. That is practically the same base as if you took 1923–25, but it gives you a more convenient and nearby look. I think the 1923–35 figure, on this basis, would be about 99.

Your pay rolls came down here from 110 in 1929 to 90 on an index basis, 90 percent on the average for the 2 years 1929–30; it dropped down to 70 percent, and finally got down to where your purchasing power, as measured by your pay rolls, was less than 50 percent of what it had been.

Now, you cannot crowd stuff on people at very fancy prices when that sort of situation exists with income, and the line representing high hog prices passed the pay-roll line.

Then we had a picnic. The packer is not unused to being the recipient of criticism, no matter what happens or who did it. We are between the producer and the consumer. We would like to get along with them both. We try to serve them both well, but that relationship often brings criticism from one side or the other. With a perishable commodity and with this situation of high prices and low pay rolls, people just started to destroy the goodwill that our product had had.



People do not like taxed food. In the first place, it makes them mad. They will buy something else if they can. If meat is taxed they will buy fish. If fish is taxed they will buy poultry. Eventually, they will do whatever they can to get away from taxed food, if the competing articles are not taxed. In our experience they never were taxed. Certainly there is no tax on fish. The chain stores stopped advertising meat, they began to advertise fish. Fish advertising of course was intensified all over the country. Then the people began to become extremely critical. There were meat riots in New York, in Los Angeles, some little town in Pennsylvania, Chicago, and other places.

Senator KING. Michigan and Minesota, too.

Mr. WOODS. Michigan. I do not recall Minnesota, but I am sure the Senator is right. Then, as an extreme case, they threw rocks through a packing-house window. All in all, that was establishing a minus advertising value for a product which this industry had been trying, by the expenditure of money, actual money investment, for

many years to build up, and the situation was one which turned the customers of the packer over in considerable measure to the fish dealer, the poultry merchant, and the cheese manufacturer.

Now that alienation took two forms. When there was not enough meat for them to eat; the drought came along and intensified the other reduction, and there was not enough pork to go around, so that the man who had kept up his food consumption had to eat other kinds of food.

Secondly, the people got mad; they did not like the taxed food; they did not like the high prices. We were stuck at both ends of the line; we could not get enough raw material, and then we had an awful time to dispose of it at satisfactory levels.

I have here some clippings that will indicate to you in a sketchy way how strenuous some of the publicity was: "Fight police in meat war", "'Down with meat prices' shout housewives", "Danger to the housewives", "Ban high-priced meat", "6,000 join strike to cut meat cost", "Pickets launch strike against high-priced meat", and so on.

Now, that is bad for your business, when you are stumped on your raw material, in case you have inadequate supplies, and when you are stumped on the market with people in that frame of mind. It is hard going, and these people were hurt.

Chart no. 4 shows you how the consumption of pork dropped off. All that was not because they were angry, but partly because they could not help it; they just could not eat as much as they had been eating.

Now while that was going on in the domestic market the packer was losing his foreign market as a consequence of the shortened supplies. These shortened supplies carried prices to a level where we could not compete in some of our favorite markets. Estranged from our trade at home, with our advertising investment partially destroyed, we had also to witness an already diminished foreign market constricted still further.

Exports of pork and lard

[Thousands of pounds]

	1935	1934	Percent change
Pork	89,000	151,000	−41
Lard	96,000	431,000	−78
Total	185,000	582,000	−68

Percentage of total lard imports into United Kingdom purchased from United States: 1935, 36 percent; 1934, 93 percent; change, −55 percent.

You will notice the three ciphers are omitted for convenience here. In 1934, when supplies were still normal, we exported 151,000,000 pounds. In 1935 we exported 89,000,000. It was almost cut in half, 41 percent.

Our lard went down even more. In 1934 we exported 431,000,000 pounds. In 1935 the reduced supplies and high prices had put us out of the market, and lard exports shrunk 78 percent, and the total went down 68 percent. Part of it was due to tariff and exchange restrictions; it would have happened, anyhow, if we had had all the

meat in the world. Another part of it was due to the fact that with our short supply, high prices of raw material, and consequently high prices of meat, we were literally put out of the market.

One of our best customers of lard is the United Kingdom, along with Germany. Germany had exchange restrictions. The United Kingdom had no quota on lard, but we lost out there just the same.

In 1934 we were selling England 93 percent of all the lard it imported. In 1935 we were selling England only 38 percent.

This processing-tax program, however unjustifiable or justifiable it may have been—and I am trying not to bring that element into it, because this is not a political question; it is a business question, it is a competitive question, it is a question of keeping these businesses alive—whatever may have been the justice of the policy, there is no doubt of the result of it.

The CHAIRMAN. Is not the trend upward now in the export of lard this year?

Mr. WOODS. May I ask one of my associates here? Mr. Hardenbergh, is the trend upward now?

Mr. HARDENBERGH. Slightly upward.

Mr. WOODS. It is slightly upward, and the hog supply is expanding.

Imports of livestock and products

[Thousands of pounds]

	1935	1934	Percent change
Beef and veal	87,000	48,000	+82
Pork	10,500	1,650	+536
Hides and skins	303,000	201,000	+50
Tallow	345,000	43,000	+690

Now as to imports of livestock and meat products. While this was happening abroad we also began to lose some of our own markets to the foreigner. Now the loss is not very serious in tonnage. Our own production is still overwhelmingly the great part of the meat consumed in this country, but you can see here that from 1934 to 1935 the imports of pork into this country increased over 500 percent. The poundage is relatively mu·l· smaller, from 1,650,000 to 10,500,000 pounds. But it hurt us, it hurt our pride a little bit. We did not like to get things like this [indicating].

(Information referred to is as follows:)

ANGLO AMERICAN TRADING CORPORATION,
New York, April 23, 1936.

DEAR SIRS: We offer you, subject to being unsold, the following:

25,000 pounds Lithuanian fresh frozen bellies, square cut, boneless and seedless, 6 to 8 pounds, 8 to 10 pounds, and 10 to 12 pounds, at 14 cents per pound, c. i. f. New York.

50,000 pounds Lithuanian fresh frozen hams, American trim, unskinned, 8 to 10 pounds, 10 to 12 pounds, 12 to 14 pounds, and 14 to 16 pounds at 15½ cents per pound c. i. f. New York.

50,000 pounds Lithuanian fresh frozen picnics, unskinned or skinned, 5 to 7 pounds, 6 to 8 pounds, and 8 to 10 pounds, at 11½ cents per pound, c. i. f. New York.

Duty for account of buyer, 2½ cents per pound.

Terms: Irrevocable letter of credit.

Shipment: May, from Lithuania.

We will have a sample shipment due here Monday next, and you can buy the above offering, subject to approval of sample, which we could get to you in Philadelphia next Tuesday or Wednesday, the 28th or 29th.

May shipment would mean arrival end of May, first week of June, if order placed immediately.

Yours faithfully,

ANGLO AMERICAN TRADING CORPORATION.
——— *President.*

The "Anglo-American Trading Corporation, April 23, 1936. Australia, New Zealand, South Africa, and South America." The date illustrates the point I was trying to make before, that the balance sheet has not been struck yet. The mere fact that the Supreme Court spoke its piece has not pulled these men up where they have a normal supply, where they can get rid of these operating losses, and that is exemplified in this letter, showing that the foreign shipper can sell hams over here. [Reading:]

We offer you the following:
25,000 pounds Lithuanian fresh, frozen bellies.
50,000 pounds Lithuanian fresh, frozen hams.
50,000 pounds Lithuanian fresh, frozen picnics.

And so on. They can do that.

The CHAIRMAN. Delivered in New York?

Mr. WOODS. Delivered in New York.

The CHAIRMAN. With the tariff paid?

Mr. WOODS. The tariff comes on top of that, and they are still below us.

Now, I also had one of the Ampol, Polish ham advertisements. I did not put it in the exhibit because I found it also was being used in the political campaign.

Senator BARKLEY. How about the figures as compared with the total domestic consumption?

Mr. WOODS. In tonnage they are not nearly as significant as in percentage.

Senator BARKLEY. You do not happen to have those figures?

Profits in the packing industry

[Millions of dollars]

Year	Net worth	Sales	Profits	Percent profit on net worth	Profit per $100 sales
3 years, 1934-36:					
1934	$726	$2,265	$56		
1935	[1] 700	[1] 2,750	[1] 98		
1936	[1] 735	[1] 2,800	[1] 20		
Average	720	2,600	52	7.3	$2.00
5 years, 1931-35:					
1931	835	2,770	[2] 18		
1932	781	1,960	[2] 6		
1933	765	1,867	26		
1934	726	2,285	36		
1935	[1] 700	[1] 2,750	[1] 30		
Net recovery on taxes			[1] 68		
Average	700	2,326	27	3.6	1.16

[1] Estimated from incomplete reports; 1935 figures include recovery in taxes.
[2] Loss.

Mr. Woods. It would be huge. We produce, maybe, fifteen or sixteen billion pounds of meat. The importation hurts our pride more than it does anything else. It does hurt the market somewhat, because competitors tend to meet prices.

Now consider, please, the question of profit, which is pertinent to this question of unjust enrichment, just as are the losses that drove so many packers right to the edge of bankruptcy.

The first table shows you profit in the packing industry in millions of dollars, with three ciphers left off. For the 3 years, 1934 to 1936, it gives you this figure. The years run down here: 1934, 1935 and 1936. Then the average. Then we have aggregated the net worth of all the packing companies. You notice it runs from $700,000,000 to $735,000,000. The sales ran in those years from 2,285 million dollars, or two and one-quarter billion dollars, to two and eight-tenths billion dollars.

We are a big industry in point of volume. We have a rapid turnover. The average sales in those 3 years were $2,600,000,000. The average net worth was $720,000,000.

Senator King. You mean of all the assets of the packing industry?

Mr. Woods. Yes.

Senator King. That would include the value of the big packing plants in Chicago and Omaha?

Mr. Woods. Yes; that is the capital and surplus of all companies reporting to the B. A. I.

Senator King. That would include the 600 you have referred to?

Mr. Woods. Yes. It sometimes runs a few more.

Now in the year 1934 the profit was 36 million dollars, of which perhaps 26 million came from inventory profits. Any of you gentlemen could have made the inventory profits. You do not have to have a packing house to make them. You do not have to pay a processing tax. A broker sometimes makes them; a speculator sometimes makes them. That is a risk people take. Some of our people take them because they have to. The little operator did not have the benefit from inventory profit that the big operator did.

The Chairman. The profits in the packing industry in 1935 were less than they were in 1934?

Mr. Woods. The net profits?

The Chairman. The net worth.

Mr. Woods. About 26 million less. There may have been some adjustment of capital assets. Mr. Greer, can you answer that?

Mr. Greer. Dividends paid in excess of earnings.

Mr. Woods. That, according to the tax on undistributed earnings, is what we want them to do, Senator. I do not mean that facetiously or ungraciously.

The Chairman. Your profits show very much higher in 1935?

Mr. Woods. Yes.

The Chairman. Three times as much?

Mr. Woods. Not quite; but let us call it that. Two and one-half, maybe.

Senator King. Is that inventory profits?

Mr. Woods. No; this is mostly inventory profits [indicating]. This is $30,000,000 of profits, practically all inventory, plus a certain sum sometimes called windfall and sometimes called unjust enrichment.

Now that is as it was calculated from accruals, taking approximately the Department of Agriculture figure, deducting your 10 percent attorneys' allowance, and also the corporate income tax the packer would pay from that.

The CHAIRMAN. You did not use the term "windfall" in 1935?

Mr. WOODS. And we do not now, Senator; no, sir.

The CHAIRMAN. You did not use the term "unjust enrichment"?

Mr. WOODS. No, sir; and we do not now.

The CHAIRMAN. You never used that term, or you never heard of that until this bill came along?

Mr. WOODS. I heard of "windfall", but we haven't heard of the "unjust enrichment."

We think that so far from being unjustly enriched we were just pretty near ruined, but at any rate this figure includes what the people, who would take the view that there was an unjust enrichment, would put in there. That $30,000,000 consists chiefly of inventory profits.

Now bear in mind that while this $30,000,000 was being made most of the people in this room were going out of business. They did not have the inventories. Some of them actually went into bankruptcy and we almost had a wholesale failure in the packing industry. We came very near to having two or three hundred packing companies going into bankruptcy.

The CHAIRMAN. That was in 1935?

Mr. WOODS. That was at the end of 1935. In 1936—and I hope this is not quoted, because nobody can guess what profits will be a year ahead, but this is the hardest year we have had in some time—we have put down a figure of $20,000,000 for the profits in 1936, which still has quite a way to go.

The CHAIRMAN. That is just for this part up to now?

Mr. WOODS. No, sir; that is for the whole year. If you press me too hard, I will run, Senator. I think it will be worse rather than better.

Senator KING. You have ventured into the realm of prophecy there, have you?

Mr. WOODS. More than we would like to, in an effort to be of help to the committee.

Now, if you put that figure in accordingly, the average for those 3 years—and you could even put in that so-called unjust enrichment—would be $52,000,000 yearly on sales of two and one-half billion dollars; the percent profit on net worth would be 7.2, and the profit per $100 of sales would be $2. So, far from being a rich industry, we are an industry with one of the smallest margins of profits.

Now, if you will go back and take the 5-year period instead of cutting us off here at some particular date, you will find that the average net worth for the 5-year period 1931 to 1935 is $760,000,000. The sales were about two and one-third billions. The profits average $27,000,000, and the profit on investment was 3.6 percent. The profit on sales was 1.16. The packer would have put his money into Government bonds, divested himself of all the risk of the business, and come out just as well. We submit it is unfair to say that what happens to you in here (indicating) does not count, but if at some particular period you have got to retain some of your own money and it happens to make a profit for you, if it does, then that should be taxed and your losses are your misfortune.

Senator KING. Mr. Woods, you will pardon me for recurring to 1935.

Mr. WOODS. Yes, sir.

Senator KING. There was an apparent profit of $98,000,000 and as I understood you, a considerable part of that, one-third at least, resulted from alleged or perhaps real increased prices upon your commodities that you had on hand.

Mr. WOODS. Yes, sir.

Senator KING. What accounts for the residue?

Mr. WOODS. The residue is the difference between the taxes that accrued on packers, processing taxes, and were not paid by them, less on allowance of 10 percent for attorney's fees. We took that figure out of this bill, the maximum you allow. In addition to that, we deducted 15 percent on corporate taxes—or did we use 13¾? Mr. Greer, was that under the old law?

Mr. GREER. Yes.

Mr. WOODS. Thirteen and three-fourths.

Senator BARKLEY. Let me ask you, how do you account for the losses in 1931 and 1932?

Mr. WOODS. I think we had the experience that all other industries did in those years. I think most businesses got themselves girded together at the end of those 2 years and started to do a little better, or a little less worse, as you want to look at it; and I think our fellows just went straight down, because their raw material was just cut to pieces.

Senator BARKLEY. Of course the economic situation of the country as a whole was still on a downgrade, it had not reached the bottom in 1931 or 1932. After that time you began to have profits independent of the processing tax. Now from your chart there it seems that in 1935 your profits, your average profits were $68,000,000.

Mr. WOODS. In 1935?

Senator BARKLEY. Yes.

Mr. WOODS. They were $30,000,000.

Senator BARKLEY. I mean $68,000,000 above the average of the profits for that period. So that without the processing tax, if there had been no law on the subject, assuming there had been no processing tax, you would have made probably in the neighborhood of $30,000,000.

Mr. WOODS. That is right.

Senator BARKLEY. And you did make that with the processing tax, and then when you had the windfall, or whatever you call it, you got the $98,000,000?

Mr. WOODS. If you add it the way we added it in, by taking all accrued taxes and making these deductions, it gives you a total figure of $98,000,000.

Senator BARKLEY. Have you explained, or do you propose to explain your contention? I believe you make the contention that the processing tax paid by the packers were not paid to you but to the public?

Mr. WOODS. I think we say, rather, as the Department of Agriculture apparently has said many times, that nobody can isolate the tax and measure it and say exactly what did become of it, but we say this: There were many times when we were paying excessive prices

for hogs at the time the processing tax was in effect. We say we were not paid any price that was equal to the elements of the cost.

Senator BARKLEY. In fixing your price to the public you attempt to——

Mr. WOODS (interrupting). Senator, do you mind if we come back to this?

Senator BARKLEY. I may not be here when you get back to it.

Mr. WOODS. I would just like to hook the next chart onto this one, but I do not mean to be ungracious, sir.

Senator BARKLEY. I am just trying to get the facts.

Mr. WOODS. I would be very happy to come back to it, and if I can help I will be delighted.

Now, gentlemen, will you bear in mind that figure of 7.2 that we had on investment in the 3 years, and the figure of 3.6 that we had for the 5 years?

The following table shows profit in other industries:

Profits in other industries, as reported by National City Bank of New York

Industry	Number of companies	Total profits	Total net worth	Percent profit
Automobile manufacturers	18	$200,000,000	$1,235,000,000	16.2
Chemical manufacturers	37	151,000,000	1,271,000,000	11.8
Confectionery and beverage manufacturers	17	33,000,000	180,000,000	20.8
Drug and sundries manufacturers	22	38,000,000	263,000,000	14.8
Merchandise chains	39	89,000,000	591,000,000	14.9
Mail-order houses	4	38,000,000	336,000,000	11.4
Meat packers	14	[1] 79,000,000	566,000,000	[1] 14.0

[1] Including estimated net recovery on taxes for entire year.

We took the figures for other industries out of the report of the National City Bank of New York. We took our own from published reports and such information as we could gather on 14 meat packers.

Senator KING. Why did you not take more?

Mr. WOODS. Because we thought to do so would give an unduly favorable cast to our argument; the more we would take in the worse the figure would look, because, as I pointed out here, all the little factories were doing so badly that we thought it would not be a fair comparison.

Senator KING. Were any of those 14 small ones?

Mr. WOODS. No; they were practically all big ones. That would be the profitable side of the industry. Those people probably do three-quarters of the business.

Now, we have 18 automobile manufactures with total profits of $200,000,000. Their total net worth was $1,235,000,000, considerably higher than ours. Our sales, though, would run well above theirs. They made 16.2 percent on the stockholders' investment.

Senator BARKLEY. Let me ask you there: Those 18 automobile manufacturers, that is all there are, there are not any more than that. They practically represent the industry.

Mr. WOODS. I do not believe that it included Ford.

Senator BARKLEY. I say "practically." It was a large percentage of the industry, was it not?

Mr. WOODS. It was a large percentage of the industry. I think that one would be the main omission.

Senator BARKLEY. What proportion in the chemical industry would be represented by the 27?

Mr. WOODS. I do not know without looking it up from the Census of Manufactures; I do not know what their total production is, but I imagine it is a good big portion. Let us assume that all of them represent a good, big portion, Senator.

Senator WALSH. Seventeen, without the confectionery manufacturers does not represent a good proportion.

Mr. WOODS. I would not think so.

The CHAIRMAN. Why did you leave out Ford?

Mr. WOODS. Because we did not have the figures.

The CHAIRMAN. The figures were too big?

Mr. WOODS. No. That would suit our argument. We would have liked to put in all the packers, but we thought it was distinctly unfair, because the more we put in the worse we would look on financial results.

I just want to call your attention, though, to the fact that these profits on investments, running down the list of industries, including the merchandising chains, the mail-order houses, ran 16, 12, almost 21, 14, 15, almost 11.5, and 14 for us.

Now, that figure puts in the whole sum of unpaid processing taxes, less the two allowances that I mentioned awhile ago; it takes them all in, and if you do that we still measure right in line with the other industries. Of course, we do not think it is fair to do that. We do not think it is fair to cut off 1 year and say: "This is the year that counts, and none of your other transactions have any significance."

Profits in other industries, as reported by National City Bank of New York

Industry	Number of companies	Total profits	Total sales	Percent profit
Automobile manufacturers	13	$199,000,000	$1,943,000,000	10.2
Chemical manufacturers	13	31,000,000	213,000,000	14.7
Drug and sundries manufacturers	8	20,000,000	287,000,000	7.1
Merchandise chains	34	84,000,000	1,256,000,000	6.7
Mail-order houses	4	38,000,000	775,000,000	4.9
Meat packers	14	[1] 79,000,000	2,142,000,000	[1] 3.7

[1] Including estimated net recovery on taxes for entire year.

Here is the same thing on sales.

Thirteen automobile manufacturers had total profits of $199,000,000, total sales just under $2,000,000,000. Percent profit, 10.2.

Chemical manufacturers, 13 of them; profit on sales, 14.7.

Drug and sundries, 7.1.

Merchandise chain, 6.7.

Mail-order houses, 4.9.

Fourteen meat packers, 3.7, after shoving in $68,000,000 representing an accrued but unpaid tax.

The CHAIRMAN. Were those the same 14 meat packers?

Mr. WOODS. Yes, sir. Is that right, Mr. Greer?

Mr. GREER. Yes, sir.

Mr. WOODS. That was 3.7. That is the rate for all of them with the difference between the accrued and the paid, less the

allowance for attorney's fees and the income tax paid out, added in here, just arbitrarily chucked in to give ourselves the worst deal on the comparison that we could.

Senator KING. If you had not chucked that in what would it have been?

Mr. WOODS. Oh, it would have been about 22½ million, and nearly all of it from inventories.

Senator KING. But the 3.7 would have been reduced down?

Mr. WOODS. It would have been very trivial.

Senator KING. Less than 1 percent?

Mr. WOODS. Yes; I would think so, on that figure. This would go down to 22.5 [indicating], and that would go down about the same ratio.

Senator KING. The accretion from the processing tax taken off your earnings would be less than 1 percent, is that right?

Mr. WOODS. That is 1.1 percent, adding in the unpaid processing tax. I do not know whether we would like to term that an "accretion." We are just lumping that in arbitrarily.

Senator BARKLEY. Of course, inventories is not simply a paper proposition, providing you sell the inventories at the increased value. That is true of all going businesses where there is a rapid turn-over. If your inventories increase in value, of course that is reflected in all business in receiving an increased price, provided you sell them while the increase is on.

Mr. WOODS. Yes, and you replace them in the same market.

Senator BARKLEY. Oh, yes; they both go together.

Mr. WOODS. If you are going to keep your inventories you are going to spend that much money for them.

Senator BLACK. That is the percentage on sales. The other percentage is a percentage on net?

Mr. WOODS. That is right.

Senator BLACK. This is the average. I wonder if you know whether or not the profits were practically uniform for the 14 companies, or whether they were largely uniform for the 14 companies?

Mr. WOODS. No, they would not be uniform at all. These people would have made most of the profit [indicating].

Senator BLACK. I am talking of those 14. I did not think the profits were very nearly the average of all of the 14 large ones.

Mr. WOODS. That is that group?

Senator BLACK. Yes.

Mr. WOODS. I do not know the answer to that. Do you, Mr. Greer? I think there would be a considerable variation, would there not?

Mr. GREER. A great variation.

Mr. WOODS. In general the fellow who did the most storage business did the best in that year.

Senator KING. Supposing you take the rest of the 600 meat packers, eliminating these 14, what would have been the figure over there which is represented by 3.7, profits on sales?

Mr. WOODS. I cannot figure it quite that fast, sir. On the 79,000,000 figure you could take off nearly all of the 30,000,000, and all profit for the industry, or nearly all of it, would vanish. These people made most of it. Of the 68,000,000 that we added in you could take off three-fourths. Does that get toward the point?

Senator KING. Yes.

Mr. WOODS. We can figure it out for you and hand it to you afterward, if you like.

Senator KING. That is satisfactory.

Mr. WOODS. Now, gentlemen—not that it is of any point—when we hear of this industry, which is in a difficult situation; when we hear of these hundreds of packers who do not know whether they are going to be in this business after your bill is passed, if it is passed, and we trust it will not be, in this form, when we hear them spoken of in terms of unjust enrichment—and we think of our industry as having the largest output in point of value although not in investment, of all the industries in the United States—when we think of its extremely low margin of profit we cannot help just being a little startled when we pick up financial reports and find that one automobile company—we do not doubt it earned every cent that it gained—had profits in 1 year, last year, that it would take all the profits of our industry for the last 6 years to equal.

Now, we do not question at all that that company earned its profits, but we do tell you that our people have proceeded on a modest basis of earnings, that they have had losses, that if there was any beneficence of any kind in this result of the invalidation of the act, it was more than offset by the damage that was done to their business, when they watched their advertising value destroyed, when they watched the foreign market definitely contracted, when they watched their domestic consumers turned against their product and shifted to competing foods, when they still see themselves operating on a basis of two-thirds of capacity, with increased unit costs, and continuing to operate at losses—then we say to you that these people have not been unjustly enriched.

I was in Baltimore the other day. I was talking with some packers there and I asked them how this thing affected them.

Senator KING. You mean the bill before us?

Mr. WOODS. Yes, particularly this "unjust enrichment" and the processing taxes. We did not go so much into the proposed tax on undistributed earnings, but rather as to how the processing tax, which this committee is considering had affected them, how this proposed processing tax would affect them, and the unjust enrichment proposal; and their answer was exactly what I have heard from packers, particularly the smaller packers, from all parts of this country, some of whom are right here in the room, who will tell you the same story, illustrating it from their businesses. Their answer is that they fear that if this tax on unjust enrichment is enacted a good part of the industry would be swept away. They thought that if they were allowed to retain it, it would put them on their feet in some degree. It repaired part of the damage that was done. It gave them a new lease on life, although they are still being hurt by continuing to operate at losses which are also an element of the processing-tax program. Within an hour we had called up three or four packers who we knew had a typical experience—that was Friday—and asked how they had come out, and then I talked in Chicago with Mr. Hardenbergh, who is here with me, and I told him what I had done there and asked him if he could not get me some pictures of actual plants whose experiences we knew, that I wanted to get before this committee and tell them as

earnestly as I could that we are dealing here not with paragraph 1 of subsection (a), of section 602, but we are dealing here with men and women, with going factories, with people employed, with buying power, with men who built up their little businesses over years of time, and some of them very substantial businesses; who had taken a modest rate of profit and have kept their concerns going for years, and who say to you now either "We have been ruined" or "We will be ruined by one or the other of the things that you propose to do."

Here is one man whose case is so striking that I was afraid I would almost be accused of sentiment in bringing it in. This is a man named Eichner. He said I might use his name. He is over at 302 Stinson Street, Baltimore. For 65 years he killed hogs. He had his home on the end of his packing plant. Here [indicating] I assume is his flower garden. He is a simple meat packer in a small way with about 300 feet of buildings. The processing tax sunk him. He had to put a mortgage on his home to pay his processing tax. He will be glad to speak of his experience, I have no doubt, if you want him to do so. Then he lost the rest of his business. He had to quit killing hogs. He lost his plant, except two rooms, to a competitor, and is now jobbing somebody else's meat from those two rooms.

Here is a packer, Charles G. Kriel, of Baltimore, who also told me that I might use his name. He is a going, substantial packer. Mr. Kriel's company had been killing hogs since 1810.

Senator KING. 1810?

Mr. WOODS. The company had been killing hogs that long. He says that the processing tax came along and he just could not stand up under it. He had to quit killing hogs. He is not doing it now. He had 200 employees and now he has 100. He said if this situation clears up, with reference to the proposals in this bill, he hopes to get back again into the business of killing hogs and enlarge his employment roll.

Now this is the plant of John Gebelein, as is shown by the signs on it, and Mr. Gebelein gave me to understand that I could use his name. That is the case that you heard so much about in the course of the litigation. He told me Friday that this was the only trouble he had ever had since 1855. In the court he argued that he had always made a profit, and that when the processing tax came up he made a loss and it was because of the processing tax. After an examination of the evidence the judge took the same point of view.

Here is a packing plant out in Ohio. I have talked with the owner of it. I noticed earlier in the afternoon that he was here. It is a larger plant than those I have talked about. It has several hundred employees. He is one of the most honest and upright men I have ever met. He may or may not be right, but I am sure that he is sincere in his statements. He says that if this tax on unjust enrichment, so-called, goes through, and restores him to the state of unjust impoverishment which he formerly occupied, that he need not kid himself, he is going out of business.

Senator KING. Have you any figures showing, if this bill should pass in its present form, the aggregate tax which would be required to be paid by all of the meat packers?

Mr. WOODS. I cannot give you a figure I can depend on, but it would be a good many millions of dollars.

Senator BARKLEY. About how many?

Mr. WOODS. If you just made me guess——

Senator BARKLEY (interposing). That is better than to say "a good many."

Mr. WOODS. Thirty-five to sixty-five, maybe.

Senator BARKLEY. That is a good deal of territory.

Mr. WOODS. I know it, but I need a good deal of territory on that one, Senator.

This is a plant in Philadelphia, and his statement is, in his sworn petition, that if he fails to pay the tax—and this relates to the processing tax—all of his property, "both real and personal, will become subject to lien and distraint by the collector of internal revenue." He avers "that such action will completely and permanently destroy the business of the plaintiff. The very threat of this lien tends to affect adversely the line of credit extended by banks and members of the trade supplying the plaintiff with the raw products essential to his operations."

The next plant actually went under on account of the processing tax. He just could not pay and meet all of his other obligations, and he just went into bankruptcy. That is a plant in New York.

Now, this other plant was taken over for processing taxes by the Government. The pay roll was reduced.

Senator KING. Is the Government still operating after it took it over, or has it discharged the employees?

Mr. WOODS. No, sir. When the tax was discontinued, when this man was allowed to keep the money, that partly offset his previous losses and he was able to take over his business and is now able to operate it again.

Now this next gentleman will be before you, I think, later in the week. He knows his business and he is very frank in discussing it. That is a Michigan packer and he says [reading]:

> We can compete with the national packers only when our volume of business reaches a minimum of 4,000 hogs a week. At no time when the tax was in effect did our business maintain that minimum. The answer was that we operated at a loss. There were periods when we handled no more than 500 hogs a week.
>
> We just want the public to understand that the processing tax refunded to this company is in no sense a bonus. It is, instead, a new lease on life. It is the only thing that keeps this plant running and saves the jobs of our workers, some of them of the third generation of Hammond Standish employees.

This one is another Ohio plant. It made no profits in 1933, 1934, or 1935, and I call your attention to that merely as an example of the thing we were talking about, that when you did have profit in the industry it was not inconsistent with the thought that a great majority of these packers made no profits, and some of those profits of most of them were inventory profits.

In 1935 it showed a loss of working capital of over $47,000, and an executive of that company said that the application to his company of the tax on unjust enrichment would further reduce the working capital and place the business under such a severe strain that he doubted whether it would be able to obtain further capital with which to operate.

Now, the last one of these plants I would like to show you is in New York State, and the president of that company, in a public statement, has said:

The invalidation of the A. A. A. has given the small and independent packers at least a fighting chance to continue. The processing tax paid in escrow to the court was borrowed from friends and reduced working capital, and the refund will be used to liquidate loans and other obligations with small return to working capital but in no way add to profits that were not possible to make on hogs slaughtered in 1933, 1934, and 1935.

Now, that picture, Mr. Chairman and gentlemen of the committee, is characteristic of hundreds of packing companies as they tell us of their situation. They are not unjustly enriched, and if you put on them, and this Congress puts on them, a tax on "unjust enrichment" which picks out one particular thing that happened in the course of the processing-tax program and ignores every other thing that happened to them, all the other consequences of that program, and takes away from them the one thing that saved them from the ruin that these reduced supplies and the tax brought near them; and then if on top of that you pass an undistributed earnings tax in the exact form in which you have it here, so that these small fellows operating on two-thirds of the volume cannot grow as this supply grows; and if finally, you put on them again a processing tax, which has fairly infuriated the consuming public and turned packers' domestic and foreign customers over to competitive food manufacturers, then, gentlemen, I submit that you will have ruined a considerable part of this industry.

Senator BLACK. Mr. Woods, may I ask you whether you have a list of the bankruptcies in this particular line of business for the past 2 years?

Mr. WOODS. We can gladly make that up for you. I want to leave this statement, though, on that point: As this suit went on many of these packers quit paying their taxes, in February and March of 1935, they could not stand up, they just stopped, some of them, and took the chance that they would be subject to distraint, that their properties would be taken. They said, "Well, we cannot stand it anyhow." Others went along until about May, when I think the first of them brought an injunction suit. Others followed along with suits about June, and a good many of those who brought suits had already had 30- or 60-day extensions, which would put that period back.

Then when this suit was pending they all gambled on the verdict of the court. That was not a gamble that they elected to make, but had to make to keep going. They assumed that they would not have to pay that pending tax and took it off the price of the products, or added it to the hogs, or something else.

The unjust enrichment that you gentlemen thought of certainly worked in reverse in that period, and they hung on by their teeth; and I think the curtain call of the thing was the decision of the court. I think if the court's decision had gone the other way practically all of our bankruptcies would have come immediately following the court decision, and ranging through this year. With 4 lean years behind them, and with the kind of year we are having this year, which could be anticipated—I mean anybody who is close to the industry knew this would be still another year that would be hard on small packers, and hard, in considerable degree, on every packer—that is when I think you would have gotten two or three hundred bankruptcies.

Senator BLACK. I wonder if there is one other think that you would get for me. I assume you will be here tomorrow morning?

Mr. WOODS. Yes.

Senator BLACK. As to the 14 packers that you have, could you give us a break-down of them, so we could get the particular individual? I do not mean the names necessarily.

Mr. WOODS. I think we could give you that in almost any form you want it.

Senator KING. I suppose this year's failure to make the progress that you anticipated, or hoped for, is the result of the policy which has resulted in such a small production of hogs, or raw material, as you call it?

Mr. WOODS. It was the result on the production, Senator. I do not want to comment on the policy, because we are determined that we shall not be treated on a partisan basis, and that is the reason, when I found one of these exhibits was being used in the campaign, that I cut it out of mine. We cannot play with this industry on that basis. I know the Senate would not want to do so.

Senator KING. Certainly not. The less politics we have in our business and governmental activities the better it is for the country.

Mr. WOODS. Senator, I cannot comment on that either.

The CHAIRMAN. Who is the other witness now?

Mr. POWELL. Mr. Schmidt.

STATEMENT OF GEORGE A. SCHMIDT, PRESIDENT, EASTERN MEAT PACKERS ASSOCIATION, INC.

Mr. SCHMIDT. Mr. Chairman, I am the president of the Eastern Meat Packers Association, Inc. I represent some 35 small, independent meat packers, whose business is chiefly the processing of hogs. Last year these 35 small, independent meat packers killed 3,000,000 hogs, which is approximately 10 percent of the total Federal slaughter of hogs in the United States.

The proposed unjust enrichment tax, in my opinion, would be a very serious financial burden to those packers whom I represent, as well as to most small, independent packers throughout the country whose business is chiefly the processing of hogs.

At the time the processing tax was put into effect these packers generally enjoyed a fairly good financial situation, but due to the processing tax and other factors, chiefly the activities of the A. A. A., their financial structure has been impaired, and I am here to ask the committee to seriously consider the effect that this unjust enrichment tax proposal in the 1936 revenue bill will have on these small, independent packers.

Many of these packers at the time the tax was declared unconstitutional by the Supreme Court were on the verge of bankruptcy. As a matter of fact, some of them had already gone into bankruptcy, and it is my opinion that if these moneys are taken away from them they would, to a great extent, be forced to liquidate their plants and thereby affect the competition, both on the buying side and on the selling side, of hogs, which would have a monopolistic trend.

The effect on unemployment would also be quite serious, because the number of small packers throughout the country is such that their going out of business would have a serious effect with regard to unemployment in the event they would be compelled to liquidate.

The small packers throughout the country represented approximately 45 percent of the total Federal inspected hogs slaughtered during 1935.

In closing I would strongly urge that the committee give serious consideration to the effect that this tax would have on the small, independent packers.

The CHAIRMAN. All right; thank you very much.

Are there any others?

Mr. POWELL. I wonder if we could bring our other witnesses in the morning? They will not take very long.

The CHAIRMAN. I think Mr. Woods has made a very splendid presentation of this matter. We will recess until the morning at 9:30.

(Whereupon, at the hour of 5:15 p. m., a recess was taken until 9:30 a. m., of the following day, Wednesday, May 6, 1936.)

REVENUE ACT, 1936

WEDNESDAY, MAY 6, 1936

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

The committee met, pursuant to adjournment, at 9:30 a. m., in the Finance Committee Room, Senate Office Building, Senator Pat Harrison presiding.

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

The CHAIRMAN. The committee will be in order. Is Mr. Scully here? [No response.] Mr. Newhall.

STATEMENT OF CHARLES H. NEWHALL, BOSTON, MASS., REPRESENTING BOOTT MILLS

Mr. Chairman and gentlemen, Mr. Dorr of the Cotton Textile Institute has briefly called to the attention of the committee the ruinous position in which a large number of cotton textile mills will be placed by the March 3, 1936, deadline contained in the following quoted provisions of section 501 (c) (3) of title III of the House bill:

> The term "selling price" means selling price minus (a) amounts subsequently paid to the purchaser on or before March 3, 1936, or pursuant to any bona-fide agreement in writing entered into on or before March 3, 1936, as reimbursement for the amount included in such price on account of a Federal excise tax;

Mr. Dorr has also pointed out a simple method of correcting this section. The situation in connection with Boott Mills will illustrate one set of facts where the March 3, 1936 deadline will effect such a ruinous result. Although Boott Mills will be used as an illustration, we wish to emphasize that a large part of the cotton-textile industry will be adversely affected in one way or another by the March 3, 1936 deadline.

The basic assumption on which we are proceeding is that it is the intention of this committee to report to the Senate a bill which is equitable and fair to all concerned, and that this committee will be only too ready to act after it is pointed out to the committee that a particular detail in the House bill will effect an extremely inequitable result and that a slight change, which is perfectly consistent with the object of the proposed act, will avoid such unfair result.

STATEMENT OF FACTS

Boott Mills is a cotton textile goods manufacturer located in Lowell, Mass., employing in recent years approximately 1,000 hands, and in peak times about 1,800 hands.

PROCESSING TAXES INVOLVED

For processing of cotton done by Boott Mills during the period March 1, 1935 to January 6, 1936 (the date of the Hoosac Mills decision invalidating the Agricultural Adjustment Act), Boott Mills paid no cotton processing taxes to the Government. If the cotton processing taxes had been legally collectible in the opinion of the United States Supreme Court, approximately $215,000 in such taxes would have been payable by Boott Mills on account of goods processed subsequent to February 1935. Somewhat more than half of the goods processed by Boott Mills subsequent to February 1935 had been sold by Boott Mills prior to January 6, 1936, the balance of such goods being held in its own floor stocks on that date. It is estimated that the floor stocks held on January 6, 1936, by immediate customers of Boott Mills and by customers of such immediate customers contained goods processed by Boott Mills subsequent to February 1935 from cotton with respect to which more than $100,000 in cotton processing taxes would have been payable had they been legally collectible by the Government. The selling price at which these customers' floor stock goods were sold by Boott Mills, included in whole or in part, it is claimed by customers of Boott Mills, the processing taxes purported to be imposed in connection with the goods so sold.

UNDERSTANDINGS WITH CUSTOMERS

In 1935 many textile mills began to use the so-called "dry-goods merchants' clause" in some or all of their invoices. This clause provided, in substance, that if the Agricultural Adjustment Act should be held invalid, the seller would repay to the customer the tax content of his floor stocks on the date of invalidation, the floor stocks being arbitrarily determined by the goods invoiced to the customer within a specified time prior to invalidation. Boott Mills did not make use of this or any similar clause, except in the case of one concern where the amount involved was very small. The processors which used the so-called "dry-good merchants' clause" took the risk that a new retroactive tax might be imposed by Congress that would apply to processing tax amounts which such processors had been relieved from paying, and that such processors would have to pay over these amounts to the Government, although they were obligated to make refunds on account of such amounts to their customers. This would mean a double payment—one payment to the Government and one payment to the customers. In the case of Boott Mills, with the sole exception above mentioned, no written agreement or contract to make refunds to customers was entered into on or before March 3, 1936. There was merely a general gentlemen's understanding between Boott Mills and its customers, not embodied in writing, that Boott Mills would treat its customers fairly, and that it would not permit itself to profit at the expense of its customers in the event that the United States Supreme Court should declare the processing taxes to be unconstitutional.

REFUNDS TO CUSTOMERS BY COMPETITORS

A short time after the Hoosac Mills decision, several mills began to make refunds to customers on account of floor stocks held on the date

of invalidation. The news quickly spread throughout the industry and it was not long before all customers were demanding refunds, regardless of whether or not their invoices contained the so-called dry goods merchants' clause. The situation was further complicated by the uncertainty as to what Congress would do. There were many reliable reports to the effect that the Administration would seek to impose new retroactive processing taxes to recapture the processing taxes which were lost by the invalidation of the Agricultural Adjustment Act. Those mills which made refunds ran the risk that new retroactive taxes would be imposed with the result that they would have to pay to the Government the same amounts which they refunded to their customers. Under these circumstances, Boott Mills felt at that time that it would be best to wait as long as possible before making any actual refunds to customers. Consequently, no refunds of any material amount were made by Boott Mills to customers on or before March 3, 1936.

PRESENT PRACTICAL NECESSITY TO MAKE REFUNDS

The situation has, however, changed since March 3, 1936. The greatest asset of mills such as Boott Mills is of course the good will of their customers without whose business the mills could not continue. In view of the refunds to customers on account of floor stocks which have been made by a considerable number of Boott Mills' competitors, enormous pressure has been brought on Boott Mills to make similar refunds. This pressure is especially great in the case of a finisher which is one of the most important customers of Boott Mills. This finisher has informed Boott Mills that it has actually made refunds to its own customers on account of floor stocks held January 6, 1936, and the finisher therefore demands that Boott Mills should make the finisher whole. It is understood that the refunds made by the finisher were subsequent to March 3, 1936, and otherwise than pursuant to a written contract or agreement entered into on or before that date. The result of this pressure on the part of Boott Mills' customers is that, entirely regardless of any strictly legal rights which the customers of Boott Mills may have and in order to maintain the good will of these customers which is vital to its business, Boott Mills feels that it has no practical alternative at this time except to make refunds to its immediate customers on account of the floor stocks held January 6, 1936, by such immediate customers and the customers of such immediate customers. For compelling business reasons, Boott Mills feels that it is impossible for it merely to stand by and do nothing.

ARGUMENT

1. *Double payment if refund made.*—However, the wording of the pending revenue bill is such that if Boott Mills made such refunds, Boott Mills, after paying refunds to its customers on account of January 6, 1936, floor stocks, would in addition have to pay to the Government a tax of 80 percent of the amount so refunded to customers, assuming for the moment that it can be established that Boott Mills had passed on to its customers the full amount of the tax. In other words, although even on the customers' own theory, Boott Mills had received at the most, let us assume, only $100,000 from its customers on account of processing taxes, the total of the amount refunded by

Boott Mills to its customers and paid by Boott Mills to the Government in "windfall taxes" would be $180,000. That is, Boott Mills would pay substantially the same amount twice, once to its customers and once to the Government. The reason for this unjust result is that under the above-quoted wording of section 501 (e) (3) of title III of the House bill no deductions are allowed on account of refunds to customers unless either made on or before March 3, 1936, or made pursuant to a written contract entered into prior to that date obligating the processor to make the refunds. As has already been pointed out, Boott Mills' refunds to customers would fall in neither of these categories.

2. *Yet refunds merely what Government would otherwise do.*—It will be noted that the refunds which Boott Mills (and other mills similarly situated) feel that they are compelled to make for overpowering business reasons are solely with respect to floor stocks held on January 6, 1936, either (1) by immediate customers of Boott Mills or (2) by customers of such immediate customers.

As stated in the majority report of the House Committee on Ways and Means, one of the purposes of the proposed bill is that such floor stocks held on January 6, 1936, should "move into the channels of trade—equally untaxed." With this object in view, section 602, of title IV of the House bill, proposes to give to nonprocessors the right to recover from the Government refunds on account of their floor stocks held January 6, 1936. If in fact Boott Mills passed on to its customers the full amount of the processing taxes, there seems no good reason why Boott Mills, instead of paying the Government in the first instance and letting the Government repay its customers (and their customers), should not be allowed to make the equivalent payment direct to customers.

Senator WALSH. Did many of the textile mills take the position you did?

Mr. NEWHALL. I believe there is a substantial number of other mills that took that position.

Senator WALSH. Who refused to make any payment at all?

Mr. NEWHALL. Yes. I understand that from Mr. Dorr, of the Cotton Textile Institute.

Senator WALSH. Are there other mills?

Mr. NEWHALL. There are a very large number of other mills.

Senator WALSH. They have the same set of facts that you have enumerated?

Mr. NEWHALL. Yes; a similar situation.

Senator WALSH. They are applying for the same remedy?

Mr. NEWHALL. Through the Cotton Textile Institute they have already made a brief statement to the same effect. Mr. Dorr says a very large number of mills in the cotton-textile industry are in the same situation, either in whole or in part.

With respect to nonprocessors' floor stocks held on January 6, 1936, it should make no difference to the Government whether refunds to the person holding such stocks are made by the processor or by the Government. If the processor makes the refund to the customers, it is merely doing for the Government what the Government would otherwise do for itself. Surely Boott Mills should not be penalized to the extent above indicated for doing what the Government itself feels is the fair thing to do.

3. *Present wording opposed to object of bill.*—Again, under the provisions of the pending House bill it will not be true that floor stocks held on January 6, 1936 will "move into the channels of trade—equally untaxed." As has already been pointed out, Boott Mills feels that overpowering business reasons will compel it to make the refunds above indicated, although Boott Mills is probably not legally obligated to do so by any written contract or agreement made on or before March 3, 1936. However, under the provisions of section 602 (b) of title IV of the House bill, customers to whom such refunds were made by the suppliers would be barred from obtaining a floor stock refund from the Government by reason of having already received a refund on account of such floor stocks from their suppliers. This would of course mean that all suppliers making such refunds to their customers on account of floor stocks held on January 6, 1936, would in substance be paying a "windfall tax" to the Government on account of floor stocks held on January 6, 1936, and no one, neither processors nor nonprocessors, would be entitled to receive a refund from the Government on account of the tax content in such floor stocks. As a result, contrary to the expressed intent of the majority report of the House Committee on Ways and Means, such floor stocks would move into the channels of trade taxed to the supplier, not untaxed.

4. *No basis of "unjust enrichment."*—Again, there is no basis of "unjust enrichment" on which to found any "windfall tax" on Boott Mills with respect to the amounts refunded to customers on account of January 6, 1936, floor stocks, and if a proper deduction should be allowed, the Government would not be adversely affected, so far as collection of taxes is concerned. The stated object of the pending bill is, in substance, that no taxes should be retained by the Government with respect to floor stocks held January 6, 1936.

5. *Present wording results in discriminations.*—Again, there should be no discrimination against mills in the position of Boott Mills. It cannot be too strongly emphasized that in order to continue in business, if for no other reason, Boott Mills and other mills similarly situated, feel that they are forced to make refunds to their customers on account of floor stocks held January 6, 1936. This is the fundamental fact which has apparently been overlooked in the House bill. In the spirit of equity and fair play, mills in the position of Boott Mills should not be compelled to assume the possible double burden of making these refunds to customers and in addition paying the Government an 80-percent tax. Complete fairness requires that such mills should be allowed the same deductions as are allowed such of their competitors as have either made refunds on or before March 3, 1936, or on or before that date entered into written contracts to make such refunds. Boott Mills is now, and always has been, willing to do the fair thing, and it should not be offered up as a sacrifice for the sake of any imagined administrative advantages.

6. *Present wording may result in two 80-percent taxes.*—Moreover, the fact that under the March 3, 1936, deadline mills in the position of Boott Mills will not be entitled to any deduction on account of refunds which they are compelled to make will probably result in double taxation and injustice so far as the January 6, 1936, floor stocks of the customers of the processors' immediate customers are concerned, assuming for the purposes of this analysis that it could be established

that the processing taxes have been passed on to customers. Thus, for example, if the immediate customer of Boott Mills, to whom Boott Mills is for business reasons compelled to make a refund on account of the floor stocks held by the customers of such immediate customer, included the amount of the processing tax in the price of goods resold by the immediate customer, the result under the provisions of the House bill would be that such immediate customer would in turn be subject to an 80-percent tax on such part of the net reimbursement to him by Boott Mills as represents the amount of tax burden which has been passed on by such immediate customer to his customers. Under the House bill, this tax would be imposed on such immediate customer even though he had made a refund to his customers, provided such refund was not made either on or before March 3, 1936, or made pursuant to a written contract entered into on or before that date. This would mean the imposition of two 80-percent "windfall taxes" with respect to the tax content in the same goods—one 80-percent tax from Boott Mills, on the assumption that it could be established that the processing taxes had been passed on to customers (since Boott Mills under the Mar. 3, 1936, deadline would not be entitled to a deduction on account of such refunds), and one 80-percent tax from Boott Mills' immediate customers. This is obviously unfair and unjust.

Senator KING. Do you think the bill, as it came to us from the House, is susceptible of that construction?

Mr. NEWHALL. It expressly so provides, sir.

Senator WALSH. The Commissioner does not agree with you.

Mr. NEWHALL. If the refunds are made by a processor to a nonprocessor and that nonprocessor has in turn resold the goods to another customer, assuming that the tax has been passed on to him, then the tax, in the first instance, is imposed upon the processor, assuming that the tax is passed on to the first immediate customer; and, secondly, the immediate customer having received a refund from the processor and having in turn passed on the tax to his customer, there would be an 80 percent tax by the express provisions of the House bill on the nonprocessor, because he has received a refund from his vendor, and he has, in turn, by hypothesis, passed on the tax to somebody else. So he in turn would be subject to an 80-percent tax. There would be an 80-percent tax in the first instance on the processor and another 80-percent tax on his immediate customer.

Senator KING. There seems to be some difference of opinion here, and I suggest that you confer, before you leave the city, with the Commissioner, or such representative of the Department as may be suggested, to see if the construction for which you contend is possible, and if so it would seem there should be some amelioration. Proceed.

SUGGESTED AMENDMENT

Mr. NEWHALL. One suggested method of avoiding the inequitable situation with respect to refunds on account of customers' floor stocks held on January 6, 1936, is to change the March 3, 1936, dead-line to a reasonable time after the enactment of the revenue act. However, any other method of avoiding this inequitable situation would be equally satisfactory. So far as we can see, there is no particular reason why March 3, 1936, should be picked as the deadline rather than some other date. The substitution of a later date for the March

3, 1936, deadline would be perfectly consistent with the object of the pending bill since each nonprocessor to whom refunds are made subsequent to March 3, 1936, will under the terms of the pending bill be subject to an 80 percent tax on such part of the net reimbursement to him by his vendor as represents the amount of tax burden which has been passed on by him to his customers. If the tax burden has not been passed on by the nonprocessor there should of course be no tax. It is difficult to see how this tax on nonprocessors could be successfully avoided where it is properly payable. In any event, it is to be assumed that Congress will not be willing to offer up mills in the position of Boott Mills as a sacrifice for imagined administrative advantages.

ADDITIONAL OBJECTIONS TO MARCH 3, 1936, DEADLINE

In conclusion, attention is called to the following additional unjust situations created by the March 3, 1936, deadline which would be cured by substituting in place of that deadline some date which is a reasonable length of time after the enactment of the statute:

First, under the language of the House bill no deductions may be made even though refunds to customers may be paid after March 3, 1936, because the refunding mill was compelled to make such refunds by reason of binding oral (as distinguished from written) contracts with customers even if such contracts were entered into in good faith on or before March 3, 1936.

Second, under the language of the House bill no deductions may be made even though refunds to customers may have been paid subsequent to March 3, 1936, because the refunding mill was compelled to do so under written contracts entered into in good faith after that date and prior to the report on March 26, 1936, of the Subcommittee on Taxation of the House Committee on Ways and Means.

Third, under the language of the pending House bill no deductions may be made even though refunds to customers may have been paid in good faith (in the absence of any legal obligation) during the period of more than three weeks between March 3, 1936, and March 26, 1936, the date of the Report of the Subcommittee on Taxation.

Fourth, the question whether in any particular case a written commitment to a customer constitutes, as a strict matter of law, an "agreement" within the meaning of section 501 (e) (3) of the House bill may be determinable only through expensive and prolonged litigation. The word "agreement" as used in the House Bill may be construed to mean "contract." It is stated in Black's Law Dictionary, for example, that the term "agreement" is often used as synonymous with "contract." In cases where a refund clause was merely stamped on customer's invoices and the underlying contract was not actually rewritten to include the clause, there would be some question whether the clause created a legally binding obligation.

Senator KING. The word "agreement" as you construe it then, as applied to the activities and the matters covered by this bill, is more than unilateral, it is multilateral.

Mr. NEWHALL. The term "agreement" and the term "contract", as stated in Black's Law Dictionary, are often used as being synonymous.

Senator KING. Yes.

Mr. NEWHALL. If they want to use the term in the idea of distinguishing "agreement" from "contract" some broader language should be used, such as a written "understanding", or something of that sort, which would not be susceptible of the construction that it was a contract.

Also, in cases where a refund promise was made in a collateral letter and not expressly embodied in the final written contract, there would be some question whether the refund promise constituted a legally binding obligation. As stated in Williston on Contracts [reading]:

> All courts agree that if the parties have integrated their agreement into a single written memorial, all prior negotiations and agreements in regard to the same subject matter are excluded from consideration whether they were oral or written.

Fifth, under the language of the House bill no deductions may be made for refunds made subsequent to March 3, 1936, pursuant to court order or decree.

Sixth, under the language of the House bill no deductions may be made for refunds subsequent to March 3, 1936, which are made to customers in cases where selling agents have, by mistake, failed to stamp the refund clause on certain invoices.

QUESTION OF PASSING ON OF TAXES

With reference to everything which has been stated at this hearing and in order to avoid any misunderstanding, it should be emphasized that the extent, if any, to which Boott Mills has in fact been able to pass on to customers the burden of the processing taxes under the Agricultural Adjustment Act is a difficult question of fact on which Boott Mills is unable to give any opinion at this time.

CONCLUSION

Boott Mills respectfully requests that the provisions of section 501 (e) (3) of the House bill be amended so as to avoid the inequitable situation created by the present wording of that section, preferably by changing the March 3, 1936, deadline to a date which is a reasonable time after the enactment of the statute.

Are there any questions?

The CHAIRMAN. Thank you very much. Judge Fletcher.

Mr. FLETCHER. Mr. Chairman, on the calendar for today appears my name and that of Mr. Fred Sargent, president of the Chicago & Northwestern Railway. If the committee would permit I should like to substitute him for myself at this time, because his engagements call him out of the city.

The CHAIRMAN. All right, Mr. Sargent.

STATEMENT OF FRED SARGENT, CHICAGO, ILL., PRESIDENT, CHICAGO & NORTHWESTERN RAILWAY CO.

Mr. SARGENT. I shall undertake to be very brief, and if I am not brief enough I trust you will stop me. I want to present, if I may, the situation as it applies to railroads in reorganization.

Section 105 of the act provides for a tax upon the net income of every domestic corporation in receivership, or in bankruptcy, of 15

percent of the amount of net income in excess of the credit provided in section 26.

I assume it was the intention of those drafting the measure to afford some relief from the other provisions to domestic corporations in the process of reorganization through court procedure.

If such was the intention then may I respectfully point out that the purpose is not accomplished by the language and, indeed, the provision is of no practical value, except to a trustee or receiver while he remains as such, and offers no relief to the corporation in its efforts to get out from under such bankruptcy or receivership. This is so because from the date of reorganization the full tax schedule applies. I make that clear, I think, and no doubt you have that in mind.

The property which I represent, to wit, the Chicago & North Western Railway Co., is now in trusteeship under section 77 of the Federal Bankruptcy Act. It is necessary under the order of the court that we file a reorganization plan not later than the 27th day of June, next.

Because of a number of causes, such as the prolonged depression, several consecutive years of droughts and crop failures, and mounting highway competition, gross revenues of the North Western Railway declined from $155,000,000 in 1929 to a little over $72,000,000 in 1932. The trend is now upward again, and we have reason to believe that we can submit a reorganization plan that will be reasonable and just. Because of the prolonged struggle the company's cash reserve has been exhausted, and there is some undermaintenance to be made up as well as unavoidable expenditures for additions and betterments chargeable to capital account.

Any plan of reorganization, therefore, must necessarily provide for the building back of a cash reserve of sufficient proportions to provide for the requirements if the company is to furnish adequate and efficient transportation service in the territory it covers, and any plan of reorganization ought to also provide for a sinking fund of reasonable proportions for the retirement of bonds and other obligations.

Senator KING. May I interrupt you right there, Mr. Sargent?

Mr. SARGENT. Yes, Senator.

Senator KING. Would improvement upon, for instance, the roadway, and other improvements which I might mention, which are essential for the safety of passengers and the carrying of freight, be chargeable to the capital investment or to repairs?

Mr. SARGENT. Both. I will explain that a little later on, but I would just as soon explain it now if you would rather have me do so.

Senator KING. All right. It seemed to me that it is difficult to draw the line there.

Mr. SARGENT. It is difficult, Senator, but I think I can make it perfectly plain by analyzing for you the accounting rules of the Interstate Commerce Commission, which I will do very briefly in just a moment.

Senator KING. All right.

Mr. SARGENT. While in our case we believe a reorganization plan can be submitted that will preserve some reasonable equities for the stockholders, yet we think it is also certain that dividends cannot be paid on these equities for some period of time after reorganization.

If we are to reorganize on a secure and sound basis in the interest of the public welfare, since we are a quasi-public organization, we must build up the cash surplus sufficient to meet ordinary capital

requirements for additions and betterments, provide for a working capital, and to create a reasonable sinking fund.

Until this is done it would be unwise, and I am sure the eminent men on this committee would not approve, the distribution of earnings as dividends.

Now, we want to create a sinking fund to secure payment of interest, and also to pay off our obligations to the Reconstruction Finance Corporation. We owe them $42,000,000.

Senator KING. They haven't taken you over yet?

Mr. SARGENT. No, they have not. They have been very nice and very helpful. We appreciate it, and we think they are going to be paid 100 percent.

Senator KING. I suppose in the reorganization, when it shall have been effectuated, the old stockholders will be wiped out.

Mr. SARGENT. No, I think not. I think the reorganization will set up a plan that will protect, in a measure, the existing stockholders. That is what we are working for. To get back their equity they will have to wait a period of time until the earnings improve. If we can get our earnings back to $130,000,000 then we will be in a comfortable way.

The CHAIRMAN. What percentage of railroads are in receivership?

Mr. SARGENT. Twenty-eight percent.

The CHAIRMAN. What percent of the value of the railroad is in receivership?

Mr. SARGENT. What value?

The CHAIRMAN. Yes.

Mr. SARGENT. Well, I am afraid I cannot answer that question.

Mr. FLETCHER. Could I supply that? About 24.5 percent.

Senator KING. I suppose some of those receiverships are the result on the value of keeping up the interest on the bonded indebtedness or to meet the maturing obligations incident to the operation of the road?

Mr. SARGENT. I think it has been both, Senator.

Senator KING. Both?

Mr. SARGENT. Yes. If our company is to be subjected to the corporate tax levy proposed it will make it extremely difficult, if not impossible, for some time to come to reorganize under any plan that would enable it to promptly reestablish a cash surplus out of earnings commensurate with solid business requirements.

We would necessarily come under the schedule of adjusted net income of more than $10,000, and for the first year at least, and in all probability for the first 2 or 3 years, we would not be able to pay any dividends after providing for fixed charges, cash reserves referred to, and so forth. We do not contemplate dividends for some few years to come. We would, therefore, be required to pay 42½ percent of our adjusted net income, and this would make it quite impossible to offer any substantial amount to existing creditors and at the same time have sufficient cash on hand to meet ordinary requirements.

To illustrate what I have in mind, let me refer to a class of expenditures that we are compelled to make out of earnings that cannot be charged to current operating expenses, under the accounting rules of the Interstate Commerce Commission.

In carrying on the program for the maintenance of ways and structures there are unavoidable items chargeable to capital account.

This year our budget for maintenance of ways and structures chargeable to current expenses is $14,000,000, but to carry out this program there will be items chargeable to capital account that must come out of net earnings of about $3,000,000.

To illustrate what I have in mind, and I think this gets to your point, Senator, let me refer to a class of expenditures that we were compelled to make out of earnings, that cannot be charged to current operating expenses under the accounting rules of the Interstate Commerce Commission. Just to illustrate one or two items, let me refer to relaying steel rail, and to putting in of ballast. If we replace existing rail with heavier rail the increased weight must be charged to capital account and not to current expenses, and if we lift our ballast above existing elevations the increased elevation must be charged to capital account.

Senator CONNALLY. May I interrupt you just a moment there?

Mr. SARGENT. Yes, Senator.

Senator CONNALLY. In fixing your corporate tax now can you take off depreciation for your tracks, depreciation for your rolling stock, anything like that? Is that permissible?

Mr. SARGENT. I think that would be permissible. We do charge depreciation on equipment, Senator. We charge no depreciation, none of the railroads have charged depreciation on ways and structures. It would be permissible to set up a rate of depreciation, but that would not change this situation, because that depreciation would only be allowed to the extent of replacements in kind.

Senator CONNALLY. I understand. I just wondered if they are going to charge to capital account the putting in of new rails they ought to allow you depreciation on the old over a period of years. That is beside the point. Go ahead.

Senator KING. Let me ask you right at this point: How do you adjust your taxes with the different States?

Mr. SARGENT. They are mostly ad valorem taxes, Senator, they are practically all ad valorem, except Minnesota, that has a gross income tax, and there we work it out on a formula with the State of Minnesota under which we attempt to allocate to the State a percentage of the gross income applicable to that State.

Senator KING. In your ad valorem ascertainment of value for taxes, how do you allocate your rolling stock, the engines, and so on? For instance, your road runs through four or five States; how do you allocate your rolling stock to the various States, and how do you determine the value of your iron rails, some of them rather rusty because of lack of use, in the various States for the purpose of taxes?

Mr. SARGENT. You have asked a very pertinent question and one that, to answer, would take a very long and extensive brief and analysis of all these different formula. We have, for instance, the mileage basis of allocation; we have the wheelage basis of allocation; we have the allocation of actual fixed value within the State in proportion to the total value of the system; we have the average market value of stocks and bonds on the New York Stock Exchange; the weighted average, taking it every day over a period of years and then undertaking to allocate that back to each of the States, based on a mileage basis and based on a wheelage basis, and based on a 1,000-gross-ton-mile basis, and then, in some way or other, the tax commissions of the States take all of these formula and put them together and arrive

at some conclusion. But I admit it is not scientific. I will admit I do not know how to get at any real, scientific basis. Our total taxes at the present time run about $6,000,000 a year.

Senator KING. What is your mileage?

Mr. SARGENT. 8,417 miles. I think the most thorough and expert studies we have on that subject, year after year, have been found in the State of Wisconsin, so far as our system is concerned.

Senator KING. Thank you.

Mr. SARGENT. This and other analogous items running through the whole category of our maintenance program means that to maintain the property for the service of the public we are compelled to pay out of net earnings for items chargeable to capital account an amount of $3,000,000 for a normal year's maintenance program. This $3,000,000 could under no circumstances go to the stockholders because it would under no circumstances be available for dividends, but it goes back into the property for the service of the shipping and traveling public. Since, therefore, we would not be able to pay any dividends for a few years after reorganization, the proposed corporate tax would be 42½ percent of this amount that went back into the property, or $1,275,000. In addition a railroad company is confronted with a long list of unavoidable expenditures chargeable to capital account which it can only provide for out of net earnings, or if its credit is sufficient, out of the sale of securities. But even if its credit is sufficient the sale of securities for this class of expenditures is not good business management and is not in the interest of the shipping and traveling public if railroads are to survive and their rates be held to the low level that the common welfare requires. For instance we must have cash with which to build nonremunerative improvements chargeable to capital account, such as highway grade separations, the payment of public assessments for street and other improvements, track elevation through cities and towns, and so forth, and if these things are to be carried forward we must have surplus net earnings therefor.

In addition it is essential that a railroad company build up and have on hand a reasonable working cash fund out of surplus earnings in order to be able to meet emergencies, such as are created from time to time by floods and storms, and in order to stabilize employment. Without a surplus a railroad is compelled to live from hand to mouth, depending upon its current receipts from month to month to meet its obligations. It must have a surplus cash fund out of which to at least make a 25-percent payment on the purchase of new and additional equipment, and a corporation such as ours that has been compelled to exhaust all its cash reserves must under any reorganization plan to provide for building these back again.

Just now many progressive things are coming along in the field of transportation. The railroads if they are to be progressive must be able to take advantage of modern developments. It may be necessary within the next 3 or 4 years to scrap a great deal of existing equipment, not because it has been worn out but because progress in the art will make much of it obsolete, and the railroad must have a cash fund out of which to help finance such developments and changes from time to time.

Now, the art is developing very rapidly, as you know. The Union Pacific and ourselves just had on exhibition in Chicago the other day the new City of Los Angeles, a train that cost a million dollars. The

Diesel is coming along very rapidly and it takes some additional cash out of earnings to keep in step with progress. We are trying to join the Union Pacific in the City of Los Angeles, the City of Portland, and City of Denver, three new streamline trains, and, of course, frankly, I do not want the Union Pacific to know it, but we are having an awfully hard struggle to meet our end of the situation.

Then, too, there is a constant demand as new industries come along or as old industries expand or change their method of operation, for the building of industry tracks.. That is another illustration. In the farming regions there is demand for the building and enlarging of stockyards and other facilities, all of which come out of earnings, and when the expenditures are made they are chargeable to capital account. Anything that we make, no matter what it is, for the service of the public, that is new, or that is over and above what we have must be charged to capital account and is not charged to operating expenses.

Senator KING. You may try new experiments and you may not get any returns for perhaps several years.

Mr. SARGENT. That is right.

Senator COUZENS. Do you have any idea as to the amount of time that may be required to get out of receivership?

Mr. SARGENT. I am getting to that in a moment. These unavoidable expenses to properly serve the demands of the shipping and traveling public on a system such as ours would normally require from four to five million dollars a year, which under the accounting rules of the Interstate Commerce Commission must be charged to capital account and not to current operating expenses; therefore, they can only be provided out of net earnings.

In addition, a company such as ours should have a sizable working cash fund, especially if we are to make any semblance of stabilizing employment. With a surplus on hand we can keep a normal force in slack periods, taking a reasonable chance that business will revive and the work be of value later on. Our company attempted to do this until we were forced to abandon this principle of stablizing employment by reason of the exhaustion of our surplus cash resources.

I might say there, Senator, that I tried to stabilize employment on our railroad, and I did. One of my troubles was I stabilized it too long, keeping up when business went up and down. As long as we had a surplus to work on I kept an even number of man-hours in the shops, and things of that kind.

I might say also that one of the men that was partially responsible for my doing that was none other than Senator La Follette and the Governor, who talked with me about it and thought it would be a very fine thing if we could stabilize employment in our shops throughout the State of Wisconsin, where we have 26 percent of our mileage, and I attempted to do that. Now, I cannot do it because we are just living from day to day and from month to month. We must build up our cash as earnings come back.

If we are to come out of bankruptcy proceedings under any reorganization plan that will enable us to reestablish our credit and meet those items of expense chargeable to capital account for ordinary maintenance of the property and undertake to stabilize employment and have a reasonable working cash fund, we will be most seriously handicapped for a number of years to come if we are compelled to

pay 42½ percent of our net by way of taxes. As I see it this percentage will be a disastrous blow to those railroads that have not been able to weather the storm but could build themselves back into a sound and stable position with the return of reasonably prosperous times.

It occurs to me that the committee in charge of the bill probably intended the 15 percent provision to help companies in receivership, but it only helps them so long as they stay in receivership. The minute they attempt to come our or do come out under any plan of reorganization they are immediately met with an almost impossible situation, since they would be unable to pay dividends until they have reestablished surplus cash reserves and working capital, and while trying to do so would have to pay 42½ percent of their net earnings in taxes.

If the committee could and would give favorable consideration to the extension of the 15-percent provision for a reasonable period of time after reorganization, say 5 years, it would help to remove an otherwise almost impossible situation with relation to reorganization. Without some such relief I am frank to confess that railroads now in the process of reorganization will be under very serious handicaps, if not impossible handicaps, as against those roads that may be in a comfortable position with relation to surplus, and that could afford for a while at least, though even then not permanently, to pay out a very large percentage of net income in dividends.

There is one other phase of the discussion I would like to speak of very briefly. With the exception of the eastern border line of our territory we are in a country of small industries. The ability of these small industries to meet changing conditions and to expand and grow in competition with larger industries is essential to our future traffic development.

In 1934 there was created what was known as the business advisory and planning council, and it functioned under the guidance of the Department of Commerce. This council created what was known as the small industries committee. Mr. Edmund C. van Diest, of Colorado Springs, was made chairman of this committee. I had the honor of being a member of the committee. The committee undertook a survey of the small industries of the Nation with relation to credit needs of small industries, and under date of April 15, 1935, the Department of Commerce released a digest of the report. Page 3 of that digest contains the following [reading]:

> As a matter of fact long-term financing for small industry has always been difficult. It is not simply a depression problem. Through private investment bankers it has been available only to concerns of sufficient size and standing to warrant the investment banker in bringing out an issue as small as, for instance, $1,000,000. And so it may be said that this facility has been practically denied small concerns. Such enterprises have been obliged to develop their capital structures gradually and out of undistributed earnings, or to attract the participation of individual capitalists. They have not received the benefits of recourse to the capital markets for their long-term requirements.

Under date of November 15, 1934, the chairman of the small industries committee submitted report to Mr. S. Clay Williams as chairman and to the members of the business advisory and planning council. In his letter transmitting the report Mr. Van Diest said among other things [reading]:

The report indicates that the total manufacturing establishments in the United States, 97 percent employ 250 wage earners or less, and that the percentage of wage earners so employed approximates 48 percent of the wage earners in industry. The report further clearly indicates the serious financial condition in which most of the small industries find themselves not only as to working capital but also current and long-term capital obligations, and that the situation is serious and unless protection is provided national danger for industry impends.

Mr. Van Diest also points out that the summary of conclusions were reviewed by Assistant Secretary of Commerce Dickinson, by Dr. Viner, by Mr. Austin, Director of the Census, and other Federal officers, and he then says that the report as prepared by Dr. Beckman of the State University of Ohio he believed had the approval of these parties named.

I merely cite this report as evidence of the fact that the smaller industries constituting 97 percent of the total number of industries and employing 48 percent of the labor, must be in a position to conserve their net earnings in order to meet their capital requirements, and the percentage of net earnings which they must conserve is necessarily larger than that of a rich industry able to command new capital on advantageous terms to meet progressive developments in what is now a very rapid changing industrial world.

While some recognition is given to this principle in the bill yet it seems to me that it is wholly insufficient to enable the great majority of small industries to build back their surplus, reestablish their credit, and be prepared to make new and progressive improvements if they are to remain in the competitive field.

Senator KING. Have you any other amendments to suggest to the bill on behalf of the railroads?

Mr. SARGENT. I am only speaking with relation to section 105.

Senator KING. I say with reference to railroads.

Mr. SARGENT. Frankly, Senator, there is so much in the bill that I do not understand, I am, honestly, incompetent to discuss it.

Senator HASTINGS. If you give them 5 years would that not be an incentive to keep the road in receivership as long as possible?

Mr. SARGENT. No; I think that would be an incentive to get out. The present bill is an incentive to stay in, because just the minute you get out you are subject to the full tax, and as long as you stay in you only pay 15 percent.

Senator COUZENS. Let me ask you a question or two. You made a statement a while ago that you made an effort to stabilize employment in your shops in Wisconsin and under the aegis of Governor and Senator La Follette you did stabilize it?

Mr. SARGENT. Yes.

Senator COUZENS. Have you any figures to show what that effort cost you?

Mr. SARGENT. No; I have not, Senator, but Senator La Follette will remember the conversation in which we discussed the whole situation.

Senator COUZENS. I was wondering what effect that had on your revenue.

Mr. SARGENT. In the long run, it did not have any adverse effect, for the simple reason, Senator, that what we did we needed in time, we did no wasteful work. If business dropped down to where we had a surplus of locomotives or a surplus of cars we kept right on repairing cars and locomotives, because we expected business to come back and absorb it. Finally, when we ran out of cash we had to stop

that, then we lived from day to day and month to month, as we are now living at the present time. We would like to get back.

The CHAIRMAN. You feel that there is an improvement in business on your line?

Mr. SARGENT. Yes; I think there is. We are running 8 percent ahead of a year ago, and every indication points to a gradual pick-up of business.

Senator BLACK. Eighty percent?

Mr. SARGENT. Eight percent.

Senator BLACK. Eight percent over last year?

Mr. SARGENT. Yes. I wish it were 80 percent. I might say we kept charts of iron-ore loadings since 1865. In 1929 we handled over 9,000,000 tons of iron ore. In 1932 that had dropped down to 440,000 tons. Now, it is on its way up again, and indications are it will continue up, as far as we can determine.

Senator KING. Your prosperity depends on the steel industry then?

Mr. SARGENT. Yes; in some measure, but the movement of iron ore is a good index to the general trend of business, based on the chart we have.

I might say that there are a number of very fine men in small industries that come to see me, that try to get me to help them, get money to carry on, just to carry on. The reason I mention that here is that our future traffic out in our territory, when we get farther out west, is dependent on the small industries, as well as on agriculture, and if they dry up it is a very serious thing for our railroad. I just call that to your attention because I know you would want me to do so. Could not you desire to protect these small industries? They are in such a postion that they must build back the reserves, if they are going to meet competition, and this competition is coming along with an enormous rapidity. I never saw anything like it, especially in the field of chemistry. What is going on in chemistry is certainly startling. We are trying to get certain plants located in our territory to process, for instance, the soy bean. It is remarkable what can be done with it. It is hard to get new capital to go into it.

The CHAIRMAN. Do you think it would be an impetus to business if in this bill there should be written a provision that new industries be excluded for, say, 5 years, as you have suggested in the matter of receivership and reorganization of railroads?

Mr. SARGENT. I think that would help, Senator, but I would be partial to the old industry that has tried to live, that has gone on and given employment during this period and has exhausted all its resources. I do not want to mention any names, I know you do not want me to. I can name a number of those very fine industries that have just done that very thing.

Senator COUZENS. Is it a sound conclusion to reach from your statement, Mr. Sargent; that this bill, as it stands now, would be an impetus to the growth of large concerns, and to monopoly?

Mr. SARGENT. Well, now, I am not competent to express an opinion on that, but since you have asked it I will do the best I can.

Senator COUZENS. That is all we expect.

Mr. SARGENT. Offhand, and without having studied it as deeply as I ought to to answer such a question coming from this body, I will say my general impression is that this will just fold up a lot of small industries and remove a lot of competition all over the territory, that they cannot survive under this and meet the progressive competitive

changes in the art from time to time. I do not see how they can do it, I do not see how they can get the money. Now, as you dry up the small industries I would think that would give an impetus to the large industries. That would be my own conclusion about it.

Senator CONNALLY. Mr. Sargent, I suppose it is conceded that we have got to get some more money out of taxation.

Mr. SARGENT. Yes.

Senator CONNALLY. Havy you any suggestions to make as to the least painful method?

Mr. SARGENT. I know your problem, Senator. I am in great sympathy with it. I want to be helpful. I honestly feel that this taking away of surplus earnings will, in the long run, get you less money out of corporations than you would get even under the present plan.

Now, how you are going to get the money I really do not know, except this: I believe, as long as you have asked for my opinion on it, my own honest judgment is that we have got to grit our teeth and meet the situation, do it courageously and go on and reduce the income bracket and increase the rate of income return, and let us do it in a really practical way, without at the same time doing the things that it would seem to me dry up a large amount of industry and employment in these small industries throughout the United States. That is my own guess. It probably is not worth anything.

Senator CONNALLY. Oh, yes; it is.

Mr. SARGENT. I say it for no reason whatever other than to say that it is the best solution that I can think of.

Senator CONNALLY. You mean a solution of the individual's difficulties?

Mr. SARGENT. Yes.

Senator CONNALLY. It is pretty clear here from these hearings that the corporations relatively are paying less tax now than the individuals. Now, to do what you suggest would simply aggravate that situation. If we have got to operate on the corporation on what part of its anatomy can we perform the operation with less time to it and with less pain?

Mr. SARGENT. Perhaps the anesthetic would not be very efficient, but even an enlargement of excise taxes would help.

Now, as I understand it, a part of the money we must have is to take care of the farm situation, due to the upsetting of the A. A. A. I am in sympathy with that. I made every fight I knew how for the American farmer. I defy anybody to outdo me in trying to help the American farmer. I am in sympathy with him. We ought to pay him, and he needs the money, but I wonder if the Supreme Court had not upset the A. A. A.—that is not a very dignified expression—but I wonder if the Supreme Court had not held it unconstitutional, I presume we would have been going along with the processing tax. That is merely another name for an excise tax, as I see it. If under those circumstances we would have been willing to go along with that kind of excise tax I am wondering why we should not be willing now to go along with the same principle in order to raise more money.

The CHAIRMAN. That does not raise enough, that does not raise a sufficient amount for us, Mr. Sargent. Of course, the President suggested the processing tax on a fresh basis.

Mr. SARGENT. Yes.

The CHAIRMAN. Without reducing the rate.

Mr. SARGENT. Yes. Well, I do not know. You might find some modified way, Senator. In answer to your question I will say—and I am only speaking in behalf of the small industry and in behalf of railroads under reorganization—I think it is disastrous to us to do it.

Senator CONNALLY. How about moderately increasing the flat rate and then superimposing a supertax on undistributed capital, not sufficient to wreck them but to stimulate them a little?

Mr. SARGENT. I really wish you would excuse me from answering that, because I would want to study that question, I would want to see its effect, I would want to see what revenue it would produce before I attempted to answer it, I would want to see the effect on the corporate structure of the organization.

Senator KING. Mr. Sargent, you appear to me to be such a frank witness, and you have made so many constructive suggestions, do you intend to be in the city for a day or so?

Mr. SARGENT. I was going home this afternoon, Senator. I may stay over if it would do any good.

Senator KING. For my own benefit, if not for the benefit of the members of the committee, I wish you would read that editorial which is in the record, the editorial from the New York Times. It made some very valuable suggestions for raising as much practically as is contemplated by this bill, and give us your reaction to that, either in a letter to the Chairman, or further appearing before the committee. If you could do that I would be greatly obliged.

Mr. SARGENT. You compliment me greatly now, because I do not claim to be competent or skilled to discuss all these features. I know your problems. I will try to study it and write Senator Harrison my reaction to the editorial.

The CHAIRMAN. Thank you very much, Mr. Sargent. Mr. Fletcher.

STATEMENT OF R. V. FLETCHER, WASHINGTON, D. C., REPRESENTING THE ASSOCIATION OF AMERICAN RAILROADS

Mr. Chairman, I will take only a moment. My name is R. V. Fletcher. I represent the Association of American Railroads.

Mr. Sargent has made it unnecessary for me to make an extended statement here. I listened carefully to his suggestions, which apply particularly to railroads now in the hands of the sheriff, and I would like to have the privilege of filing with your committee, if I may, a brief statement which would embody some suggestions that the railroad industry is making for amendments to this bill, which would take care of their special situation.

The CHAIRMAN. You have that permission.

Mr. FLETCHER. That situation is not one which applies alone to the roads in the hands of the courts, but generally.

(The suggested amendments are as follows:)

SECTION A

That railroads be permitted, in arriving at "undistributed net income", to deduct from "adjusted net income", in addition to the other deductions mentioned in recommendation II of the subcommittee's report, the following items:

(1) Amounts applied to sinking and other reserve funds under mortgages, deeds of trust, or other contracts, or paid or reserved to retire funded debt, issued or assumed.

(2) Amounts paid to the United States of America or any corporation or other agency thereof in the reduction of loans made to or assumed by the taxpayer.

(3) Expenditures chargeable to "Capital account" made pursuant to requirements by or agreements with Federal, State, or other public authority.

(4) Amounts provided for by reorganizations plans to be invested in additions and betterments before the payment of interest on bonds issued pursuant to said plans.

SECTION B

Further, that railroads, in arriving at "Adjusted net income", be permitted to deduct allowances for depreciation and losses on retirement of property as provided hereunder:

(a) Where property, including equipment, is being operated under an agreement with the owner thereof, the lessee shall be entitled to deduct a reasonable allowance for the exhaustion, wear and tear, and obsolescence of such property, unless by contract the lessee is obligated to pay to the lessor such an amount as additional rental, in which event, the lessor shall be entitled to make such deduction.

(b) The amount of losses incident to the retirement of leased property, including equipment, as permitted under regulations prescribed by the Interstate Commerce Commission, shall be allowed as a deduction from the gross income of the lessor or lessee, as contracts may provide.

Mr. FLETCHER. I will take just one moment to say that these suggestions are predicated upon the theory that it is highly important for the railroad industry to be permitted to create a sinking fund and set up reserves for the retirement of their very embarrassing and heavy burden of bonded debt.

Senator COUZENS. Is not that a new policy of setting up sinking funds?

Mr. FLETCHER. I think it is time it should be adopted, Senator.

Senator COUZENS. Yes; but it is new, though, is it not?

Mr. FLETCHER. Speaking broadly; yes. We think it is new. I do not want to leave the inference that it is new just because this tax bill was introduced.

Senator COUZENS. It is obviously new.

Mr. FLETCHER. It was adopted before the inception of this tax program that is now before the Congress.

Senator KING. Do not many of the bond issues, not only for the railroads but for other corporations, require a sinking fund?

Mr. FLETCHER. That is just what I was about to remark, Senator. Whether it is new or not, it grows out of the fact that there is an increasing tendency on the part of the regulating authorities—and I speak now of the Interstate Commerce Commission—which has to pass upon all these propositions of refunding and reissuance, to require the setting up of sinking funds in varying amounts for the purpose of retiring the bonds. So that many of the railroads are in this unhappy situation, if this bill becomes a law, that they are required by the Interstate Commerce Commission, in some cases, by administrative orders of the Reconstruction Finance Corporation, to set up sinking funds.

Senator KING. And sometimes by State regulation?

Mr. FLETCHER. And sometimes by State regulation. They are required to set up these sinking funds, and then we are taxed a very high rate if the sinking funds are created; and that is one of the reasons why I am suggesting here, in this memorandum, that the railroad industry be permitted to deduct from the net adjusted income, before

arriving at the figure of undistributed income, such sinking funds as they are required by their contracts, or by their agreements, to create. I will not elaborate that, because it is very simple.

Then there is an indebtedness now to the Government, to Government-loaning agencies, on the part of the railroads of nearly $600,000,000. That runs about $400,000,000 to the Reconstruction Finance Corporation and about $187,000,000 to the Public Works Administration. The Public Works Administration has sold its own indebtedness, however, I think practically all of it, to the Reconstruction Finance Corporation. So perhaps it is a little more accurate to say that the entire $600,000,000 is owed to the Reconstruction Finance Corporation.

Senator COUZENS. They have sold a good deal of it themselves.

Mr. FLETCHER. They has sold a good deal of it for themselves, and made some money out of it, which was legitimate, I dare say.

Those debts ought to be liquidated as soon as possible. In some cases the loan which has been made by the Reconstruction Finance Corporation prohibits the payment of dividends until after these loans have been paid off. You see that introduces a factor into the situation that makes it difficult for the railroads to handle the affairs under this bill.

Senator HASTINGS. Does the contract with the Reconstruction Finance Corporation follow the securities themselves into the hands of the public?

Mr. FLETCHER. Yes. In some cases they do, Senator, because they are written into the face of the bonds, or of the obligation. That is not true of all railroads, however. It depends a good deal on the state of the credit of the railroad at the time it made the loan.

And then, as Mr. Sargent has so well pointed out, it is very essential that certain railroads, particularly those now undergoing reorganization, expend a good deal of money for capital purposes in order to rehabilitate their property and overcome quite an accumulation of deferred maintenance, and those requirements are frequently written into the orders of the court which approved the plan of reorganization.

In that connection, I was very much interested in what Senator King, I believe it was, asked Mr. Sargent about the peculiarities of railroad accounting in that respect.

The ordinary industry can usually charge to what I will call "operating expenses" the cost of replacements. Railroads cannot do that, but only in part. As an illustration I will use the illustration I used before the House Ways and Means Committee.

If there is a switch stand to be replaced, which has worn out, which cost $200 30 years ago, and that same switch stand, of the same type, will cost $400 now, due to the change in the level of prices, when you come to handle that $400 in the accounting of the railroads, $200 of that is charged to operating expenses and the excess $200 is charged to capital, under the rules of the Interstate Commerce Commission; whereas in private industry, which is not thus regulated, they may, I imagine, charge the entire $400, the cost of the new structure, to operating expenses.

Now, the result of that may be, as you see, that a railroad company might have at the end of the year gross earnings of $100,000,000. The net adjusted income which is derived by the application of processes with which the committee is familiar might be $20,000,000.

That is the thing they have got to face when they come to figure up their taxes. But of that amount, $10,000,000 of that $20,000,000 may be represented by additions and betterments to the property, which simply represents the difference between the cost of old structures and the cost of new structures which take the place of the old structures, so that $10,000,000 has added nothing to the income-producing capacity of the railroads, and you are left there only with the $10,000,000 in cash from which to pay the taxes and to declare your dividends. Now, that is the peculiarity of the railroad industry which I trust that the committee will consider.

Senator HASTINGS. Mr. Fletcher, is it not true that in the law, or the ruling of the Internal Revnue Department, where we have a case of this switch, for instance, that now costs $400, you can only have credit for $200, because that is the rule of the Department?

Mr. FLETCHER. That is the rule for replacements; yes.

Senator KING. If the switch is worn out, if it utterly failed to meet the requirements of the patrons of the road and they would put in a new one, would you have to charge one half of that to capital and one half to expense?

Mr. FLETCHER. Yes; if it was twice as expensive now, if it cost twice as much as it did originally cost on the books—I am not quarreling with the principle, I am talking about how it happens to work out in a case of this sort.

Senator HASTINGS. If the books show it cost $300 originally, then the difference is only $100.

Mr. FLETCHER. That is right, Senator; and if the cost happened to be $400 and the cost of the new one $400, there would be no additional capital.

Senator HASTINGS. Yes.

Mr. FLETCHER. When you apply that to structures and to bridges, and to large and costly structures of the railroads, you run into money very rapidly.

Now, another question was asked about the depreciation of the railroads. Ordinarily, as has been stated correctly by Mr. Sargent, very few of the roads of the United States have set up depreciation reserves on their ways and structures. All of them for many years have been required to set up depreciation on their equipment. They have been permitted to set up depreciation on their ways and structures, and in some cases depreciation has been accumulated on the books of the company as to particular structures, large passenger stations or large bridges that are outstanding in that particular railroad.

My understanding is, and I am not much of a tax expert, that the Commissioner of Internal Revenue has been inclined to deny to the railroads any accumulated depreciation upon their track. I think that matter was carried into court. I know it was carried into court at one time, and the court held with the Commissioner of Internal Revenue, upon the theory that a well-maintained track did not depreciate.

That is a principle that we would like to see established in connection with the valuation of railroad property, but which we have not had much luck with, with the Interstate Commerce Commission.

That suggests to me that I may, without impropriety, just mention the fact that on this depreciation on equipment the railroads are

being very much disturbed by rulings of the Department, and by the courts, for that matter, that no depreciation can be taken on leased equipment. That is an old question.

A writ of certiorari, on which we pleaded with the Supreme Court to review that question, has just been denied. May I take a moment to spend on that, because it is a very vital and important matter?

The CHAIRMAN. Proceed.

Mr. FLETCHER. The Boston & Albany Railroad, which extends, as you remember, from Albany, N. Y., to Boston, is leased for a long term—I think 999 years—to the New York Central. Under the terms of that lease not only does the road convey to the New York Central the tracks, but its equipment as well, and there is a provision in the lease that requires the New York Central to keep the equipment in repair, and at the end of the leased period it must restore to the Boston & Albany Railroad the equipment in as good condition as it was when it was taken over.

Now, when we come to talk about depreciation on that equipment in connection with income taxes, we are met with the statement that the New York Central cannot take off depreciation on that equipment because it does not own it, and that the Boston & Albany cannot take any credit for depreciation on that equipment because they have a covenant with the New York Central whereby it will, at the expiration of the lease, be restored to the same sound condition it was in when the lease was made. So we are caught there between Scylla and Charybdis, if that is the right way to pronounce the classic.

Senator CONNALLY. What is the advantage of a lease in a case of that kind? In reality a 999-year lease is as good as a sale. There was some reason, of course, for it.

Mr. FLETCHER. The history of the thing has got to be considered.

Senator CONNALLY. Never mind about that.

Mr. FLETCHER. I can explain it in a moment. In 1920 a law was passed governing the railroads of the country, requiring that the railroads of the country be divided up into a limited number of systems, in accordance with a rather comprehensive scheme adopted by the Interstate Commerce Commission, but it permitted leases to be made in the meantime, and those leases were made very generally throughout the country, because neither the railroads nor the Commission were quite ready to approve this elaborate scheme.

Senator BARKLEY. If the method of transportation keeps improving during the next 999 years nobody will be interested in railroad equipment except in a museum, will they?

Mr. FLETCHER. I heard the senior member of the Interstate Commerce Commission, the Honorable Mr. Meyer, say the other day in a speech that possibly in 25 years from now there will be no transportation on land and that the railroads would be obsolete, and so would the automobiles be obsolete. The only comfort I had about that, Senator, was that 25 years from now will mark the end of my activity, I am sure.

Senator BARKLEY. And 999 years from now will mark the end of the activity of all of us.

Senator HASTINGS. Mr. Fletcher, with respect to depreciation, taking the illustration that you have just given, under the present law you cannot very well quarrel with the Internal Revenue Bureau, nor with the courts either, can you, with respect to their decisions?

Mr. FLETCHER. No. It is the law that I am asking to be changed. That statement of Senator Connally, I think gives force rather than the contrary to it, that anybody who has leased a railroad for 999 years is, for all practical purposes, an owner.

I thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Judge. Is Mr. Scully in now?

Mr. SCULLY. Yes, sir.

STATEMENT OF JAMES N. SCULLY, BUFFALO, N. Y., JACOB DOLD PACKING CO.

The CHAIRMAN. Mr. Scully, you may present your matter to the committee.

Mr. SCULLY. What do you want to know?

The CHAIRMAN. We have got you here on the calendar at your request, I imagine. Did you want to state anything to the committee?

Mr. SCULLY. Well, I do not know what I could say, but this windfall tax, we cannot pay that, and we cannot pay the processing taxes. I have paid the processing taxes as much as I could, and after the hogs got higher I could not pay any more.

The CHAIRMAN. You are not in favor of this windfall tax then?

Mr. SCULLY. No.

The CHAIRMAN. And you are not in favor of the processing taxes?

Mr. SCULLY. No; unless you make a lighter processing tax, so we can pay it.

The CHAIRMAN. What is your business, Mr. Scully?

Mr. SCULLY. I have got a packing business. I have got a little packing plant, working 20 people, 18 married men, they have all got families, they have got children that go to school. The plant is owned by just myself and my boys. I do not have anything more than this to keep going, buying and selling, getting the money back, keeping going, that is all.

The CHAIRMAN. You agree pretty generally then with Mr. Woods' statement yesterday with reference to this windfall tax?

Mr. SCULLY. Yes, sir.

The CHAIRMAN. We thank you very much, Mr. Scully. Mr. Geier.

STATEMENT OF FREDERICK V. GEIER, CINCINNATI, OHIO, PRESIDENT, THE CINCINNATI MILLING MACHINE CO.

The CHAIRMAN. Are you going to discuss the windfall tax?

Mr. GEIER. No, sir; the undivided profits tax.

The CHAIRMAN. All right, proceed.

Mr. GEIER. I am representing today four machine tool companies in Cincinnati. We generally approve and endorse the presentation on the part of the machinery industries that has been made by Mr. John W. O'Leary. However, we are four small, individual companies, and we do not come here in any sense in the spirit of opposition; we come here to tell you, in a few words, about the problem that we would face in endeavoring to operate under this tax. Our industry as a whole is to be heard this afternoon.

As employers and manufacturers we have tried to figure out how they would have been able to go through the depression years under

this tax, and we felt that we owe it to our employees and to ourselves to show you just what our problem would be.

I will give you just for a moment a picture of the fluctuation in orders in the machine-tool industry. I am not going to discuss this, because this will be touched on this afternoon, but I want to merely point out the horizontal line on this chart A represents the average for 1926 taken as normal. We have an extraordinary fluctuation in volume to deal with.

Senator BARKLEY. What period does that chart cover?

Mr. GEIER. This covers from 1919 through the end of 1935.

Senator BARKLEY. What does that high peak in the middle represent?

Mr. GEIER. That represents 1929.

Senator CONNALLY. Is that up or down?

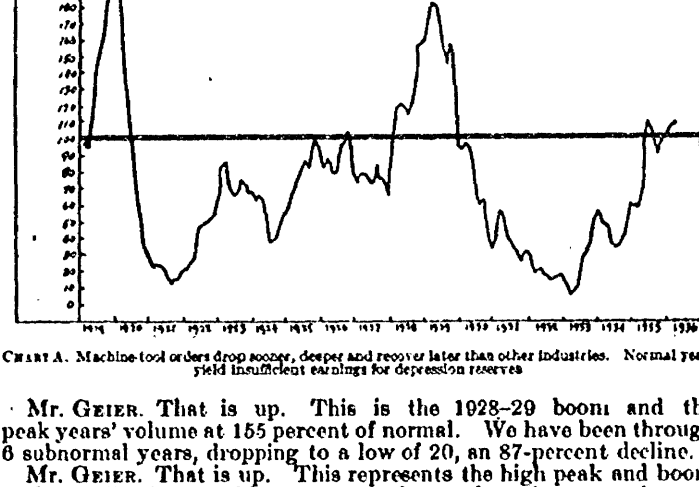


CHART A. Machine-tool orders drop sooner, deeper and recover later than other industries. Normal years yield insufficient earnings for depression reserves

Mr. GEIER. That is up. This is the 1928–29 boom and the peak years' volume at 155 percent of normal. We have been through 6 subnormal years, dropping to a low of 20, an 87-percent decline.

Mr. GEIER. That is up. This represents the high peak and boom period [indicating]. This represents what we have just gone through and where we are today [indicating].

The CHAIRMAN. You are proceeding upward?

Mr. GEIER. Yes, sir; we are at this point [indicating]. Our average shipments for last year were 86 percent of 1926.

Now, first of all, we want to present the problem as to our chances of getting orders. We are in the business of manufacturing machine tools.

Senator CONNALLY. What kind of machinery is that?

Mr. GEIER. They are metal-working machine tools that remove metal either by a metal tool or abrasive wheel, such as lathes, drills, milling machines, grinding machines, and planers. The four companies for whom I am speaking build the basic tools, like milling

machines, grinding machines, drills, and lathes which are used to make all the other kinds of machinery and tools, and everything metal products. I might say at this moment that there is no one, beginning with the farmer who has to depend on his truck, his agricultural machinery, his automobile, or the railroads to bring his produce to market, who is not ultimately dependent on the basic machine tools with which all these can be built.

Machine tools, too, are basic to the national defense by sea, on land, or in the air, and this is even more true today as our forces are being mechanized than during the World War when machine tools were given the first priorities.

Our industry is small indeed, but without machine tools, as the transportation, communication, household, and industrial equipment of the Nation wore out, we should slip back through untold hardships to a primitive handicraft age.

Senator BARKLEY. How many companies are there making the same type of machine tools in the country?

Mr. GEIER. In the whole industry there are perhaps 150 or more.

Now, if our customers spend all the money that they are allowed to take as depreciation, they will not have spent enough to keep their plants in up-to-date productive condition. That is shown by this chart B, data taken from the United States census, going back to the beginning of the century.

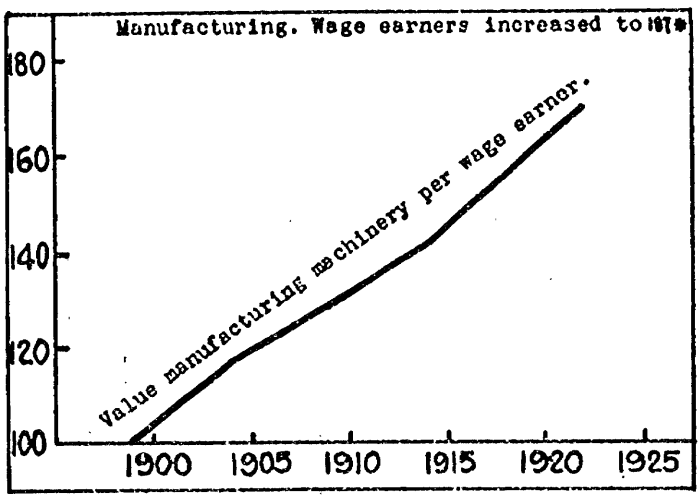


CHART B. Since 1900 wage earners in manufacture increased 80 percent. Each wage earner requires 60 percent more machinery value.

You will note that the number of wage earners in manufacturing has risen, and further that the value of machinery required per wage earner has constantly risen because of the need to improve the productivity and the necessity for more elaborate and refined processes.

It would be impossible today to produce the modern automobile, refrigerator, and the many mechanical devices now considered a necessity, at present prices where they can be purchased by millions of people, if we had available only the machine tools of a generation ago. Where machine tools formerly worked to manufacturing tolerances of a few thousandths of an inch, today we deal in tenths and even hundred-thousandths of an inch. Naturally these complex, highly accurate machines require a materially greater investment per wage earner than the simpler machines of the past.

Senator BARKLEY. Coincidental with the advance of machinery the number of employees falls off.

Mr. GEIER. During this same period the number of wage earners in manufacturing industries has risen up to 187 percent of what it was in 1899. But at the same time that the number of employees in these industries was rising the amount of machinery required per wage earner was rising.

Senator HASTINGS. I suggest, Mr. Geier, that you give the percentages for the record, because a person reading the record will not have the advantage of seeing the chart as you go along.

Mr GEIER. Yes, sir. I will just say this, that during the first 25 years of the century the value of machinery per wage earner has risen to about 170 percent, the value of industrial buildings required to about 160 percent and the power to about 200 percent.

We point this out to show we are competing to get our customers to spend their depreciation money for our equipment, but if they spent all of it they would not have enough, because today it takes this much more [indicating].

Senator HASTINGS. How much more?

Mr. GEIER. Well, let us made it very conservative, say 50 percent more per employee to provide the wage earner with the modern machinery that he needs to be productive.

Senator GERRY. How much has your own employment increased?

Mr. GEIER. Since 1900?

Senator GERRY. Well, since 1900; whatever your figures are on that chart.

Mr. GEIER. Oh, at least three times. So we are competing for this depreciation money, and if it were all spent it would not be enough to keep these customers up to date in equipment.

Now a survey was made some time ago of the buying policy of machinery users, 200 of whom answered the question "What savings do you require when purchasing machinery for replacement purposes?"

The summarized results are shown on chart C.

I will not read you all these figures except to say that 64 percent of the firms said that they would not buy unless the machinery would pay for itself within 3 years, and 100 percent of them said it would have to pay for itself within 5 years. In other words, the economic equation determined whether or not the purchase was justified.

Now, we wish to point out that since the mere expenditure of depreciation reserves historically is inadequate to maintain plants up-to-date and since the great number of our customers have no access to the capital markets, therefore they can only buy machinery with earnings which, under this bill, will be taxed as undistributed income.

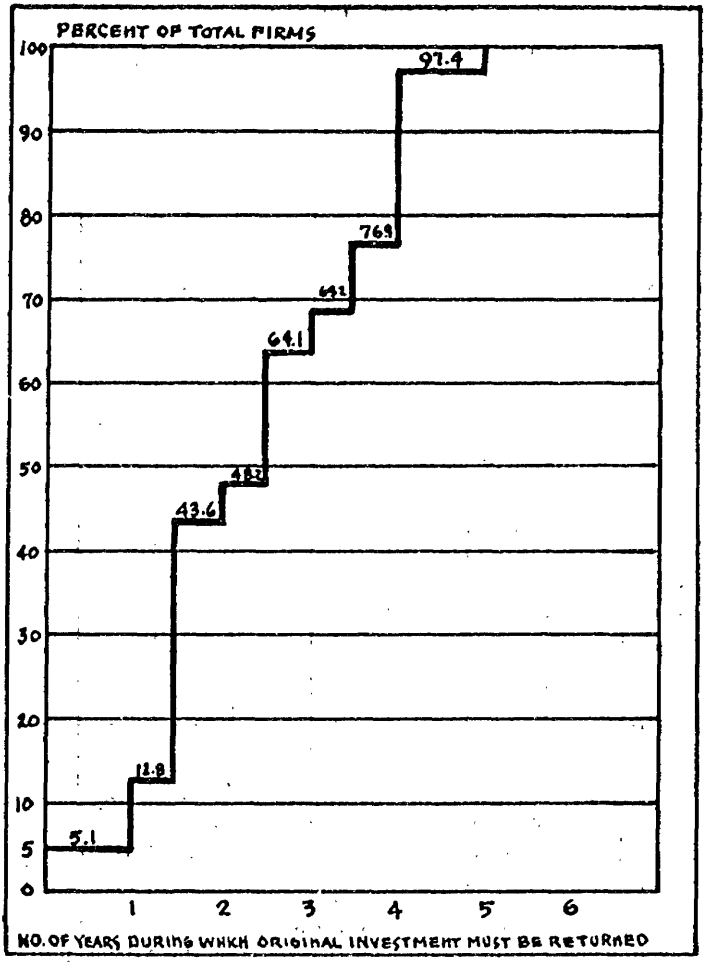


CHART C. Buying policy of machinery users. Sixty-four percent require savings within 3 years to equal purchase price

Now let us take the case of our customer who needs new machines costing $10,000. His year's depreciation allowance, much reduced under recent Treasury regulations, and recognized as inadequate, is already spent. The works manager requisitions the new equipment at $10,000, but the president replies that it will take from $13,300 to $17,000 of the year's earnings to make the $10,000 purchase, depending on the dividends paid. Paying dividends instead of replacing

machinery would save the tax. But the excess cost of from $3,300 to $7,000 represents the tax which must be paid under the proposed law for the privilege of buying the $10,000 of new equipment. Chart D shows the added purchase cost for different percentages of undistributed earnings.

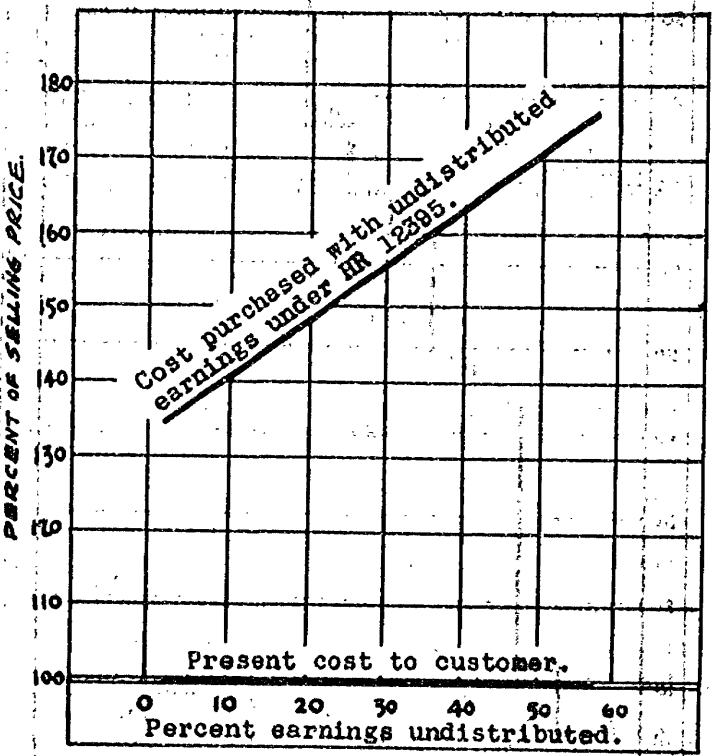


CHART D. Cost of machinery and equipment purchased from undistributed earnings under H. R. 12395 is increased from 30 to 70 percent above selling price.

If, for example, the customer must improve his plant and he keeps only 40 percent of his earnings for that purpose, this $10,000 purchase would actually cost him $16,200, a 62 percent penalty above list price. How can we sell machinery in the face of this?

In the heavy-goods industry there is still much unemployment, and yet the effect of this law is to put a prohibitive cost on our product. In other words, when a man is figuring whether he can afford to buy that equipment, he says, "Well, the equation is entirely changed. What paid for itself at the list price in 3 years will now take 62 percent longer. It will take 5 years, and I will not buy it."

We point that out to show you the extreme adverse effect it has on us in trying to sell machine tools and durable goods. Later on I

will suggest an amendment to mitigate this hardship and partially offset this obstacle to the recovery of the durable-goods industries.

When we considered the problem of carrying on a machine-tool business through good years and bad under this bill, we were startled by the consequences. Could our experience be typical? A small group of us put our figures for the past 10 years together, and because several of the group are competitors, we used the common-size basis with 1926 as the base normal year. You gentlemen are undoubtedly familiar with this method, which weights all the companies the same. One company is quite small, one large, and two medium size, but all are old-established builders of the basic standard machine tools. We found the composite data thoroughly typical and representative of the industry, and the following charts, E, F, G, H, and I, portray this group condition.

Now, what have we done during the depression years? Someone testifying before the committee has questioned whether manufacturers really used their reserves to maintain employment. As the basic source of accuracy, and of mechanical development, our whole existence is bound up with the inventiveness and technical knowledge of our engineers, with the skill and experience of our shop employees. Even without the mutual and human ties of long association, we have the strongest business reasons for holding our employees to the limit of our financial ability.

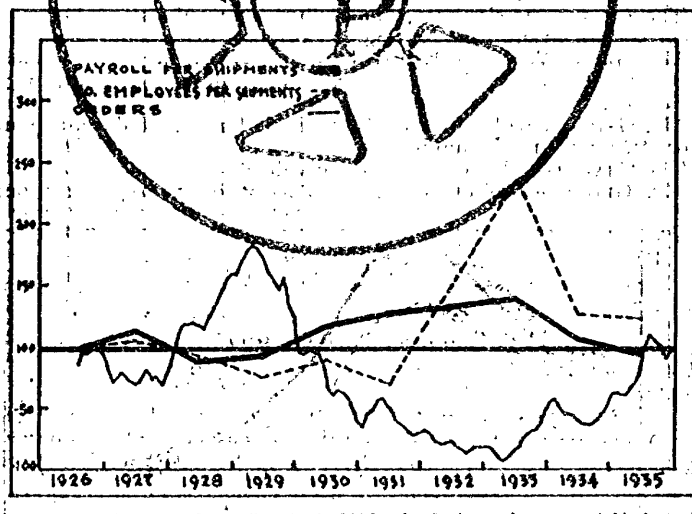


CHART E.—Employment and pay rolls maintained higher than business volume warranted in depression. Pay roll 30 per cent more. Number of employees anticipating orders. Composite of four machine-tool companies.

Despite the unprecedented severity of the depression, which forced such severe layoffs, you will note on chart E that we provided more employment in numbers and pay rolls in proportion to our slender means than in the normal and boom years. In other words, when

things went from bad to worse, we did not slash our pay rolls to the extent of our ability—should I say inability—to finance them out of our going business.

Senator HASTINGS. Give us some figures instead of just pointing to that.

Mr. GEIER. Well, let us see. Take for the year 1932. The pay roll per dollar of shipments was 30 percent more than it was in the normal year of 1926, and in 1933 it was 35 percent more.

As to the number of employees we managed to keep, I consider our record was relatively good. The dotted line is the index of the number of employees we maintained per dollar of shipments, and throughout the depression we were equal to or substantially above the basis of 1929, our best business year.

The CHAIRMAN. Why did you drop off so much in 1934?

Mr. GEIER. Well, for two reasons. One is that the operations were getting back to a more normal ratio. The other is that we anticipated the demand. We have to start our men at work substantially many months before we realize the shipments. Therefore, at the beginning of a building-up period this index will have to rise, because the employees increase long before the shipments materialize. Is that clear?

Senator BARKLEY. What is the capitalization of the four companies?

Mr. GEIER. I do not know, but I imagine the total capitalization of the four companies would be approximately $10,000,000.

The CHAIRMAN. Have you maintained about the same hours of labor and wages since the N. R. A. went out of existence?

Mr. GEIER. Very closely, except wages are higher.

Senator BARKLEY. What have you been doing in the way of dividends?

Mr. GEIER. I will show you that, sir, if I may. I do not know how much my time is running.

The CHAIRMAN. Well, give us the dividends.

Mr. GEIER (exhibiting chart F). This solid line represents our

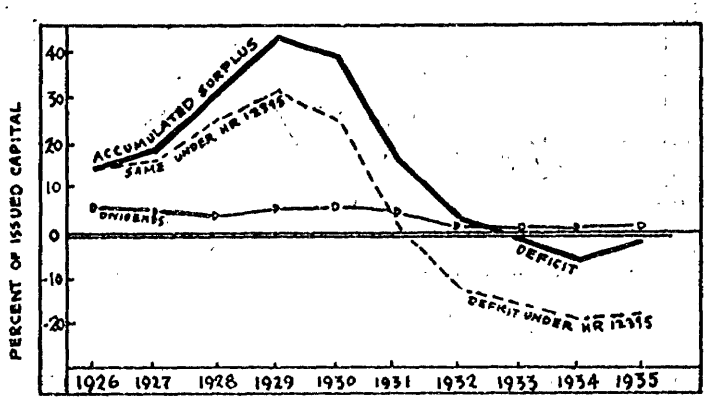


CHART F. Depression years wiped out 1928 surplus and all profit of the few succeeding good years under present tax. Had H. R. 12395 been effective, the resulting heavy deficit would have made survival doubtful.

composite surplus rising from 13 percent of issued capital in 1926 to a peak of 46 percent in 1929, and dropping to a deficit of 5 percent in 1934. The dash line D represents the dividends paid. The highest dividends were in 1926, when we paid 5.45 percent on invested capital. In 1929 and 1930 we paid 4.5 percent, and then you see the dividends went right on down to the last year they were 1¼ percent. You can see the modest dividends. We did not pay those dividends on that small scale because we would not have liked to pay more, but these four companies on the average have been in business in this industry almost 50 years, and the gentlemen who are with me here today in the back of this room have spent their entire lives in this industry; they have been through various depressions, and they know the problems.

So, when we get these extreme peaks in volume, as in 1928–29, we know that is just a matter of a year or two until we have the reverse. Then what do we do? We try to protect both ourselves and our employees.

Now, let us consider the percentage of earnings undistributed as defined in the new bill. In 1926, undistributed was 13 percent; 1927 it was 19 percent; in 1928, 71 percent; and in 1929, 65 percent.

I believe that this bill is predicated upon the idea that 30 percent is about all that should normally be retained. We have retained twice as much in 1928–29. We did not do it because we were capricious or because we did not want to pay it to the stockholders, but simply because our experience showed us that we would need those earnings, and as you see, we certainly did need them, because from 1933 on [indicating] there is a composite deficit on the part of these four companies.

Senator BARKLEY. What would be the net profits of these four companies for 1935?

Mr. GEIER. I have not got it in dollars, but I will show it to you here on a graph in a moment.

Senator BARKLEY. It is more understandable to me if it is in dollars, based on a composite $10,000,000 investment.

Mr. GEIER. I cannot give it to you, but I will show you the gains and losses for each year, in a moment, in percentage.

Senator BARKLEY. Which one of these companies are you interested in?

Mr. GEIER. The Cincinnati Milling Machine Co.

Senator BARKLEY. What is its capitalization?

Mr. GEIER. We are the largest. About four million.

Senator BARKLEY. What were your net profits last year?

Mr. GEIER. We made last year something under $800,000.

Senator BARKLEY. How much of that did you distribute?

Senator CONNALLY. You did pretty well with a 20-percent profit.

Mr. GEIER. We certainly did. We only do that once in a few years, and that is only a small part of our previous losses.

To answer your question, we distribute about $170,000 dividend.

Senator BARKLEY. You distribute about $170,000 out of $800,000?

Mr. GEIER. Yes, sir.

Senator BARKLEY. Can you give me roughly the same figures for 1934?

Mr. GEIER. We just broke even. We distribute our preferred dividends of $115,000, and I think about $40,000 besides that. About $155,000. That is just from memory.

Senator BARKLEY. How would that compare with 1932 and 1933?

Mr. GEIER. About the same or a little more; a little more. We paid our preferred dividends. In our particular company we have paid that without interruption from the first.

Senator BARKLEY. Did you pay any dividends on your common?

Mr. GEIER. Yes; a small amount.

Senator BLACK. How many preferred-stock holders did you have?

Mr. GEIER. I did not come prepared to answer all of these questions, but I think we must have 170 or 180 or thereabouts.

Senator BLACK. How many common-stock holders?

Mr. GEIER. Perhaps 50 or 60.

Senator KING. Is that in your company or all four?

Mr. GEIER. I am only speaking of my company.

Senator BLACK. What is the largest percentage of stock owned by any one person? Is it pretty evenly divided?

Mr. GEIER. I guess maybe there might be one person would own 15 percent.

Senator BLACK. Of the preferred or the common?

Mr. GEIER. Of the common. The preferred is pretty well distributed.

Senator CONNALLY. Are you an officer of the company?

Mr. GEIER. Yes, sir; I am the president.

Senator CONNALLY. You know then, about all of these things that you are talking about?

Mr. GEIER. Yes, sir; I am giving you the information to the best of my knowledge and belief.

Senator CONNALLY. Have you not a statement of your company anywhere?

Mr. GEIER. I haven't it here.

Senator CONNALLY. I thought the president carried all of that around in his head.

Mr. GEIER. I wish I could. There are plenty of other problems.

The CHAIRMAN. He has plenty of information.

Senator HASTINGS. All these charts are the combined companies?

Mr. GEIER. Yes; had we paid the taxes under the new bill and identically the same dividends during this 10-year period, you will see from the dotted line on chart F that our surplus would have been reduced to a very heavy deficit, and it would not have been possible for us to carry on, measured in terms of surplus. Under the new bill undistributed earnings from 1926 to 1929 would have been 17, 18, 48, and 46 percent, respectively, and of course nothing in the 5 last years, and 46 percent in 1935.

Senator BARKLEY. Looking at that chart from the standpoint of an engineer, it would look as if that high hill there when you pull that off into the hollow would about level it up; is that about right?

Mr. GEIER. No, sir; we started in 1926 with this amount of surplus [indicating].

Senator HASTINGS. Tell us what it is.

Mr. GEIER. Yes, sir. It is about 13 percent.

Senator HASTINGS. Of your earnings?

Mr. GEIER. Thirteen percent of this index. Of our capitalization.

Senator HASTINGS. May I call your attention to the fact that this record is not showing a lot of valuable information which you have collected. I am not able to follow all of those charts.

Mr. GEIER. Can we put these figures into the record subsequently in a brief?

The CHAIRMAN. Yes; you may.

Senator HASTINGS. I think it will be very helpful if you could.

Mr. GEIER. We will present a brief giving the detailed figures.

The CHAIRMAN. Do it pretty soon.

Senator BARKLEY. Do you have a permanent and more or less stationary surplus?

Mr. GEIER. No; the composite surplus got down below zero. You can see in our own company's case it was down to about 2 percent. It was down to where it had vanished. But for this group, the surplus was a deficit from 1932 on, if we had paid the tax on the new basis [indicating].

Senator HASTINGS. Just what do you mean by the tax on the new basis? Do you mean if you had distributed all of your dividends?

Mr. GEIER. No; if we had paid the same dividends as we had actually paid, and we had paid tax under House Resolution 12395 on whatever we had left.

Senator GEORGE. You mean if you had paid the same dividends and made the same withholdings and retained the same amount you did during the years.

Mr. GEIER. Yes, sir; the dotted line, chart F, shows the difference between the old tax schedule on our financial position, and the new one over this period of 10 years. Confronted with this problem of how to finance our pay roll and so on, we could not have paid those dividends, because we could have done so only by wholesale sacrifice of pay roll—in fact, we could not have done it. So we have shown

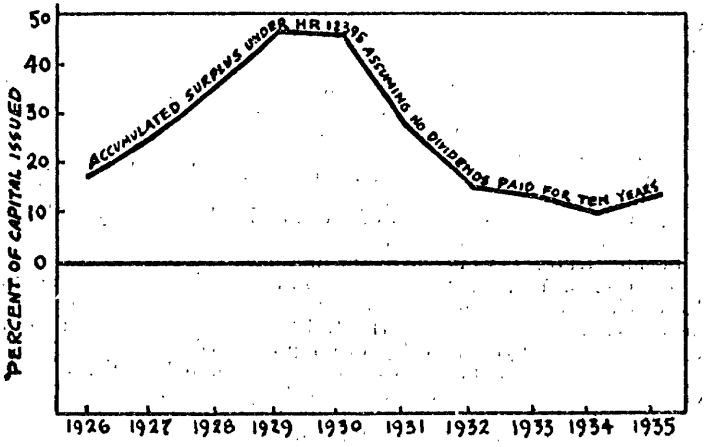


CHART G. Taxes under H. R. 12395 and losses exceed total earnings during 10-year period. Even abolishing all dividends, surplus, and net worth are less than at beginning. Composite of four machine-tool companies.

here on chart G exactly the same figures. If we had paid no dividends whatsoever in 10 years [indicating] we would have wound up under the new tax plan with a less surplus than we had at the end of 1926.

Senator HASTINGS. Without having paid any dividends?

Mr. GEIER. Yes, sir. The only way, in other words, for us to have survived would have been not only by cutting the dividends, but we would have had to further reduce our employees, and I want to touch on that in a moment, later.

Senator KING. You would have been broke?

Mr. GEIER. Yes, sir; we would most likely have been broke before this time came. Some of us came very close to it as it was.

Senator HASTINGS. If you had paid out all of the dividends, how much trouble would you have had to have gotten the stockholders to reinvest that and thereby give you some additional working capital?

Mr. GEIER. We are in a small industry that does not have access to the normal capital markets. In our entire industry, there are not 10 people who have ever sold their stock publicly.

Senator BARKLEY. Would you, in figuring the price of your products, when you figure the price of your products you figure in the taxes and everything, do you not?

Mr. GEIER. I wish we knew some way to do that.

Senator BARKLEY. Your price includes something more than the actual cost of manufacture?

Mr. GEIER. Our prices are fixed by two things. One is the competition and the other, which is more important, is the economic justification for our product in the hands of the buyer. What it will save him.

Senator BARKELEY. In figuring how much you have got to set aside for expenses before you have any profit at all, you have to figure in the overhead, interest, labor cost, and whatever taxes are paid to the State, county, and city, or to the Federal Government?

Mr. GEIER. So far as my experience goes, I do not believe any of the companies that I am speaking for have even been able to figure their taxes in as a part of their costs.

On the question as to whether or not we could finance ourselves, with this record of an up-and-down volume which is well known throughout the industry and throughout financial circles, we do not have an access to the capital markets.

May I bring in one point here——

Senator HASTINGS (interposing). What is that chart that you have in your hand?

Mr. GEIER. This is a record of the sales in this industry and our figures parallel that very closely.

Senator KING. Thus is one of the first ones you referred to there?

Mr. GEIER. Yes, sir, chart A; this will be explained this afternoon. Here is how we would wind up if we had never paid a dollar of dividends, since taxes under the H. R. 12395 and losses exceed total earnings of the 10-year period [indicating chart G].

The effect of this bill on us is to force us to reduce the meager dividends which at no time exceeded 5.45 percent of net worth and steadily dwindled.

Senator HASTINGS. Is that on the common?

Mr. GEIER. The total disbursed, including the preferred and the common.

Senator KING. Were the sales of your preferred stock for capital investment?

Mr. GEIER. Yes, sir. In the days gone by.

Senator BARKLEY. What is the dividend rate on your preferred stock?

Mr. GEIER. Six percent.

Senator HASTINGS. Is it cumulative?

Mr. GEIER. Yes, sir. Some of the companies in this group have long since been unable to pay their preferred dividends. We are the only ones to my knowledge that were able to keep it up.

Senator KING. Out of the four companies?

Mr. GEIER. Yes, sir. We had discussed whether we could have paid this tax on the basis of having a book surplus from which to pay it. Now we will look to see if we had the cash to pay it, in other words, were our earnings in the liquid form that they could have been distributed as taxes?

The height of these bars represents the total earnings for the years, Before, Federal taxes, in 1926, 8 percent; in 1927 7½ percent; in 1928, 20 percent; in 1929, 25 percent. The loss for the succeeding years, is shown below the line, in 1930, even; in 1931, 13½ percent; in 1932, 12½ percent; in 1933 11 percent; in 1934, 4½ percent. In 1935 a gain of 5 percent.

The diagonal shading represents the dividends disbursed; the black up here [indicating] represents the tax paid under the old law. The white bars represent the undistributed net earnings. On this undistributed-net-earnings portion, you see here in white in these 2 years is the only portion of the undistributed net earnings which was available in net quick assets. The balance was either in plant, fixed investment, or in inventories.

You might say, why are not the inventories, considered current assets from what taxes can be paid? Unfortunately, we wish we could pay things out of that, but at the time we needed to do that that inventory of course was wholly unsalable. Had it been salable, our sales would have been better than they were. In other words, it was not possible for us to turn that inventory into cash.

Some years ago the Robert Morris Associates, who analyze industry statistics for bankers so that they can use them in determining whether credit is to be extended to possible borrowers, made a 10-year study of the figures of our industry. They analyzed and compared the various ratios, and of the 35 industries listed, we had the dubious honor in turn-over of inventory to total capital investment, of being the second slowest of the 35 industries, and we were only surpassed by standing timber.

So you can see how liquid our inventory is. We do our best to sell our product. But you will see that while we have this so-called undistributed net income, we do not know how to turn it into cash, and this little white area of 9 percent in 1928 [indicating] and of 5 percent in 1929, is the liquid total that we would have had that we could have paid out in cash in dividends or in additional taxes. In 1928, had the new tax bill been in effect, 4½ percent, or half of this liquid remainder, would have been paid in increased Federal taxes, and in 1929 the entire remainder of the years liquid earnings would have been absorbed by the tax. These added taxes are shown on chart H by the offset black bars.

Senator HASTINGS. I would prefer to have that in figures.

Senator COUZENS. He is going to put it in the record.

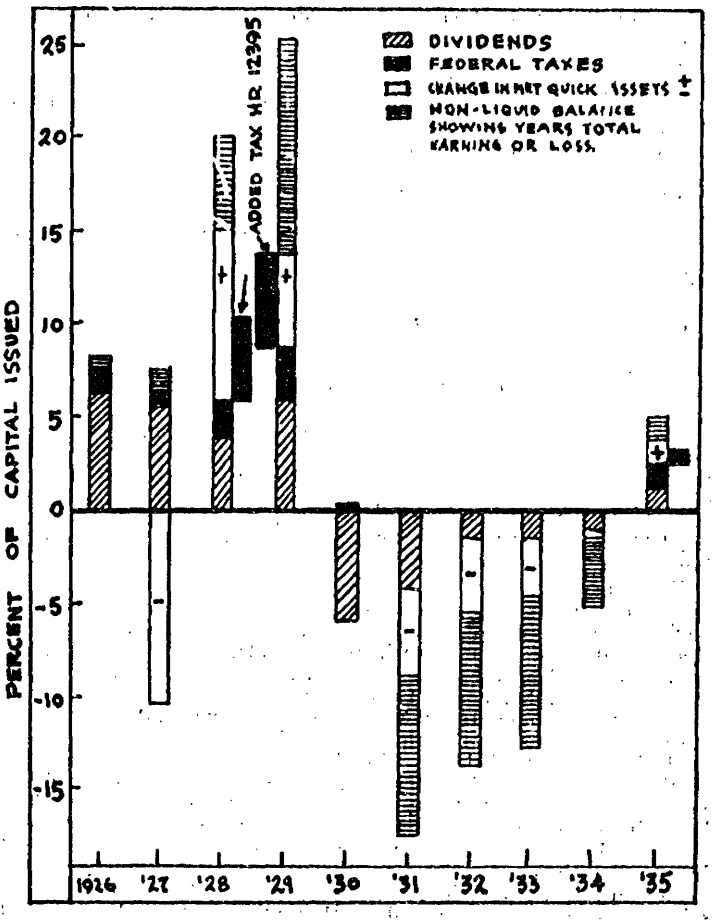


CHART H.—The retained liquid earnings of 1928 and 1929 (white bars) were inadequate for succeeding heavy loss years. Added tax under H. R. 12395 would have absorbed one-half of 1928, as well as all of 1929 liquid earnings.

Mr. GEIER. As a result, 1928 with the tiny white area of liquid undistributed earning, amounting to 5 percent of capitalization, is the only peak year showing any liquid assets left over after taxes under the bill. But after we had paid the new tax out of the 4 profit years of the boom, we would have entered the depression with liquid capital one-fourth less than in 1926.

Now, reverting to actual experience under the old tax, we got into the depression years, and you see they are pretty long and pretty severe. The white bars with minus signs represent the annual decline

in net quick assets for each one of those years over and above the previous year. I will not take time to cite the figures, but you will note the liquid balance of 1928–29 was utterly inadequate to cover this. We did not withhold our dividends in the good years because we did not want to pay them, but we knew that this sort of thing is characteristic of our industry.

Consider now our net liquid assets, as shown on Chart I, leaving the inventory out, because, as I have shown you, it is not liquid.

Senator BARKLEY. Over what period is that chart?

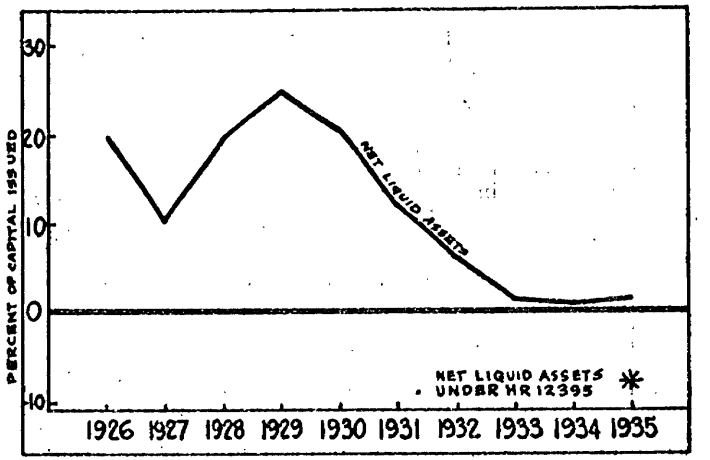


CHART I. Depression years exhausted net liquid assets. Increased dividends or tax under H. R. 12395 would have made continued existence doubtful. Composite of four companies.

Mr. GEIER. This is the same period of 10 years from 1926 to 1935. In 1926 we had 20 percent in net liquid assets [indicating on chart]. This rose to about 25 percent in 1929 and then declined to current levels just above zero. Obviously, we could not have distributed more in dividends or taxes. Now, had we been under the new tax during this whole period, all quick assets would have been gone and we would have dropped to 6 percent below zero, shown on the chart by the asterisk. Of course, we could not have paid that; we could not have survived that long, but that is where we would have been instead of being practically at zero.

Gentlemen, we think there are two kinds of relief that we would like to urge upon you to consider for an industry of this kind. First, I pointed out the fact that this bill effectively increases the cost of our product to the user, measured in terms of the earnings usually used to buy machinery.

We would like to suggest, in view of the fact that the Treasury rulings have gradually reduced further and further the allowable depreciation, already inadequate, that one kind of relief should be that corporations or individuals who will buy machinery and capital goods should be allowed in addition to their depreciation reserve, an

additional reserve allowance if actually spent, equal to their depreciation reserve, before the tax applies. That is the only way you can give us partial relief from the penalty cost imposed on our machinery and the further barrier to recovery of durable goods industries thereby erected under this bill.

Senator HASTINGS. Under this bill?

Mr. GEIER. Yes, sir. And we respectfully ask you to consider this additional amendment Inasmuch as we have shown that we cannot survive unless we are allowed to save a large protion of our earnings in the good years, we believe that relief should be afforded to the extent of allowing industries like ours, before the tax is calculated, to set aside 40 percent of their net earnings in a depression reserve so that it will be available to finance their employees and the business during the succeeding depression, with the limitation that that would be inoperative when any corporation had a surplus of 50 percent of its capitalization.

We are not seeking something that is wide open, but merely for the fellow who has no surplus and has no chance to live through a severe depression, to give him an opportunity to get up to 50 percent before the full weight of this taxation falls upon him.

Senator HASTINGS. What do you say about the tax on that 40 percent?

Mr. GEIER. We think it ought to be specified as a reserve.

Senator HASTINGS. You mean without tax?

Mr. GEIER. Yes, sir.

Senator HASTINGS. Of any kind?

Mr. GEIER. We maintain that any earnings that we make in boom periods cannot really be classified as earnings without a substantial reserve to take care of the corresponding losses to come, and for the reason that our inventory turnover is so slow. Some of us started lots of machines back in 1929 and 1930 and we would not like our customers to know this, but we still have some of these machines unsold. It is not possible to calculate profits in our industry on 1 year or even on several years.

If we were in a retail business or a consumer goods industry, a few months or even a year covers usually all the phases of the business turnover for substantial purposes as subject to taxation, but a natural accounting period for us is not 1 year. It ought to be the full cycle which, as you have just seen, has been 10 years.

Senator BARKLEY. Under this bill it is calculated that from 30 to 40 percent of the net earnings may be set aside without any increased taxation over what is now in the law. Is it your position that that 40 percent ought to be allowed to be set aside without paying even the present tax on it?

Mr. GEIER. We certainly should pay the present tax, but we think that an industry like ours should set aside at least 40 percent more than the consumer goods and other big industries, because they do not have these terrible depressions to deal with, the way we do. I do not want to talk too much of our troubles.

Senator BYRD. You do not mean that this 40 percent would be free of taxation? You propose to pay the present rate of taxation?

Mr. GEIER. Yes, sir. I believe we ought to have something in addition. We do not consider the reserve as profit. We will agree not to pay it out in dividends. We want to keep our employees

together. We have been through the process of seeing our cash dwindle, with no orders, and seeing men who have been on our pay rolls for many, many years let out. One of these companies has 12,000 years of accumulated service represented by the people on its pay roll.

If you gentlemen can picture what the problem is for us when we are forced to lay off our experienced, long-service men, when we have to dismiss good engineers who have been with us for many years and whom we know that we need because of their technical qualifications, and tell them that we cannot keep them because we have not the money to do so.

There is only one way that we might survive under this bill, and that is if we adopt the policy of cutting our organization and cutting every man to the point that our cash receipts will force us; but that is terrible. That is going to be the destruction of these technical organizations, and the employees—we can cut out the dividends, but if we cut the dividends out, we will still be unable to go through.

Senator HASTINGS. Do you know what your average pay per man is per week.

Mr. GEIER. I cannot give you that. I can say this, that in this group, as far as our direct knowledge extends, the average hourly earnings of these employees were higher in 1929 than they were in 1926, and they are higher today than they were in 1929.

Senator HASTINGS. Do you know about what they are?

Mr. GEIER. I would not be able to say. There are so many classes, producers, nonproducers, designers, technical men of all kinds. I could not give an offhand statement. But that is the problem we face, gentlemen.

The CHAIRMAN. Thank you very much, Mr. Geier.

Mr. GEIER. Thank you very much for your kindness.

The CHAIRMAN. If you want to add to your remarks and supply any information more specifically than the charts, we will be glad to have you do so.

Senator HASTINGS. Are the charts to be placed in the record, Mr. Chairman?

The CHAIRMAN. I do not see how they can be placed in the record.

Mr. GEIER. We can reproduce them on a small scale.

Senator KING. You mean without colors? You could not put them in in colors.

The CHAIRMAN. You can explain them.

Senator KING. I wish you would leave them with the secretary.

Mr. GEIER. If you wish, we will reproduce them on a small scale and file them with our statement.

The CHAIRMAN. The next witness is Mr. Otto Cullman.

STATEMENT OF OTTO CULLMAN, PRESIDENT, CULLMAN WHEEL CO., CHICAGO, ILL.

The CHAIRMAN. Do you want to discuss a question along the line that Mr. Geier has been talking?

Mr. CULLMAN. No; I am speaking from an entirely different angle.

The CHAIRMAN. How much time do you require?

Mr. CULLMAN. It will take about 12 minutes. I am speaking for the consumer.

I count it a pleasure to leave my business in Chicago and come here to Washington to counsel with you about this revenue bill. Somehow I seem to feel the thrill of public service which must be a large part of your compensation. It is to be hoped that you are not nearly as nervous of me, a mere businessman, as I find myself of you statesmen with the destinies of 130,000,000 people in your hands.

Of course, every fair-minded man will recognize the practical difficulties with which you representatives of the people are faced. No gain comes from refusing to recognize these difficulties. You have the unpleasant task of finding revenue to continue the upward climb of the Nation out of this dreadful depression.

Now as I see it you would be very short-sighted indeed did you pass a tax bill which defeated this object of yours. For the following reasons I believe that this bill would do just that:

1. These proposed taxes are taxes on industry. I am aware of the fact that industry is an impersonal thing and cannot strike back, so it seems. I know that industry appears a fine thing to tax because it gives everyone the feeling that they will not be taxed. This you know is both a delusion and an illusion. It arises from a wrong concept of taxation effects and from a disordered imagination. All taxes on industry become a part of the cost of production and thus increase the price of goods. To increase the prices of goods under present circumstances is to reduce further the purchasing power of the masses. The President has very forceably reminded us, I think, on several occasions that the majority of our products are consumed by families with incomes below $2,000 a year. Now every time you reduce the purchasing power of the masses you put someone out of a job and to that extent increase your own difficulties of adequately caring for the relief problem.

2. You see I am really pleading the cause not of industry not of the consumer. There has been a very dangerous trend in taxation over the last few years—and as a friend of the real bosses of industry—the consumers—I want to protest against it. These present proposals go in that direction more rapidly and to a greater extent and distance than any previous enactments which have come from any Congress.

On page 1 of the report of the Secretary of the Treasury for the year 1934 you will find a very significant chart depicting this tendency. It reveals that in the period from 1925 to 1934 the taxes received from "miscellaneous internal revenue sources" have gone from a low of 15 percent of the total in 1930 to a high of 47 percent in 1934. In his report of 1935 he states that this has been reduced in percentage to 43 percent but that is vastly larger in total amount. The decrease in percentage he ascribed to increases in other taxes. Now it does not take much argument on my part to prove that these "miscellaneous internal revenue sources" are consumption sources. I merely need to quote the Secretary himself. He says:

> In 1934 nearly 90 percent of miscellaneous internal revenue came from the following sources, in order of their importance as revenue producers: Tobacco taxes, manufacturers' excise taxes, the tax on fermented liquors, National Industrial Recovery taxes, the estate tax, and taxes on distilled spirits and wines.

Could the low spirits of the people have been taxed in this year the revenue income might have been prolific.

The difficulty I apprehend in this proposed bill, in these taxes you statesmen are devising is that they are consumption taxes. They have inherent in them all the vicious elements of discriminatory taxes because they bear most heavily on the poor. You may levy them on the apparent ability of industry to pay them but under economic laws they will come down on the consuming masses in a flood of higher prices—a flood which will wipe away all the progress which we have painfully made and leave us deeper in a depression from which we cannot rise by the expedient of taxing consumption. The poor will pay these taxes and it does not matter how much you attempt to hide this fact it will rise up like the blood spot of Macbeth to curse you. They will pay these taxes by lowered wages and they will pay them in increased living costs. King Canute could not stop the tides and no finance committee can ever change the laws of economics.

It would manifestly be unfair to me to make this destructive criticism without doing what our President has incited us to do, namely, offer constructive suggestions. I have some to make.

About this time last year I visited your city and left with Hon. Mr. Eckert of Pennsylvania enough copies of my book "Twenty Million Dollars every Day" for each of you to receive one with my compliments. Some have acknowledged the receipt to me but I recognize that many have been too engrossed in the difficult task you gentlemen have to do this.

Recently I mailed to each of you a copy of a petition which The Consumers' Recovery League, Inc., is circulating in Illinois. This petition contains the germ of the suggestion I would like to make to you gentlemen.

Your major consideration must be the effect of your taxation policies on employment. I am contending that this bill will tend to increase unemployment and I am suggesting that something be done to stimulate the building industry which is as everyone knows the greatest single industry for employment. Its ramifications are so wide in our whole economic life that to stimulate it is to lift all others onto a higher plane of prosperity.

My proposal is, that to stimulate the building industry and to begin a curve of the whole unemployment problem you make it a condition of the Federal grants to States for relief that they stimulate the building industry by passing laws which will exempt all new buildings from State and local taxes. It might be objected that such a plan would cost State and local governments too much in lost revenue. The adequate answer to this is that no government gets any revenue from buildings not yet erected just as the unemployed find no jobs on buildings not erected.

Senator KING. That would mean, would it not, that when we come to pass this $1,500,000,000 bill for Mr. Hopkins to expend, that we insert a provision in that that none of it shall be used for building purposes unless the States within which it is to be expended shall exempt the buildings from taxation for a reasonable time?

Mr. CULLMAN. Or should receive no relief.

Senator BARKLEY. Of course, that would mean that they would receive no relief at all, because there is not a State in the Union that could exempt new buildings from taxation without amending its constitution, which would have to be submitted to the people, and which probably would be defeated.

Mr. CULLMAN. I realize there are difficulties.

Senator BARKLEY. The depression would be over before your remedy could start.

The CHAIRMAN. All right; proceed.

Mr. CULLMAN. Let me finish, and then you can ask any questions if you have any to ask.

That this has very practical difficulties inherent in it I am fully aware but that these difficulties do not begin to compare with those which face us if we continue as we are going is beyond question. After all, the unemployed are in our local communities and it is there that riots and insurrections will start. It is there that the future burdens and probelms created by this depression will have to be faced.

Now what I am proposing has already been done and attended by such a marked success that only selfish interests could possibly object to it. It was done in New York City. The result was a phenomenal stimulation of the building industry, an unheard-of spread of employment and a most gratifying outpouring of private finance to carry on the program.

What I am proposing is being done in one other part of the world. In Santiago, Chile, they are experiencing a building boom of most gratifying proportions. This has been induced by a simple tax exemption law. It could eventuate in much larger and more beneficial enterprise here in America where we need so much new building.

It is conservatively estimated that this building activity would amount to from 25 to 35 billion dollars, and all this would result without loss of revenue to State or local governments because, as I have already pointed out, they can collect no revenue from buildings not yet erected.

Gentlemen, I thank you for this courtesy and leave this statement with you for your further consideration.

The CHAIRMAN. Thank you very much, Mr. Cullman.

The next witness is Herman H. Lind, General Manager, National Machine Tool Builders Association.

STATEMENT OF HERMAN H. LIND, CLEVELAND, OHIO, GENERAL MANAGER, NATIONAL MACHINE-TOOL BUILDERS ASSOCIATION

Senator KING. I see you have charts, Mr. Lind. If you will direct attention to them and if you can identify them in the record, so that we can follow them, I will appreciate it.

Mr. LIND. The bigger charts I have copies of for the record. One of the charts that I use was used a moment ago by Mr. Geier. I would like to cover some different points with it, if I may.

The CHAIRMAN. I hope that you can cover those which he did not cover.

Mr. LIND. That is what I hope to do.

The CHAIRMAN. All right; proceed.

Mr. LIND. My particular job is general manager of the association, and that job carries with it a lot of traveling among the members, in fact that is the principal duty. So that I am talking to you men from the standpoint of actually visiting the plants, both during the depression and at the present time.

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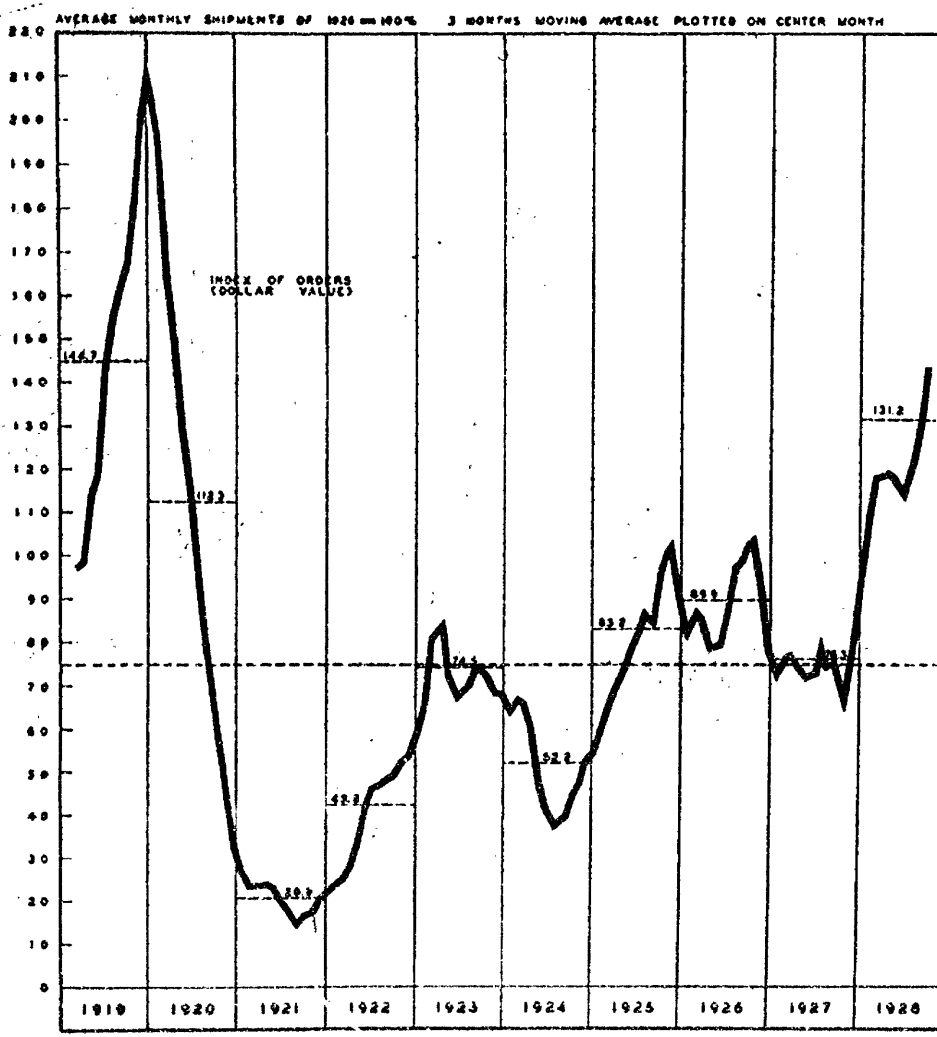

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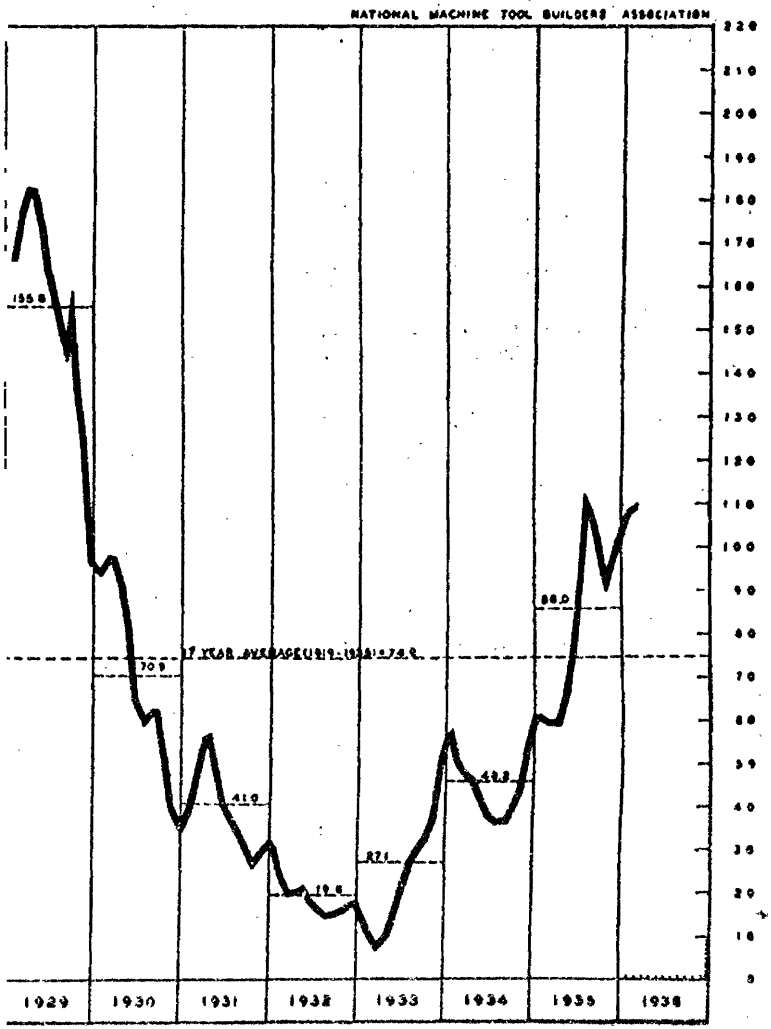


Senator KING. How many members are there of the association?

Mr. LIND. There are about 150 people in the industry that we call machine-tool builders. In addition to that, there are some people, foundries, machine shops, and so forth, who build a few machines and tools as a very small part of their business. Of the 150, we have about 135 in the association.

It is a very active and aggressive association in the matter of standardization and promotion of its sales, and that sort of thing. The lifesaver of the industry has been the accumulation of these over-all figures to develop this chart.

This chart [indicating] represents about 90 percent of the industry, going back to the original time. This particular peak in here in 1929 [indicating] was of very short duration, and the value of it was not as much as you might expect, because the expense of sliding over in business from there [indicating] to there [indicating] is a terrific job.

Senator KING. What is that chart?

Mr. LIND. This graph is a 3-month moving average of the sales for the entire industry. It looks pretty humpy if you see it; but if we would not use the 3-month floating average, that would be just full of crickets, and even that is tremendously smooth as compared to an individual company's chart. We would have brought that along, but it is such a jumble of lines up and down that it would not mean a thing.

But from the standpoint of the operation of an individual business, they have one of the most difficult jobs that I know of in industry to maintain a uniform flow of business through their plants, and then you have to couple with that the fact that a tremendous percentage of their mechanics are specially skilled, and I mean really skilled over the years, because we have gotten to the point now that talking of a thousandth of an inch is a very loose fit. We are splitting ten-thousandths, and in some of the refrigerators you are buying today you are getting the splendid use of the refrigerators by reason of the fact that they are measuring and producing parts off of our machines measured in two light waves, which is about a millionth of an inch. That is the type of men we have to have in the industry, and that is the terrific strain that is thrown on the manufacturers when they come to terms of this kind. They must maintain the nucleus of these men in the designing department, in the engineering department, and all through the plant. They are artisans of the very highest order.

At this particular point [indicating] in 1932 and 1933, I called on approximately 100 plants in a matter of about 6 months; and, gentlemen, I wish it were possible to paint a picture to you men of what I found in these plants. I would go into the president of the company, and there would be a few people around the office, and no business coming in, and a good office saved on heat and light and all that sort of thing, and the first thing they would ask was whether they were going to be able to live through this or not. But they would hardly be through that before they would be telling about their worries with their workmen, men that had been with them for years, and they felt that they were responsible for them.

Averages are deceptive in a good many ways, gentlemen. Most of our plants are very old. A 50-year plant is not unusual in our industry at all. We have some that are 100 years old. Over the

years, they had accumulated enough so that they could get along pretty well, but there were a great many of these people in 1932 that they were down to the point that they just could not do anything for their men to speak of, at all. They tried to get them jobs here and there and the other place. These men are capable men, and they went out into industry and got jobs in other industries. We found them in the butcher shops and the gasoline stations, and some of them we have not gotten back. But we are hoping to get more and more of them all the time.

This industry is the farthest back in the durable-goods industry, because it makes the machines that make the machines for both capital-goods and consumer-goods industries. A chart of the consumers' goods, food, for instance, only runs about 12 or 15 percent off of the line, and normally their cycle is a year. They may have fluctuations by the month, depending on the business or by the quarter, but by the end of the year their operations even out over the year.

For a like consideration for our industry, as Mr. Geier pointed out, it is absolutely essential that our tax be based on some consideration of the cycle, and evened out a bit, particularly if the tax gets any higher than it is today, in any way. That is the particular point that I want to make.

The CHAIRMAN. I notice the line started up about March 1933, on the chart.

Mr. LIND. Yes; very fortunately, at that time. At the time you passed the first P. W. A. allotment, the P. W. A. people gave some money to the Army and the Navy; and, gentlemen, it was a lifesaver for a great many of our little people at that time. Your Army and Navy plants—Mr. Geier was talking about depreciation and obsolescence. I could not help but think that down at the Washington Navy Yard, for instance, we have a plant, at the best, on a very conservative depreciation, a $15,000,000 value; and as I remember, the depreciated value a year or two ago was down to something like two and a half million dollars on a very low depreciation.

That is what started us up at that point [indicating]. They gave us a little kick. And along in here [indicating] we got some foreign business. About 20 percent of our business runs foreign. At this point [indicating] one of the large automobile plants in France decided to put in a new line of machinery comparable to the automobile plants in this country, so we got a little kick there.

Our people had to use their engineers and designers during the depression; when they found that they did not have orders, they went ahead and developed new things; and last year we promoted a good-sized show, and the automobile and the refrigerator and house-appliance industry saw that by putting in these newer tools they could expand their markets and sell more; and the result of that gamble on the part of our people—and it was a gamble, gentlemen—it cost quite a bit of money—but as a result of that gamble that they took, they have sold a great many machines. Their first publicity on their show started here [indicating], and that largely accounts for that, and the results of employment in the industries that used these machines and received them and benefited by them. A recent study shows that 10 industries who are most highly mechanized in this country, using our tools, are most nearly to their 1929 employment, and some are by.

That is by reason of the expanded market that the lower costs and better products creates.

Senator KING. Many of these large industries then, depend upon your industry for tools?

Mr. LIND. Our industry is a service to all metal-working industries; and one of the things that is very essential, not only to keep our men going through the depression but when the depression is over, our industries must be in a sound shape in order to render the service to all other industries that are dependent on it. There are machines to be repaired, parts to be replaced, new machines, new products to come out, and all that sort of thing.

We are really worried about the curtailment of sales if our customers are taxed too hard, so that we think we get a sort of a double blow from a bill of this type. Not only does it hurt our own companies who have to maintain a surplus to go through the shallow years, but also we fear that the cost of the machinery in terms of keeping the money in our customers' hands will interfere with the sale of our product, so we fear we are going to get a double shot of this.

If I may, I would like to give you a couple of illustration of a couple of our companies, to get away from the averages for a minute. Here is a company, for instance, that would normally employ, say, 250 men. I am talking from known facts. They came into this period, and they had a good many orders on hand, and they happened to get a lucky break and kept building a little extension, and about 1931 they found themselves extremely low on money. That particular plant got down to the point that the only thing that saved it was the personal integrity of the president of the company, who is a most marvelous engineer and has the respect of his customers and the whole industry, and it was just his personal integrity that saved him.

I am thinking of another company that went into this depression, a company over 50 years old, and in the hands of the second generation, who is himself an elderly man, worth about two and a half millions, and employing about 200 people normally. They went into the depression with about $600,000, approximately, of cash and securities. He was down to his last $20,000 when the orders started to come in.

I am going to show you now what happens. This is the year 1929, there as 100 [indicating]. Here is where the sales went [indicating]. Here is where our taxes kept, but here [indicating] is where our people kept hanging on to their employees. Not all of them were able to do it financially. They all wished to, but some of them got down to here [indicating]. Some of them were able to maintain their employees here [indicating]. That shows what our people went through during that period. Now, I have for you some actual figures, and there is a copy of this for the record.

Senator KING. You mean you have had it reproduced?

Mr. LIND. This is enlarged from the record, for convenience to use here. These are the figures of 16 of what we term "our smaller companies"; not the smallest. These are $750,000 companies and less, 16 of them selected at random.

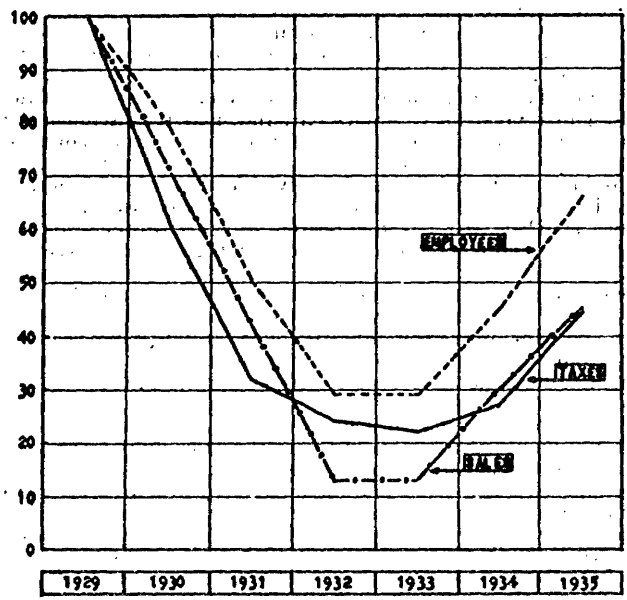
You will notice that they had these current assets, including inventories and all the things they do business with outside of fixed, worth $4,259,000. That had shrunk to 69 percent of that in 1935, a heavy drop in here [indicating], of course. Of course, their capital at the

same time had shrunk. Their combined capital and surplus from $5,865,000 dropped to $4,170,000, and, of course, that is working capital.

Here is an interesting thing on earnings. They made $1,268,000 in this huge year of 1929. They lost in 1932 $605,000; $352,000 in 1934; they lost $42,000, and then in 1935 they made $87,000. They are not in a healthy condition, gentlemen, to borrow money or anything else until they get this figure back somewhere to this [indicating], because bankers all know the ups and downs of this business.

SALES, EMPLOYMENT AND TAXES

EXPERIENCE OF 32 COMPANIES IN PERCENT OF 1929



Senator KING. Are these various firms scattered throughout the United States?

Mr. LIND. Yes. I do not know exactly who they are. We collect figures of this kind without identification, and I really do not know who they are, but I am sure they are scattered

Senator KING. But you have stated you traveled around a great deal in the various States?

Mr. LIND. Yes. The situation in all of these plants is just about the same, because they compete in the same markets.

Senator KING. What proportion of the industry would be in plants or in corporations with less than $100,000 corporations or less than $250,000 capital?

Mr. LIND. Less than $200,000 capital, I should say we would have 15 or 20 concerns. The machine-tool industry is peculiar in the type of men that engages in it. He is fundamentally an engineer and inventor, and I often think—well, I know that in many cases the joy they get out of designing and producing and inventing a new machine overcomes their money interests, but they do have to have some money to do the job.

Here [indicating] is one of the 16 larger companies, $750,000 and up. You will notice there is a quick asset of $34,000,000. That went down practically to half, 51 percent. The liabilities—they do not vary very much. Their profit in 1929 was $9,000,000. Then they began to lose money, and they continued to lose money here [indicating] and in 1934 they made $2,000. In 1935 they made $1,546,000.

Senator KING. What was the loss in 1932?

Mr. LIND. $4,086,000.

Senator KING. In 1933 it was how much?

Mr. LIND. $2,783,000. Then they just practically played even at that point.

Senator GUFFEY. What was the approximate loss in 1930 and 1931?

Mr. LIND. We did not have those figures, sir. I am sorry, but we got these together in such a hurry that we had to be a bit easy on our companies.

Notice the difference in the drop-off of employees in relation to sales. Here we have 100 percent sales in 1929; we dropped to 13, 13, and 29. In employees, 28, 28, 44, and 65.

Mr. Geier covered the fact that our employees go up faster than our sales.

Senator CONNALLY. Do all of those charts cover 1929 to 1935, pretty much?

Mr. LIND. Yes; we do not have them for the earlier years.

Senator CONNALLY. That is the depression period. Is it not true that probably all other industries were affected very much in the same way?

Mr. LIND. Not nearly to the degree.

Senator CONNALLY. Why should you start from 1929 and come up to 1935 unless that is true?

Mr. LIND. We just wanted to show the surplus we had at 1929 that permitted us to live through these other years.

Senator CONNALLY. Those same conditions pretty much obtained with all other industries?

Mr. LIND. Not to the same degree. I do not know of any other industry except the locomotives that that same thing would happen. Relative to sales, I do not know of any other industries outside of machine lines or very heavy equipment that went down like that.

Senator CONNALLY. One reason for that is that your industry serves other industries?

Mr. LIND. Yes.

Senator CONNALLY. If they went down, you went down?

Mr. LIND. Yes; and they can put off buying our stuff, because they have got some of it and they do not need any more.

I believe I have covered the specific things. There is just one item that I would like to cover that I have not heard covered before. I will read this if I may. That is the matter of conflicts arising under this bill.

There will be conflict between business management and the tax authorities. Business has become adjusted to the present tax method which has become pretty well understood through many years of regulation and interpretation. Managers of business and the tax collecting authorities substantially agree in their understanding of it. The new bill is so much more complex that it will immediately open misunderstandings between those who collect the taxes and those who pay them.

The determination of dividend policy within an individual company will bring to the fore conflicts among various types of stockholders. A very different interest in the amount of earnings to be distributed will be found between stockholders of large incomes and those of small incomes—between those engaged in the management of a business and those who are purely investors. It has been said that in a small company, largely family owned, of which there are many in the machine-toll industry and industries like ours, dividends can be paid out and then reinvested in the stocks of the company. Some of the stockholders may want to reinvest and others may not. Immediately the value placed upon the new stock presents a problem. Conflict of interest as to dividend policy and the basis of reinvestment created bad feelings among stockholders. Those responsible for management who look forward to lean years will almost certainly want to be conservative. They will be aware of the added difficulty in borrowing money because after all the money must be paid back out of profits.

There will be conflict between the comptroller of a company and its planning engineers. The comptroller will be unable to determine far ahead what actual profits and taxes are going to be, and the margin of safety he will require will handicap constructive forward planning.

There will be conflict of policies among units in the same industry. Those who now have large surpluses will have a great advantage over those who have followed the proposed policy of paying out their earnings as dividends, or for any reason do not have large surpluses.

There will be conflict among tax advisers because the proposed law contains many passages open to differences in interpretation. The fees of the advisers will place a substantial charge against the business and its customers; and if the tax experts do not agree in their recommendations, as is probable, the burden will be still greater.

There will be conflicts arising out of inheritance taxes. In the case of the death of a part owner in a small company the absence of reserves will add to the difficulties of bringing the company through such a period.

As I see it, these and other conflicts which will be brought about by the enactment of the proposed tax bill will be as sand in the bearings of the business machine. They will deflect the energies of management from the aggressive production and sale of goods and services which are its main function, to attempts to cope with a tangled mass of administration problems and uncertainties. The machine tool industry under such conditions would soon find it impossible to maintain itself in sound condition, and its ability to serve industries dependent upon it as in the past would be seriously handicapped.

(The tables referred to above follow:)

CROSS SECTION OF THE LARGE UNITS OF THE INDUSTRY

[Data compiled from reports of 16 companies]

	1929		1932		1933		1934		1935	
	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent
Current assets at end of period: Includes cash, accounts and notes receivable less reserves, inventories less reserves, securities at market	34,824,158	100	18,754,718	54	16,805,720	48	15,022,815	43	17,631,811	51
Fixed assets at end of period include land, buildings, machinery, and equipment, less reserves and depreciation	20,557,347	100	16,195,485	79	14,965,088	73	15,143,747	74	15,665,968	76
Current liabilities at end of period include accounts payable borrowed money, taxes accrued and payable, accrued payrolls, and dividend declared and payable	5,760,345	100	3,869,473	67	3,270,857	57	3,750,523	65	4,074,801	71
Capital at end of period includes common and preferred stocks at par or declared value, capital notes, and bonds	30,195,006	100	24,423,018	64	20,876,128	56	20,540,783	54	20,519,127	56
Surplus at end of period	21,270,423		8,666,831		8,248,588		7,022,572		8,578,635	
Capital and surplus (combined)	51,465,429		32,089,849		28,824,716		27,563,355		29,097,762	
Net profit or loss for period	9,511,530		[1] 4,096,833		[1] 2,783,615		2,141		1,546,028	
Sales for period	52,592,492	100	6,887,748	13.1	7,048,741	13.4	15,559,713	29.6	23,787,206	45.2

CROSS SECTION OF THE SMALLER UNITS OF THE INDUSTRY

Current assets at end of period include cash, accounts and notes receivable less reserves, inventories less reserves, securities at market	4,259,327	100	3,198,887	75	2,914,131	68	2,875,630	67	2,936,389	69
Fixed assets at end of period include land, buildings, machinery, and equipment less reserves and depreciation	2,625,546	100	2,302,536	88	2,064,022	79	1,916,457	73	1,857,555	72
Current liabilities at end of period include accounts payable, borrowed money, taxes accrued and payable, accrued pay rolls, and dividend declared and payable	913,799	100	990,992	108	745,155	82	782,431	86	687,896	75
Capital at end of period includes common and preferred stock at par or declared value, capital notes, and bonds	4,090,915	100	4,028,571	83	3,960,721	77	3,656,316	70	3,687,976	71
Surplus at end of period	1,774,573		866,310		551,755		472,093		482,186	
Capital and surplus (combined)	5,865,488		4,897,181		4,512,476		4,128,404		4,170,162	
Net profit or loss for period	1,263,496		[1] 605,606		[1] 352,757		[1] 42,275		87,170	
Sales for period	8,005,220	100	1,128,332	14.1	1,006,573	12.6	2,496,636	30.8	3,617,241	45.2

[1] Denotes red figures.

NOTE.—If exact information not available, use closest approximations.

The CHAIRMAN. The next witness is Mr. Ernest Williams.

STATEMENT OF ERNEST WELLS WILLIAMS, WASHINGTON, D. C.

The CHAIRMAN. Mr. Williams, how much time do you want?
Mr. WILLIAMS. I would like to feel that I can take 15 minutes.
The CHAIRMAN. Whom do you represent?
Mr. WILLIAMS. I will have to say that I have been called a political economist. There has been some question about that——
The CHAIRMAN (interposing). Well, proceed.
Senator CONNALLY. Whom do you say you represented?
Mr. WILLIAMS. I will say that I am more or less informative here.
Senator CONNALLY. We hope that all witnesses are informative.
Mr. WILLIAMS. I shall try to be. I represent myself.
Senator CONNALLY. You are speaking for the public?
Mr. WILLIAMS. Perhaps.
The CHAIRMAN. Proceed.
Mr. WILLIAMS. You will appreciate that it takes a slight amount of confidence to appear before you gentlemen as an economist, in view of the fact that probably you have the opportunity to hear more theories and be in contact with more actual experience in business than probably any organization in the country. It would seem very strange if there had been a fundamental error in social organization and if it is possible that there is some little detail that has been escaped by even you gentlemen.

Certain things have happened that are quite unusual. The big thing is that as an organization, that is as a country, we have passed from what may be called a productive country in which people individually were productive, and everything seemed to run smoothly, to a condition where the people are individually nonproductive. I shall trace that very simply for you, and see if we have missed anything and if we have, where we missed it and where that little change occurred.

There was some slight laughter at a very simple picture here [indicating] but it is quite an important picture. It shows something that we seem to have lost. In other words, these people [indicating chart] without any government, were productive. They were farmers; they grew their own products and they used them; they manufactured their own shoes; they made their own clothes, and it was a very simple state; but it was a productive group; and we lost that. There was a change that occurred.

And this picture [indicating chart] is not quite so simple. The fact that it took 15 years to draw it would seem that it is a greatly more complicated——

Senator BYRD (interposing). What does the first chart indicate? I do not understand it.

Mr. WILLIAMS. That is just about a picture of the people that go to a new country to support themselves. That is how this country started, as a matter of fact.

Senator CONNALLY. It looks sort of like a swastika sign. [Laughter].

Mr. WILLIAMS. A little bit.

The CHAIRMAN. What does the other picture represent?

Mr. WILLIAMS. It is a very strange picture. In this change from this picture [indicating] to this picture [indicating] there has been no loss in the ability of the people to support themselves.

The CHAIRMAN. Which one did it take 15 years to draw?

Mr. WILLIAMS. This one [indicating]. [Laughter.]

Very strange.

Senator CONNALLY. You started out before the tax bill came up.

Mr. WILLIAMS. I started it before the depression started, because I was studying depressions before the depression started.

The CHAIRMAN. All right; explain that to us.

Mr. WILLIAMS. The reason that this was satisfactory [indicating chart] was that it could be extended. And this shows another thing.

The CHAIRMAN. You have not a copy of those charts so that you can give them to the newspapermen?

Mr. WILLIAMS. If they are interested, perhaps they can have these.

It is very interesting indeed, because of this fact, that this is a nonproductive system, and it is a very strange picture. It looks very much like—well, I won't say what it looks like. [Laughter.]

Very, very funny, indeed. It shows a condition where people instead of being able to support themselves, are not. It shows a condition where instead of being able to get taxes to report to the Government, it is impossible any more.

The CHAIRMAN. That is very plain.

Mr. WILLIAMS. Here is why it is plain. This man here [indicating on chart] who formerly had the benefit of his production, either he had to produce it himself or having traded it with someone else, he is in debt. A very unfortunate circumstance. And this man [indicating] is in debt; and this man [indicating] is in debt; and so is this man, who is his natural market.

When this man [indicating on chart] is in debt, and this man [indicating on chart] is in debt, you have a situation where that exchange is not made that was formerly made in that picture where the group was productive.

If that exchange is not made, what happens?

Business gets its return, its income, any income it gets, from that exchange. When they do not get that income, what do they have to do? They have to borrow money. They say "Well, there is a depression", and so they go and borrow money, and when that happens, what is the condition? That exchange which they made before, cannot be made, and that becomes all the more impossible. In other words, there [indicating] is your exchange line, and it cannot go through.

The CHAIRMAN. What does your next chart represent? The blue chart?

Senator CONNALLY. That is the depression chart, the blue one. [Laughter.]

Mr. WILLIAMS. That is what has to be. In other words this [indicating chart] is a condition which is not a self-curing condition.

Now, we did not get into this thing all at one time. We got into it gradually. In other words, this man got into it, and he destroyed himself or he was destroyed as a market for this man [indicating on chart] and business did not get into debt all at once. It was slow, but it happened completely just the same. Government did not get the deficit, it did not get the debt all at once, it happened slowly, but it happened just the same.

This picture is not a picture that is permanent. When it gets to this point [indicating on chart] this is a picture of any social organization. It is the picture of an old government. People left a government like this to come to a government where there was not much government at all. They left this and they came here.

Why did they come? They came because here they had the benefit of their own production. And here [indicating on chart] it is taken away. This is a picture, we will say, of the United States at the present time. It is a picture here [indicating] of England when the people left there. Everything is perfectly logical, it is perfectly constitutional in this picture, and yet things have stopped.

You call it a depression. People say the depression is over. As a matter of fact, it is not a depression.

In the second place it is not over. We have come along a certain route and we have come to the end of the route.

This is a view of the reasons why it is bad [indicating chart].

In the first place, when you come to this point [indicating] this man has reduced his use of the things that other people buy and there is your unemployment. You are trying to support your unemployed, but you cannot do it. The Government cannot do it.

Senator CONNALLY. If we can go back to that first chart you had there, it would be all right, where everybody made their own shoes and everything else?

Mr. WILLIAMS. Senator, you cannot go back; you have got to go on.

The CHAIRMAN. Your first chart shows why they cannot go back?

Mr. WILLIAMS. Well, I will tell you, Senator, you have got to go back.

Senator CONNALLY. I thought you just said that you could not go back.

Mr. WILLIAMS. We have got to go back to this point [indicating on chart]. You have got to go back to where the benefits of man's production is his own. Until you go back, you are in trouble and will continue to be in trouble.

This tax bill as such is a very heavy, comparatively, tax bill. It is not fit enough to handle the actual necessities of the case, and yet if you try to tax, I know what will happen, and you know what will happen to it.

Here is what will happen. When you tax houses or property or business, you add still further to the fact that this is unproductive. In other words, you take it from one place, and he passes it on, the man that is, we will say the productive man, a primary producer. You pass it on to him and he cannot pay it. He has destroyed his market still further.

Well, what happens then? He has to go on relief; in other words, you have increased unemployment for every dollar you get in taxation, you have got to pay it out in the dole, and you are nowhere. That cannot continue forever.

Even Ogden Mills said this, that it cannot continue; in other words, there has got to be a change. Where is that change going to come from? Is it going to come from a foreign country and the United States copy it, or is it going to come from an individual in the United States here, and which you gentlemen will have no power, perhaps to say yea or nay, or will it actually be directed by you gentlemen with the experience you have had, and actual scientific accomplishments?

It is actually the choice of you gentlemen. Of course, there is a very laughable matter in the idea that I would have come up here and shown you something about social systems and tell you we have gone as far along a certain direction as we can go. We have, and it is no joke.

You say the depression is over, but it is not a depression. We are not going to come out of it, in other words. We have gone along with the idea that we would come out, but what if we did not come out?

Strange to say, I have been educated as a soldier, and a bit of a soldier, enough so that I know you will all have to figure on our losing, you see? Suppose instead of winning, we lose. Have we dug any trenches?

Suppose the unemployed would really say, "We are tired of living out of garbage cans, and if nobody can do anything for us, we will do it for ourselves."

The CHAIRMAN. You have 3 minutes left.

Mr. WILLIAMS. I have broken down the equity of a constitutional picture. It is constitutional according to what we have thought, but in this picture when it is broken down—it is not so simple. In the breaking down of a thing which you gentlemen have considered as impossible of breaking down, I break it down. I break it down by showing these facts.

In this picture you have a condition where people start out the same way as these people started out, and the same way that people always start out where they had the benefit of their own production and they got into debt. One of them got into debt and he was destroyed as a market. All right.

Another one got into debt because he did not have any market, and it continued on. All right. Then when it got to this point [indicating on chart] they were in the same position as this picture here which I said could not continue. All right.

Here [indicating] was the ownership of property. Here [indicating] was the ownership of the homes that these people were living in. Of course, rent is all right; there is no question about that. It is reasonable. But nevertheless, what happens when people get in a groove? The first thing that happens, they very foolishly go to war. When they go to war, what happens? They either win or lose. What if they lose? Then you have a condition where these people here who have fought the war have fought for nothing. They have less than nothing. They were in debt.

They have been the only source of protection for property. That was the inequity right there, the ownership of the property and transferring of it, there was the inequity; right there.

In other words, what would a man defend in a war? He would defend the things that he owned himself, of course. But suppose he did not own anything, what would he defend? He would defend for the man that had the property, he would defend the things he uses.

There [indicating] I had a break-down that I could change this picture, and I might show you the picture——

The CHAIRMAN (interrupting). This is very interesting, Mr. Williams. It might be that the newspaper gentlemen did not get all of this, so you might explain it to them if they want to ask you any questions about it.

The committee will recess until 2 o'clock.

(Whereupon, at 12:30 p. m., a recess was taken until 2 p. m. of the same day.)

AFTERNOON SESSION

The CHAIRMAN. The committee will be in order. Mr. L. D. Beckwith. Is Mr. Beckwith here? (No response.) Mr. C. J. Ewing.

STATEMENT OF C. J. EWING, CHICAGO, ILL. PRESIDENT, SINGLE TAX LEAGUE

Mr. EWING. Mr. Chairman and gentlemen, a tax bill is supposed to be for the purpose of producing revenue.

A tax bill is supposed to give some consideration to such matters as justice, equity, and the rights of citizens, including therein the rights of private corporations, which are owned and managed by citizens.

A fundamental principle of democracy is that of equal rights to all, special privilege to none.

It was a leading and foremost Democrat who said:

> That Government is best which governs least.

Jefferson also said:

> The earth belongs in usufruct to the living, the dead have no power nor dominion over it.

It was another Democrat, Henry George, who said:

> We cannot go on prating of the inalienable rights of man and then denying the inalienable right to the bounty of the Creator. If we turn to Justice and obey her; if we trust Liberty and follow her, the dangers that now threaten must disappear, the forces that now menace will turn to agencies of elevation.

The pending tax bill is in violation of economic laws. If you are opposed to wealth, you can legislate against it, and thereby create universal poverty. If it is not desirable for the citizens to have wealth, efforts can be made to pass laws confiscating this wealth and stealing it away from the owners thereof. If you are opposed to wealth legislation might even be devised to prevent wealth production.

It seems to me that a better thing to do would be to legislate against poverty, to remove the hindrances to production.

The organization that I am representing is in favor of wealth and we are opposed to poverty. We favor an increased production of the good things of life. We favor the idea that labor and industry should be free to produce wealth in ever-increasing abundance, and that those who produce it should have the effective right and opportunity to retain and enjoy that wealth which they produce, without being robbed or dispossessed of that wealth by any monopoly, special privilege, or even by government.

There seems to have grown up in some countries, in the legislatures thereof, a sort of a notion or theory that if an individual, partnership, or corporation, produces any wealth, that thereupon the government or legislature has some power or privilege to pass a law taking away that wealth or some large part of it from the individual, partnership, or corporation that created the wealth.

In some countries there has grown up the idea that a government or legislature has a privilege and power to regulate and stifle, to

obstruct and tamper with the production of wealth. It cannot be said that this is an American idea.

In some European governments there has long prevailed the idea that the central government is supreme; that if the citizen has any rights at all they are only such rights as are granted to him by some centralized government, and revocable by such government.

The American idea, as expressed by that great Democrat, Thomas Jefferson, in the Declaration of Independence is that all men are created equal and that they are endowed, not by any government, but by their Creator with certain inalienable rights, among others, the rights to life, liberty, and the pursuit of happiness, involving of course an equal right to the use of the earth.

In Europe the idea was that citizens derived their rights, if any, from the government. In America, the opposite idea prevailed, viz: that the citizen has his rights from the Creator, and that the government has only such limited powers as are granted by the citizens, except in case of war.

This pending tax bill is a move in the direction of Communism in that it is a denial of the right of private property and the private management thereof. The essence and spirit of communism may be expressed thus:

First, find someone who has something of value.

Second, take it away by force.

Third, reallocate it.

This bill proposes to do that very thing, and is communistic in essence and spirit, in that it is a denial of the right of private ownership and management.

This bill has in contemplation both the subversion and confiscation of private property and the management thereof. Why should the Federal Government assume any such elaborate rights or powers? It certainly is not an American or a democratic idea. It cannot be said that the passage of this bill can produce in this country any feeling of confidence that there is any intention to regard or to maintain any rights of the individual either to conduct any business or to own any wealth, goods, or property.

It must be apparent to all that taxes on labor, business, and industry do have a strangling and deadening effect not only in reducing the purchasing power of labor, but in killing the processes of production, manufacture, and transportation. If you want to destroy the purchasing power of labor, keep on taxing the products of labor.

If the purpose is to destroy business, manufacture, and transportation, keep on piling up heavy taxes on those activities. These activities can be killed by taxes. This is not theory, it is history.

On the other hand, a tax on a monopoly will not destroy the purchasing power of labor; it will not interfere with but will accelerate the processes of production, manufacture, and transportation.

If you gentlemen can eventually pass a tax bill that will take all taxes off of labor products and off of business, and place a tax on monopoly, you would solve not only the revenue problem but also the more sinister problem of unemployment.

There is enough land in this country to provide ample employment and sustenance to all our fellow Americans. The natural resources and area are here but they are held in the grip of monopoly. In a

certain sense the entire land of this Nation should belong to the people living here. As Blackstone said:

> The earth, therefore, and all things therein are the general property of all mankind from the immediate gift of the Creator.

And as Herbert Spencer said:

> The world is God's bequest to mankind. All men are joint heirs to it.

It is known to all economists that the monopoly value of land is an unearned increment, and that of right it belongs to the entire community and constitutes a fund sufficient to defray the ordinary expenses of government.

Theodore Roosevelt recognized this when he said:

> The burden of municipal taxation should be so shifted as to put the weight upon the unearned value of land itself.

The great American economist, Henry George, pointed out clearly that taxes on labor products and on industry have an effect of reducing wages, reducing the purchasing power of labor, causing stagnation of industry and causing unemployment.

To remove these inequitable and confiscatory taxes would vastly increase business, production, and employment.

A tax on monopoly, or the collection of land rent into the public treasury would vastly stimulate business and wealth production and would open up the field for universal and steady employment. It would end and prevent depressions.

If it is desirable to preserve our present civilization—which is based on mass production—and also to preserve individual liberty and initiative, there is only one way to do it, in my opinion, and that is by the method that I have proposed.

Abolish taxes on labor products; abolish taxes on business, labor, and industry; levy a tax on monopoly and especially take into the Public Treasury the annual economic rent of land.

I therefore oppose this bill. I oppose the imposition of any additional tax burdens on business, industry, production, manufacturing, or transportation. In my opinion it is not a proper function of government to impede or restrict the production of wealth, or to take from citizens the right to manage their own business.

If it is said that a sum of 800 million dollars is needed for revenue purposes, I will say that it is rather generally known throughout the country that great waste appears in the expenditure of public funds. According to our Constitution, the Houses of Congress have something to say as to appropriations.

I would suggest that this 800 million be saved or lopped off from wasteful expenditures, and thus it would not be necessary to enact this so-called revenue bill at this time.

I would further suggest that some other Federal taxes that now fall with paralyzing effect on business and industry should be repealed, and in place thereof there might be enacted a Federal tax of 1 percent on land values or monopoly sites.

The huge sums being spent for power dams and public works, which have a tendency to greatly increase the value of lands contiguous thereto, should be charged up against the areas thus benefited, and the increased land values caused by said works—if the said works are necessary and useful—should be sufficient to pay for the cost of construction.

I have one further suggestion, viz: That for the raising of Federal revenue, the Constitution be consulted, and that the Federal Government, for its necessary expenditures, should levy an assessment on the States in proportion to population. This would be entirely constitutional and would produce three very charming results. First, it would have a tendency to do away with the Santa Claus idea or miracle theory which some seem to have. They seem to think that the Federal Government has some source of wealth other than the old, well-known method of the Government forcibly taking wealth from individuals. It is really time that the Santa Claus idea as to Federal revenue should be clarified. Labor and industry create all wealth.

Second, by levying assessments on States, it is likely that some State might soon be wise enough to adopt the proper system of taxation as outlined by Henry George, the American economist. Such State would thereby be in a fine position to enjoy fully the prosperity that would flow from its wisdom and justice in taxation methods.

Third, some other States might be unwise enough to place confiscatory and burdensome taxes on labor, on labor products, on business, and on industry.

Such States should be in fine position to completely enjoy the fruits of their folly. It is the natural law and quite scientific: "Whatsoever a man soweth that shall he also reap."

The CHAIRMAN. Thank you. Mr. Albert Waterhouse, former tax commissioner of Hawaii.

STATEMENT OF ALBERT WATERHOUSE, HONOLULU, HAWAII, FORMER TAX COMMISSIONER OF HAWAII

Mr. WATERHOUSE. My name is Albert Waterhouse of Honolulu, Territory of Hawaii; my temporary address is the Roosevelt Hotel, Washington, D. C.

I appear as an unattached individual deeply interested in public finance and more particularly on matters relating to improvement in revenue legislation. What income I have is modest and not subject to surtaxes.

My background consists of business management and tax administration during the latter part of some 30 years in business, I was principally interested in the sale and distribution of business machines and systems, representing in Hawaii among others the National Cash Register Co., Monroe Calculating Machine Co., Underwood Elliott Fisher Co. During this period the subject of taxation was a personal hobby.

Some 6 years ago I became active as a Territorial governmental official; first, as a member of the tax equalization board; second, as the executive secretary of the tax board wherein I completed an economic study of the Territory and worked out a new tax code; third, as tax commissioner. This position is somewhat unique inasmuch as it is a one-man commission responsible for the administration, assessment, and collection of all the major revenue laws of the Territory and its political subdivisions.

With reference to the pending revenue act, I limit myself to matters germane to title I. I am in accord with proposals under title II and have no praticular interest or knowledge in the subject matter of title III or IV.

The proposals under consideration are designed, first, to increase of revenue to the extent of some 600 millions annually, and, secondly, to bring about needed tax reform so that levies against business profits shall be brought into line irrespective whether such profits came from operations under corporate form or otherwise.

The second objective is sought by the use of the ratio of undistributed net income to total net income as the yardstick in determining the rate applicable to the total net income.

There can be no dispute as to the desirability of the suggested tax reform, but the road chosen for its accomplishment seems rocky. This was very tersely brought out by Mr. Alvord in his appearance on behalf of the National Chamber of Commerce before the House Ways and Means Committee when he testified as follows [reading]:

> * * * I think practically every student of taxation agrees that corporate income should be taxable according to the distributive shares of the stockholders. But you cannot do it. The Constitution says, "No." So that every attempt to bring that about necessarily results in an arbitrary system; and your system being arbitrary is going to enforce unexpected and unanticipated tax liabilities.
>
> The difficulty in the attainment of the desired objective is, I believe, not only constitutional but has been largely brought about by the fact that our tax system has more or less been allowed just to grow like "Topsy." I am thinking of the entire tax structure, Federal, State, and local. We have "seesawed" corporate income taxes against individual taxes in what someone has termed a catch-as-catch-can procedure to a point when the initial steps leading to a de novo tax system seems imperative. The, to me, wierd tax liabilities under present laws as well as under proposed legislation; though, I believe, the latter shows some evidence of improvement, are shown in the following charts which purports to be merely a hypothetical study of what might happen under a single set of circumstances. It is a purely fictitious setup which I have named "The Parable Co." In the hopes that by a study of the figures, a lesson may be learned. Is not this the objective of a parable?

CHART I: THE PARABLE CO.

Earnings and profits net statutory income adjusted net income, $1,650,000.

Break-down of owners proprietary interests

Percent ownership	Taxable income other than from company	Proprietary interest in corearnings	Total
A, 0.2	$4,000	$3,300	$7,300
B, 0.4	4,000	6,600	10,600
C, 0.6	4,000	9,900	13,900
D, 0.8	4,000	13,200	17,200
E, 1	4,000	16,500	20,500
F, 2	4,000	33,000	37,000
G, 5	4,000	82,500	86,500
H, 10	4,000	165,000	169,000
I, 20	4,000	330,000	334,000
J, 60	4,000	990,000	994,000
Total (100)	40,000	1,650,000	1,690,000

Chart I shows that the "Earnings and profits", "The net statutory income", and "The adjusted net income", in this case may miraculously be used synonomously as under each term the amount would be $1,650,000. It further shows that 10 individuals hold a proprietary interest of varying amounts from two-tenths to 60 percent, and that each individual had other than profits distributed from the company a "taxable income" amounting to $4,000.

We will now place the taxable earnings of these 10 individuals, towit, 10 times $4,000 or $40,000, plus $1,650,000, of company earnings, a total of $1,690,000 through the grist mill of Federal taxation.

Note that a straight 15 percent rate has been used to determine corporate taxes under the existing law, what I term the old tax laws; that corporate rates were determined, under the proposed law of 1936, and that no allowance has been made for earned income to the individual. My calculations have not been audited and there may be some discrepancies.

CHART II. THE PARABLE CO.

All profits distributed—Federal Government's share.

[Columns 2 and 3 show owner's personal tax (the direct tax) plus his pro rata of the company tax (the indirect tax)]

	As a partnership	As a corporation—	
		Under old tax laws	Under law of 1936
A	$437	$775.20	$497
B	766	1,426.60	765
C	1,148	2,118.20	1,148
D	1,600	2,949.60	1,600
E	2,155	3,658.25	2,155
F	5,910	8,500.00	5,910
G	26,175	26,125.75	26,175
H	77,160	80,875.00	77,160
I	187,800	191,740.00	187,800
J	676,440	678,430.00	676,440
Total	979,691	999,218.85	979,691

Owners "cash income" after taxes

	As a partnership	As a corporation—	
		Under old tax laws	Under law of 1936
A	$6,563	$6,534.75	$6,808
B	9,884	9,173.40	9,884
C	12,752	11,781.80	12,572
D	15,600	14,950.20	15,600
E	18,345	18,961.75	18,345
F	31,090	28,500.00	31,090
G	80,325	57,824.25	80,325
H	91,840	88,435.00	91,840
I	144,200	142,260.00	144,200
J	317,560	318,580.00	317,560
Total to individuals	710,409	693,780.15	710,809
Total to Government	979,691	999,218.85	979,691
Total individual and company earnings	1,690,000	1,690,000.00	1,690,000

Chart II: The upper schedules shows Government share and the lower schedules the owner's share of the $1,690,000 as if all profits were distributed and company and stockholders taxed under column 1 as a partnership, column 2 as a corporation under old laws and column 3 as a corporation under revenue law of 1936, wherein their being no undistributed profit, there is no corporate tax.

Note that all pay more taxes under the old law, but insofar as the individual is concerned rather sharply proportionately less as income increases. This feature would be more dramatically shown if I had included smaller stockholders with modest income. Please bear in mind that resultant taxes as indicated by the use of this particular set of figures should in no way reflect on the reliability of estimated revenue made by Treasury Department.

CHART III. THE PARABLE CO.

$402,500 approximately 25 percent of profits not distributed Federal Government's share

[Columns 2 and 3 show owner's personal tax (the direct tax) plus, his prorata of company tax (the indirect tax)]

	As a partnership	As a corporation	
		Old tax law	Under law of 1936
A	$437	$735	$713.93
B	766	1,330	1,287.84
C	1,145	1,945	1,885.42
D	1,600	2,580	2,509.00
E	2,153	3,235	3,061.80
F	4,910	7,010	6,832.46
G	26,172	21,474	22,061.06
H	77,160	87,230	59,119.52
I	187,800	141,240	143,363.56
J	676,440	507,460	538,842.38
Total	979,591	744,240	778,659.77

Owner's "cash income" after taxes

	As a partnership	As a corporation—	
		Old tax laws	Under law of 1936
A	$6,058	$5,760	$5,781.08
B	8,234	7,660	7,702.16
C	10,337	9,540	9,596.58
D	12,880	11,400	11,471.00
E	14,320	13,240	13,423.20
F	23,040	21,940	22,017.52
G	40,200	44,900	44,383.94
H	51,800	71,520	69,630.48
I	65,700	112,260	108,196.44
J	76,000	243,040	218,957.60
Total to individuals	307,909	543,260	509,040.22
Total to Government	979,591	744,240	778,659.77
Amount undistributed	402,500	402,500	420,500.00
Total individual and company earnings	1,690,000	1,690,000	1,690,000.00

Chart III is the same as chart II except that $402,500, or slightly less than 25 percent of company profits, were undistributed and thus under the new law a levy of 11.634 percent is laid against the corporation.

Referring to the upper schedule Federal Government share, note that individuals A and F, inclusive (in direct and indirect taxes), are penalized under either tax plan for doing business as a corporation while stockholders G to J, inclusive, are benefited, have increased levies of $240,170 (column 1 to column 2) and $205,500 (column 1 to column 3), indicating that insofar as taxation is concerned, those of large interest must resort to the corporate form for doing business.

Note further that there is no material difference in the total tax burden in either group by the use of the 1936 formula. The reduction of corporate rate from 15 percent to 11.634 percent being largely offset by the inclusion of corporate dividends in the normal tax base of the individual. In this particular case we did not push the individual to higher brackets to any extent.

CHART IV. THE PARABLE CO.

$825,000 or 50 percent of profits not distributed Federal Government's share

Columns 2 and 3 show owner's personal tax (the direct tax) plus his pro rata of corporation tax (the indirect tax)

	As a partnership	As a corporation— Old tax law	As a corporation— Under law of 1936
A	$427	$701.20	$1,354.60
B	766	1,245.50	2,549.20
C	1,168	1,798.25	3,743.80
D	1,600	2,337.20	4,938.40
E	2,158	2,921.50	6,137.75
F	5,910	5,849.50	12,206.00
G	16,178	14,008.75	30,341.25
H	77,160	36,482.50	61,662.50
I	187,800	90,970.00	126,425.00
J	676,440	303,993.00	418,150.00
Total	970,591	462,417.40	662,467.30

OWNER'S CASH INCOME AFTER TAXES

A	$5,213	$4,948.80	$4,295.40
B	9,534	8,954.50	4,750.80
C	7,802	7,181.75	5,206.20
D	9,000	8,242.80	5,661.60
E	10,066	9,228.50	6,112.25
F	14,800	14,650.50	8,295.00
G	18,975	20,181.25	14,808.75
H	9,340	50,617.50	24,837.50
I (minus)	15,800	78,000.00	42,875.00
J (minus)	177,440	195,007.00	85,900.00
Total individual less borrowings in first column	114,591	402,862.60	202,832.70
Total Government	970,591	462,417.40	662,467.30
Total amount undistributed	825,000	825,000.00	825,000.00
Total individual and company earnings	1,900,000	1,690,000.00	1,690,000.00

Chart IV is same as chart II except that $825,000, or 50 percent of company profits, were undistributed and thus under the new levy of 35 percent is laid against the corporation. Comparing the upper schedule of chart III with chart IV, we will see that observations under chart III are now considerably magnified, and we may further note that under the old tax law (column 2) there is a sharp decline of governmental revenue; that to hold up this revenue as proposed in the new tax law (column 3) a proportionately greater burden is placed on owners A to F than on G to J. The progressive curve of ability to pay is reversed.

In the schedule of owners cash income, owners I and J, if operating as a partnership (column 1) would need to resort to borrowings to meet the commitment of Government and business as well as living expense.

CHART V. THE PAYABLE CO.

Individual's "cash income" plus proprietary interest in undivided company earnings

WHEN 25 PERCENT UNDIVIDED

	As a partnership	As a corporation— Under old tax law	As a corporation— Under law of 1936
A	$6,863	$6,565	$6,586.08
B	9,834	9,370	9,212.16
C	12,752	11,956	12,011.58
D	15,600	14,620	14,661.00
E	18,345	17,265	17,445.20
F	31,000	29,990	30,067.52
G	60,225	55,025	54,448.94
H	91,840	111,770	109,850.48
I	146,200	192,760	188,636.65
J	317,560	486,540	458,457.62
Total to individuals	710,409	945,760	911,540.28
Total to Government	979,591	744,240	778,459.77
Total individual and company earnings	1,690,000	1,690,000	1,690,000.00

WHEN 50 PERCENT UNDIVIDED

A	$6,863	$6,598.80	$6,945.40
B	9,834	9,454.50	9,960.80
C	12,752	12,101.75	12,156.40
D	15,600	14,842.80	15,261.60
E	18,345	17,678.50	14,362.25
F	31,000	31,150.50	24,795.00
G	60,225	70,401.25	56,145.75
H	91,840	13,251.40	107,137.80
I	146,200	243,090.00	207,675.00
J	317,560	660,001.00	580,900.00
Total to individual	710,409	1,227,582.80	1,027,432.70
Total to Government	979,591	462,417.40	662,567.30
Total individual and company earnings	1,690,000	1,690,000.00	1,690,000.00
Government share expressed in percentage:			
Percent to Government when all distributed	58	60	58
Percent to Government when 25 percent undistributed	58	44	46
Percent to Government when 50 percent undistributed	58	21	33
Percent to Government when 50 percent no distribution	58	15	42

The upper two schedules combine owner's cash income with his proprietary interest in undivided profits, that is the residue of chart I after all taxes have been paid, and attention is called to owner J, original proprietary interest as shown in chart I is $994,000, now reduced by taxation to one of the following points:

	Column 1	Column 2	Column 3
Chart II, all profits divided	$317,560	$315,580	$317,560.00
Chart V, 25 percent divided	317,560	486,540	458,457.62
Chart V, 50 percent divided	317,560	660,007	580,900.00

To J there still remains considerable incentive not to distribute profits.

In the bottom schedule the Federal Government share of the original $1,690,000 under the different plans discussed is expressed in percentage.

That avenues of tax escape exist in our present method of corporate taxation cannot be denied. My experience as a tax gatherer brings me into full accord with every effort to make the "chiseler's" road more difficult, which I take to be one of the objects of the law now under consideration. Yet I do not find myself in full accord with the method chosen, as to me better roads seem open for the improvement and all are in accord with the basic ideas striven for. Therefore, in the hope of contributing a useful suggestion, the following is submitted:

1. That dividends received be made subject to normal tax.
2. That no income tax lie against such corporation as shall adequately show the Commissioner that (a) all net income has been distributed to stockholders, or (b) all stockholders have voluntarily included in their personal income-tax returns their pro-rata share of the corporate income not paid out in dividends, or (c) that the same objective is obtained by transfer of tax liability on undivided income pro rata to stockholders through provision of corporate charter or bylaws.
3. Taxes on dividends paid out of "paid-in" surplus to be tax free to the recipient thereof.
4. Corporations not availing themselves of the provisions set out under "2" to be taxed either as at present or on a basis to be patterned somewhat along the lines of the British system wherein the rates could be increased and corporations allowed to recoup themselves out of dividends paid.

I think this can be brought out by the reading of a proposed letter which could take place if those three provisions, (1), (2), and (3), were in the law. It is a letter from the Secretary of "The Parable Co." to a stockholder:

"DEAR STOCKHOLDER: Your directors have declared an extra dividend of x percent, totaling an amount equal to 15 percent of the company profits for the year. Under the old Federal corporation tax law, the amount of this dividend would have been diverted from you to the Government, as your share of an indirect tax.

"Your directors have further decided that it is for the best interest of your company, shareholders and employees alike, not to distribute $xxxx of the year's earnings. Under the new tax plan this amount has been transferred from the 'Profit and loss' account to the 'Paid in surplus' account, and will not be taxable if and when distributed as dividends to stockholders.

"The pro rata of your holdings allot to you $—— of the amount thus transferred and you will find enclosed debit and credit memoranda covering your part of the transaction.

"Under provisions of the agreement (bylaws) you must treat this amount, to wit, $——, as income for Federal tax purposes in return for the year just ended.

"You will note that unless the extra dividend plus the amount assumed has not increased your taxable income to a total in excess of $22,000, that the proceeds of the extra dividend will not only pay in full taxes on the amount assumed, but will be of assistance in meeting the balance (if any) of your Federal income tax.

"Very truly yours,

"THE PARABLE CO."

The adoption of such a plan would probably result in inadequate revenue as to the estimated needs. To meet this contingency, I would recommend the imposition of a business tax, to be levied on all types and kinds of business, both corporate and noncorporate, to be measured by what may be termed (if I may be allowed to coin such a phrase) "gross operating income."

I can best illustrate the proposed tax-measuring base by reference to chart VI and discuss the same on the basis of the question and answer method, in which I anticipate that members of the committee will ask the questions.

What I term "gross operating income" in each unit of business is very close to the annual receipts from sales of commodities, plus receipts from services rendered, less cost of goods and raw materials sold. In this connection, it is interesting to note how close it is to the definition of "national income produced" as given in chapter 1, page 1, of Senate Document No. 124, Seventy-third Congress, second session, which reads as follows:

* * * If all commodities produced and all personal services rendered during the year are added at their market value, and from the resulting total we subtract the value of that part of the Nation's stock of goods which was expended (both as raw material and as capital equipment) in producing this total, then the remainder constitutes the net product of the national economy during the year.

It is referred to as national income produced; and may be defined briefly as that part of the economy's end-product which is attributable to the efforts of the individuals who comprise a nation.

The incorporation of such a tax-measuring base into the Federal tax structure would, I believe, be a distinct improvement. A rate of 1 percent applied to this base would produce some 500 to 600 millions or more annually, thus eliminating the necessity of the use of new excise or processing taxes, and would further allow of the abandonment of many of the, to me, iniquitous manufacturers' excise taxes now imposed.

In argument for the consideration of such a tax, may I quote from Principles and Methods of Taxation as recently revised by R. G. Hawtrey, the noted British tax economist and administrator, as follows [reading]:

Taxes are contributions from the national dividends; they must ultimately come out of the annual earnings of the nation. The private income of a nation is the index of the capacity of its people to pay taxes, since it is the real source of public revenue. Labor and wealth employed productively by individuals create a fund which can be drawn upon; hence, as Adam Smith urged, the importance of measures which remove restraint on production and which tend to stimulate the enterprise of a people.

CHART VI. A UNIT OF BUSINESS

	RECEIPTS		
1.	Gross from sales of commodities and/or service		xxx
	Gross from investments:		
2.	Rents		xxx
3.	Interests		xxx
4.	Dividends		xxx
5.	Gross receipts		xxx
6.	DISBURSEMENTS		
7.	*Nonoperating costs*		
8.	Amount paid "other business" for goods and/or raw material in or		
9.	incorporated in commodities sold (delivered cost)		xxx
10.			xxx
11.	Operating income		xxx
12.	*Operating costs*		
13.	Interest	xxx	
14.	Service rendered by "other business"	xxx	
15.	Rents	xxx	
16.	Goods consumed	xxx	
17.	Allowances for use of durable equipment (depreciate and obsolescence)	xxx	
18.	State and local taxes	xxx	
19.	Federal taxes	xxx	
20.	Salaries and wages	xxx	
21.	Total operating cost		xxx
22.	Profit from operations		xxx
23.	Gains and losses through sale of capital assets		xxx
24.	Owners' share (if any) available for distribution of accumulation		xxx

NATIONAL INCOME PRODUCED AS PER DEFINITION SENATE DOCUMENT 124, SEVENTY-THIRD SESSION, ON PAGE 1

Line (1)		xxx
Less line (8 and 9)	xxx	
Less line (16)	xxx	
Less line (17)	xxx	
		xxx
National income		xxx

(Line 11 as tax base is recommended or as an alternate tax base)

Line (11)		xxx
Less line (4)	xxx	
Less line (13)	xxx	
Less line (14)	xxx	
Less line (15)	xxx	
Less line (16)	xxx	
Total deductions		xxx
Taxable		xxx

The statement of Hawtrey's, previously quoted, may, I believe, be boiled down to: Labor and wealth employed productively, which is business, creates a fund, which is national income, which can be drawn upon. Or again, business creates national income—the index of the capacity of the people to pay taxes—which can be drawn upon.

Under the present tax laws, Government seems to measure everything but national income. A packet of cigarettes—electric energy—automobiles—radios—a gallon of gasoline—capital stock, and so forth. Why not go back to the source and tax at or near the point where national income is created; that which I term the "gross operating income" of business, at a uniform rate, and balanced by an individual income tax with graduated rates under which ability to pay is fairly and fully reflected?

Such a tax system seems fundamentally sound and fair, and if inaugurated by the Federal Government would bring many advantages, some of which may be listed as follows:

(1) Full equity between businesses in direct competition and reasonable equity between noncompeting businesses.

(2) Provide statistical data of the economic structure not over 90 days old and of inestimable value to all economic planning, both in Government and in business.

(3) Would provide a tax basis which could be used by all taxing bodies, Federal, State, and local, without multiplicity of forms and returns, allowing of either local assessment and collection in conjunction with Federal or complete Federal administration and a fair means of determining exact amounts allocable to localities.

(4) Would give a much wider tax basis in which each and every unit of business would contribute its share toward maintenance of the Federal Government.

(5) Be a tax which can be very closely predetermined by business.

The CHAIRMAN. Mr. George O. May; New York City; Price, Waterhouse & Co.

STATEMENT OF GEORGE O. MAY, NEW YORK CITY, REPRESENTING PRICE, WATERHOUSE & CO.

The CHAIRMAN. Mr. May, you represent the Price, Waterhouse & Co.?

Mr. MAY. Yes; I am senior partner of the firm, sir. I appear here as an individual interested in the subject of taxation, upon which I have worked from the time of the passage of the first income-tax law.

I was in the Treasury during the war and subsequently I served on the advisory committee of the Joint Congressional Committee on Taxation, and my interest in the subject has been active and continuous.

I represent no private interests of any kind, nor any clients or institutions in the country. I would like to state broadly the reasons why I am here today.

I am intensely sympathetic with the view of the Treasury regarding the avoidance of taxes by withholding of dividends. Nevertheless, I am convinced that a graduated tax on corporations undistributed earnings is not a satisfactory solution, is unsound in principle, will cause great injustice, and the evidence that I have seen in the record does not lead me to believe that this bill will produce any substantial increase in revenue.

I would like to say in regard to that that my reason is not so much that I think the estimates of the revenue that will be produced are excessive—I am in no position to pass on that—but I think the Treasury underestimates the yield under the existing law if business picks up. I think the Treasury underestimates the effect of the recovery of earning capacity of the country under the existing law.

I would like in the first instance to address myself to the paragraph in the statement of the Secretary of the Treasury to this committee which reads as follows:

> What are the dimensions of tax avoidance with which we are dealing? A few simple figures tell the story. It has been estimated by the Treasury Department that under the present tax law the income-tax liability of corporations on the basis of 1936 earnings would approximate 964 millions. The Department has also estimated that under the present law more than 4½ billion dollars of corporation income in the calendar year 1936 will be withheld from stockholders and that if this income were fully distributed to the individual owners of the stock represented in those corporations, the resultant yield in additional individual income taxes would be about $1,300,000,000.

It is, I think, most unfortunate that the Secretary should have been permitted by his advisers to make, as he does make in this paragraph, an obvious and serious misstatement of fact upon such an important question. The misstatement is apparent on a comparison of his language with that of the Commissioner of Internal Revenue, who said:

> The Treasury estimates that, if the present corporation income, capital-stock, and excess-profits taxes were repealed, and all corporation earnings during the calendar year 1936 were currently distributed, the income of individuals would be increased by more than 4½ billions of which approximately $4,000,000,000 would be taxable.

The Secretary says that the 4½ billion represents the sum available for distribution to stockholders under the existing law; the Commissioner makes it clear that the repeal of the existing law is prerequisite to the existence of the 4½ billion. Under the existing law, according to the Treasury tables, approximately $1,100,000,000 of the 4½ billion

mentioned by the Secretary as being withheld from stockholders would go to the Federal Government in taxes.

In the second place, it is unjust to describe the figure, even when it has been reduced by a billion or more, as "tax avoidance." A very large part of this income accrues to public companies whose dividend action is not in the least influenced by thoughts of tax avoidance but is dictated either by legal or contractual requirements or practical necessities, or an honest regard for the best interests of the stockholders.

Senator KING. There were considerable dividends from those corporations, I assume?

Mr. MAY. Yes; but some withheld profits for perfectly good reasons that have nothing to do with tax avoidance.

In the third place, I think the figure of 4½ billion dollars, even when interpreted as the Commissioner interprets it, is greatly overstated. This figure appears on the sixth line of the main statement submitted to the Treasury in support of the proposal which appears at page 36 of the House hearings. A careful study of that table leads me to the definite conclusion that the figure is excessive even as applied to the special circumstances of the year 1936. If it be regarded—as we are entitled to regard it—as an indication of the permanent increase in revenue which the proposed law is expected to produce, the overstatement becomes larger and even more apparent.

If the Treasury estimate of statutory net income for 1936 of of $7,200,000,000 is correct, then the increase of yield which may be expected from this law if all net income is distributed thereunder, turns on the estimate of the dividend distribution which would take place under the law as it now exists. To secure a fair comparison this estimate should be an estimate of the dividends which will be paid out of 1936 earnings either in 1936 or in the first months of 1937. The Treasury, however, makes the comparison with the dividends which it estimates will be paid in 1936 partly out of 1935 earnings and partly out of those for 1936. Since dividends naturally rise as income rises, and since the Treasury estimates that 1936 income will exceed that of 1935 by $1,700,000,000, or 30 percent, this method of comparison artificially inflates the estimate of increase of yield from the new law by a sum which must run into the hundreds of millions. It is like comparing the rainfall in two places, A and B, taking the rainfall at A for the calendar year and that of B for the year ending on the 15th of March in the following year, with the knowledge that the first 75 days of the earlier years were in both places a period of relatively small rainfall.

Further, the estimate of distribution within the year 1936 seems to me to be low. The Treasury estimates that the increase of dividends in 1936 over 1935 will be from $3,600,000,000 to $3,900,000,000, or 8½ percent. Statistics for the first quarter, covering rather less than 3,000 corporations, show an increase from $659,000,000 to $781,000,000, or an increase of $122,000,000, equivalent to more than 18 percent. If earnings continue to rise, as the Treasury estimates they will, then the rate of increase in dividends should grow. Only on Monday the General Motors Corporation declared a dividend on its common stock for this quarter which was greater by 43½ million dollars than the dividend which it paid to the corresponding quarter of last year. This is one-seventh of the total increase for all corporations for the entire year as estimated by the Treasury.

dend which it paid to the corresponding quarter of last year. This is one-seventh of the total increase for all corporations for the entire year as estimated by the Treasury.

Approaching the question in a somewhat different way, I find from a table submitted by the Treasury showing the statutory net income and dividends for corporations having net income that during the 12 years for which actual or approximate figures are given dividends have averaged about 66 percent for statutory net income. The Treasury's estimate of $3,540,000,000 as the dividends which would, under the existing law, be paid by such corporations in 1936 is equivalent to about 49 percent of the estimated statutory net income The difference of 17 percent amounts to about $1,200,000,000

Apparently, also, the Treasury, while making its main calculation on the basis that all net income would be distributed within the year, assumes that the amount of dividends paid by corporations having no net income will not be affected by the change of law. This seems to me to result in an overstatement of the increased distribution to be expected by some two or three hundred million dollars.

Finally, the amount estimated as the increase in yield due to the change in law includes taxes which will or might be recovered under the existing law in respect of dividends unreasonably withheld by corporations, and I am not convinced that the Treasury has made adequate allowance for the changes in taxable status that such laws inevitably produce, such as charitable gifts, reclassifications of capital stocks, and so forth.

Taking all these considerations together, I do not find in the statistics presented any ground for believing that this law, if adopted, will increase the revenue. It is, of course, possible that it will do so, but the Treasury has not, to my mind, made out any case that it will. The position is such that immediate enactment of the law is certainly not necessary from a fiscal standpoint.

No doubt there is a large amount of tax avoidance through the device of withholding profits from distribution, and all taxpayers—especially, I might say, those professional men whose income is almost wholly taxable—are sufferers from it. It should be curbed, and I am entirely symphathetic with the desire of the Treasury to curb it. But measures which affect equally those who are and those who are not avoiding taxes are unnecessary and unjust, and too often, like Herod's massacre, they cause great suffering but fail to reach the particular cases which inspire them.

The figure of profits withheld should be revised and analyzed. Corporations may be divided into three groups—(1) a very large number of small corporations which in the aggregate contribute and should contribute only a small fraction of the revenue from taxation of corporate income; (2) a relatively small number of public corporations most of which are owned by large bodies of stockholders and follow dividend policies practically uninfluenced by consideration of taxability of their stockholders; (3) a relatively small number of privately owned companies, some engaged in business, others substantially private holding companies, the dividend policies of most of these being governed largely by tax considerations. If we knew how much of the profits withheld were retained by these different classes of companies, the formulation of sound legislation would be facilitated greatly.

After all, the problem is not one of stupendous magnitude. In 1933, for instance, about 10,000 corporations paid 90 percent of the corporation income tax. An analytical study of those 10,000 cases would not be a burdensome task, and I think the Congress and the people are entitled to have some information of this kind furnished them and legislation framed in the light thereof, instead of being asked to support a hit-or-miss measure of the kind now before the Senate.

I would emphasize the fact that continuity in taxation *is* a consideration of great importance. It inspires confidence and it minimizes the injustice which inevitably results from heavy and changeable taxation applied to income on the basis of a necessarily very imperfect allocation of income to particular years. Hasty experiments are wholly undesirable.

I would point out, further, that income taxation, and the business to which it is applied, constitute an intricate network, and that any important change in the frame of this network produces all sorts of strains and stresses which can only be guarded against by very careful and prolonged study. The Treasury, when proposing this measure, contemplated its universal application. Some of the most striking injustices that this would produce have been brought to the notice of Congress, and in the House provisions were improvised to guard against, or at least alleviate, these injustices. It cannot be supposed that all the important injustices have been developed. Obviously, the Tresaury made no exhaustive study of them, because it contemplated a rigid rule, free from any exceptions.

I should like, purely by way of illustration, to mention one or two injustices which immediately occur to me. Take, first, the law which taxes capital gains but substantially denies relief in respect of capital losses. Suppose a corporation to have an ordinary income of $100,000 in each of 2 years, and to make a capital gain of $100,000 in 1 year and a capital loss of $100,000 in the other. Its true income over the 2 years is clearly $200,000, whether capital gains and losses are or are not considered as entering into the determination of income. This is the amount that it should be required to distribute in order to get the maximum benefit of the proposed law. Actually, it would have to distribute practically $300,000 in order to get such a benefit.

Again, in this same field we have recognized that capital gains should not be taxed in the year in which they are realized in the same way as if they were ordinary income of that year. We have provided that individuals making capital gains shall pay a tax which decreases according to the length of time for which the investment has been held. An individual who sells property which he has held for more than 10 years pays tax on only 30 percent of the profit. Under the proposed law, if a corporation in which he is interested makes such a profit, and in order to avoid taxes distributes all its statutory income, the individual would pay tax on his share of the full amount of this profit—yet the whole basis of the present proposal is that individuals shouod pay neither more nor less on profits which come to them through the medium of a corporation than on profits which come to them directly.

Section 27 (i) also violates this same principle, not only in respect of the holding companies at which it is aimed, but also in respect of minority stockholders in corporations in which such holding companies

own a majority. Their tax is determined not by their own status but largely by the status of the other stockholders. This provision should be eliminated.

Many other instances of the same kind could be cited. I do not think it is possible to anticipate all the serious injustices. I am inclined to agree with the Treasury that once you begin to make exceptions there is no logical place at which you can stop. This, however, merely means that the real choice is between a rigid rule and the abandonment of the principle, and I have no hesitation in saying that the wise choice is to discard the principle.

I should like to point out, also, that all the injustices which result from the taxation of corporate income under the existing law which will be magnified by the substitution of a steeply graduated tax on undistributed earnings for a practically uniform tax on the whole amount of earnings.

For instance, the injustice which even under the present law results from the discontinuance of consolidated returns will be aggravated. Certainly opportunities ought to be given to readjust corporate structures so as to prevent double taxation resulting from the discontinuance of such returns and section 112B (6) is quite inadequate for the purpose.

To sum the matter up, I think the bill is as likely to produce less revenue as it is to produce more, and to produce more injustice than it remedies.

When we consider the measure from the standpoint of social policy as distinct from a fiscal policy, we of course enter the realm in which wide differences of opinion are possible. On this point I should first of all like to point out that this law does not constitute an application of the principle of "ability to pay" which underlies the graduated tax on individual incomes and has no analogy to that scheme of taxation. The closest analogy in the field of individual taxation would be a steeply graduated tax on income saved under which all individual income would be exempted from taxation if spent. It is a surprising thing to me that Dr. T. S. Adams—who regarded the opposite concept of a tax on spending which would leave saved income free as ideally preferable to the individual income tax—should be claimed as a supporter of a measure of this kind.

Senator KING. What was your view when you were in the Treasury advising them?

Mr. MAY. As a matter of fact, I had extended discussions with Dr. Adams and Treasury officials on the question of a substitute spending tax. We agreed it was ideally preferable, but there were some objections on the ground of excessive accumulation of fortunes by individuals with practical advantages, and on the whole we advised against it. But certainly, in all the long and intimate talks I had with Dr. Adams I had never heard a word that would lead me to suppose he would support this measure.

Senator BARKLEY. A tax on spending is a sales tax.

Mr. MAY. A graduated tax on spending is paid by the individual.

Senator BARKLEY. That is a sales tax.

Mr. MAY. An ordinary sales tax is a regressive tax because it falls equally on all products.

Senator BARKLEY. Any sort of a tax based on spending is a tax on sales.

Mr. MAY. It is in one sense, but not when it is ordinarily thought of as a sales tax.

Senator BARKLEY. You have got to buy something when you spend anything, and you are taxed on that.

Mr. MAY. That is the same thing. The sales tax is usually levied on the sale.

Senator BARKLEY. Regardless of that, it is levied on the price, whether you levy it on the sale or on the expenditure.

Mr. MAY. There is a great deal of argument that under an ordinary income tax there should be an exemption of saved income. I think the argument is against it.

Senator WALSH. Is a graduated spending tax a spending tax?

Mr. MAY. That is what we contemplate, a graduated spending tax. It would reach the man who spent his capital.

Senator WALSH. A man who spent $50,000 would pay a higher tax than a man who spent $5,000?

Mr. MAY. That is right.

Senator HASTINGS. Would the spending tax apply to the wages of a chauffeur, for instance?

Mr. MAY. Yes.

Senator HASTINGS. In that instance it is different from a sales tax.

Mr. MAY. Yes; it covers all expenditures for goods and services.

Upon the social aspects of the bill generally all I propose to do is to indicate some effect that it seems to me to be likely to have, leaving the committee to decide whether those consequences are socially desirable.

I do not want to go over ground already covered by other witnesses. I agree with Mr. Ballantine that the adoption of these proposals will have a serious adverse effect on the development of industry and the ability of industrial corporations to withstand depression. Not only was the policy of withholding profits in periods of prosperity followed and approved before our income tax was initiated; it is common in all countries and was followed in England before the principle of graduation was introduced here. I believe that in recent years the proportion of profits retained by English companies has been as great as here even in the years of prosperity. To regard such retention by publicly owned corporations as tax avoidance or even as prejudicial to the interest of the revenue, is, I think, an error.

Clearly, if corporations are compelled by taxation to distribute all their surplus in times of prosperity, it is inevitable that in any subsequent period of depression when they suffer losses they will be forced into bankruptcy or compelled to resort to State aid to a greater extent than heretofore. The idea that they should sell additional stocks to finance future losses seems to me academic and unrealistic.

I think it is a great mistake in formulating measures such as this to attach much importance to averages. Taxes are not levied on averages, but on individual cases. Businesses differ radically in their character. Some companies are what may be called developing companies, creating a new industry or exploiting a new idea. At the other extreme are corporations of a liquidating character, either because the nature of the business is in itself liquidation, or because the businesses are declining. Mining companies, for instance, are essentially liquidating in their nature. Such companies can well afford to pay out all of their profits in dividends. As a matter of

fact, statistics show that they do in almost every year in the aggregate pay out more than they earn.

Senator KING. Now, in regard to profits, most of the mining companies have had no profits for many years.

Mr. MAY. That is true.

Senator KING. Where one succeeds there will be two or three hundred who fail.

Mr. MAY. That is quite true; but as a matter of fact, the statistics show that in almost every year the mining companies, in the aggregate, pay out more dividends than they earn, so they would be practically free of tax under this law.

On the other hand, developing companies, if they paid out in dividends the net cash they received from operations during the year, would as a rule be liable under the law to a heavy tax. It seems to me a pertinent question whether it is desirable to frame laws which favor those who are exhausting the natural resources of the country for private gain, and handicap those who are developing new industries which they expect, no doubt, to be profitable to themselves but which, if successful, would also strengthen our industrial system.

I think it is unquestionable that the law will operate in favor of the large, established companies as against those of their aspiring rivals. This no doubt accounts for the fact that comparatively little opposition to the bill has come from the large corporations.

Senator GERRY. Mr. May, I notice in going over the House hearings that there were certain large copartnerships, 23 of them, if I recollect correctly, that had incomes of over a million. What sort of businesses would they be in?

Mr. MAY. Senator, I saw those figures myself. I thought that 23 must be on the low side, to be quite frank, because I thought I could have named 23 firms within a gunshot of the corner of Broad and Wall in New York that had incomes of a million, the large stock-broking firms which, under the New York Stock Exchange regulations, cannot incorporate, and the large Wall Street law firms, and other service firms of that kind, I should think would have numbered more than 23 alone.

Senator GERRY. How would the partnership compare with a corporation? Of course, the corporation has the advantage of a limited liability.

Mr. MAY. Yes. I think, broadly speaking, when you get into large partnerships they represent, in the main, different classes of business than corporations, comparatively few of your partnerships carry on an industrial business. They are mostly what I might call service businesses. Their income is derived in cash. They would make their returns on the cash basis. So they have cash equal to the profits that they return.

On the other hand, business corporations, as we all know, have either got to develop or else die, generally speaking. That means that they are constantly making new investments in plant and capital assets, and the reality on their profit today is dependent on the usefulness of their plant in the future. Their income is determined, as I see it, on a less favorable basis to the corporation than the average partnership's income is determined to it.

So I think the disparity between the two is somewhat exaggerated, and, incidentally, in relation to those figures that you mentioned,

I think you will find that while the Commissioner took as an illustrative case a partnership with an income of $1,000,000 and four partners, the more typical company in that number of 23, or whatever the proper number may be, would be a firm with far more partners than that. Big law firms have, perhaps, 15 or 20 partners, which rather modifies the conclusion.

Senator BARKLEY. Mr. May, is your firm a corporation or a partnership?

Mr. MAY. It is a partnership, sir.

Senator BARKLEY. It is a partnership of certified accountants, economists, experts, or which?

Mr. MAY. Certified public accountants.

Senator BARKLEY. You appear here just as an amicus curiæ, a friend of the court, you do not represent anybody?

Mr. MAY. No; not at all, sir.

Senator WALSH. Mr. May, you stated that corporations could be placed in three classifications. One which you have stated was few in number. Are those the corporations that did not distribute their earnings because they wanted to avoid their taxes?

Mr. MAY. When I say "few", I mean relatively few, of course.

Senator WALSH. Have you any information as to their number?

Mr. MAY. No, sir; I have no knowledge at all. It must be a considerable number. You know, under the English law there is a distinction in taxation between the publicly owned corporation and privately owned corporation, and I always thought we ought to pursue the question in that way if we are to arrive at really satisfactory legislation.

Senator WALSH. You think that there are a considerable number of corporations that withhold distributing their earnings for the purpose of taxation avoidance?

Mr. MAY. I have no doubt that that is a substantial element, undoubtedly.

Senator BARKLEY. What do you mean by the distinction between publicly owned and privately owned corporations? You do not mean that in the sense that we use the term "public ownership"?

Mr. MAY. No; owned by the general public. In England, of course, the legislature has a very great advantage. We have always got to recognize, in comparing our procedure with the English, that all their legislation is confined to the one body. They control corporations as well as taxation and they can classify corporations for their own purposes, which you cannot do, because the States have jurisdiction in one field and you are legislating in another. I do think that that whole problem could be intensively studied to great advantage.

Senator BARKLEY. Where is the line of distinction in the number of owners of stock in order to make it public or private?

Mr. MAY. You mean in England?

Senator BARKLEY. Yes.

Mr. MAY. In England there is a limit on the number of stockholders, and as a penalty for being a public corporation you have to disclose a lot of information which private corporations do not have to, and they offer advantages that counterbalance. On the other hand, the private companies stand in a different relationship for tax purposes from those that are called public companies, and they are a larger number.

Senator BARKLEY. What is the line of distinction?

Mr. MAY. Any line is bound to be more or less arbitrary.

Senator BARKLEY. Under the British law, how many stockholders form a private corporation and how many does it take to make it public?

Mr. MAY. I do not know at the moment. If I should make a guess, I would say 20 was the figure; something of that sort.

Senator WALSH. You do not mean that private corporations are personal holding companies?

Mr. MAY. No.

Senator WALSH. For your information, in connection with the question I asked you, the expert informs me that there are 4,000 personal holding companies who make filings under the existing law and who, in all probability, do so for the purpose of the tax.

Senator BARKLEY. Do you know whether the British law makes any distinction as to whether the shares of stock are listed on an exchange where they may publicly inspect and purchase them?

Mr. MAY. I do not think it turns on the listing on the exchange, but it does require disclosure of information to the registrar of companies. They have to give more information to the public than the private companies do.

Senator BAILEY. You began by making a statement which indicated a contradiction of fact as between the Secretary of the Treasury and the Commissioner of Internal Revenue. I would like for you to make a statement about that. Just give me the facts over again.

The CHAIRMAN. May I ask you, was the Commissioner's statement from which you quoted made before the House Ways and Means Committee?

Mr. MAY. No; I think they were both made before this body.

The CHAIRMAN. You read the statement which was made before this committee?

Mr. MAY. Yes; I think I am right about that.

Senator BAILEY. Just what is the difference between them?

Mr. MAY. The Commissioner states that if the existing taxes were repealed, there would be four and a half billion dollars. The Secretary says——

Senator BAILEY (interposing). Four and a half billion dollars of what?

Mr. MAY. On income available for distribution, which the Treasury estimates would not be distributed. I think that is a fair way of saying it.

The Secretary said there would be that same amount of money available under the existing law.

The difference between the two statements is that the amount of the taxes under the existing law, which is a billion one hundred million dollars, roughly——

Senator BAILEY (interposing). Is it possible that both statements could be reconciled?

Mr. MAY. I do not see how. It seems to me that the Secretary misunderstood the figure, and I believe the wording of the figure was a little unfortunate and may have given rise to that misunderstanding.

Senator BAILEY. Did he adopt that figure for this statement from the Commissioner's statement without getting the facts upon which the Commissioner's statement was predicated?

Mr. MAY. I am not in the confidence of the Treasury.

Senator BAILEY. Can you explain that?

Mr. MAY. I think there is no other explanation.

Senator HASTINGS. As I understand your position, you figure that there ought to be a billion one hundred million taken from the figures given by the Secretary of the Treasury?

Mr. MAY. I think one billion one hundred million should be deducted from his figure.

Senator HASTINGS. So that instead of his figure being four billion one hundred, it ought to have been three billion?

Mr. MAY. If he wanted to state it on that basis.

The CHAIRMAN. Thank you, Mr. May.

Senator BAILEY. Your other statement is that, in your opinion, the proposed legislation if adopted is not likely to raise much more money, if any, than the existing law? Is that your opinion about it?

Mr. MAY. And the reason is I think the Treasury underestimates the yield of the present law on the conditions.

Senator BAILEY. We have been predicating legislation on the basis of fifty-five billions this year. I read in the New York Times this morning an article in which the President was quoted as saying that the annual income this year would be about sixty-five billion. Can you give me some information or view about that?

Mr. MAY. I am afraid I am not currently up to date on the statistics sufficiently for that, Senator. I am taking the same estimates that the Treasury assumes; they take as their basic year on which these calculations are predicated, an estimate of seven billion of statutory net income. I think the yield under the existing law would be larger than they have assumed on that basis. It is not that I think they are exaggerating the yield under the new law, but that they are underestimating the yield under the existing law.

Senator BAILEY. Your theory is that the bill is wrong in principle and that we cannot get rid of injustices in it?

Mr. MAY. Yes. And I do not feel that we have adequate bases to formulate legislation in which we could reasonably limit the injustices.

Senator BAILEY. Are you prepared to suggest to us legislation that would surely add $800,000,000 revenue as compared with the last bill?

Mr. MAY. I do not think that I can say that on the Treasury figures it is necessary to increase the yield of the taxation under the present law by $800,000,000 in order to reach the total taxation that is contemplated. I think you will get pretty close to it under the existing law, if all of the other estimates are realized; that is what I got from an analysis of these figures of the Treasury. Certianly my strong feeling is that there is not sufficient fiscal advantage in passing this law to justify precipitate action, and I would like to see a very careful study made and more considered legislation based on it.

Senator CONNALLY. Would you rather raise the flat corporation tax, rather than this plan?

Mr. MAY. I would; I would rather see any rational levy raised, frankly. I would be willing to see my own taxes raised, because I think it is much better for us to pay more taxes.

Senator CONNALLY. I congratulate you.

The CHAIRMAN. All right, Mr. May.

Senator GERRY. I would like to ask Mr. May a question, and see if I get it clear, on this last statement. What you feel is that the revenue raised by the present bill will be greater than the Treasury estimates?

Mr. MAY. Yes.

Senator GERRY. Under the present law?

Mr. MAY. Under the present law.

Senator GERRY. Than the Treasury estimates?

Mr. MAY. That is my feeling.

Senator BAILEY. How much greater?

Mr. MAY. Very considerably, sir.

Senator BAILEY. Six or seven hundred millions?

Mr. MAY. Of course, I have not got the detail, but I should say pretty nearly the amount that this increase was expected to raise. Five or six hundred million.

Senator BAILEY. Could you prepare the data in a short time?

Mr. MAY. I could make a summary, as I have done here of the causes which lead to it; but I should have to have some information from the Treasury to convert increases in individual incomes into taxes on individual incomes, because they have figured it out on the distribution to be expected, which I have not.

Senator BAILEY. I would like very much to have it.

Mr. MAY. I would have to have certain data from the Treasury in order to do it.

The CHAIRMAN. You believe the increase would come under the present law because of the general increase in business?

Mr. MAY. Yes, sir.

Senator CONNALLY. Disregard the income. Could you estimate how much the corporation income in 1936 would be over 1935 if we make no change in the rates? Can you give a rough estimate?

Mr. MAY. I do not carry those figures clearly enough in my head to make the estimate. I am cautious of making estimates except from actual figures.

Senator CONNALLY. I am not calling for an opinion that I will pay you for as an expert.

Mr. MAY. My services are always at the disposal of the committee.

Senator CONNALLY. You figure the business in 1936 is going to be better than in 1935?

Mr. MAY. The Treasury estimates it, and I believe there is ground to believe it.

Senator CONNALLY. But you do not know how much?

Mr. MAY. The Treasury estimates that there will be one billion seven hundred million increase in taxable statutory income, which, on a 15-percent basis, would be $255,000,000.

Senator BARKLEY. You think that the present law, unchanged, would raise this eight hundred million in addition to the amount raised in 1935, or in addition to the Treasury estimates for 1936?

Mr. MAY. I think for the graduated tax end of it, it would raise the larger part of the six hundred million that was supposed to raise over the Treasury's estimates for 1936; yes.

Senator BARKLEY. You think we are liable to be more prosperous than the Treasury does?

Mr. MAY. I think more money is going to be distributed than the Treasury estimated, and that will mean large increases to the individual income tax.

The CHAIRMAN. All right, Mr. May; thank you.

Is Mr. James R. Everett, representing the American Cotton Waste Exchange of Boston, here?

Mr. EVERETT. Yes, sir.

The CHAIRMAN. I understand you want to make a brief statement to the committee?

Mr. EVERETT. Yes, sir.

The CHAIRMAN. How long do you wish?

Mr. EVERETT. Not more than 10 minutes; probably less.

The CHAIRMAN. Proceed.

STATEMENT OF JAMES R. EVERETT, BOSTON, MASS., REPRESENTING THE AMERICAN COTTON WASTE EXCHANGE

Mr. EVERETT. My name is James R. Everett. I am a cotton-waste merchant and exporter, and I represent here the American Cotton Waste Exchange of Boston, the trade association of the cotton waste merchants and exporters.

As representative of the American Cotton Waste Exchange, which has a large number of members engaged in export trade, I take the liberty of bringing to your attention the fact that section 601 of H. R. 12395 is incomplete because provision is not made for payment of export claims, allowable under that section, without proof that the processing tax has been paid. In contrast, section 602 which would allow refunds to holders of floor stocks on January 6, 1936, does not require proof of tax payment in claims made under that section, for section 602 (e) provides [reading]:

> No claim under this section shall be disallowed on the ground that the tax with respect to the article or the commodity from which processed has not been paid.

As exactly the same reason exists for allowing the claims under section 601 as exists for allowing the claims under section 602, we feel that there should be incorporated in section 601 the same provision found in section 602 to provide that no claim under section 601 should be disallowed on the ground that the tax with respect to the article or the commodity from which processed has not been paid.

Both sections are remedial legislation. Chairman Doughton of the House Ways and Means Committee in his report covering this bill stated—

> that this section should be enacted into law as a matter of fair dealing and sound public policy.

He also notes that the section is purely remedial and provides a form of relief which is justifiable as a matter of equity and sound policy. Equally, Secretary Morgenthau in his statements before your committee and referring to both sections 601 and 602 stated that—

> the Ways and Means Committee which inserted the refund provisions in the present bill, regards these particular refunds as fulfilling a moral obligation of the Government, and I agree.

Yet as section 601 is now written, this clearly stated intent is nullified as far as the exporter is concerned unless a paragraph is inserted in section 601 similar to section 602 (e).

Both sections 601 and 602 are designed to permit refunds to the processing taxes incident on articles exported, articles delivered to charity, articles held as floor stocks on January 6 and certain related cases. Section 601 deals with export and related claims. Section 602 relates solely to floor stocks claims. All these claims hold sub-

stantially the same legal and economic status and should be accorded like treatment as mentioned above.

The reason for not requiring proof that the processing tax has been paid is explained by the House Ways and Means Committee report on the bill as follows:

Section 602 (e) relieves claimants of any necessity of proving that any processing tax has been paid with respect to the article or articles on which their claims for refund are based. It is the opinion of your committee that this provision is justified and that any advantage which might otherwise result to the processor or other person liable for the tax but who did not pay the same will be largely eliminated by the tax on unjust enrichment under title III.

Unless the suggested change in section 601 is made, the export trade will suffer severe and irreparable loss in spite of the fact that their sales were based on the belief that the Agricultural Adjustment Act was valid, and that the Government would collect and enforce the collection of the processing taxes and that the exporters would in due course receive from the Government the export refunds in accordance with the act. Our purchases from the mills were based on the price obtainable in the domestic market, which price in turn reflected the processing tax. We sold these goods for export at a price lower than the purchasing price, expecting to collect our export refunds from the Government. We could hardly be expected to find out in each case what attitude the individual mill would finally take in connection with their processing tax obligations to the Government, or whether the Government would be able to enforce the collection of the tax.

Senator WALSH. Did you collect these export refunds from the Government up to the time of the Supreme Court decision?

Mr. EVERETT. Yes; more or less.

Senator WALSH. And the export refunds that you had pending and expected to collect upon, have not been collected since that time?

Mr. EVERETT. That is right, Senator.

I should like to give at this point the export refund situation as it affects our own part of the cotton industry.

Since the middle of 1933 a processing tax of 4.2 cents per pound was assessed on raw cotton. The law provided (sec. 17 (a)) that because of this tax burden on manufactured cotton goods there would be a refund of the tax item on such articles as were exported. All exporters of cotton products had to adjust their business operations and could only continue the export business by relying on the export refund arrangement. Exporter's purchases were at the domestic market prices, which on account of the processing tax were in all cases proportionately higher than the world market prices. The exporter, in order to do business, had to sell to the foreign buyer at a price which did not include the tax. In other words, the proceeds of every export sale were really split into two items, first, the amount which would be paid to him by the foreign buyer; second, the amount which he would receive as an export refund from the Government.

The exporters, upon exportation of such articles, would present their refund claims to the Internal Revenue Department, and such claims were allowed in the regular course of handling, until collection of the cotton tax was to a great extent retarded in the summer and fall of 1935.

The export refund item was at least six to eight times the usual gross profit margin which the exporter had on such export sales. On cotton comber waste, for instance, the refund item is 3.36 cents per pound, while the usual gross profit is from three-eighths to one-half cent per pound. Every export sale was made at an actual substantial loss to the exporter until he received back from the Government the export refund accruing under the regulations. This clearly shows that the exporter could only do business on the assumption that the Government would live up to its export refund promises.

The delay in refunds had always tied up a considerable amount of capital, but during the second half of 1935, when tax collections virtually ceased the amount of capital involved was increased considerably, causing real hardship to many exporters.

When the Supreme Court declared the law unconstitutional, the exporters had a great many claims pending, all of which represent frozen capital, as above mentioned. The Internal Revenue Department at that time suspended action on all claims. Quite clearly it was not the exporter's fault if the law was held invalid and the Government was unable to make all the necessary collections.

If exporters are required under section 601 to submit, with their refund claims, proof that the tax with respect to the articles exported has been paid, a virtually impossible condition is demanded and the relief intended to be granted by section 601 will, to a great extent, be nullified. Bearing in mind the injunctions against processing tax collections, the 90-day extension, the many other extensions granted by the Government, and the final invalidation of the tax, it can be clearly understood how nearly impossible it would be for the exporter to submit proof of tax payment with each claim.

Senator WALSH. You would have to have documentary evidence from every person from whom you purchased this waste?

Mr. EVERETT. In most cases; yes. It was always written advices to fulfill the regulations of the Bureau of Internal Revenue under the regulations. It was not in all cases an affidavit. Some mills would furnish affidavits instead of the other written advices.

The anomalous situation and inequity resulting from the failure to give like treatment, as far as tax payment is concerned, to claims under sections 601 and 602, can be illustrated by a simple example. On goods exported January 7, 1 day after the A. A. A. decision, the exporter can obtain a refund under section 602 without proof of tax payment since, on January 6, he held the goods as floor stocks. He would receive a "floor stocks" refund and not an "export" refund. However, had these goods been exported on January 5, 1 day before the A. A. A. decision, the exporter is in most cases unable to obtain the refund under section 601 as now written because proof of tax payment is required.

In conclusion, I wish to state that I appreciate the purposes of section 601 and heartily endorse the end it was designed to achieve. The purpose of my statement, as I have said, is solely to point out that because of the absence of a provision respecting dispensing with proof of tax payment comparable to section 602 (c), section 601 will largely fail to achieve its purpose—at least as far as exporters are concerned.

It is respectfully submitted that, for the reasons above given, section 601, subsection (c), page 230, line 10, should read, after the word "Treasury"—

and no claim under this section shall be disallowed on the ground that the tax with respect to the article or the commodity from which processed has not been paid, but no claim shall be allowed in an amount less than $10.

Senator CONNALLY. In all cases did those exporters pay the tax, or did many of them give bond and not pay them?

Mr. EVERETT. We are cotton-waste merchants, exporting and buying cotton waste from the mills. Most of the mills that manufacture under bond for export, manufacture coarse goods, and did not make quality waste which was very largely exported, and which quality had a refund under the regulations of the A. A. A.

Senator WALSH. Whether tax was paid or not?

Mr. EVERETT. Whether the tax was paid or not.

Senator CONNALLY. That does not quite answer the question. Many of them did export without payment of tax, but gave bond in lieu thereof.

Mr. EVERETT. Those are the manufacturers.

Senator CONNALLY. It does not make any difference who they were. They got the refund if they would be entitled to a refund, just like you would?

Mr. EVERETT. If they paid the tax, they would be entitled to the refund, but most of the mills manufacturing export goods, I believe manufactured bond and never paid any tax.

Senator CONNALLY. Exactly. That is just what I want to bring out.

Mr. EVERETT. That is right. But those mills manufacturing for the export trade, did not make the kind of waste that was exported to foreign markets.

Senator CONNALLY. I understand that. Still, they exported goods?

Mr. EVERETT. They exported goods.

Senator BARKLEY. This amendment you suggest, should apply to all of them just as it would to your own company?

Mr. EVERETT. Well, it would. Of course, we are speaking of exports now in a pretty broad way, and I think that that is probably true.

Senator BARKLEY. That is one of the things about making an amendment here to fit someone's particular situation.

Mr. EVERETT. The same thing is true under the floor stock plan. If a mill is manufacturing for export and makes its waste, if that waste is on hand as of January 6, 1936, under the provisions of section 602 (e) that would apply. That waste is clearly without the bill.

The CHAIRMAN. If there is anything further you want to say or want to talk to any of the experts, they will be glad to talk to you. I understand you have already talked to some of them.

Mr. EVERETT. Thank you.

The CHAIRMAN. The next witness is Charles P. Bloome.

Mr. BLOOME. Yes, sir.

The CHAIRMAN. I understand you want to appear briefly?

Mr. BLOOME. Yes, sir; very briefly, Mr. Chairman.

The CHAIRMAN. Mr. Bloome is executive vice president of the Wearing Apparel Board of Trade of Philadelphia.

STATEMENT OF CHARLES P. BLOOME, EXECUTIVE VICE PRESIDENT WEARING APPAREL BOARD OF TRADE, PHILADELPHIA, PA.

Mr. BLOOME. Mr. Chairman and members of this committee, I am here to plead for the passage particularly of title IV, section 601, which applies to one item that is very important to the wearing apparel industries in Philadelphia. Possibly the same is true in other markets.

The Federal Government had made contracts with a number of manufacturers of wearing apparel and stipulated in the contract that they will receive a drawback of their processing taxes; in other words, they told the manufacturer that in calculating his price to the Government, they can eliminate that portion of the price which constitutes the processing tax.

The manufacturer did so and obtained the contract, realizing that the Government will give him back that amount of money which the Government said that they will give him back.

Senator WALSH. And you did get it back up to the time of the Supreme Court decision?

Mr. BLOOME. Correct.

Senator WALSH. And since then you have not?

Mr. BLOOME. That is right.

Senator WALSH. And you want to get it back now?

Mr. BLOOME. That is right. Here is one particular case amounting to $9,000 on one contract. It is a comparatively small manufacturer. As a matter of fact, the wearing apparel manufacturing business lies in smaller and medium class hands.

This $9,000 is very urgently needed by these people. They employ about a hundred girls, they pay an average of $18 a week to a girl; between $18 and $20 a week. This $9,000 would help them to pay roll almost 5 weeks.

Here under date of February 29, 1936, the Internal Revenue Department advised these manufacturers that they have suspended paying, and today I was told at the Internal Revenue Department when I took this up, they said:

That is true; we have suspended, and, unless Congress acts on it, we do not hold forth any hope that you will get it back.

I could see stars when I heard that.

Senator BAILEY. Notwithstanding you had paid the processing tax?

Mr. BLOOME. Notwithstanding, because we have confronted the Government with affidavits by the original manufacturers that on the goods stipulated in the contract with the Government, that the original manufacturers have paid the processing tax. That is a very clear case.

If it was John Smith, they would have to pay, and our board of trade would see that they paid very quickly. But here is a different thing, and it is still $9,000, and, Members of Congress, $9,000 is a lot of money to us poor people. Of course, to the rich it does not mean much.

The CHAIRMAN. What you are arguing for is to retain section 601?

Mr. BLOOME. That is precisely the thing that I am here pleading for.

One more item here. Judging by the papers, and you can not always believe everything you read in the papers, complete power, unlimited power, is being vested under this law in the hands of the Commissioner of Internal Revenue insofar as making the decisions. Now, Members of Congress, I have implicit faith in every act of a Government official, that he will act fairly, justly, and righteously. However [laughter]——

The CHAIRMAN. Let us have order, please.

Mr. BLOOME. I am not to blame for all of this.

The CHAIRMAN. What you want is the right to appeal?

Mr. BLOOME. That is right.

The CHAIRMAN. Thank you very much.

Mr. BLOOME. I certainly appreciate this courtesy.

The CHAIRMAN. The next witness is Mr. G. L. Childress.

STATEMENT OF G. L. CHILDRESS, HOUSTON PACKING CO., HOUSTON, TEX.

Mr. CHILDRESS. Mr. Chairman and members of the committee, my name is G. L. Childress, and I live in Houston, Tex. I am not very comfortable up here and I won't stay any longer than I have to.

I am general manager of a small packing plant that has been in business for 39 years.

I want to give the committee the viewpoint of an active operating executive of a small company engaged in the slaughter of hogs and the sale of pork products so that it may help you to some extent to understand the practical application of the so-called unjust enrichment tax to our business.

I believe I could state the position of most packers in a couple of nutshells—that is, the small concerns—by saying that we are identically in the same position with the man who is about to be hanged. The sheriff asked him if he had anything to say and he said, "All I can say is, well, Sheriff, I don't think I am going to be able to get over this." That is just about the way we feel about it.

If I may, I would like to sit down and read a little of my scrip.

The Agricultural Adjustment Act was passed by Congress for the purpose of relieving great distress to agriculture. I recognized that our producers had gone through a period of distressingly low prices and were in great need of help. I personally hoped that the Agricultural Act would relieve this situation. As you know, the theory of the act assumed that the great distress of the producers was occasioned by overproduction and for the purpose of controlling this overproduction the act contemplated the payment of benefits to those who curtailed their production to meet what was thought to be the consumptive demand. In order to raise the money to pay these benefits to producers the act authorized the imposition of a processing tax.

Mr. Woods told you yesterday that our business is the largest business in the United States in volume of sales. Some of the members were not here present, and I think it is important that they should know and get the reason why packers are so much concerned about the new tax bill. We are not simply coming up here to oppose a method that the Government has suggested of raising additional revenue. We are not here for that purpose; I know personally that

I am not. We are here for and in favor of the Government being in a good financial condition.

In the case of hogs, the tax was first imposed in November 1933. The initial tax was 50 cents per hundred live weight and has increased or stepped up so that in March 1934, it was $2.25 per hundred live weight.

To give you an idea of that, it runs close to about $5 per hog, that we kill.

The tax was assessed against the initial processor, or, in other words, against the packer who slaughtered the hogs.

Hogs and pork products are highly perishable from the time we purchase them until the pork is consumed, and pork and pork products are sold in competition with many other food products and the price that the consumer is willing to pay must be in line with the prices of other competitive foods.

I mean by that, gentlemen, that if the consumer has so much to spend for good food, and if any one product gets too high, she is going to substitute fish or fowl or whatnot in the place of meats, and that was the position we found ourselves in after the tax was in full swing.

The business is operated on a strictly small margin of profit, extremely small.

Senator CONNALLY. Do you suggest that on the theory that you were not able to absorb the tax?

Mr. CHILDRESS. It was a cost that we could not pass along to the consumer.

Senator CONNALLY. That is what I mean.

Mr. CHILDRESS. The business is operated upon an extremely small margin and it was inevitable that the addition of further costs to the extent of this tax should cause more or less confusion and trouble during a period of adjustment. At the outset it was necessary to raise money to pay floor-stock tax at the rate of 50 cents per hundred light weight on all pork-products stocks on hand on the day the tax first went into effect and each month thereafter it was necessary to raise cash to pay this huge tax imposed on the slaughter of hogs.

I want to say in the case of most packers, and a lot of them that Mr. Woods did not cover yesterday in his testimony, that are not members of the institute, there are literally hundreds and hundreds of small plants that operate with 15 or 20, and some as high as 100 men, that did not have the money when the floor-stock tax was put on to meet that charge without going out and borrowing it.

If the summer of 1933 Congress passed the N. R. A. which also increased the amount of money necessary to carry on our business. The N. R. A. brought about substantial increases in wages and salaries, increased the price of fuel, packages and supplies and other costs incidental to conducting our business.

Everyone knows that the packing industry cooperated with the President in his program to raise wages and decrease the hours and have more men, and we did, and I think our record stands as a very fine record before you gentlemen.

In addition to all this, we had our fuel bill increased, we had our supply costs increased. Supplies that are furnished to the packing industry are important to the business in general in the country. We also use almost every conceivable kind of supplies that you can imagine, from automobiles right on down to small crates and boxes and bales and cartons, and so forth, and so forth.

You can readily see how the small business like our own was soon facing a very serious problem of raising money to finance this huge additional cost.

We also had a real problem in trying to buy our raw materials, or, in other words, live hogs. We did not have many hogs in Texas when the A. A. A. program was first inaugurated, and in the fall of 1933 the Government inaugurated the pig-killing program and paid a bonus to farmers to sell young pigs weighing 100 pounds or less. In all, around 6 million pigs were purchased and slaughtered. This pig program made a very serious problem for our company in getting our hog supply in Texas and made it necessary for us to go to distant States to buy hogs in order to stay in the pork business. It was even more difficult than it would have been had normal conditions continued in the area where our company normally purchases its hogs.

In addition to the Government's reduction program, nature took a hand. There was an unprecedented drought throughout the country in the year 1934 which reduced feed supplies, and that and the Government's reduction program reduced the supply of hogs available for slaughter from 40 to 50 percent.

In spite of the common opinion to the contrary, there is keen and intensive competition in all phases of the meat-packing business. When our company goes out to buy hogs it has to bid for its supply against many other pork packers who also are seeking hogs. Pork packers seem to be natural optimists, and always feel that prosperity is just around the corner, and that conditions are going to be better and that dressed pork prices are going to advance. This has a tendency to make all purchasers of hogs bid more than they are worth, and all of them do so with the feeling and hope that they are going to get back their money through a rise in the price of the product.

Keep in mind, gentlemen, that the supply went down from an average kill of 42,000,000 a year, down to about 30,000,000, and everybody putting the hogs up to a very high price, so we had one fine mess in the pork business. We were trying in some way to maintain the good will that we had gotten by so many years of advertising, but we had to have some hogs, so the price that we could sell pork was determined by the consumers' ability to buy the product. The housewife buys 90 percent of the meat sold in the retail store, and when she says that she won't pay the price for meat, that is all there is to it; you might just as well get the price down or else you will have these riots that Mr. Woods showed you the pictures of yesterday.

With the great reduction in the supply available for slaughter which existed at the time the processing tax went into effect, the necessity of keeping their plants running, and of holding their customers, had a tendency further to make them bid more than the hogs were worth. The competition in selling the product is not less keen than that in buying the hogs. The price at which the packer is able to sell his pork and pork products is determined by the consumer's ability and willingness to pay. During this period that the tax was in effect the consumer's ability to pay was greatly curtailed because of the great unemployment. His willingness to pay was affected by the price of competing food, such as beef, lamb, poultry, fish, potatoes, and dozens of other items that could be substituted for pork on the consumer's table.

I have pointed out briefly some of the operating problems that our company had to face in order to bring home to you the fact that the processing tax was not a simple matter, and that it could not be taken care of by simply adding it to the wholesale prices of meat, or by deducting it from the live price of the hogs, as has sometimes been claimed by persons who are not conversant with the business from a practical standpoint.

During the year 1934 it was just impossible to conduct pork operations at a profit. Our company sustained severe losses, and we thought our troubles in that respect had reached their peak during the year 1934, but, to use a slang expression, until we got into 1935 "We hadn't seen nothing."

Commencing in about December 1934, a great many pork packers had sustained such heavy and severe losses in their operations that the loss of their capital and bankruptcy seemed inevitable, and while all of them had great hesitancy in opposing the program of the A. A. A., self-preservation demanded that something be done to stop this rapid descent into bankruptcy.

I can give you a number of instances about that, friends that we know, small packers that we know that I am intimately acquainted with. I have been in this business ever since I have been a boy. I came directly from the farm to the packing house, and I hope to continue in it, and that is the reason I am up here, because I do not want our picture on this group that Mr. Woods exhibited yesterday afternoon.

Many pork packers sought legal advice on the validity of the processing tax, and early in 1935 eminent laywers gave written opinions that the processing tax was unconstitutional and that further collection could be enjoined. This seemed to be the universal opinion of lawyers that were consulted, and a great many of the pork packers believed that the processing tax was unconstitutional and that it would never have to be paid. Many packers' financial condition had become so desperate that they simply ceased paying their taxes and continued operating with the hope that the Government would not seize and sell their plants. Other packers, in the hope that they could avoid starting a suit against the Government, obtained long extensions, feeling, however, that they would never have to pay the tax. As time went on in 1935 the conviction that the tax would never have to be paid became more fixed in the packers' minds, and when the Supreme Court in the spring of 1935 invalidated the N. R. A., this belief became the firm conviction and for all practical purposes most of the pork packers then and there in their own minds declared the A. A. A. unconstitutional.

During this time we had another circumstance that made the problem extremely difficult and that was the great amount of bootlegging of pork that took place.

I don't know whether you can get a picture of what it meant to bootleg pork, except that I could give you this one. If a man was so inclined, and apparently thousands of them were, to bootleg pork, the saving that he made in paying the processing tax as against the processor who was having to pay the processing tax at the rate that the law specified, found it a very profitable business; in other words, stating it in another way, we might say that a farmer could make

more money evading processing taxes in the Roosevelt Administration than he could selling hogs in the Hoover Administration. That is just about the way it went. There was such a vast difference between those periods.

The act itself invited this by the exemption that was granted to farmers. Bootlegging of pork was inevitable on account of the great difficulty, if not impossibility, the Bureau of Internal Revenue would have in policing and checking literally thousands of local pork slaughterers who were selling pork on the argument that such pork was not subject to a tax.

During most of 1935 a large number of packers, including those who paid no tax and did not ask injunctions and the hundreds who asked and received injunctions, virtually ignored the $2.25 per hundred of tax in their calculations. If a person had not ignored the tax he would have been out of business, and would have had to discontinue his pork operations, because he couldn't have brought his supply of live hogs and couldn't have sold his product. The effect that this frame of mind had was to compel the packers to pay more for hogs than they were worth and, on the other hand, the price of competitive foods prevented a sufficiently high sale price for pork to recoup the tax or any part of it.

The tax also had a very adverse effect upon pork sales and pork consumption in spite of the fact that the price of pork was relatively not out of line with other foods and especially beef and lamb. The housewife felt and believed that she was paying a huge sales tax and this was particularly because of the increase in price that was brought about by the extreme shortage in supply. As you gentlemen know, this resentment against pork prices which the consumer or housewife attributed to the tax caused several consumer strikes throughout the United States. It seems impossible to me that anyone knowing these circumstances, which were a matter of common knowledge, could fail to understand that the operations of a pork packing business of necessity must be conducted at huge losses.

These extremely different conditions that I have detailed to you, coupled with many others, are very discouraging to the operators of a small packing business.

Many of them just folded up and quit. I have in mind, gentlemen, one case of a company which had been operating a great many years, a company down in Milwaukee had been in business about a hundred years, the Layton Packing Co. We had been getting a certain cut from them for many, many years and considered them our regular source of supply. About the middle of last year they wrote us a letter and said that on account of the tax and other conditions they were simply going out of business, and they sold their business. There are dozens of others that we could relate to you.

Senator BARKLEY. Was the business continued by whoever bought it?

Mr. CHILDRESS. I don't think so, Senator. I think the plant is closed today.

Senator BARKLEY. What would be the object of buying it and closing it?

Mr. CHILDRESS. I think it might have some warehouse value.

Senator BARKLEY. By some other packer?

Mr. CHILDRESS. Yes; another packer bought it. And it was very fortunate for him that there was another packer that was willing to invest the money in those physical facilities.

In invalidating the processing tax the Supreme Court literally saved hundreds of other packers and I think it can be safely said that if the decision had been the other way that there would only have been a small number of pork packers left who would have been soundly financed and who could have carried on their businesses in a business-like way.

When the Supreme Court declared the A. A. A. unconstitutional the pork packers had a sort of a new lease on life and felt that the unpaid taxes could be used to pay their debts and put their plants back in shape that had been neglected during this troublesome period and would permit them to stay in business and at least work out a modest living.

I know, gentlemen, that there are plants in the country which needed new equipment, I know that they needed repairs, I know that they needed all of those things, and a great many have used that money for this purpose.

This spirit of optimism, however, was very quickly dispelled. Almost immediately after the A. A. A. was held in the Court unconstitutional on January 6, the consumers of pork products practically went on a strike and refused to consume pork at the prices which existed just before January 6, and this condition existed even though prices at that time were not sufficiently high to make the operations profitable. In order to move the extremely small supply, which at that time was at a record low, into consumption, it was necessary to reduce wholesale prices of pork practically 20 percent.

And that was just immediately following the invalidation of the act. This necessarily occasioned huge losses on all stocks on hand and again demoralized the pork-packing business, and it has continued to be demoralized up to the present time.

Nobody is ever going to be able to convice me, and I don't think any executive of a company in the pork-packing business, that the retaining this money represented by this unlawful exaction amounts to an unjust enrichment. Personally I don't feel that the amount of money that our company has will compensate it for the losses that it has sustained and will sustain until hog prices return to normal and until we can get a normal pork supply back on the consumer's table. The ultimate effect of passing this so-called unjust enrichment tax will be to drive literally hundreds of small operators out of business, and those who are not driven out of business will be so curtailed in their operations that their businesses cannot be efficiently carried on. As I said before, this is not going to be a good thing for this country. It is going to harm the producer of livestock because it is going to greatly lessen the number of buyers who are going to be bidding for his hogs when he wants to sell them.

I hope you understand without my taking up too much of your time that when a farmer brings a carload of hogs to the market he gets a check for them. He wants the money; he does not take a warehouse receipt. And he has always found that the packer has it. If he is in business, he has to be in a position to buy this raw material and pay the cash for it.

It is sure to cause permanent unemployment. Many of these packing plants are located in rural centers, and unless the people who work for the packing company work there, there is nothing else for them to do in that community. It is going to hurt the consumers because it is going to lessen the number of people who are offering pork for sale to retailers.

You understand, gentlemen, that not only do we pay cash for all of the livestock we buy, but that 75 percent of all of our sales are on credit to the retail concerns on anywhere from 7 to 15 days, so it really takes money to stay in this business.

If you gentlemen will get the profits of the packing industry and compare its returns with the returns of manufacturing business generally, you will agree with me that there is nothing about the profits of the business that would attract an investor.

I say that very frankly and with the direct knowledge that if a lot of these people have to refund this tax and go to their banks to get this money, they will have a tough time doing it.

When the return is supposed to be good, it means a return of less than 2 percent on the industry's sales and that includes sales of many other items other than meat.

This is the most serious threat that has ever been made to small packers. I am not up here as an economist or lawyer or a big businessman, but I am simply here asking my Government not to pass a law that I know is going to be unjust to small packers.

Even if this law is not passed I appreciate the very, very difficult problem that our company is going to have. Our pork losses ever since the A. A. A. was held unconstitutional have been extremely bad and the industry has not yet adjusted itself to the changed conditions brought about by the Court's decision. I know that as soon as it can be done hog production in this country is going to get back to normal and with present prices this is going to happen in spite of anything the Government or anybody else can do. This is going to create a real problem that the farmer is just as much interested in as the packer. Because of the high prices and the competition of the other foods, we have lost a large percentage of our domestic, as well as our foreign market.

We speak with absolute authority on that, because we have in years gone by exported a lot of lard to England, and we have exported practically none during the last several years.

In other words, pork has gone off the American table. We experienced this same situation during the World War when the public was exhorted to have meatless days in order to have meat for the soldiers. It took us almost 10 years to get the American consuming public back to the normal amount of meat after the war and it is going to take a long time to get a normal supply of work consumed by the American public unless it is done at sacrifice bargain prices, and every packer who is now in business ought to be permitted to remain in business during that period because each of them can help solve this problem and it is a real problem, and if Congress is really interested in the livestock producer's welfare it will not place any more burdens on the people who perform the marketing function of the farmer or the man who puts the farmer's meat on the consumer's table. This applies to windfall taxes, processing taxes, corporation surplus taxes or any other thing that is going to burden or handicap the processors of the farmer's livestock.

I don't claim to be competent to be able to discuss the constitutional features of the tax on unjust enrichment but to an ordinary small businessman it seems to me that the Government is attempting to access a penalty against us because we opposed the collection of a tax which afterward was held to be an unlawful exaction. Although we were reluctant to start an injunction suit when we did, the preservation of our company demanded that we should do so. We took the risk involved in commencing our suit, incurred attorney's fees and other expenses and faced the possibility of heavy penalties and interest if the tax had been valid. As it turned out the Court said that this money could not be collected from us and if this windfall tax is passed many processors are going to feel that it is not a tax at all but an unjust penalty.

We don't feel that we have been unjustly enriched but I sincerely feel that nothing more than common justice has been done and it does not mean that we have had a net profit or we are going to have a net profit during the period the pork-packing business was dislocated by the Agricultural Adjustment Administration. As I pointed out to you before, we had severe losses in 1934. We are having a severe loss in 1936 and I know even if this windfall tax is not passed our losses for 1936 in the end are going to be serious. In addition to that we have lost a tremendous amount of goodwill. We have lost many customers on account of not having pork available to sell them and we have seen resentment built up in the minds of the housewife on account of the high price of pork which is going to take years to overcome and I don't think now, even with this processing tax, that we have been compensated for the loss that our business has sustained.

Senator BAILEY. How much did you lose on your inventory when the Supreme Court opinion came down as compared with December 31, 1935, and January 6, 1936? Did your inventory shrink in value?

Mr. CHILDRESS. About 20 percent, the amount of the reduction in meat prices, yes. In our own particular operation, that would amount to eight or ten thousand dollars. We are a small operator.

Senator BAILEY. That was lost by reason of what?

Mr. CHILDRESS. That was lost because the housewife had been paying the high price of meat, and when the tax went off, she said that the price of meat ought to be radically cut down and she waited about purchasing.

Senator BAILEY. This subsection (b) on section 232 states the rule whereby you will find that the burden of Federal taxes was shifted. Did you examine this rule?

Mr. CHILDRESS. Yes, I have. I talked to a number of small packers about it, and our own accountant has worked on it, and we find no two persons who agree on exactly what that rule would mean to us.

I can say this, that if that rule is going to be followed all the way through, it is going to be a long time before we know how much we owe the Government in the way of windfall tax, because following the tax through on each article of pork that we produced during this whole period of time would be an almost unlimited task.

Senator BAILEY. Are you prepared to suggest a better rule or a more equitable rule?

Mr. CHILDRESS. I am not prepared at this moment to offer any better rule for the protection of those who did not pass the tax on.

I have not given that sufficient study, but I know that under the law as it is written now, that we do not know where we are and we do not know where we are going to be for quite a long time. We imagine, though, that we are going to get a penalty on the 1935 operations and show a tremendous loss, probably more than offsetting it in 1936. That is just my own opinion; that is the way I feel about it.

Senator BAILEY. You will show a larger loss in 1936 than you did in 1935?

Mr. CHILDRESS. Because of the fact that we are going through this readjustment period in hog production. The business is shifting from the period of small receipts to a period of large receipts, and we are going to need all of the money that we can get to buy those hogs with and manufacture the product. On such an increase in production, we always have shiftingly low prices, or usually do; and unprofitable operations.

The CHAIRMAN. Thank you, Mr. Childress.

Is Mr. Gehrmann in the audience?

Mr. GEHRMANN. Yes.

The CHAIRMAN. How much time do you want?

Mr. GEHRMANN. About 5 minutes.

The CHAIRMAN. I may say that this calendar apparently is quite lengthy. It seems apparent that we will not be able to finish up with these witnesses and some others that are of some importance tomorrow, therefore I have instructed the clerk and Mr. Parker to send wires accordingly, and we will try to close the hearings on Friday.

STATEMENT OF FELIX GEHRMANN, CHICAGO, ILL.

Mr. GEHRMANN. I was born in Decatur, Ill., in 1870, and went to the public school until I was 15 years old, and then worked for the Anglo-American for 15 years, and during that time I went to night school. In 1900 I went in business for myself, and have been in business ever since. In 1923 I went in business with Earl Thompson, who started the Reliable Packing Co. The first 5 years we did not pay ourselves any salary or any dividends or anything; just kept sticking money into the business, and since then we have not been drawing very much out of it.

When I went with the Anglo-American in 1885, hogs were selling at 4 and 5 cents a pound, and at that time they were called the "mortgage-raisers", and they were never over 9 and 10 cents until the big war came on, and then they got over a dime.

While we are heartily in accord with balancing the Budget, we believe it is far better to have that temporarily unbalanced than to assess a highly unpopular tax upon livestock by a so-called windfall tax. If collected, it will cause many small packers, including ourselves, to be compelled to discontinue business.

We are strictly pork packers. We are not Government inspected; we are State inspected, and we cannot sell anything out of the State.

The A. A. A. program of restricting production has decreased the available supply of hogs the past months approximately 50 percent or more less at the Chicago market. It was apparently the last several months of the processing tax of $2.25 on hogs, that the majority of our competitors were selling their hogs and buying their

hogs on a basis of not paying the tax, which made our business so highly competitive that we who paid the tax up to within the last few months did so at a great disadvantage. All of our inventories when the tax was discontinued, suffered a reduction in value. So far this year we have continued to operate at a substantial loss. The lightness of receipts and the highly competitive nature of our business resulted in that.

The other feature which carries with it the good- or ill-will of a large percentage of the public in the stockyard district is the amount of work available for a vast number of employees that normally had steady work in the hog-packing industry. Our old-time hog butchers who don't know how to do anything else and who enjoyed working reasonably long hours, being compelled to divide the work available and are only getting 15 to 30 hours per week, which at the wage scale, does not compensate them. That is about all I have to say.

Mr. POWELL. Mr. Chairman, with the idea in mind of shortening your time that you have to give to this as much as possible, I have a list here of about 125 packers who are in Washington, many of them in this room today, that I would like to have entered. And we represent approximately 200 more of the small packers. I have told these gentlemen that they should not take over 5 or 10 minutes, and I think we can limit them to that. We will call them as fast as we can.

The CHAIRMAN. How many of them are here?

Mr. POWELL. There are eight here to be heard.

The CHAIRMAN. There is no need for repetition.

Mr. POWELL. We will cut it down just as much as possible. I ask to have this list inserted in the record.

(The list referred to is as follows:)

Albany Packing Co., Inc.; Wilson C. Codling, Albany, N. Y.
Allison & Co., J. H.; Howard W. McCall, Chattannooga, Tenn.
Auth Provision Co., No.; Elliot Balestier, Jr., Washington, D. C.
Banfield Bros. Packing Co.; R. C. Banfield, Tulsa, Okla.
Baum-Phillips; C. M. Baum, Danville, Ill.
Bels Prov. Co. J. H.; Henry Bels, St. Louis, Mo.
Braun Bros. Packing Co. The; Charles E. Rasor, Troy, Ohio.
Brighton Dressed Meat Co., James E. McMahan, Boston, Mass.
Burk, Inc., Louis; B. C. Dickinson, Philadelphia, Pa.
Burkhardt Packing Co., H.; C. F. Welhener, Dayton, Ohio.
Chester Packing & Provision Co.; W. F. Medford, Chester, Pa.
Columbus Packing Co. The; E. A. Schenk, Columbus, Ohio.
Danahy Packing Co., Arthur M. Danahy, Buffalo, N. Y.
Davies, David; H. W. Jameson, Columbus, Ohio.
Dold Packing Co. Jacob; J. M. Scully, Buffalo, N. Y.
Du Quoin Packing Co.; Lyle D. Flavell, Du Quoin, Ill.
Du Quoin Packing Co.; W. W. Naumer, Du Quoin, Ill.
Durr Packing Co., C. A.; John F. Nash, Utica, N. Y.
Durr Packing Co., C. A.; D. M. Sweet, Utica, N. Y.
Eckert Packing Co.; H. H. Farmer, Henderson, Ky.
Emmart Packing Co.; G. W. Cook, Louisville, Ky.
Falter Packing Co.; John Falter, Columbus, Ohio.
Felin & Co., Inc., John F.; W. E. Felin, Philadelphia, Pa.
Fischer Packing Co., Henry; Henry Fischer, Louisville, Ky.
Florence Packing Co.; T. T. Hackworth, Florence, Ala.
Fried & Reineman Packing Co.; Walter E. Reineman, Pittsburgh Pa.
Frey & Co.; Chas. Frey, Seattle, Wash.
Fuhrman & Forster Co.; Lawrence Forster, Chicago, Ill.
Gebelein, Inc., John A.; John A. Gebelein, Baltimore, Md.
Gibson Packing Co.; Mr. Coffin, Yakima, Wash.
Gobel, Inc., Adolf; Scott McLanahan, Brooklyn, N. Y.
Gobel, Inc., Adolf; V. D. Skipworth, Brooklyn, N. Y.

Goetze, Inc., Albert F.; Albert F. Goetze, Baltimore, Md.
Goetze, Inc., Albert F.; Harry R. Parkhurst, Baltimore, Md.
Hannond-Standish Packing Co.; T. W. Taliaferro, Detroit, Mich.
Heil Packing Co.; Geo. L. Heil, Jr., St. Louis, Mo.
Hilgemeier & Bros., Inc.; F. Geo. Hilgemeier, Jr., Indianapolis, Ind.
Houston Packing Co.; G. L. Childress, Houston, Tex.
Hughes Provision Co., The; J. L. Bishop, Cleveland, Ohio.
Hunter Packing Co.; Frank Hunter, St. Louis, Mo.
Hygrade Food Products Corporation; Harold J. Gallagher, New York City.
Ideal Packing Co., The; A. W. Goering, Cincinnati, Ohio.
Illinois Meat Co.; A. W. Brickman, Chicago, Ill.
Kahns Sons Co., The E.; L. W. Kahn, Cincinnati, Ohio.
Kearns Packing Co.; W. A. Kearns, Mansfield, Ohio.
Keefe Packing Co.; S. F. Spencer, Arkansas City, Kans.
Knauss Bros., Inc.; Louis E. Knauss, Poughkeepsie, N. Y.
Krey Packing Co.; Fred Krey, St. Louis, Mo.
Kriel Co., C. G.; Andrew G. Kriel, Baltimore, Md.
Kunsler Co., Ch.; G. Wm. Birrell, Lancaster, Pa.
Laclede Packing Co.; F. G. Haeussermann, St. Louis, Mo.
Lake Erie Provision Co., The; Chester G. Newcomb, Cleveland, Ohio.
Lohrey Packing Co.; George R. Lohrey, Cincinnati, Ohio.
Louisville Provision Co.; F. E. Wernke, Louisville, Ky.
Shenandoah Abattoir; H. W. Walburn, Shenandoah, Pa.
Luer Bros. Packing & Ice Co.; O. S. Catt, Alton, Ill.
Luer Bros. Packing & Ice Co.; W. J. Luer, Alton, Ill.
Luer Packing Co.; R. F. Tyldesley, Los Angeles, Calif.
Merkel, Inc.; Henry Merkel, Jamaica, N. Y.
Meyer Packing Co., H. H.; H. H. Meyer, Cincinnati, Ohio.
Miller & Co., Chas.; August Miller, North Bergen, N. J.
Miller Co., O. W.; Harry G. Miller, Newark, Ohio.
Milner Provision Co.; W. E. Milner, Frankfort, Ind.
Milner Provision Co.; Mr. Stumpf, Frankfort, Ind.
Ohio Provision Co., The; Mr. E. L. Schneider, Cleveland, Ohio.
Peet & Co., Inc., G. M.; H. D. Peet, Chesaning, Mich.
Provision Co., The; T. G. Strange, Columbus, Ga.
Punxsutawney Beef & Provision Co.; Chas. C. Hoy, Punxsutawney, Pa.
Reliable Packing Co.; Felix Gehrmann, Chicago, Ill.
Reynolds Packing Co.; W. G. Reynolds, Union City, Tenn.
Rochester Packing Co.; G. F. Pfuiffin, Rochester, N. Y.
Sandusky Packing Co., The; Guy Manaugh, Sandusky, Ohio.
Scala Packing Co., Inc.; James S. Scala, Utica, N. Y.
Schaffner Bros. Co.; Milton Schaffner, Erie, Pa.
Schluderberg, Wm.-F. J. Kurdle Co.; J. H. Richardson, Baltimore, Md.
Schluderberg, Wm.-F. J. Kurdle Co., W. F. Schluderberg, Baltimore, Md.
Schmidt Packing Co., The F. Fred; Geo. L. Schmidt, Columbus, Ohio.
Schroth Packing Co., The J. & F.; Elmore M. Schroth, Cincinnati, Ohio.
Sieloff Packing Co.; Emil Sieloff, St. Louis, Mo.
Stahl-Meyer, Inc.; Geo. A. Schmidt, New York City.
Standard Packing Co.; George H. Lincoln, Los Angeles, Calif.
Steidl Bros.; Donald Steidl, Paris, Ill.
Steiner Packing Co. The; Mr. Steiner, Youngstown, Ohio.
St. Louis Local Meat Packers Association; A. F. Versen, St. Louis, Mo.
Stolle Sons, Anton; Anton Stolle, Richmond, Ind.
Sucher Packing Co., The Chas.; Louis A. Sucher, Dayton, Ohio.
Taylor Packing Co.; James Burt, Pleasantville, N. J.
Theurer Norton Provision Co.; W. B. Smith, Cleveland, Ohio.
Trunz Pork Stores, Inc.; Max Trunz, Brooklyn, N. Y.
Ulmer Packing Co., Jacob; Julian F. Ulmer, Pottsville, Pa.
Vissman & Co., C. F.; R. E. Vissman, Louisville, Ky.
Vogt Sons, Inc., F. G.; Frederick A. Vogt, Philadelphia, Pa.
Vogt Sons, Inc., F. G.; H. B. Powell, Philadelphia, Pa.
Weiland Packing Co.; Frank B. Weiland, Phoenixville, Pa.

STATEMENT OF F. E. WERNKE, LOUISVILLE, KY., PRESIDENT, LOUISVILLE PROVISION CO.

Mr. WERNKE. My name is F. E. Wernke. I am president of the Louisville Provision Co., a corporation of Kentucky, with its principal office and plant located in Louisville, Ky. I am representing principally my own corporation, but I am also here to represent 10 other Kentucky owned and controlled packing plants.

During the year 1935, even after taking into consideration the greatly reduced volume of hogs slaughtered by packers all over the country the volume of sales of these 10 houses amounted to more than 25 millions of dollars. These Kentucky companies during the past year paid for livestock to the farmers of the State of Kentucky and southern Indiana, from which section they draw 90 percent of their livestock, slaughter between 17 and 20 millions of dollars. These companies employ in excess of 2,000 persons with a total annual pay roll of about 2½ millions of dollars.

In November 1933, the so-called processing taxes under the Agricultural Adjustment Administration went into effect. The original tax effective November 6, 1933, was 50 cents per hundredweight, live weight. On December 1, 1933, the tax was increased to $1 per hundredweight and on February 1, 1934, increased to $1.50 per hundredweight and the final rate effective March 1, 1934 was established at $2.25 per hundredweight, live weight, and from March 1, 1934, to January 6, 1936, the rate remained unchanged at $2.25 per hundredweight, live weight. These companies paid their processing taxes as they accrued until they had paid up to the 1st of January 1935, a total of about 2½ millions of dollars.

During the time that the companies were paying these huge sums as processing taxes, conditions had developed in the pork packing business that made it extremely difficult and at most times impossible for the packer to get back the cost of the live hogs and his expense of doing business from the sale of the product. Some of these conditions were caused by the extreme shortage of livestock occasioned by the Government program in killing the 6,000,000 little pigs, the corn-hog production-control program, the unprecedented drought. Increased expenses of business brought about by the N. R. A. increased wage and salary rates, and increased supply and packing costs. In fact, practically all expenses during this period went up. For example, my fuel costs increased almost 200 percent during the period that these enormous taxes were in effect.

The packers of Kentucky, on or about the 1st of January 1935, realized that if they were going to preserve any portion of their working capital it was necessary for them to cease paying these huge processing taxes, and had had this matter under consideration for several months. On March 1935 the critical condition brought upon us by the payment of this tax made it absolutely necessary to take some action to get relief. We applied to the United States courts and were granted injunctions enjoining the collection of the tax. I think that it is safe to say that if these injunctions had not been granted at that time very few of the Kentucky packers would have survived and been doing business when the Supreme Court on January 6, 1936, invalidated the A. A. A.

To illustrate how serious the situation had become, the Federal court in granting these injunctions, in some cases did not require a deposit of security in the full amount of the tax, but instead, permitted the filing of a nominal bond.

As the committee knows, from the early part of 1935 until the Supreme Court of the United States finally passed on the validity of the A. A. A., thousands of processors instituted suits in the United States courts, and were granted injunctions against the collection of the tax. Consultation of the processors with their attorneys had their participation in the injunction suits thoroughly convinced them that the A. A. A. was invalid and that the Supreme Court of the United States would so hold. The invalidation of the N. R. A. helped to strengthen the feeling of the processors that the A. A. A. was invalid and this feeling, coupled with the extreme shortage of livestock which existed in the year 1935, made it absolutely impossible to buy hogs at anywhere near a realizable value on the pork products. As I said before, there was an extreme shortage in hogs—only 40 to 50 percent of the normal supply available for slaughter—and the same number of packers as formerly were in the market bidding for them, each of them realizing that his overhead was fixed, and that keeping up his volume was positively the only way he could save himself. It was only natural that everybody should pay more for hogs than they were worth.

Senator BAILEY. What do you mean by paying more for your hogs than they were worth?

Mr. WERNKE. We could not realize the value of the hogs out of the hogs we purchased.

Senator BAILEY. You could not pass on the price paid to the farmer?

Mr. WERNKE. We could not pass the price to the consumer, the price we paid for the hog, plus our operating expense and taxes.

Senator BAILEY. You say you paid more than the hog was worth?

Mr. WERNKE. Yes, sir; and we are doing that right today in order to keep the market alive.

Senator BAILEY. I wish you would tell me what you mean by that, paying more than it is worth?

Mr. WERNKE. I mean that right today we are paying around $10.50——

Senator BAILEY (interposing). If you pay more than he is worth, what is he worth?

Mr. WERNKE. For the value we are getting out of the hog, hogs today should be selling around about $8 per hundred. Instead of that they are selling around $10.50 per hundred.

Senator BAILEY. You could not get $2.50 more in the retail market?

Mr. WERNKE. No, sir; we cannot.

Senator CONNALLY. Are you operating at a loss now?

Mr. WERNKE. Yes, sir; at a very substantial loss.

Senator BLACK. What is the retail price now?

Mr. WERNKE. There are different commodities. The retail price of pork loins alone in our community is about 30 cents a pound retail.

Senator BLACK. And you are paying 10.5 cents a pound?

Mr. WERNKE. We are paying 10.5 cents a pound for the live hog.

Senator BARKLEY. How much of that hog is wasted in the final processing in making it edible?

Mr. WERNKE. You can get now about a 68 percent yield from live weight. Between 68 and 70 percent yield from live weight.

Senator BLACK. And 30 cents is about the average?

Mr. WERNKE. No, 30 cents is approximately in our territory the retail price of pork loins only. Pork loins only represent a very small percentage of the live animal, and that is the highest priced article of the animal today.

Senator BAILEY. What is the average retail price of pork for the entire hog?

Mr. WERNKE. I imagine around 12 or 13 cents. That is wholesale, not retail.

Senator BAILEY. And you get only 68 percent of the hog?

Mr. WERNKE. Between 68 and 70 percent. Some hogs will yield a little better than others.

Senator BARKLEY. Depending upon the size?

Mr. WERNKE. Depending upon the quality.

Senator BAILEY. Has the size anything to do with it?

Mr. WERNKE. Something, but mostly the quality.

Senator BARKLEY. It depends on how fat he is, and things like that?

Mr. WERNKE. Yes, sir.

Senator BARKLEY. Thank you.

Mr. WERNKE. You men can appreciate that a packing company's overhead is practically fixed—in other words, it is necessary to carry the same amount of insurance, to pay the same amount of taxes, have the same supervision expense and practically the same amount of labor and when you understand that the volume of production of our plant was reduced 50 percent—and, by the way, it is still only about 50 percent of normal—I think you can see why it was necessary to get in other lines of business such as fish, cheese, poultry, and oysters in order to reduce the overhead expense on our meat departments.

That has been a very bad condition in the packing industry.

The problem was no less difficult and severe when we came to the selling of our pork products. In a very short time pork had gone from extremely low prices to what appeared to be relatively high prices.

I have made a comparison in the years 1930 and 1931 when live hogs on the Louisville market were selling at approximately $8 per hundred live weight. Taking that same figure during the years 1934 and 1935 and comparing the selling prices of the commodities that we made out of that animal with the prices we received for the same commodities during the years 1934 and 1935, and I find there is a variation between 3 and 5 cents per pound—that is, the amount of money that we realized from the hogs, the products out of those hogs in 1930 and 1931 was 3 to 5 cents per pound greater than the amount that we received during 1934 and 1935 when hogs were relatively the same price. And on top of that, we were asked to contribute $2.25 per hundred as a processing tax.

Senator BAILEY. If instead of paying that $2.25 per hundred you had impounded it in court and in the meantime sold your meat as if you had paid the $2.25—that is the theory of the unjust enrichment. If those facts could be established, you would agree that the consumer ultimately has paid that $2.25, do you not?

Mr. WERNKE. There is no way in the world that I can see that you can finally trace it down, because the tax was never added by any of

the packers as a separate item, and never carried as a separate item in their books. It all went into the origial cost of the item.

Senator BAILEY. But there was that $2.25 as part of the overhead. If, instead of paying it to the Government, you paid it in courts, but the price of your meat to the jobber or to the consumer carried that $2.25. The consumer paid it, but you got yours back—I am not speaking personally—you got it back out of the court. If anybody should get it back, it should be the consumer who paid it, should it not?

Mr. WERNKE. If it could be traced to that consumer, but that cannot be traced in the packing industry. There was a rapid rise also in the price of hogs. That is what caused the rapid rise in the amount of the commodities, not the tax.

Senator BAILEY. The processing tax did not account for the price rise altogether?

Mr. WERNKE. The killing and the drought had a great deal to do with it. Practically all to do with it.

Senator BAILEY. There was notice to you of the fact of a tax of $2.25 a hundred. Every packer was expecting to pass it on. He knew he had to pay it. Instead of paying it he put it into court and had a suit about it and resisted the constitutionality of it. In the meantime he sells the meat and the consumer, presumably, buys the meat with that tax on. That is a presumption of law, and that is a presumption of common sense. At the end of it all, the packer gets the money back out of the court. He cannot pay it back to the consumers, there are too many of them, so why should he hold it? That is the problem.

Mr. WERNKE. Senator, let me make this illustration to you. Suppose you and I were in the same business, or two gentlemen were in the same line of business, and you have got an article that you want a certain price for and I agree to pay you for the article that certain price. We will say that the amount of it is $15, and you represent that article to be just sold to me. I agree that it is all right and I purchase it from you for resale at $15. I am figuring my overhead expense and my additional costs, and I figure it will cost me $5 to do that, and figuring to get my expense back and that this is a reasonable margin of profit. I sell that article for $20.

A little later on I turn around and I have found that that article is not what you represented it to me to be, and I come back at you with a claim for an additional $5. I have already sold that article for $20 and got my money, but I come back to you for an additional claim of $5, and I am successful in prosecuting that claim and getting that claim of $5.

Senator BAILEY. You might be.

Mr. WERNKE. I was supposing I am. We are just supposing all of this.

Senator BAILEY. You could not get damages from me unless you showed damage.

Mr. WERNKE. I would have damage that that article which you sold me was not as you represented.

Senator BAILEY. You got the full value and the other man suffered the damage. If you came out whole, you could not sue me. Are you a lawyer?

Mr. WERNKE. No, sir; I am not.

Senator BAILEY. It is the party that suffers from a fraud that recovers; not any other individual.

Mr. WERNKE. In this case I am still suffering, because in this article as represented to my customer, I have represented that it was just what you represented it to me to be, and I in turn am offering special services to that customer on account of that article and it is costing me money.

Senator BAILEY. I sell to you for $15, and you sell to the other fellow at $17, and earn your profit, and then the other fellow finds that the thing is defective and comes back on you——

Mr. WERNKE (interrupting). And I am servicing it.

Senator BAILEY. Then you can go back on me.

Mr. WERNKE. And I have done that.

Senator BAILEY. There is no defect or fraud or concealment. That is a case of mutual mistake. This is neither fraud nor mutual mistake. It is a tax. You say, "I do not think this tax is going to be imposed on me; I am going to put it into court," and it accumulates there. Meantime you continue to sell the article as if the tax were upon it. Somebody down the line pays that tax, but the Supreme Court holds the whole thing unconstitutional, and the money paid in court through the man that brought the suit, you recover the tax notwithstanding you have passed it on and the ultimate consumer has paid it. There are the facts underlying this theory. I am not saying it is correct or incorrect, but would you not say under those circumstances that the man who paid the tax should recover it rather than the man who passed it on?

Mr. WERNKE. The man that paid the tax should recover it, and that is the processor. We are the man that paid the tax.

Senator BAILEY. You paid it in the first instance, but you added it on to the price.

Mr. WERNKE. No, sir; we say we did not.

Senator BAILEY. If that is the case here, your tax would be automatic, because the bill does not pretend to take a tax which he did not pay.

Mr. WERNKE. I personally think, and I have discussed it with the packers in our locality, that the method is entirely wrong, that it is impossible for us to show.

Senator BAILEY. It says: "From the selling price of each article, there shall be deducted the same first cost of such article plus, second, the average margin with respect thereto." And "margin" is defined later. I agree it is a rule and it may be an arbitrary rule, but what have you to say about that rule?

Mr. WERNKE. Senator, I have not made a thorough study as to just how it should be. I would be unable to say.

Mr. WOODS. Mr. Chairman, I qualified as a witness yesterday. If the Senator really cares for information on this point, I would be glad to clear up the point in his mind which he makes.

Senator BAILEY. I assure you I will read what you had to say.

Mr. WOODS. This question was not raised in the testimony yesterday.

Senator BAILEY. Are you coming up this afternoon?

Mr. WOODS. No; I am not, but I would like to clear up the point that the Senator has in mind.

Senator BARKLEY. Before you do that, let me make an inquiry. While this money was being accumulated in the courts, awaiting a decision, of course you had to anticipate the possibility of an unfavor-

able decision, in which case the money would have to be paid into the Treasury. While that decision was being awaited and while this money was being accumulated, to what extent did the packers protect themselves against the anticipated decision?

Mr. WOODS. It did just the reverse of what the witness said. But as he stated in the beginning, the general legal opinion was that the decision would be for the invalidation of the act.

Senator BARKLEY. Of course, you could not take that for granted; you had to take a chance on it, and I assume not only the packers, but also all other processors who were impounding money in court, were hedging in some way against the possibility of losing.

Mr. WOODS. There was no way for the packers to hedge. I don't know what the other processors did, but the policy in the case of the packer was exactly the opposite of the one indicated. He assumed as soon as those first injunction suits were started and some of them where they found their businesses going over the brink assumed that even before they were started, that the Supreme Court would invalidate the act, and that those remaining unpaid taxes would not have to be paid, and they bought their hogs accordingly.

Senator BAILEY. The men that bought the hogs did not sell the meat?

Mr. WOODS. No, sir. Your question assumes that we sell our meat on a built-up cost, and that may be true, and I think it is true in many industries. I think the millers have said freely that they could pass the tax on and took it into consideration in their price.

In the case of an industry handling a perishable as we do, we sell regardless of cost. We have nothing to say about whether the price shall cover the cost or not. We have to take what we can get at the going market, whether it is more or less than the cost, because the product is perishable.

In this period in which we are speaking, the practice was not to add the tax to the product on the theory that we would have to pay the tax; and then when the act was invalidated, we did not have to pay the tax, so we put the money in our pockets and that was the situation. That was your question, Senator, was it not?

Senator BAILEY. I was stating that as the theory of the legislation.

Mr. WOODS. Yes; that was the theory of the legislation, and it applies to a good many of the industries, but it does not apply to ours.

Through the shortage of the receipts, we began in 1935 particularly to pay more for the hogs than they were worth, and we did not in this so-called tax-free period put on the added tax and pass it on, because we were dealing with a perishable and we have to sell at the market.

Senator BAILEY. You meant the tax-free period since the decision?

Mr. WOODS. That is a misnomer. The period during which the tax was imposed but was not paid.

Senator BAILEY. Impounded?

Mr. WOODS. Impounded. Of course, the packers earlier just quit paying it.

Senator BAILEY. Your contention is that the price of hogs was raised due to the drought and the slaughter of some six million pigs, and that was so rapid and to such a high point that you could not exact the tax?

Mr. WERNKE. That is true.

Senator BAILEY. Then if you say you did not pass it on, it does not have to be paid?

Mr. WERNKE. This does not pay up.

Senator BAILEY. Can you suggest a formula that would meet the situation?

Mr. WERNKE. That would have to be given thorough study, and I am not prepared right at the present time to suggest one.

The fact that there was a processing tax on pork was widely advertised by competing food industries, such as the fish industry, among the consumers and especially housewives, and caused them to show a very keen resentment against what they thought was a sales tax on pork, and develop a very hostile and resentful attitude toward the purchasing of pork. In many consuming centers this resentment reached the stage of meat strikes and similar demonstrations. This consumer resistance on the part of the housewives made it absolutely impossible for the pork packer even to get his money back on the sale of his pork. When the packer attempted to price his pork at prices that would only let him break even, it simply backed up on him. As you gentlemen know, pork is not like whisky—it does not get better as it gets older.

Senator BARKLEY. That is not true of hickory-cured Kentucky ham. [Laughter.]

Mr. WERNKE. That is something entirely different from fresh pork commodities.

And the only way the packer could move his pork for consumption was by selling it at a great loss.

Another factor that must not be lost sight of and that was responsible for the huge pork losses that were sustained during this time was the lack of consumer purchasing power. Pork is essentially a workingman's food, the consumption of which is limited by the workman's ability to pay. During all the time that we were asked to pay this huge tax we had an unprecedented number of unemployed people who were our natural customers and no matter how much they wanted pork they were simply unable to buy it at a price which would reimburse the processor for the cost of hogs and his other expenses.

In that connection, your pork prices went up to about 105 or 107 percent above what you would term normal in the period of 1928 and 1929, and your consumer purchasing power was down to about 68 percent; consequently those people could not pay higher prices for pork.

I think you gentlemen can see from what has been said that the Government's program so ably assisted by the drought to reduce the production of hogs, coupled with this huge processing tax was bad enough for the pork packers and we went through 1934 and 1935 one of the most difficult periods that you could expect to encounter in that business. It was just impossible to carry on pork operations without sustaining severe losses and this bad situation was not remedied by the Supreme Court decision invalidating the A. A. A. We still have this consumer resistance to pork that I have described and the most serious thing of all is the fact that pork has been off the consumer table for a long period of time and it is going to take very keen merchandising and very keen salesmanship to get the American public consuming a normal supply of pork again.

Almost immediately after the Supreme Court announced its decision invalidating the A. A. A. the consuming public, believing that it had been paying this huge processing tax, refused to buy except at lower prices and notwithstanding that pork prices immediately prior to January 6, 1936, were relatively low in comparison with the live cost of hogs, it was necessary to reduce pork prices from 20 to 25 percent to move into consumption the small volume of pork that had to be sold.

Right after the invalidation of the A. A. A., we had to cut our pork prices 20 to 25 percent, because the consumers refused to buy. We had the pork on hand and we had to get rid of it.

This, of course, occasioned huge losses on all stock on hand and again may I say, gentlemen, that pork is the most perishable of all meats and must be sold promptly after slaughter.

The section of the tax bill that is a very great source of worry to the packing industry is the so-called unjust enrichment tax. My own company did not pay any processing tax during the year 1935, but the modest profit which I made in 1935 is not attributable to that fact or to the decision of the Supreme Court invalidating the tax and I do not feel that that modest profit can in any just sense be termed unjust enrichment. I don't feel that this profit will compensate my company or the companies that I am speaking for, for the serious and permanent losses and damage that we have sustained and that we will continue to sustain for some time to come because of the Government's experiment in farm relief.

Senator BLACK. You said something about the amount of profits you made.

Mr. WERNKE. That amount of taxes that were accrued on our books at that time which would be credited back to the losses sustained during that year, would probably leave me a very modest profit during the year 1935.

Senator BLACK. Do you have your records for the years 1932, 1933, 1934, and 1935?

Mr. WERNKE. Senator, I myself started in this business in November 1932. This company that I represent, and I am the president of it, has been in the packing business in Louisville for about 30 years, although in 1931 it got into some financial difficulties and I purchased the company myself and reorganized it with some of the other older employees of the company, and I have been operating it since then.

Senator BLACK. The plant was in financial difficulties in 1931?

Mr. WERNKE. Yes. And operated under a receivership in 1931 and 1932.

Senator BLACK. What were hogs selling for then, do you know?

Mr. WERNKE. In 1931 they were selling for about $8 a hundred.

Senator BLACK. And what in 1932?

Mr. WERNKE. In 1932 they dropped away down.

Senator BLACK. Do you recall what it was?

Mr. WERNKE. I think in 1932 they went down to 4 cents.

Senator BLACK. And 1933, what was it?

Mr. WERNKE. They were selling around 4 or 5 cents.

Senator BLACK. And in 1934?

Mr. WERNKE. In 1934 they went up to around $8 again.

Senator BLACK. And in 1935 they went up to 10.5?

Mr. WERNKE. 10.5.

Senator BLACK. Did you make a profit in 1933 when they were down low?

Mr. WERNKE. Yes, sir; I believe I did. I could not tell you just what percentage of that profit would be attributable to our pork business, because we do business in calves, lamb, and other related industries.

Senator BLACK. Your company made a profit in 1933?

Mr. WERNKE. Yes, sir.

Senator BLACK. Did it make a profit in 1934?

Mr. WERNKE. Very, very small. Not on hogs.

Senator BLACK. Was it more or less in 1934 than 1933?

Mr WERNKE. A great deal less.

Senator BLACK. And in 1935, you had the processing tax, and you say you would have a loss?

Mr. WERNKE. A loss on the hogs; yes, sir.

Senator BLACK. Would you have a loss on your entire business?

Mr. WERNKE. No, sir.

Senator BLACK. What was your profit in 1935?

Mr. WERNKE. I think we had a very small profit of somewhere around $2,000 or $3,000 on over $2,000,000 worth of sales.

Senator BLACK. How does that compare with 1934 or 1933?

Mr. WERNKE. It was away less.

Senator BLACK. And if you had the processing tax, how much would it be?

Mr. WERNKE. I could not say exactly. I would have to take and check into those figures.

The CHAIRMAN. Would it be possible for you to put your brief into the record? We are not going to be able to give any time tomorrow on this packing proposition, Mr. Powell, and I understood you would take about 5 minutes on each one of your witnesses.

Mr. POWELL. I do not think any of the rest will take more than 5 minutes.

Mr. WERNKE. Senator, I will file my brief, but I would like to leave this thought with you, that those 10 plants in Louisville are operating and paying about $2,500,000 in wages, and we have about 2,000 employees. If this unjust enrichment act is passed and we have to pay back to the Government the amount of money which they would exact from us, there is no doubt but what it would put us all out of business. Those 2,000 employees would have to go on relief, because I do not see where they would get jobs anywhere else, especialy at this time. Then you have the farmer element that would be just as much hurt by eliminating that local market which is so necessary to their existence.

We did not start these injunction proceedings until we were forced to do so as a matter of self-preservation. As the Supreme Court later decided, we were perfectly justified in going to the courts to save our property and businesses from confiscation. I don't know whether this so-called unjust-enrichment tax will be sustained by the court or not but to me as an ordinary small businessman the attempt by Congress to pass another law to accomplish the very thing that the Supreme Court of the United States in no uncertain terms held illegal seems an outrage. I hope you gentlemen on this committee who are eminent lawyers from your respective States will consider the possibility that this proposed law does violate the Constitution of the United States

and does violate every sense of American justice and will not be a party to helping it to become a law. After all, as a citizen I feel that a member of the Senate who knows the law is unconstitutional should act in my interests to prevent such unconstitutional measures from being placed on the statute books to further harrass and annoy me in the conduct of my useful and lawful business.

Even if there were a possibility that this punitive law would be sustained by our courts it should not be passed. The taking of money from my company and the other companies that I am speaking for as proposed would so seriously cripple their working capitals that it is extremely doubtful whether or not they could continue in business. After all, those of us engaged in the packing business are not parasites and as I pointed out to you earlier in my statement, we furnish the livelihood for 2,000 families and if these plants are forced to close I don't know how these people are going to get a living except on relief.

If the smaller packing plants are closed the farmer in the area of those plants will likewise be seriously affected. He will lose his immediate market and be subjected to the additional cost of shipping his livestock to more distant points for sale, and with the additional loss caused by shrinkage and injury to the livestock. The number of buyers competing for his livestock will be substantially decreased which would tend to result in lower prices than he otherwise would obtain.

The situation that exists in Kentucky exists all over the United States where there are packing companies, and the passage of this law would have the effect of closing a great number of small and medium-sized plants. This would have the tendency to concentrate the processing of meat in a few large companies. This concentration of business would continue for an indefinite period of time. A packing plant in the main is an insulated and refrigerated plant. When a plant is shut down for any period of time and neglected as these plants would be, it would be economically unsound to attempt to reopen them. No new capital will be attracted to the packing business until such time as it shows earnings over a period which greatly exceed any earnings that have been made for a great many years, and if this bill is passed, no matter whether you like it or not, the business is sure to be concentrated in the hands of a few large companies who have sufficient working capital and credit to enable them to pay this punitive exaction.

The CHAIRMAN. The next witness, Mr. Powell?

Mr. POWELL. The next witness is James N. Scully.

STATEMENT OF JAMES N. SCULLY, VICE PRESIDENT, JACOB DOLD PACKING CO., BUFFALO, N. Y.

Mr. SCULLY. Mr. Chairman and members of the committee, we will just file this statement, but we would like to say just a few words because we feel that we have a terribly serious situation.

I am vice president of the Jacob Dold Packing Co. of Buffalo, N. Y. Our principal business is pork packing. We have three plants; one at Buffalo, N. Y., one at Omaha, Nebr., and one at Wichita, Kans. Our company has been in the pork-packing business for 70 years.

The fact that the Supreme Court allowed us to retain that part of our moneys which we had not paid was the only thing that saved us from

serious financial difficulties. If the Court had decided that that processing tax was legal, we would have been in an awful state of hot water. We would probably have had to close up two of our three plants to get sufficient working capital to carry on one plant.

I think the majority of the smaller pork packers would be put out of business if any real attempt is made to collect most of the processing taxes or any part of them. The pork business is carried on by about 800 to 1,200 packers, and over half of the volume is done by about five or six. The rest of it is done by the balance.

All of these men are in practically the same boat, whose business is principally pork. They were unable to carry on and make a profit under the conditions that existed. Our volume was cut around 50 percent in hogs. That is our principal business, and we were unable to get all of our overhead sufficiently to take care of the situation.

It looks to me as if, if this tax is retained as part of the operating profits of these plants, they will show something if the tax is retained, which would be only a reasonable amount by the end of this year. The 1935 and 1936 operations will exhaust any moneys that they have benefited by through the recovery. From then on we are going to be in real difficulty, because this decline in hog volume has cut the needs so that we cannot operate at a profit until hogs return to a normal supply in the country.

Senator KING. The supply is inadequate for the demand?

Mr. SCULLY. The normal supply is about 45 million hogs, and that has been cut to about 30 million. We who are principally in the pork business just cannot dispose in our plants or cut our overhead, and we are condemned to an operating loss.

Senator KING. Would the people eat more pork if they could get it?

Mr. SCULLY. If they could get it at a price that is reasonable.

Senator KING. The reduction in production has of necessity caused an increase in the retail price as well as in the whole price of the packers?

Mr. SCULLY. Obviously you pay more if there are fewer of anything. We want to make the serious statement very frankly that if this tax on unjust profits is carried out and we have to return any substantial part of the money, that we will be very seriously injured and be put out of business, and we have about 2,000 or 2,500 employees, and we think those who are smaller than us will be hurt perhaps even worse.

Senator KING. Do you think it has proven advantageous to have these packers such as yourself in various parts of the United States, instead of being concentrated in Chicago, Omaha, and a few concentrated places?

Mr. SCULLY. I think if we are put out of business, the hog kill is going to gravitate toward the five or six national packers, and certainly that is not a good thing, to concentrate the industry. It is going to make it so that the farmer will not have a local market for his hogs. The numerous small stockyards that exist because they sell to the independent pork packers are going to have to fold up, and the farmer will have to send his hogs farther, and probably at a disadvantage, to the market.

Senator KING. That will help the railroads get more freight?

Mr. SCULLY. We have always paid a lot of freight to the railroads.

Senator BLACK. How much is your tax involved in this? You say it would probably put your company out of business.

Mr. SCULLY. We had a recovery of around a million eight or nine.

Senator BLACK. $1,800,000 or $1,900,000. That is what is involved for your company?

Mr. SCULLY. Yes, sir.

Senator BLACK. What is the capital stock of your company?

Mr. SCULLY. We have a net worth of about four and a half to five million. The balance sheet will run around $12,000,000.

Senator BLACK. Do you know what your loss was or what your profits were from the years 1931 to 1935, inclusive?

Mr. SCULLY. No; I have no record of that, but I am quite certain that the books will show that we already have lost a substantial part of this recovery.

Senator BLACK. What about 1935? Did you make or lose?

Mr. SCULLY. In 1935 we lost approximately $400,000.

Senator BLACK. What about 1934?

Mr. SCULLY. In 1934, we made a profit.

Senator BLACK. How much?

Mr. SCULLY. I think around $350,000.

Senator BLACK. And 1933?

Mr. SCULLY. 1933 I believe was a loss.

Senator BLACK. How much?

Mr. SCULLY. $100,000.

Senator BLACK. $100,000?

Mr. SCULLY. I might have it here. No; I have not got it here.

Senator BLACK. Do you remember how much loss it was in 1933?

Mr. SCULLY. No; I do not, Senator.

Senator BLACK. What about 1932?

Mr. SCULLY. I think I can give the picture that you are trying to get. We have not been one of the most profitable companies. We have done a little better than break even.

Senator BLACK. What about 1932; do you recall?

Mr. SCULLY. I do not recall.

Senator BLACK. Whether it was a profit or a loss?

Mr. SCULLY. I do not.

Senator BLACK. Do you remember about 1931, whether it was a profit or a loss?

Mr. SCULLY. I think we did not make a profit in all of the years prior to 1935, from 1928. We had a profit in probably 3 of those years. We had a little better than an even break for that period.

Senator BLACK. In 1932, hogs were cheapest, and you do not remember whether you had a profit or a loss?

Mr. SCULLY. No; I do not.

Senator BARKLEY. What part of this $1,800,000 did you actually pay?

Mr. SCULLY. That was the tax on the hogs slaughtered for about 6 or 7 months.

Senator BARKLEY. Where was that money?

Mr. SCULLY. That money was impounded.

Senator BARKLEY. In the courts in New York?

Mr. SCULLY. New York and Omaha.

Senator BARKLEY. Do you operate in Omaha?

Mr. SCULLY. Yes; we have a plant in Omaha.

Senator BARKLEY. How much of that can you estimate that you put into your cost of production when you sold your product?

Mr. SCULLY. It is almost impossible to tell, Senator. I do not know how we could tell. We put it all in as part of the cost of the hog, or attempted to, but our tax was considered part of the cost of the hog, but whether we recovered or were able to pass any on, we cannot tell.

Senator BARKLEY. You passed on all that you could of the total cost of the hog?

Mr. SCULLY. Oh, yes. But that was the market.

Senator BARKLEY. You were not foolish enough as a businessman to impound nearly $2 000,000 that you might have to pay into the Federal Treasury if the court decided the other way, without protecting yourself in the price of your product?

Mr. SCULLY. We could not protect ourselves in the price of our product.

Senator BARKLEY. To no extent whatever?

Mr. SCULLY. We would try and get as high a price as we could compared to our competitors.

Senator BARKLEY. Your competitors were all in the same boat, they were all paying the same prices, and paying the same processing tax or impounding it?

Mr. SCULLY. Yes, sir.

Senator BARKLEY. So that from a competitive standpoint, you were all on the same footing?

Mr. SCULLY. Yes; but that could be altered by the consumer——

Senator BARKLEY (interposing). If anybody else tried to pass it on, I realize you could not, but if everybody else was trying and you were trying to, of course the market conditions reflected it.

Mr. SCULLY. But if one or two people took a gambling point of view, and we don't know who they were—and we tried to get the top of the market—they would depress the market if they were discounting that tax. Then there were some that were in such a serious financial condition that they said, "We are going on anyway without serious consideration to the tax."

We only know that we sold at the market, and we know we had a loss in 1935, which was effective of about $400,000, and the way things look this year, we are going to have a terrible wallop.

Senator BARKLEY. Did the price of the finished product start up before the price of the hogs started up, or did it follow? How about that?

Mr. SCULLY. There had been a few periods where inventories advanced more rapidly than the hog, and more sales from inventory showed a profit, but in the main, the hogs have been advancing very rapidly, so that you had no practical profit in your cutting margin at any time, and four or five months before the Supreme Court decision there was a tendency for some people to discount that they might not have to pay, and I think that depressed the market for all of us, but we always tried to get all we could.

Senator BARKLEY. What portion of your business is pork packing?

Mr. SCULLY. Our kill from 1928 to 1935 would average about a million one of hogs to about 130,000 cattle.

Senator BARKLEY. On the whole, taking packers all over the country, what proportion of their business is hogs and what proportion is all of the others?

Mr. SCULLY. I have mentioned ourselves as pork packers, because I think any packer whose business was over 50 percent pork or hogs by volume would be considered a pork packer, because your pork operations per pound consume a great deal more of your money and your facilities than a pound of beef. Beef is large and you just sell it fresh, where pork, you make it up and process it. If you were half pork, a great deal of your money and expenses would be involved in the pork business, and our business has been considerably over that.

I am here to protest against the tax on unjust enrichment. The history of the processing tax is well known to all of you. However, we do not know that you realize the desperate plight that many pork packers were in at the time that this money or ours was returned as the result of the decision of the Supreme Court. If the Supreme Court had declared this processing tax legal and we had had to pay over the funds due under this tax on January 6, I think the majority of the small pork packers would have faced a crisis because their capital would have been so radically impaired, their credit destroyed, and the only alternative would have been to liquidate their business in whole or part.

There are approximately 800 small packers and they handle about 45 percent of the annual hog kill, as compared with over 50 percent handled by 5 or 6 large packers doing a business of national scope. If the local pork packer is forced out of business it would have the effect of throwing his volume to the national packers, restricting the market for hogs and eliminating healthy competition which has existed, centralizing the pork business in the hands of a few. This is not surely the intention or aim of the Government. In many cities the independent pork-packing industry is an important factor, and their elimination from the business life of that area would be seriously felt. There are many small stockyards who are sustained largely by their sales to this type of pork packer. Should he pass out of existence these stockyards would go, and the farmer in the nearby territory would be forced to ship his hogs to more distant points to his probable disadvantage. The employees of these packers would very probably have to give up their homes and move to cities that had opportunity for employment, as the packing-house employee is highly specialized and he probably would find no opportunity for his services in other lines of business except at a much lower wage.

Many of the pork packers did not realize when the corn-hog reduction plan went into effect, along with the processing tax, that this curtailment in volume was really a sentence to unprofitable operation. He had been used to temporary declines in volume due to the seasonal manner in which hogs came to market and the shrinkage which occurred in early 1935 did not seem unnatural, but as the year progressed the overwhelming penalty of this lost volume became so apparent and this has continued up to the present time and very probably will continue for another year or more.

We wish to emphasize that pork is strictly in competition with other types of meat, fish, and poultry and that the processing tax was on pork alone. The reduction in supplies took place in pork alone and immediately other industries took up the job of satisfying the volume that had been lost by the pork packers by the reduction in the amount of pork available. It is possible that it has brought about some change in eating habits which will continue even when

and if the hog supply comes back to normal. If this is true it will work to the distinct disadvantage of the farmer who is raising hogs as it is always hard to displace substitutes if they have gotten a substantial foothold. We wish to emphasize that the pork packer has suffered great financial loss through this arbitrary decline in his volume.

The decline in the number of hogs available has cut the hog kill of many packers to between 50 and 60 percent of their average kill, between 1929 and 1933, and the kill for that period was certainly not over 80 percent of their capacity. I would say in our own cases that our kill from the beginning of 1935 to date has not been over 40 percent of our capacity.

The farmer was paid for taking hogs and corn out of production, but the pork packer was not paid for taking his plants out of production; and in the case of the independent and small packer, many of whom were engaged principally in the pork business and had only a small business in side lines, this brought about a penalty which will result in his elimination if the hog supply does not, within a reasonable time, get back to something like normal, and if he is not allowed to retain in full this money which the Government is seeking to take from him through this bill on unjust enrichment. It would seem morally that the pork packer, at the present time, has a just claim against the Government for damages, though I am sure it was not the intention of anyone in the Government to hurt us when this corn-hog reduction plan was put into effect, as we ourselves did not know fully the burden and penalty which we were to suffer.

There are many localities from which the pork packer has had to withdraw his salesmen because the tonnage of pork available was so small it would not support his services; yet the people in that territory were familiar with his brands and the withdrawal of his product from these areas and the loss of the continuous business relationship with the consumer and with the trade in that territory, which in many instances has gone on for 20 to 40 years, may make it impossible to reestablish ourselves when the volume of hogs returns to something like normal. Competition is so intensely keen that all of us independent and small packers should have the most efficient type of equipment and organization.

There have been many mechanical changes and improvements in manufacturing during the last 3 or 4 years, because of the adversity of the pork business the packer who is principally in pork packing has not had capital to put in improved methods. Our larger competitors have been in position to keep in pace with technical progress. If any part of this tax on unjust enrichment is to be taken from the small packer and we are not able to keep our plants in up-to-date condition, our ability to compete with the big national packers will be further decreased, which, in the long run, means a further decline in competition and a further centralization of the pork-packing business, which we do not think would be favored by the consuming public, the farmer, or the Government.

It would be, of course, difficult if not impossible to secure increased capital by the sale of stock with which to purchase new equipment and to further modernize our plants, because no investor is going to look with favor on going into a business which has had such a very poor earning report and has been subjected to penalty as the pork-

packing business. If we cannot retain our competitive position our elimination is only a matter of time, yet there are hundreds of pork packers who have been in business from 30 to 50 years and have been able, up to now, in varying degree, to hold their own in competition with companies whose volume is 20 to 100 times their own.

In conclusion we wish to state that we believe that if you give consideration to the facts as they pertain to the pork-packing industry, particularly in the case of the independent and small pork packer whose principal business is pork, that you will see that we have a very real reason for protesting against this tax on unjust enrichment. We have no thought of challenging any unjust motive behind the original processing tax or the tax on unjust enrichment, but we believe that the full knowledge of the facts in our case will indicate that we would be under an unbearable penalty by the application of the tax on unjust enrichment as proposed. We have been, of course, bothered by impending legislation of the tax on surplus and of the suggestion of a reimposition of the processing tax, but for the moment we have felt that our principal hazard was this tax on unjust enrichment; and because we want to survive and want to continue in business, we are concentrating our attention in trying to put before you principally the effect that that tax would have on our very existence.

STATEMENT OF WILSON C. CODLING, VICE PRESIDENT AND GENERAL MANAGER, ALBANY PACKING CO., ALBANY, N. Y.

Mr. CODLING. Mr. Chairman and members of this committee, I represent the Albany Packing Co., a small pork packer. Probably we are comparable to a number of other small independent packers in this business.

Senator KING. Just one plant?

Mr. CODLING. Yes, sir. Up until March 1, 1934, we never made a loss or showed a loss in our killing and cutting operations of hogs. After that time, when the tax of $2.25 was passed on hogs, every month showed a loss. We were not able to realize back the value of the hog; and I say this, that I hope that this committee will seriously consider that if this present proposed tax becomes a law there will be a serious condition in the packing industry, especially with the eastern independent pork packer, because that is practically all that he handles is pork, not beef or lambs.

I thank you.

STATEMENT OF G. WILLIAM BIRRELL, TREASURER, CH. KUNZLER CO., LANCASTER, PA.

Mr. BIRRELL. Mr. Chairman and members of the committee, in order to conserve the time of the committee, we do not wish to go into the economics of the pork-packing industry. That was very ably handled by our Mr. Woods yesterday.

I want to endorse what Mr. Woods said. I shall, however, confine my remarks very briefly to the conditions that we will find if this proposed tax goes into effect.

My name is G. William Birrell, and I am treasurer of the Ch. Kunzler Co. of Lancaster, Pa., a very small sausage-manufacturing plant and slaughterer situated in an agricultural community. My reason for appearing before this committee is to acquaint you with

the effect that the Revenue Act of 1936 will have on my concern. The Ch. Kunzler Co. has been in existence for over 30 years, founded by its present president, Christian Kunzler, and has grown from a small retail meat establishment to its present size, now employing between 80 and 90 people.

I am neither a lawyer nor an expert accountant, but I can see if the "windfall" tax becomes a law that we will be faced with considerable difficulty in order to raise the amount of the tax. We have heretofore depended on the banks to finance us; but unfortunately, during the banking crisis, our bank, along with a number of others in the community, was compelled to close and liquidate. Banks will make short-term loans for current operations only but frown upon loaning money today that means a long-drawn-out period and which is not used for purchasing materials.

Senator KING. Would they loan for capital?

Mr. BIRRELL. No, sir; they will not loan for capital. I happen to be a bank director; and that is one of the principles of our institution, that we do not care to loan for capital investments; only liquid loans.

We cannot get an increase in the mortgage which now exists, because in order to get an extension we had to agree to pay approximately 10 percent of the mortgage annually during the period of the extension—the mortgagee feeling it was too high, although it had been reduced to 60 percent of the original amount. Incidentally, we had spent about $75,000 improving the plant.

We have money borrowed from the bank at present, and we have given them security to cover part of it.

If the bank refuses to help us, our only recourse will be to curtail the business, reducing the inventory and accounts receivable; and incidentally, on the question of accounts receivable, that is very difficult to reduce, because if we stop selling to these accounts, they will buy elsewhere and hold you up for the amount of the money they owe.

That will mean, too, reducing the number of employees, which would be unfortunate both for the community and the company. After over 30 years of business activity to be forced to this condition by an act of Congress would be a tragedy.

I can appreciate the intent of the bill is to prevent anyone from profiting by the unconstitutionality of the A. A. A. at the expense of the consumers, "unjustly enriched", but I can't see where we have benefited, although it will be difficult to prove it. The bill provides a certain formula; but our operations are thrown together, and we have no way of determining the result of hog operations for the period mentioned.

We slaughter cattle, calves, lambs, have a large sausage business, smoked meat, and so forth, and everything else is combined, so that we cannot break down the sales.

Large and small pork packers have had difficult times during the last few years, and it will be another year or so before we are adjusted again; and if the "windfall" tax is allowed to pass, there will be great misfortune—many plants will be forced to close, and there is no question it will upset the orderly marketing of livestock. The ninety or one hundred millions which the tax is supposed to produce will be gained at the expense of shattered lives—men who have devoted all their lifetime to building up a business only to have it wiped out—or

seriously embarrassed—at the expense of unemployed men and women—at the expense of communities through the closing of plants. Gentlemen, I don't believe, measured by the misery it will create, that it will be worth it.

Senator KING. Let me ask you this: Would it be possible to unwind the threads of your business so as to determine what the profits or losses have been in the sale of lambs and beef and your other products?

Mr. BIRRELL. It would be very, very difficult, sir, because part of what we slaughter is converted into other departments. It would be very difficult to break it down, and being a small packer, we are compelled to buy elsewhere. We buy hams in carloads, fresh bellies and Boston butts and other cuts that we manufacture into other products, so that it would be very difficult for us to arrive at any conclusion.

We determine the success of our business more by the results of the entire operation rather than by any one part of the entire business.

Senator KING. If you purchased hams and then resold them, would you have to pay a processing tax on them?

Mr. BIRRELL. No, sir. We purchased the hams at the market price, convert them into smoked meats, and there was no processing tax. The original processor paid the tax.

Senator BAILEY. What is wrong with this formula?

Mr. BIRRELL. The formula as it applies to us, Senator, is that we have all of our operations grouped together. Now, as I understand the bill through reading through it—as I mentioned, I am not a tax expert—you have to arrive at the profits or losses during a specified period on hogs. "Hogs" was the item that had the processing tax.

Senator BAILEY. You begin with the selling price?

Mr. BIRRELL. But you see, our operations, Senator, are so grouped together that it would be difficult to unwind it. We killed so many hogs, and part of it goes into the cellar, part of it into the sausage room, and part is sold fresh.

Senator BAILEY. Your idea is that the formula should not be applied?

Mr. BIRRELL. Not to us. Unless you were willing to take the gross profit over a period of years of the entire operation.

Mr. POWELL. Mr. Chairman, in order to save time if you will instruct the remaining witnesses that they are not to talk over 2 or 3 minutes, we will get through in a hurry.

I would like to call Mr. Paul W. Trier.

STATEMENT OF PAUL W. TRIER, TREASURER, PERRY PACKING & PROVISION CO. OF IOWA, PERRY, IOWA

Mr. TRIER. My name is Paul W. Trier. I am treasurer of the Perry Packing & Provision Co. of Iowa, Perry, Iowa, an Iowa corporation doing a slaughtering business. The company is operated exclusively by residents of Perry and obtain all of their livestock from the local vicinity. Originally the plant specialized in the slaughter of hogs. A market has been developed for this locality which is recognized as a great benefit to the farmers of that vicinity and in the city of Perry. If the collection of the proposed windfall tax becomes a law that will shut down the Perry plant because the working capital is so depleted, due to the severe operating losses sustained, and consequently eliminate the competition in the cash livestock

market for that district and throw out of work the people who are now on the pay rolls of that institution.

I am also vice president and treasurer of Arnold Bros., located at 660 West Randolph Street, Chicago, Ill., an Illinois corporation. Arnold Bros. were founded in 1868 in the same location where they are today and were exclusively a pork and sausage firm. On account of the unsatisfactory results in the handling of pork, volume was severely reduced and consequently expenses increased, which in turn reduced the working capital of the firm. If the windfall taxes are collected the working capital will become depleted. If it becomes necessary to close the plant approximately 350 people, many of whom are of the second generation of employees, will be out of employment.

I am also directed to speak for the Packers and Sausage Manufacturers Association of Chicago, an organization which has been in existence for approximately 25 years and which is composed of approximately 25 of the small packing firms of Chicago. Many of the members of this organization have paid thousands of dollars into the Government funds for processing taxes and I am directed to state that if the windfall tax becomes a law it will produce a disastrous and ruinous effect upon their business.

In view of the above and also in view of all the other testimony that has been given at this hearing pertinent to the application of processing taxes, the collection of windfall taxes and the surplus corporation taxes, I urge you to consider the facts as briefly stated above and make laws so that those whom I represent will be allowed to exist and will not be destroyed or eliminated from the industry.

STATEMENT OF CHESTER G. NEWCOMB, VICE PRESIDENT AND GENERAL MANAGER OF THE LAKE ERIE PROVISION CO., CLEVELAND, OHIO

Mr. NEWCOMB. My name is Chester G. Newcomb. For the past 25 years I have been connected with the Lake Erie Provision Co. of Cleveland. My present title is vice president and general manager.

Our company began its business in Cleveland almost 70 years ago and stands well up in the list of old established firms serving the community. My father, who has been active in the affairs of the company for almost 50 years and who now approaches his seventy-fifth birthday, has served as president of the company for a long time. Throughout the years that our company has been a factor in the packing business of Cleveland, we have never made more than a modest profit. On the other hand, it has furnished a means of livelihood not only for ourselves, but for a long time back to some 150 to 250 men, depending upon how busy we were at any particular time. I might also add that we have men in our employ who have been with us for as long as 50 years.

Payment of the processing tax began in November 1933. We continued to pay the tax up to and including the month of January 1935, by which time we had so depleted our working capital that it was impossible to pay out any more and continue to operate. Furthermore, we could not have paid out the amount that we did, had not the collector of internal revenue at Cleveland seen fit to be lenient in the matter of granting us time extensions. Such extensions

were not granted by him, however, until he had satisfied himself that to disallow them would have meant closing the business.

Following this and being unable to make further payments, we were successful in obtaining a temporary injunction without being required to put up the money representing the amount of the unpaid tax. Here again the court recognized the fact that were this insisted upon, it meant closing the company's doors. For the same reason liens likewise were placed upon most of the other independent packing plants in the Cleveland area.

Had the Supreme Court not held the tax unconstitutional, it would have meant bankruptcy for every one of the four independent pork-processing concerns in Cleveland. It would also have meant turning a total of some 1,200 men out of their jobs. The plant operated by one of the large packers would have been the only one in the city in a position to continue operations. Should the windfall-tax proposal be enacted into law and the law upheld in the courts, the same result cannot be avoided. In passing it probably should be mentioned that the oldest one of the four independent companies referred to, was forced this past June to seek relief under section 77B of the amended Bankruptcy Act.

The situation in regard to the small packers of Cleveland is in no way different from that obtaining for small packers all over the country. From my contact with a large number of small packers, I would say as a conservative estimate, that it would close some 75 percent of their total number. Business for most of them has been conducted at a loss ever since the Agricultural Adjustment Act became effective and the money is not available to make any further payments.

Moreover, as the windfall proposal stands, if payment is to be avoided, the burden of proof is on the packer to show that he did not pass the processing tax on. Regardless of opinion to the contrary, this is impossible to show. The packer can only point to his losses and of these he is certain.

To the packers in my section and for whom I speak, it is inconceivable that Congress would pass any law, the effect of which would be to force the small operators into bankruptcy. In my opinion a request for packers to send in sworn financial statements would in a few days bring in a flood of figures that would amply support the truth of the statement I have made, that the tax by the small companies cannot be paid if such packers are to continue in business. Such a proposal if enacted can only result in extending a monopoly of the business to the national packers. Certainly nothing else could happen for we would have the competitive market for the farmers' live stock as well as the competitive market for the consumer's largely destroyed.

Senator BAILEY. What would you say about putting something into the formula which would protect these institutions to prevent their being destroyed?

Mr. NEWCOMB. I do not know what formula.

Senator BAILEY. Suppose we say that no taxes shall be covered if the result of making the refund would reduce the profits below 6 percent for 1935?

Mr. NEWCOMB. We are in the position of the witness before the last. Our departments are all thrown in together, and I do not know how we could work out the present formula.

Senator BLACK. Did you get an injunction?
Mr. NEWCOMB. Yes, sir; we did.
Senator BLACK. When did you get yours?
Mr. NEWCOMB. It was along in June or July, I believe.
Senator BLACK. Of 1935?
Mr. NEWCOMB. Yes.
Mr. POWELL. The next witness is Carl F. Welhener.

STATEMENT OF CARL F. WELHEMER, REPRESENTING THE HENRY BURCKHARDT PACKING CO., DAYTON, OHIO

Mr. WELHEMER. My name is Carl F. Welhemer.

Mr. Chairman and gentlemen, I have been asked to speak on behalf of the Ohio delegation, a large number of whom are in the room, and I am going to be very brief in order to save time and not go into a lot of things pertaining to our own business, but just into a few highlights that pertain to all of us.

I am connected with the Henry Burckhardt Packing Co., of Dayton, Ohio, an old, established firm, but considered in the small independent packers class. We are representative of hundreds of small independent packers throughout the United States and of a number in Ohio. I believe that our situation is typical of many others throughout the country and we know from actual contact that it is comparable to quite a number in Ohio.

In order to save the time of the committee, I will be very brief.

The matter of collecting the windfall tax is a serious matter to all of us and if it must be returned to the Government it will make our present situation worse. All of us have lost money on our pork operations, which is easily proven by our records. We do not believe that we were unjust enriched.

When the processing taxes which were impounded were returned to us on account of the processing tax being declared unconstitutional, we naturally and sincerely felt that we were entitled to use this money when it was returned to us. It was used in reducing our bank indebtedness, paying off some old bills, rehabilitating our plants, permitting the discount of our current bills, and gave us a little freer action in operating our business, as it restored some of our reduced working capital that had been occasioned by previous losses.

The claim is made that the processing tax was passed on to the consumer. In our experience and results shown we did not succeed. We admit the necessity existed for all of us but it was not accomplished as we made losses on our pork operations.

During the period of the processing tax our plants operated at a third to 50 percent hog-killing capacity. This reduced hog slaughter, increased overhead, and fixed charges per unit which occasioned heavy losses on account of not realizing enough in our sales prices. Unless we will be permitted to retain the moneys refunded we are going to be in a severe desperate situation.

Handling a perishable product from the time that livestock is purchased until prepared for market it must be sold regardless of cost, meeting market competition. Selling markets were low compared to cost due to the reduced buying power of the public. Also much agitation about the high prices and taxes resulted in the public turning to other foods, such as fish, poultry, cheese and other items

which fact is admitted by the handlers of these various articles. This naturally lowered the demand for our pork products, in turn reducing our selling prices and produced a loss.

The small independent packer, with his working capital materially reduced and without cash to pay for livestock which must be paid for daily and to pay his monthly processing taxes, many times was forced to sell not only his fresh but his cured stocks freely in order to obtain funds quickly. This in turn weakened the whole market structure, resulting in insufficient prices for our products. There was a great deal of competition from the bootlegging of pork products on which no processing tax was paid. This illegal competition also reduced volume and sales prices. All of these items contributed to our failure to obtain enough money for our pork products to show anything like a profit.

If the small independent packer is compelled to return the windfall tax it will further reduce his working capital, jeopardize and place his business under a severe strain and hardship, and in many cases put him entirely out of business. In many cases there will be no funds to return the windfall tax as they have been expended, which will mean the Government will have to levy on the plants.

The seriousness of this will be realized when you take into consideration that there are about 900 so-called small packers in the United States who will be very much handicapped should the windfall tax be collected, and many of them state that they cannot weather this condition and will be put out of business. With firms discontinuing business it means that hundreds of old employees will be thrown out of employment and in many cases become public charges.

Livestock must be purchased for cash and to carry inventories some working capital is absolutely necessary. Further bank borrowings and the introduction of new capital will be impossible, as no one would be interested in a business that is in such a desperate situation. The small packers simply cannot operate with only their buildings and equipment. They must have some working capital to buy and sell merchandise and if you take this refund away from us we will be helpless.

Furthermore, in many communities if the pork packers are handicapped or go out of business it will destroy many markets for livestock on which the farmers are dependent, as many of them do not raise enough livestock to permit them to go to the large primary markets. With the severe hardship imposed on many small concerns of the country by cutting down their operations and in many cases putting them out of business it will have a tendency to destroy competition, which will result in higher prices for the consumer.

With these plants nonoperating or doing less business it will affect all business activities in our communities and further reduce regular and income taxes. We feel that we are an economic necessity and a service to our communities and if small firms are forced to further reduce their operations and in many instances close, it will destroy the future of hundreds of small operators throughout the country as well as their thousands of employees.

Therefore, the small independent packer makes the earnest plea that his business be relieved of the burden of returning the so-called windfall taxes by not passing the proposed measure.

The CHAIRMAN. Is Mr. Stump here?

Mr. STUMP. Yes, sir.

The CHAIRMAN. I understand that Mr. Stump is anxious to get away, and we will therefore hear from him now.

STATEMENT OF ALBERT STUMP, INDIANAPOLIS, IND.

Mr. STUMP. This is a joint statement concerning two Indiana pork packers—F. Hilgemeier & Bros., Inc., Indianapolis, Ind., and Milner Provision Co., Frankfort, Ind.—presented in the hope that it will get before you the problem of two small packers, in relation to the windfall taxes, which no doubt are typical of the problems of small packers throughout Indiana and the Middle West.

The business of F. Hilgemeier & Bros., Inc., is confined entirely to Indiana, 95 percent of their product being sold in Indianapolis and the remaining 5 percent in territory near Indianapolis. They engage in no interstate business. They are not members of the Institute of American Meat Packers.

Their business grew from a small beginning in about 1885 to where they were slaughtering from 1,200 to 1,500 hogs per week in normal years during the hog-killing season from September 15 to April 15, or a total of 50,000 to 55,000 hogs per year. They would build up their inventories during this season, borrowing funds at the bank to finance these seasonal operations and paying it back as their inventory would be reduced during the summer. Thus every year their bank loans were cleaned up before the beginning of each season's heaviest killing.

This continued until 1931, during which year adverse conditions already discussed in public hearing before this committee, produced a loss of $43,890.27 on hog-killing operations. These conditions continued in 1932, producing a loss of $26,605.02, and in 1933 a loss of $18,833.28. The operations of 1934 show a profit of $7,450.46; and of 1935, $64,761.06. But included in this profit of the year 1935 were the processing taxes which were levied but not paid for the months from May 1935 to December 1935, inclusive, amounting to $126,387.19.

In the meantime, during these unprofitable years the loans at the bank were not cleaned up as the inventories were moved. In order to curtail losses the number of hogs slaughtered was reduced. The pork prices had gone so high, because of $12 hogs, with $2.25 tax, that the market would not absorb the normal output. Killings were reduced to 400 to 500 per week during the killing season, for the purpose merely of meeting demands only, and no inventories could safely be accumulated for appreciation during the summer, on account of the additional cost because of the tax. The loans at the bank had to be increased to meet the taxes, and finally amounted to $90,000, and at the same time the inventory had been reduced over a period of about 1 year by about $100,000.

When the refund of $127,387.19 was obtained, the loan was paid, and immediately killings were increased to about 1,000 to 1,200 per week. As a result, loans were again necessary, and now amount to about $60,000, with the possibility of an additional $20,000 being necessary to restore the inventory to normal conditions for the coming season.

Now suppose 80 percent of the $126,387.19 would have to be paid in taxes. That would amount to $101,109.75. That would be an overwhelming blow to this small packer, which is now employing about 115 men.

The case of the Miller Provision Co. presents similar problems. It has been engaged in slaughtering cattle and hogs, and normally slaughters something over 20,000 hogs annually. Since 1918 it has been employing about 80 men in Frankfort, a town of 12,000. Its debts increased during the hard years from 1931 to 1935, until now it owes about $56,000; of this $30,000 is a loan at the bank, and $26,000 is on a mortgage on farm land.

It paid processing taxes until May 1935, amounting to more than $156,000. The taxes impounded for May 1935, to November 1935, were more than $26,000. About $4,000 of the processing tax was withheld during the month of December 1935. This making a total of about $30,000 which would be involved in the windfall tax. Eighty percent of that amount is $24,000.

Under the new State banking rules the amount of the loan must be reduced to $28,500. Now, with that as the limit the bank can loan, it is obvious that if the $24,000 is required to be paid under the new Federal Revenue Act, it will put this packer out of business entirely.

Both these cases have been figured on the basis of a payment of the full 80 percent of the processing taxes unpaid from May 1, 1935, to January 1, 1936. This is a correct basis under the pending bill. The low margin in both cases for the base period of the 5 taxable years preceding the initial date of the processing tax, produces that result under the formula provided in the bill for determining the amount of the tax.

There are probably 40 small pork packers in Indiana. The situation each faces presents these same problems. The conditions in the industry were such that no doubt all would be required to pay the full 80 percent of the processing taxes unpaid at the termination of that law, if the formula in the pending bill is followed in determining the amount. This would practically wipe out the small packers in Indiana. And there is nothing apparently to differentiate them from the packers in neighboring States.

The suggestion is ventured that agriculture in the long-time program could be dealt no more severe blow than by ruining the small meat packers. What would become of the market for hogs if that occurred?

The fact is not to be overlooked that the revenues must come from some source. But where some particular industry is burdened disproportionate to other industries, the equilibrium of the economic structure is disturbed. Substitutes for the products of that industry are developed. The readjustment is attended by ruinous losses to labor and capital, which may never be restored. The small meat packers have already contributed more than their share to the general welfare.

If food is to bear a special burden of the revenue, why not tax all food processors equally? The established equilibrium in the food business would not then be distributed so much. Knowing that the sincere interest of this committee in finding the very best solution of a difficult problem has probably led them to exhaust a study of every

possibility, this suggestion is nevertheless offered in the hope that it might prove of some assistance to the committee.

The further idea is offered, rather more in the nature of a question than of a suggestion, that any tax which rests specially upon food will ultimately be injurious to the food producer wherever he appears along the line, whether as a processor or a farmer—and will be reflected with unfortunate emphasis in the standard of living of the poor. Food, at least, should be available to all in abundant quantities to make the abundant life. Why not levy a tax upon all manufacturing, if that is within the power of Congress, and would seem adaptable to the production of the needed revenue?

The position of the small packers should not be confused with the position of the big packers. The small packers could not build up a surplus to meet the hard years of the recent past. The released funds did not constitute a real windfall to them. It placed them where they could restore to some extent their depleted capital. In the interest of the smaller packers the suggestion is also volunteered that an exemption of $500,000 be included in the law—so that the windfall tax feature of the law would not apply unless the amount of the released funds were more than $500,000.

If there is no alternative except the tax as proposed in the pending bill, then could there be some means provided by which time for the payment of the taxes could be extended without interest, over a period of years, to give the small packers some opportunity to save themselves?

Senator BAILEY. What about no tax being collected if the collection of the tax would reduce the profits below 6 percent for the year 1935?

Mr. STUMP. I think, Mr. Senator, there might be some difficulty with some of the small packers, for the reason that in the short period of time for which they paid no taxes during the time the tax law was in effect, and before its constitutionality had been determined, their income over that period might have been considerably more than 6 percent, and then having used that 6 percent for the purpose of meeting immediate necessities, debts at the bank and so on. If they were to pay it all down to what would reduce them to a 6-percent income, they would be put to the almost impossible requirement of raising that much money, all but 6 percent of the amount that was covered, whereas if there were an exemption of a small amount—I suggested here $500,000.

The two clients whom I represent here, one of them had a tax of only $26,000, and another had a tax of only $126,000. I had a small client likewise who had a tax amounting in all to about $2,000, but each of these people located in small communities are employing people in those communities.

If there were a small exemption made, whatever would be adaptable to that situation, it seems to me, might spare a good many of the small packers.

I might say that Mr. Hilgemeier is not a member of the Meat Packers Institute. You probably gathered that from my suggestion that there be an exemption. But at least I am presenting the situation as it appears to those people. The cushion of the 6 percent suggested by the Senator, in my judgment——

Senator BAILEY (interposing). It is solely for the purpose of exploration. I am not fixed on anything.

Mr. STUMP. Certainly. It might not be satisfactory as an exemption up to some definite amount below which most of these small operators would come.

Senator BAILEY. Is it the contention of the small independent dealers who appear here today that the collection of this tax would in many instances tend to extinguish them, and therefore to aggrandize the business of the larger packers: is that part of the contention?

Mr. STUMP. Of course, we are not in a position to state what effect it might have on the larger packers. I have had no contact with the larger ones, but with those, of course, whom I do represent, who are just small packers, as I have made clear, I think it would tend to eliminate them from the field. Whether there would be contending difficulties on the part of the larger packers which would interfere with their being in a position to monopolize the field, I do not know.

My impression would be that the tendency would be to cause a monopolization of the field by the larger packers. That is speaking without much information concerning their situation, but it seems to me if the smaller ones are wiped out, which I believe would occur unless there is some kind of provision made to save them, somebody is going to have to pack this meat, and it would only be those who have had built up a reserve and had a surplus ready to meet this situation.

I thank you very much.

STATEMENT OF GEORGE H. LINCOLN, SECRETARY, STANDARD PACKING CO., LOS ANGELES, CALIF.

Mr. LINCOLN. My name is George H. Lincoln, secretary of the Standard Packing Co., Los Angeles, Calif. I have been requested to represent the following individual meat packers of southern California: Luer Packing Co., Pacific Land & Cattle Co., Sterling Meat Co., Union Packing Co., Newmarket Co., Kern Valley Packing Co., Cornelius Bros., Ltd., Coast Packing Co., Bakersfield Packing Co., and Standard Packing Co.

The position of the independent meat packers of southern California with reference to the processing taxes and the so titled windfall tax has been very covered by Mr. Woods and as well by the several gentlemen who have preceded me. I do, however, genuinely appreciate the opportunity afforded to briefly outline our position.

When the N. R. A. became a law it was accepted 100 percent; wages were increased in accordance therewith and working hours reduced. Upon the declaration of the Supreme Court that the N. R. A. was unconstitutional the independent meat packers of southern California, in the main, continued to carry out and to live up to its precepts.

At the inception of the A. A. A. we accepted its terms without a question. We paid our floor stock taxes and our processing taxes month by month, from November 1933, until approximately March 1935, when at that time it became startlingly apparent that the burden of the processing taxes was leading us really rapidly toward bankruptcy. It was then and only then the injunctive relief was sought. The result of this very necessary action is written in the records of the Supreme Court of the United States and is well known.

Through this action the independent meat packers of southern California were the recipients of certain impounded funds which

they consider belongs entirely to them and their contention is supported by the decision of the Supreme Court.

It is now proposed to take most of this money away in the form of new taxation, namely, the so-called windfall tax.

We have been severely penalized by the A. A. A. and that penalty is still effective. We contend that no windfall was received by any of the independent meat packers of southern California, and that impounded moneys returned to us were in a large measure simply a recompense, if you please, of losses previously incurred. It would take altogether too long to substantiate in detail that statement, but nevertheless it is true, and there is one thought each firm I am representing wishes to leave with you, at this time.

We do not feel that it is right or proper to tell the lawmakers of our country what laws to pass and what laws not to pass, but we do feel that it is our duty to demand of those that represent us to have the courage and determination to uphold and defend the Constitution of the United States at all times.

Speaking entirely for ourselves we realize the Government must necessarily raise large funds to carry out needed programs and further realize that individuals and businesses alike must face further taxation, and we are sure that if such taxation is equitable and just and in accordance with the Constitution, very little opposition will be encountered.

STATEMENT OF T. G. STRANGE, PRESIDENT, THE PROVISION CO., COLUMBUS, GA.

Mr. STRANGE. My name is T. G. Strange, president of the Provision Co., Columbus, Ga.

At the beginning of the processing taxes on hogs we commenced paying these taxes with a 30-day extension. As the taxes gradually became more difficult to pay we got this extension increased to 90 days. Our accounts payable became past due and we could not take our customary discounts. About January 1, 1935, we owed $30,000 in processing taxes. We had repeatedly asked for 180 days extension but were refused.

At this time, in January 1935, the collector of internal revenue took a lien on our property for $27,000. We immediately filed for and were granted an injunction for further collection of processing taxes and action by the collector. We gained a 30-day breathing spell at this time, bringing our extension up to 4 months. As per court instructions, we paid the money from then on into escrow.

On November 27 the United States Bureau of Animal Industry wrote us in regard to rehabilitation of our plant, either to enlarge and correct the facilities, or curtail operations. On December 23 we applied to the Reconstruction Finance Corporation for a loan of $40,000 to so comply with the Bureau of Animal Industry request. The loan was approved on condition that I, as largest stockholder, personally put an additional $10,000 into the business for working capital. I borrowed $5,000 on my home, giving a second mortgage, and $5,000 from the bank. An additional $40,000 was advanced by the R. F. C. to retire first-mortgage bonds, that giving first mortgage to R. F. C. We now owed the banks $18,000. Money held in escrow

was returned to our company about this time. This money was used immediately to pay banks and our past due accounts.

We suffered inventory loss of approximately $15,000 during the first 3 weeks of January, due to larger customers staying out of the market, causing a drop in the meat prices coupled with the advance in price of hogs.

We are now in the midst of our new construction as insisted upon by the Bureau of Animal Industry, which will cost between $40,000 and $50,000. Work is being done by a bonded contractor on bid as outlined in R. F. C. resolution. Our bank balance at present is zero. If the windfall tax is passed and the Government calls on us for 80 percent of moneys refunded and for the processing taxes not paid, we can only throw up our hands. Since R. F. C. has first mortgage on our property no other agency will make long-term loans. In regard to passing the tax on to the retailer, we did our best and must have been successful to some extent, but how much I do not know, as we drew our checks against all moneys from all phases of our business to pay these taxes.

Mr. POWELL. Mr. Chairman, I want to take this opportunity to thank you very much for giving us the opportunity to present our witnesses and to listen to my clients.

The CHAIRMAN. I am sorry we did not have the time to listen to the entire 125.

The committee will recess now until 9:30 tomorrow morning.

(Subsequently the following letter addressed to Senator Black by Hon. Guy T. Helvering, Commissioner of Internal Revenue, was ordered placed in the record.)

TREASURY DEPARTMENT,
Washington, May 9, 1936.

Hon. HUGO L. BLACK,
United States Senate.

MY DEAR SENATOR: In accordance with your suggestion I have made an effort to secure the information relative to bankruptcies, discontinuances, and profits of the packing industry over a period of years.

I have been unable to find any readily available data as to the profits of the smaller meat packers or as to the number of such packers who may have discontinued business during the period the processing taxes were collected.

We have, however, in the Bureau data relative to the amount of hog processing tax liability incurred by processors during the year 1935, segregated to show the number of processors in various classes predicated upon the amount of tax liability declared. We also have a record of all bankruptcy, receivership, and reorganization proceedings in which Federal-tax liabilities are involved in any way which have been instituted and/or reported to the Bureau since September 1934.

For your information we have reviewed these records to determine how many hog processors were involved in such proceedings. Our records disclosed that out of 1,806 processors who reported hog processing tax liability for the fiscal year 1935 and whose returns accounted for 99.12 percent of the total tax liability disclosed, accounting for all processors whose tax liability was in excess of $1,000, there have been but 28 bankruptcies, receiverships, or reorganizations reported to the Bureau.

A detailed statement classifying the above-mentioned hog processing taxpayers in accordance with the amount of tax returned and showing the number of bankruptcies, receiverships, and reorganizations reported in each class is submitted herewith for your information and consideration.

Yours very truly,

GUY T. HELVERING, *Commissioner.*

Processing tax on hogs, fiscal year 1935

Tax liability (in thousands of dollars)	Number of processors	Total liability	Percent	Bankruptcy or receivership reorganization
Over 20,000	2	$51,527,374.05	29.68	0
10,000 to 20,000	0	0	0	0
7,500 to 10,000	2	17,890,209.92	10.31	0
5,000 to 7,500	1	7,475,027.55	4.31	0
4,000 to 5,000	1	4,356,398.20	2.51	0
3,000 to 4,000	3	11,545,246.89	6.65	0
2,000 to 3,000	5	12,422,211.67	7.16	0
1,000 to 2,000	14	18,007,850.82	10.37	0
750 to 1,000	5	4,270,465.95	2.46	0
500 to 750	13	7,770,409.49	4.48	2
400 to 500	10	4,421,850.67	2.55	0
300 to 400	17	5,940,056.02	3.43	2
200 to 300	20	5,047,318.26	2.91	3
100 to 200	47	6,719,677.93	3.87	0
75 to 100	30	2,610,022.70	1.50	1
50 to 75	31	3,151,831.12	1.82	3
25 to 50	111	3,897,100.88	2.24	5
15 to 25	85	1,648,992.22	.95	0
10 to 15	71	845,589.20	.49	2
5 to 10	151	1,084,049.64	.62	4
4 to 5	55	249,052.86	.14	1
3 to 4	80	275,787.36	.16	1
2 to 3	141	345,972.30	.20	1
1 to 2	391	562,078.30	.32	3
Total	1,306	172,065,618.97	99.11	28

(Whereupon, at 5:50 p. m., the committee recessed until tomorrow, Thursday, May 7, 1936, at 9:30 a. m.)

REVENUE ACT, 1936

THURSDAY, MAY 7, 1936

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

The committee met, pursuant to adjournment, at 9:30 a. m., in the Finance Committee room, Senate Office Building, Senator Pat Harrison presiding.

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

The CHAIRMAN. Mr. Charles Warner, Philadelphia, Pa., representing the Warner Co.

(No response.)

The CHAIRMAN. Mr. Taliaferro, Detroit, Mich., representing Hammond Standish & Co.

Mr. TALIAFERRO. Yes, sir.

The CHAIRMAN. You are here with reference to the packing matter?

Mr. TALIAFERRO. Yes, sir.

The CHAIRMAN. We have heard a great many witnesses and will be glad to get your brief. Just give it to the reporter.

Mr. TALIAFERRO. You have been so generous that we do not want to take up any more of your time. I just want to thank you for the time that you have given the industry, and I do not want to burden you with further evidence, but this brief, I think, covers ground that you have not heretofore had.

STATEMENT OF T. W. TALIAFERRO, PRESIDENT, HAMMOND STANDISH & CO., DETROIT, MICH.

Mr. TALIAFERRO. Mr. Chairman and members of the Finance Committee: I appear before you, not as a supplicant for a favor, but to ask for justice, and on behalf of our stockholders and 500 and over faithful employees, some of whom are the third generation who have married and reared their families while in the employ of this concern, which started in 1858 and is still operating under its original flag. We are the only pork packing company in Michigan that has survived the many changes that the packing business has undergone in its evolution from the local butcher without refrigeration except for ice in a limited way, to one of the greatest and most efficient businesses, operated on the smallest profit per pound of perishable product in the whole world. Its continued existence lies with you gentlemen of the Congress.

This company is the victim of the enforcement of the A. A. A. primarily because when the Government determined to kill off the pigs

and pregnant sows the prices to be paid were so arranged that no preference was made for attracting them from the sections where surplus existed, but Chicago was made the dividing line; those east were bought at Chicago prices, and west of that point at somewhat lower, whereas the prices in the West where surplus existed should have been made higher, and prices east where no surplus existed should have been made lower so as to discourage marketing, and thereby maintaining the normal and in some sections subnormal supply. This unwise price arrangement was largely responsible for our present predicament, and only is remotely to the drought, as Michigan, Indiana, and Ohio, from which States we normally draw our livestock, were not materially affected by dry weather in 1934.

When our local supply was reduced arbitrarily and unreasonably, we were forced to go west for our supplies, making it necessary to pay higher freight rates per pound on livestock than western packers paid on dressed meats shipped to Detroit. Besides standing the extra shrinkage on the live animal, we stood the extra freight on the shrink in dressing. These items added to our normal expense over $1.50 per hog. That, combined with the greatly reduced volume leaving our plant and other facilities idle and thereby adding so greatly to our expense of operation, that it was impossible for us to pass on any appreciable part of the processing expense.

We would be glad to lease our plant and organization to the Government, or anyone else, if we were guaranteed 50 cents per hog profit, whereas the processing tax alone was 10 times our normal profit. We have always sold our product for as much as we could, based on supply and demand and quality which at all times is the deciding factor.

Our supply has been drastically reduced, as the following statement shows for the years of 1933–34 and 1935.

Hogs received direct at packing house from local producers

	1933	1934	1935
January	6,890	5,150	4,057
February	7,231	5,349	2,157
March	10,881	4,743	2,323
April	11,067	6,814	3,055
May	12,563	6,141	1,904
June	7,141	4,221	1,019
July	3,413	2,305	1,106
August	5,198	2,977	878
September	3,204	3,750	1,262
October	11,221	7,535	2,762
November	9,987	6,883	3,641
December	7,026	5,652	3,644
Total	97,176	66,221	30,677

No Government-purchased pigs included.

Our demand has also been reduced due to consumer opposition to high prices and shifting to substitutes, and to the material slaughtering of "bootleg hogs" both in the city and country. In most cases the fresh meat from these tax-free hogs was sold to the trade on an average of 2 to 3 cents per pound less than the market price in competition with Government-inspected cuts. In addition to this competition, there were many butchers who bought hogs and had them

slaughtered and they sold the fresh cuts in competition with cuts bearing the abnormal expense. This kind of competition was very extensive in Detroit and surrounding territory.

The meat packer whose principal operations are pork, has little revenue from other sources to reduce the impossible burden of a processing tax.

In order to keep in business a packer must have a daily supply of fresh pork cuts to sell his customers, or they leave him, for where they buy their fresh cuts they buy the remainder of their meat. This fact forced the price of hogs to so high a basis that there was a heavy cutting loss every month during the existence of the A. A. A. The theory that the increase in expense due to A. A. A. could be passed along in the price of a perishable article has proven a fallacy. Some pork packers could survive longer than others, but in the end most of them would have to go out of business unless relief is given in some way.

We earnestly request that no expense tax of any kind be placed on the processor of livestock, or other perishable food, under the theory that it be concealed so that the consumer is not fully advised of the amount and extent of the same. The processor is absolutely helpless between two conflicting interests; he is indispensible to both and is willing to work for such small wages that they do not mean anything appreciable to either producer or consumer.

Our business in Detroit provides a cash market for our farmers at all times, and likewise provides a definite source of supply for the consumers. Its record of continued existence for 76 years is evidence of its efficiency and it should not be destroyed in order to try a theory that denies everything that experience has taught us in the history of this business.

The CHAIRMAN. Roland C. Zinn, New York City, representing the Tanners Council of America.

(No response.)

The CHAIRMAN. Paul P. Cohen, Niagara Falls, N. Y.

(No response.)

The CHAIRMAN. Lawrence A. Baker, Washington, D. C., general counsel, National Association of Life Underwriters.

Mr. BAKER. Yes, sir.

The CHAIRMAN. How much time do you want?

Mr. BAKER. I think 15 or 20 minutes.

The CHAIRMAN. Your brief may be put in the record, and you may state the high points.

STATEMENT OF LAWRENCE A. BAKER, SPECIAL TAX COUNSEL, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, WASHINGTON, D. C.

Mr. BAKER. I will ignore the written statement I have given you, Mr. Chairman, and leave that for the record. I will try to cover very briefly just the high spots of our representations.

In the first place, I want to make it clear for the record that I do not represent any insurance companies; but that I am here at the instance of the Life Underwriters Association, which is an association of field men, for the purpose of making some representations which they believe are very much in the interest of insurance policyholders.

Mr. CHAIRMAN. Is that fire or life?

Mr. BAKER. Life insurance. Those policyholders now hold policies in many instances which they would like to use to their advantage in providing against the problem of estate taxes. Those policyholders would like also to be in a position in some instances to take out policies which would protect them against the very serious burden that arises out of sudden demise, without certainty as to how the revenue is going to come out of their estates in satisfying the very large demands that the Government finds it necessary to make.

You will recall that Mr. Osgood made a suggestion before this committee last year that it should be possible for prospective decedents to protect not only against death, but against the eventualities of taxes without *tax repression*. That expression, we think, is quite apt at this point.

We also want to have the committee feel that we are thoroughly mindful of the President's objective in his message and of this committee's objective in raising the additional revenue, and that that revenue shall be presently collected, that there shall be no delay in the collection.

As the situation now stands, the Treasury Department is under the necessity on the death of a decedent of making its assessment, and in many instances waiting a considerable period of time to collect the money. The act itself does not make the money due for a considerable time after death, and the provisions as to extensions in the case of closely held estates where liquidation would bring about hardship are such that the revenue is frequently long delayed in coming into the Treasury.

We have suggested a proposed amendment here to the estate tax law which you will find set out in constructive form in the memorandum that I have filed with the committee and which I shall not read, but I will review its effect. If it be adopted there will be removed from the present law the practical restriction which makes it almost prohibitive for a man to insure his life in such a way as to take care of his estate-tax liability, because the inclusion of the additional insurance is such that it pyramids and imposes a very much heavier burden than is imposed on the other property left in his estate.

The CHAIRMAN. Do they write such policies as that?

Mr. BAKER. Policies are written today which are payable to the estate, but they are not earmarked as would be the case if this amendment were adopted.

The CHAIRMAN. This matter was presented to us in connection with the inheritance tax feature, but that was in the bill last year, and it seemed to be more important at that time when we had changed it to an estate character.

Mr. BAKER. I think the objective in suggesting it at that time was to eliminate very serious burdens that flow out of the payment of a large sum of money promptly, and that that same burden would be true in the case of an estate, as well as inheritance tax. The matter is one of payment and collection rather than the character of the tax, so that if it was of use in connection with the payment of inheritance taxes, it would be equally useful here; in fact, the bill at that time with respect to inheritance tax liability was one which did impose upon the executor or others having the responsibility of paying the taxes the duty of satisfying the Federal liability, and that is true at the present time of the estate tax levy.

The executors and administrators of an estate must meet that liability, and they are under personal obligation to see that it is done.

The present use of the money under this amendment is accomplished by providing that insurance money shall be paid immediately and directly to the Treasurer of the United States who will hold the money from the time it is paid to him by the insurance company without interest being paid, down to the arrival of the time when the tax liability is satisfied. When the tax liability is satisfied, the amount remaining which was not required to pay the tax, would then be paid over to the executors for the estate, but the entire sum during the interval that it is held by the Treasurer of the United States, would be in his hands without the payment of interest, and we all feel who have studied this question that the amount that would be so paid into the Treasury would in many instances be considerably in excess of the amount of the eventual tax, so that the matter has some bearing on the immediate need of the Government for revenue.

Senator COUZENS. There is no change in this respect in the existing law and in the bill as it passed the House, is there?

Mr. BAKER. In the bill as it passed the House there is no provision made for an exemption of this character.

Senator COUZENS. No; but what I mean is, there is no change over the old law?

Mr. BAKER. No; there is no change at all.

Senator COUZENS. So that you are proposing something entirely new?

Mr. BAKER. We are proposing something new but something which we believe is entirely within the spirit of the President's suggestion that he wants to have the Government get all of its revenues immediately and not have them deferred. That is the justification for our being here, that we believe our suggestion is a constructive one for the immediate emergency of putting the money into the Treasury, rather than having it delayed for 2 or 3 years while the estates of decedents are administered and other problems are settled before the tax liability can be determined and paid.

Obviously there would be no object in any prospective decedent providing for his estate liabilities to be satisfied in this way, so far as the Federal Government was concerned, unless there was some inducement to do so. The inducement as we see it is that the present "repression", as Mr. Osgood calls it, should be removed; in other words, he should not be penalized by having additional insurance included in his estate when he is taking that insurance out for the purpose of accomplishing the payment of his tax.

Furthermore, if in addition to having that repression removed he is encouraged to take out the additional insurance or to transfer the beneficial interest in existing policies so that the Government will become the payee of those policies instead of some other person or beneficiary, there will be some relief and should be some relief granted from the additional tax caused thereby.

Now, we are not asking that the entire amount of the policy be excluded; we are asking only that the tax be computed in such a way that a burden of taxation will not be imposed on that part of the insurance money which eventually is found to be the amount that is payable in taxes out of the proceeds of the policy.

There are some other considerations with respect to the effect on the revenue that I should urge you to consider most carefully. Those are chiefly that under the present administration of the estate-tax law, there is a terrific loss taken in the case of closely held and small estates, because they have to liquidate closely held property, real estate, machinery and equipment, and in some cases stock of small corporations so as to realize the immediate cash that it is necessary to put into the estate to pay the taxes. Your present scheme of valuation is such that executors or representatives of the decedent have the opportunity of electing the valuation date, and they can value either as of the date of death or at a time 1 year later.

Obviously, in order to raise the taxes to meet the liability, it is necessary to liquidate frozen assets of the estate; the executors and administrators will take the valuation at a time 1 year later rather than the date of death, and the value will be based on the sale price, which will be a sacrifice price, and the amount of the gross estate will be very much reduced. In addition to reducing the gross estate by reason of the sacrifice of the property during the period of 1 year, we have the difficulty that the expenses of the administration of the estate are very much increased. Those expenses would include not only the cost of selling the property and liquidating expenses, but commissions to real-estate agents and others for selling the property, and commissions of executors in the case of real estate, which in most instances would pass to the beneficiaries of an estate without going into the hands of the executors, from the standpoint of computation of executors' commissions.

All of these charges are now deductions as expenses of administration of an estate. The more we can reduce the expense of administering an estate the more we reduce the amount of the deductions, so that if this proposal will build up—and we believe it will build up—the size of the gross estate and will diminish the amount of the reduction in the gross estate it will result in a larger net estate, which, when the tax be imposed, of course, will fall in the higher brackets and yield a substantial amount of revenue, in fact, we believe an amount of revenue which will clearly offset any loss that it might be suggested would arise out of the exemption as such.

A further, and almost more important, inducement than any other is that the orderly administration of the estate with the least loss will be greatly expedited, so that the property and the assets of an estate will not remain unduly long in the hands of the executors or administrators, but the liabilities will be promptly satisfied and creditors will be paid. Among the creditors who are most important are the States themselves. The Federal Government has been criticized repeatedly for invading this field with a Federal estate tax. It is thought by many that the State governments should have the field to themselves. Here is a situation in which the State governments will be able to collect their revenue at a very much earlier date and will have less cause to call on the Federal Government for support. Anything that expedites the settlement of a Federal estate tax liability will expedite the payment of the preferred claim of the Government and will then leave the States themselves in a position to collect their revenue promptly.

Thank you very much.

BRIEF OF LAWRENCE A. BAKER, REPRESENTING AS SPECIAL TAX COUNSEL, THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, NEW YORK, N. Y.

That there may be no misunderstanding of the purpose of my appearance here, I would like to state at the outset that I am speaking solely in the interests of life-insurance-policy holders and appearing solely at the request of the National Association of Life Underwriters, an association of life-insurance fieldmen who are in daily touch with policyholders and who are aware of their interest in this question. I do not appear at the request of the life-insurance companies nor is any statement that I will make made at their request or in their behalf.

This statement and my representations on behalf of the National Association of Life Underwriters are consistent with the object of the President as disclosed in his message and the statements of your committee through its chairman that a bill must be reported and passed which will add substantially to the present revenues of the Government. We aim to be both constructive and helpful.

When the Committee on Finance of the United States Senate was holding hearings on the revenue bill of 1935, the suggestion was made that individuals should be encouraged to make special provision through insurance on their lives to provide means to pay taxes arising out of the transfer of their estates, and in particular that such provision should be encouraged by exempting from death duties the amount of insurance earmarked and actually used for this purpose. Accepting this suggestion, the Senate adopted an amendment offered by Senator Lonergan excluding from gross estate the proceeds of life-insurance policies to the extent that such proceeds would be actually used in the payment of death duties.

The bill as reported by the conference committee of the Senate and the House did not contain the amendment, and the explanation was then made that the amendment had been stricken, not for lack of merit, but because it was believed that the subject matter thereof should receive further study.

Accordingly, the association which I represent continued its interest in the proposal, and, with the aid of technical experts, has drafted a proposed amendment which it is believed will accomplish the general purpose desired.

TEXT OF PROPOSED AMENDMENT

Section 401 (c) of the Revenue Act of 1932, as amended, is amended to read as follows:

"(c) For the purpose of this section the value of the net estate shall be determined as provided in title III of the Revenue Act of 1926, as amended, except that (1) in lieu of the exemption of $100,000 provided in section 303 (a) (4) of such act, the exemption shall be $40,000; and (2) there shall be deducted from the value of the net estate as thus determined the proceeds of life-insurance policies payable to (and received) by the Treasurer of the United States in trust for the payment of estate, inheritance, succession, legacy, or other death duties levied by the United States against or with respect to the estate of the decedent, exclusive of any excess over the amount of such taxes, which excess shall be accounted for (without interest) to the executor or administrator of the decedent for the benefit of the persons entitled thereto: *Provided, however,* That the proceeds of policies on which the premium-paying period is less than 10 years shall not be deductible and that, in any event, the amount deductible as aforesaid shall not exceed $1,000,000."

We present the foregoing proposed amendment, with full confidence that careful analysis from an economic and technical standpoint will disclose that the proposal will assure and facilitate the immediate revenue objectives of the President and the Congress.

HOW IT WOULD WORK

Adoption of the amendment will mean that any individual having a taxable estate who makes the proceeds of insurance policies on his life payable to the Treasurer of the United States in trust for payment of death duties will set up a situation such that immediately upon his death the Treasurer will receive from the insurance company the entire proceeds of the policy so payable with the privilege of holding such proceeds without interest for payment of such amount in death duties as may then be due.

Take the case of a man whose net worth (after all permissible deductions) is $500,000. Suppose he has life insurance amounting to $150,000, all of which he makes payable to the Treasurer of the United States under and in accordance with the proposed amendment. The amendment would not exempt this in-

surance in its entirety; the exemption is limited to such amount as is necessary to cover the tax liability of the estate, any balance over and above that amount being taxable as heretofore. As the tax in this case would be $100,894, only that much of the insurance would be exempt. The balance of the insurance, amounting to $49,106, would be included in the taxable estate, accounting for $11,294 of the total tax due.

CONTRAST WITH PRESENT LAW

As the law now stands life insurance taken out to pay these taxes is itself taxable; it is included in the taxable estate, with the result that the tax burden is sharply increased—the reward of prudent forethought is the imposition of an additional levy.

Take, for example, the case of a man worth $500,000. The Federal estate-tax liability on a net estate of that size is $89,600. Suppose he takes out that much insurance in order to avoid a forced sale of his business. What is the result? His taxable estate will be not $500,000 but $589,600; and, in consequence, the tax liability will jump from $89,600 to $110,208, an increase of $20,608, or 23 percent. So the effective amount of his insurance is cut down to $68,992, although he must pay for $89,600—all because he wants the Government to get its money without fruitless hardship to his survivors.

If, undaunted, he sets out to obtain sufficient insurance to pay the whole tax in full (including the tax on the insurance) he must secure a policy for $117,027, on which the premium at age 50, is approximately $4,600, or about one-fifth, of the earning power of his entire estate at 5 percent.

Corresponding results for estates of various amounts are indicated in the table appended to this memorandum.

FOREIGN EXPERIENCE

All but two of the Canadian Provinces allow an exemption such as that provided by the proposed amendment and recent extension of this method of collection in the Provinces sufficiently shows that the method is favorably regarded. (See appendix to statement of Roy C. Osgood, hearings before the Committee on Finance of the U. S. Senate, Revenue Act of 1935, p. 298.)

EFFECT ON THE REVENUE

1. From the point of view of the Federal revenues the great advantage of the proposal lies in the fact that it would assure prompt payment, in full, of many assessments which must now be written off in whole or in part (due to posthumous depreciation or dissipation of assets, etc.) or collected only after numerous extensions.

In fact, it would assure payment in advance since the estate tax is not due until 15 months after death. In the interim the Government would have the use of the money without interest.

Avoidance of liquidation, especially in the cases of estates which hold stock in relatively small, closely held corporations and estates composed chiefly of real estate will substantially increase the value of the net estate subject to tax. This would be due, first, to the fact that sacrifice of property at forced sale within a year after death of the decedent would result in the inclusion of lower valuation in the gross estate; and secondly, because additional selling expense, attorneys' fees and executors' commissions would increase the deductions for these items in the administration of the estate and thereby reduce the net estate subject to tax. Increasing the gross estate and decreasing the deductions will add substantially to the net estate taxable in the top brackets.

2. From the point of view of the taxpayer the advantages are obvious. The proposal would afford an opportunity to provide against necessitous liquidation to cover Federal death duties and the disastrous consequences thereof, including unwarranted losses in property values, destruction of going concerns, interminable delays, and excessive costs in administration.

3. The public generally would likewise benefit from the proposed amendment since forced liquidation depresses values, disturbs business and causes unemployment. To collect the revenues without preventable economic disturbances is plain common sense. The interest of the community is thereby served as well as that of the Government and the taxpayer.

4. That the proposed amendment would be welcomed by a great many people is quite apparent, and it is difficult to see how any one could be hurt by it. On the contrary, it would ease the shock of the higher taxes in the lower brackets which appear to be inevitable.

5. All States imposing death duties are interested in collection thereof as promptly as may be possible after the death of a decedent. The Federal Government is vitally interested in furthering this objective, and any action which will expedite the prompt and full payment of the preferred claim of the United States will at the same time aid in collection by the States and preserve for other creditors and beneficiaries the values of the assets upon the transfer of which the State imposes its tax.

To sum up, the proposed amendment is neither novel nor untried; it is fair to all concerned; it is practical; it would not only facilitate administration of the revenue laws, including collection of taxes, but, at the same time, would prevent burdensome and unpecessary hardships, and promote economic stability.

It is respectfully submitted, therefore, that the proposal deserves favorable consideration.

Table showing effect of attempts to pay estate taxes with insurance under present law

(1) Net worth	(2) Tax on (1)	(3) Tax with insurance equal to (2)	(4) Increase in tax due to same (3)−(2)	(5) Effective insurance (2)−(4)	(6) Insurance required to pay whole tax including tax on insurance
$100,000	$8,600	$11,232	$1,632 (17 percent)	$7,968	$11,566
250,000	35,600	43,920	7,320 (20 percent)	29,280	45,750
500,000	89,600	110,208	20,608 (22 percent)	68,992	117,027
750,000	151,600	193,890	42,290 (28 percent)	109,710	211,408
1,000,000	222,600	293,832	71,232 (32 percent)	151,568	327,153

The CHAIRMAN. The next witness is V. H. Stempf.

STATEMENT OF VICTOR H. STEMPF, NEW YORK CITY, REPRESENTING COMMITTEE ON FEDERAL TAXATION, AMERICAN INSTITUTE OF ACCOUNTANTS

Mr. STEMPF. Mr. Chairman, my name is Victor H. Stempf, a resident of Larchmont, N. Y. I am a certified public accountant, a partner of Touche, Niven & Co., of New York City. I am appearing as chairman of the committee on Federal taxation of the American Institute of Accountants, my associates on the committee being Dr. Joseph J. Klein, C. P. A., of New York, and Mr. Clarence L. Turner, C. P. A., of Philadelphia.

This committee has no authority to speak for the members of the institute upon social or political questions. Therefore, my remarks and the memorandum which I shall ask to file on behalf of the institute will deal with questions of an accounting nature raised by the income-tax phases of the bill.

Our memorandum assumes that, after the utmost degree of economy has been attained—in the light of existing commitments—there remains an urgent need for immediate additional revenue.

We have certain recommendations to offer which repeat, fundamentally, proposals which you have received from other sources in respect of the retention of the present form of corporate income tax and the modification of the proposed taxation of undistributed income, but in more simple and specific form we believe; avoiding the entanglements inherent in the House bill and many of these proposals.

Our memorandum questions the advisability of abandoning the reliable revenue and the reliable method of taxing corporate income

which has taken more than 20 years to develop to a reasonably fixed or determinable basis.

We do not believe it sound to substitute a new and involved system of taxation which presents a new field of uncertainties in corporate accounting and finance, in respect of which the potential yield is, in our opinion, conjectural.

Our memorandum reviews a number of the objections which have been raised to the provisions of the proposed law, and states the grounds upon which, in our opinion as accountants, the objections cited are valid.

We revive consideration of certain historical changes in the Federal income-tax law and propose the restoration of several provisions which have been abandoned.

Our memorandum includes the solution of a hypotehtical tax calculation in a relatively plain case which, in our opinion, demonstrates the complexity of the computations required to determine the tax liability under the proposed law.

We take the liberty of emphasizing the fact that the present method of taxing income involves the application of fixed rates to fixed or determined bases, whereas the form of taxation of undistributed income proposed in the House bill entails the application of variable rates to variable bases. Therein lies the difference between the relative simplicity of the existing method and the intricacies of the proposed method. Broadly speaking, any basis of taxing undistributed income which necessitates (*a*) the calculation of the relationship between undistributed income and total adjusted net income and (*b*) the application of varying rates dependent upon such relationship must of necessity demand involved phraseology to express, and require a sequence of mathematical calculations to apply. If simplicity be sought, such relationships may be avoided.

Our recommendations contemplate a further exhaustive research into the statistical data available to the Treasury Department from which revised conclusions may be drawn in respect to the potential yield of the available sources of revenue. The recommendations are five in number:

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

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

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

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

(5) As an alternative proposal respecting taxation of undistributed income, and as an incentive to increased dividends, the following method should be considered: In conjunction with a higher corporate income tax rate (applied directly to the fixed or determinable base of "adjusted net income" as heretofore) a "drawback" at a fixed

rate (applied directly to the amount of dividends paid during the taxable year) may be allowed as a credit against the corporate income tax. This basis also avoids the mathematical complications of a variable rate on a variable base. It would seem logical that the larger the rate of "drawback" the greater would be the incentive to increased distributions of dividends (within the limits of sound financial practice) resulting in a greater yield from the surtax on individual incomes.

In conclusion, permit me to add that the institute would welcome the opportunity to assist your committee or its technical advisers in the further consideration of the accounting aspects of the proposed bill or any amendments thereof.

Mr. Chairman, and gentlemen, I thank you for your courtesy, and I request the privilege of filing with you the committee's detailed memorandum, which you and your technical assistants may peruse at your leisure.

Senator GEORGE (presiding). Your brief will be entered in the record.

(The brief referred to is as follows:)

MEMORANDUM BY THE COMMITTEE ON FEDERAL TAXATION OF THE AMERICAN INSTITUTE OF ACCOUNTANTS, NEW YORK CITY

The Committee on Federal Taxation of the American Institute of Accountants has no authority to speak for the members of the Institute upon social or political questions, and this memorandum, therefore, will deal solely with questions of an accounting nature raised by the proposals.

(1) Analysis of the statement submitted by the Treasury in support of the bill leads the committee, as accountants, to question the validity of the estimate of increase in revenue made by the Treasury. The formal statement submitted by the Treasury in support of the proposal reads as follows:

"ESTIMATED REVENUE UNDER PROPOSAL TO TAX UNDISTRIBUTED CORPORATE PROFITS (HEARINGS, P. 35).

"It is estimated that if a tax on undistributed corporate profits were imposed, accompanied by the repeal of the present corporate income, capital stock, and excess-profits taxes, and the elimination of the present exemption of dividends from normal tax, the net increase in revenue based on calendar year 1936 incomes would be about $620,000,000. The following table summarizes the basic data underlying this estimated increase:

Estimate of taxable base and revenue, calendar year 1936—Corporations showing net income. (Hearings, p. 36.)

[In millions of dollars]

1. Statutory net income	7,200
2. Taxes included in (1) to be repealed:	
Capital-stock tax	[1] 103
Excess-profits tax	5
3. Dividends received not included in (1), 90 percent of total dividends received	1,000
4. Aggregate taxable income	8,308
5. Cash dividends paid	3,540
6. Withheld earnings, (4) less (5)	4,768
7. Estimated tax on (6), assuming distribution to individuals, plus normal tax on present dividends	1,752
8. Loss in revenue from repeal of corporate-income, capital-stock, and excess-profits taxes	1,132
9. Net increase in revenue.	

[1] Total estimated capital-stock tax of both net income and deficit corporations, $183,000,000.

Corporate statutory net income and dividend distribution

[In thousands of dollars]

Years	Statutory net income	Total cash dividends paid, all corporations	Dividends received, all corporations	Net cash dividends paid, all corporations	Total cash dividends paid by corporations showing net income	Net cash dividends paid by net income[1] corporations
1923	$8,321,529	$4,169,118	$870,068	$3,299,030	$3,820,620	.....
1924	7,584,652	4,238,823	918,216	3,423,607	3,924,991	.....
1925	9,583,684	5,189,476	1,173,481	4,013,994	4,817,801	.....
1926	9,672,403	5,944,293	1,506,154	4,439,139	5,330,211	.....
1927	8,981,884	6,422,176	1,636,076	4,785,100	5,785,476	.....
1928	10,617,741	7,078,723	1,914,671	5,137,052	6,585,189	.....
1929	11,633,886	8,355,662	2,893,052	5,762,610	7,841,802	.....
1930	6,428,813	8,202,841	2,871,231	5,631,010	6,841,050	.....
1931	3,653,363	6,161,082	1,969,229	4,191,853	5,871,880	$2,640,000
1932	2,153,113	3,883,601	1,259,962	2,623,619	3,720,385	1,570,000
1933	2,985,972	3,127,459	1,023,709	2,101,750	3,385,889	1,800,000
1934[1]	4,220,000	3,300,000	1,025,000	2,275,000	3,540,000	1,750,000
1935[1]	5,500,000	3,600,000	1,120,000	2,480,000	3,930,000	2,090,000
1936[1]	7,300,000	3,900,000	1,200,000	2,700,000	3,540,000	2,430,000

[1] Estimated.

It is not clear whether the table here reproduced is intended to represent what is to be expected in a typical year, or whether it represents what is to be expected under the special circumstances of the year 1936. Since the President in his message spoke of the need "to raise by some form of permanent taxation an annual amount of $620,000,000", and said, further, that the proposals could "be put into practice so as to yield the full amount of $620,000,000", it seems proper to regard the Treasury statement as to the estimate for a typical year, based on the assumption that in that typical year taxable net income as measured under the present statute would be $7,200,000,000.

The estimate contemplates that under the proposed law a complete distribution of corporate income will take place, or that, alternatively, taxation on any amount undistributed will yield at least as much as would be paid by individuals if those amounts were distributed. The main source of increased taxation relied upon is an increase of dividend distributions to individuals over that which would otherwise take place. It follows that the validity of the computation of the fiscal results turns mainly on the fairness and the comparability of the estimate of the amounts that would be distributed under the law as it now stands, and under the proposed law respectively.

With the proposal, the Treasury submitted a table showing corporate net income and dividends (actual or estimated) over a period of 14 years. Examination of that table shows that in the years for which actual or approximate figures are available the percentage of dividends paid to aggregate taxable income was in every case higher than the percentage assumed for 1936. Over the last 10 years, the average percentage of distribution, according to the Treasury's method of computation, was slightly less than 59 percent of aggregate taxable income as compared with rather less than 43 percent assumed for 1936 or the typical year. If the estimates of distribution under existing law in the typical year were raised to 59 percent, the estimated cash dividends would be increased and the distributions attributable to the new proposals decreased by about $1,300,000,000. Such a revision would gravely affect the estimate of revenue increase to be produced by the proposed law as given on line 9 of the table.

If the table is regarded as an estimate of the effect of the proposed change not in a typical year but on the actual revenues to be received in 1937 on the basis of taxable income for 1936, the criticism takes a different form. Even on that basis it would seem that the estimate of cash dividends to be paid under the existing law is too low, and the estimate of gain in taxation from the new proposals correspondingly overstated.

(11) A further important question, however, arises from the nature of corporate dividend practice in general. Normally, the corporate income of a year is distributed partly within that year and partly in the early months of the succeeding year, and the bill as originally drafted recognized this practice and levied the tax accordingly. The practice is world-wide and financially sound, and students of

taxation have regarded it as fiscally desirable in that it tended to smooth out the extreme fluctuations in the yield from the income tax, which constitutes perhaps the most serious objection to that form of taxation. It is now conceded by the Treasury that unless this practice is changed the estimate now under consideration could not be expected to be realized in 1937, and a late amendment in the House limits the credits for dividend distribution to the amount actually distributed within the taxable year. While this amendment may make good an obvious defect in the estimate, it seems to us calculated at best to secure a temporary advantage at the expense of practicability, sound financial procedure, and permanent fiscal advantage.

The provision regarding dividends, as it now stands, will make it incumbent upon management to estimate its earnings for the year, or at least for the last quarter, in order to determine the amount of dividend to be distributed within the taxable year. From an accounting standpoint this creates a far more vexing problem than is apparent and likewise imposes a financial dilemma which may, for example, involve corporate directors in accounting difficulties, one may exemplify the point by stating that in the great majority of businesses the ascertainment of earnings depends vitally upon the fair determination of the amount of inventories at the close of the year.

Such determination cannot be made in the average case (even upon the basis of perpetual inventory records) until after the close of the year. Similarly, the audit and adjustment of liabilities, accruals, and reserves have a material bearing upon earnings. This adjustment likewise cannot be made until after the close of the year. To ignore factors such as these is contrary to the tenets of sound management.

(III) In the table presented by the Treasury which we have quoted, an amount is shown on line 6, "Withheld earnings (4) less (5) . . . 4,768 (million dollars)." The way in which this figure is arrived at is quite clear, but the description of that amount as "withheld earnings" seems to us to be open to grave criticism. It is difficult to conceive of any sense in which the expression could be used and rightfully applied to the figure in question. The natural interpretation is that under the existing law $4,768,000,000 of income available for distribution to stockholders would be withheld from distribution; but quite apart from the question we have raised as to the correctness of the assumption on which this figure is based it is clear upon the face of the table that on the assumed figures and under the existing law approximately $1,100,000,000 of this amount would be paid to the Government in taxes and could not be paid to stockholders as dividends.

It is evident from the President's message that he fell into this natural interpretation—otherwise, he could not have made the statement which appears on page 3 of the hearings: "Thus the Treasury estimates that, during the calendar year 1936, over 4½ billion dollars of corporate income will be withheld from stockholders." It seems to this committee a matter for regret that the Treasury should have put out statements open to such a natural but incorrect interpretation and as a result should have put the President in the position of creating a clearly unfounded impression on a matter of so much importance.

(IV) The hearings indicate that the Treasury has given considerable thought to the tendency of the proposals to lead to increased holdings of tax-exempt bonds by wealthy individuals. It is not clear that the Treasury has made adequate allowance for the effect of the proposal in the form of increased holdings by charitable institutions of corporate stocks which to them would, under the proposals, be completely tax exempt.

(V) As accountants, the members of the committee are keenly alive to the multiplicity of cases of individual injustice which result from frequent changes either in the scheme or scale of income taxation. The committee believes that radical changes should be made only after the most careful consideration. Examination of the record does not indicate that such consideration has already been given to the present proposals. In the course of the House hearings, it was stated by the general counsel of the Treasury that opinions on the measure from competent persons outside the Government had not been sought (p. 610), and the many changes which have been found necessary since the proposals were first put forward suggest that many practical aspects of the question had not been appreciated by the proponents.

The exceptions which have been introduced into the proposed act are an acknowledgement of circumstances under which the contemplated legislation may work undue hardship and injustice, but these are the more obvious exceptions relative to deficits, contracts not to pay dividends, debt-ridden corporations,

etc. Undoubtedly, there are many other situations in which injustice may be done, which may be disclosed only by deliberate research.

This committee believes it unsound to jeopardize the future of the great number of medium-sized corporations which are struggling back to sound financial condition by relieving corporations of the present tax on income to the extent distributed, and substituting a new basis of taxation, at high rates, which must contain, inevitably, a new field of accounting difficulties and complexities of corporate finance. The present method, involving the direct application of stated rates of tax on corporate income has taken more than 20 years to evolve a reasonably fixed or determinable basis, in which there remain present many differences between taxable net income on the one hand and corporate net income determined on the basis of recognized, sound-accounting principles on the other hand. These differences inject uncertainties into the conduct of corporate business, which plague management, cumulatively, for periods of 2 or 3 years, or more, in respect of the Federal income tax liability relative to each fiscal year; but within fairly certain minimum and maximum limits of amount in the light of precedent established by decisions of the courts, Board of Tax Appeals, etc.

The proposed legislation will magnify the uncertainties of corporate accounting and finance by adding other unkown quantities to the equation pursuant to which the tax is determinable, for example, the final determination of "adjusted net income" will have a vital bearing upon the amount of surplus available for distribution and, similarly, a vital bearing upon the amount of dividends, to be distributed to minimize the tax on undistributed income. Subsequent revision of adjusted net income by the Treasury Department may have a fatal effect upon the financial condition of a corporation by reason of irrevocable actions, in respect of dividends or otherwise, taken by the management on the basis of "adjusted net income" originally determined in good faith. Furthermore, section 14 of the proposed act provides an alternative tax in cases where the accumulated earnings and profits are less than the adjusted net income, that is, cases in which a corporate deficit is involved. The act does not define "accumulated earnings and profits." Does it contemplate deficits determined on the basis of recognized accounting principles, or a statutory deficit representing an accumulation of "adjusted net income (or loss)" after giving effect to statutory dividends? Does such statutory surplus or deficit have to be reconstructed from March 1, 1913? Section 16 provides "relief" relative to the excess of "debts" over "accumulated earnings or profits." If the latter is a deficit, does the act contemplate the addition of such deficit to the "debts" to determine the "debt excess"? These factors are indicative of the character of the uncertainties which will arise to complicate the determination of tax liability.

(VI) From the accounting standpoint there is an objection to the bill in that it will tend to increase greatly the importance of allocation of profits to particular years. Under the existing law, considerable injustice results from readjustment by the Treasury of allocations made in good faith by the taxpayer. Up to now, this injustice had been felt mainly in the field of individual incomes; in the case of corporations, with the rate of tax fairly stable, the cases of major injustice have been limited to those in which the Treasury made reallocations which decreased the taxable income of a year in respect of which recovery of the tax was barred by statute, and increased that of a year in respect of which collection could still be made. With a steeply graduated tax, measured not by the full amount of the income but by the residuum undistributed, the importance of reallocations and the probabilities of injustice arising therefrom will be greatly increased.

As examples of items of income or expense, the allocation of which is frequently challenged by the Treasury Department, there may be cited income which has been the subject of litigation, losses from bad debts or worthless investments, depreciation, additional assessments of State franchise taxes, claims paid as a result of litigation, and so forth.

If the form of taxation of undistributed income proposed in the House bill be enacted, we urge that some provision be made whereby the uncertainties relative to reallocation of income between years be alleviated.

(VII) The existence of serious abuses through personal holding companies is recognized, but we believe it should be possible to deal with that specific evil otherwise than by measures which would apply equally to corporations in respect of which no similar abuse exists. Section 102 of the proposed Act extends to stockholders of personal holding companies the right to elect to have their entire pro rata shares, whether distributed or not, of the retained corporate net income for the taxable year, included in their personal taxable net income as if such income had been distributed. Such personal holding companies were covered by

section 351 of the 1934 Revenue Act. Section 102 of that act did not include personal holding companies, but related to all corporations "improperly accumulating surplus" and extended to all such corporations the right of electing to have such income taxed as if distributed, whereas the proposed act, as stated above, limits this right to personal holding companies and to the other special classes of corporations mentioned in section 102 (a). We recommend that this right be extended to any and all corporations wishing to avail themselves of the privilege.

(VIII) Until the enactment of the National Industrial Recovery Act in 1933, the Federal income tax laws provided for the carrying forward of net losses. The repeal of the "carry-forward" provision was, in our opinion, ill advised, in that it taxed income which was sorely needed to rehabilitate the finances of corporations which had suffered serious losses in prior years and which were least able to pay taxes. We advocate the restoration of the carry-over of net losses. Moreover, as it usually takes corporations several years to recover from the effects of a series of unprofitable years, or even from one very bad year, it is suggested that provision be made to carry forward net losses for a period of say 5 years.

(IX) It has been stated that the advocates of taxation of undistributed income approached the subject with the conviction that this form of tax would answer a long-felt need for simplification of the tax structure. It is quite evident from an examination of the provisions of the proposed law that simplification has not been attained or even approached. The lengthy and involved calculations necessary to determine what the tax under the Revenue Act of 1936 will be and what dividends may be declared, even in plain cases, are illustrated by the following problem: Corporation A had a deficit of $15,000 and admissible debts totaling $60,000 at December 31, 1935. Its adjusted net income for the calendar year 1936 amounted to $35,000. The directors decided that the debt excess should be amortized over the 5 years commencing January 1, 1936. Compute the tax payable (*a*) if no dividend distribution is made, (*b*) if a dividend of $10,500 is distributed in the year 1936.

It will be observed that the above problem is about as simple as could have been selected. All amounts are in round numbers, the deficit is predetermined, the dividend is exactly 30 percent of the net income and there are no such complications as foreign tax credit in respect of which the taxpayers have an option which must be exercised before filing a return and the selection of one or other of the alternatives might materially alter the situation.

As differences between taxable income and book income have existed under prior revenue acts, no such differences have been introduced in this example although they would affect the computation of tax under section 14(a). Also, as the corporation's adjusted net income is over $10,000 and under $40,000 and as it had both a deficit and a debt excess at December 31, 1935, four computations of tax have to be made under both (a) and (b) to determine which method is applicable.

The computations of tax under section 13 (schedules II–A and III), section 14(a) and section 16(b), where there is no dividend distribution, are as follows:

I. Tax computed under schedule II–A:

Rate of tax, per schedule II–A for no dividend distributions, 42½ percent		
Tax on adjusted net income of $35,000 at 42½ percent		$14,875.00

II. Tax computed under schedule III:

(A) Computation of tax under schedule I:		
Adjusted net income	$35,000.00	
Less tax thereon under schedule II–A, as above	14,875.00	
Undistributed net income	20,125.00	
Percentage of undistributed to adjusted net income—percent	57.5	
Applicable tax rate, per schedule (7.5 55/100 × (57.5—30))—percent	22.625	
Tax on $35,000 at 22.625 percent		7,918.75
(B) Computation of tax under schedule II:		
Adjusted net income in excess of $10,000	$25,000.00	
Tax at 42½ percent (rate determined under schedule II–A)		10,625.00
Total tax under schedule III		18,543.75

III. Tax computed under sec. 14 (a):			
(1) Tax under sec. 14 (a) (1): Adjusted net income		$35,000.00	
Less surplus (before taxes) at Dec. 31, 1936		20,000.00	
Total		15,000.00	
Tax thereon at 15 percent			$2,250.00
(2) Tax under sec. 14 (a) (2):			
Adjusted net income		35,000.00	
Less:			
Portion of adjusted net income taxed in 14 (a) (1)	$15,000		
Tax computed under sec. 14 (a) (1)	2,250		
		17,250.00	
Adjusted net income for computation of tax		17,750.00	
(a) Computation of tax under schedule II-A:			
Tax at 42½ percent (rate applicable when no dividends paid)		7,543.75	
(b) Computation of tax under schedule III:			
(A) Computation of tax under schedule I:			
Adjusted net income, above		17,750.00	
Less tax thereon under schedule II-A, above		7,543.75	
Undistributed net income		10,206.25	
Percentage of undistributed to adjusted net income...percent		57.5	
Applicable tax rates, per schedule I (7.5 55/100 x (57.5—30)).percent		22.625	
Tax on 17,750 at 22.625 percent		4,015.94	
(B) Computation of tax under schedule II:			
Adjusted net income in excess of 10,000	$7,750.00		
Tax thereon at 42½ percent (rate determined under schedule II-A)		3,293.75	
Total		7,309.69	
Applicable tax under sec. 14 (a) (2) the lower of (a) or (b)			7,309.69
Total tax under sec. 14 (a)			9,559.69
IV. Tax computed under sec. 16 (b):[1]			
(1) Tax under sec. 16 (b) (1):			
Admissible debt at Dec. 31, 1935		$60,000.00	
Surplus at Dec. 31, 1935		(2)	
Debt excess		60,000.00	
Tax at 22½ percent on one-fifth thereof ($12,000)			2,700.00
(2) Tax under sec. 16 (b) (2):			
Adjusted net income		$35,000.00	
Less:			
Portion of adjusted net income taxed in 16 (b) (1)	$12,000.00		
Tax computed under sec. 16 (b) (1)	2,700.00		
		14,700.00	
Adjusted net income for computation of tax		20,300.00	
(a) Computation of tax under schedule II-A: Tax at 42½ percent (rate applicable when no dividend paid)		8,627.50	

[1] This calculation has been made on the assumption that a net deficit at Dec. 31, 1935, should not be added to the admissible debt to obtain the amount of debt excess.
[2] Deficit.

IV. Tax computed under sec. 16 (b)—Continued.

(b) Computation of tax under schedule III:

(A) Computation of tax under schedule I:		
Adjusted net income as above	$20,300.00	
Less tax thereon, under schedule LI-A, above	8,627.50	
Undistributed net income	11,672.50	
Percentage of undistributed to adjusted net income—percent	57.5	
Applicable tax rate, per schedule I (7.5 55/100×(57.5−30)) percent	22.625	
Tax on $20,300, at 22.625 percent		$4,592.88
(B) Computation of tax under schedule II:		
Adjusted net income in excess of $10,000	$10,300.00	
Tax thereon at 42½ percent (rate determined under schedule II-A)		4,377.50
Total		8,970.38
Applicable tax under sec. 16 (b) (2) the lower of (a) or (b)		$8,627.50
Total tax under sec. 16 (b)		11,327.50

SUMMARY

Tax computed under schedule II-A	14,875.00
Tax computed under schedule III	18,543.75
Tax computed under sec. 14 (a)	9,559.69
Tax computed under sec. 16 (b)	11,327.50

Under section 17, the applicable tax is, therefore, the tax computed under section 14 (a), $9,559.69.

The surplus of the corporation at December 31, 1936, would then amount to $10,440.31, as follows:

Net income for year 1936 (before tax)		$35,000.00
Less—		
Deficit at Dec. 31, 1935	$15,000.00	
Provision for tax on 1936 income	9,559.69	
		24,559.69
Surplus, Dec. 31, 1936		10,440.31

If the directors decide to pay a dividend of $10,500 in 1936, new computations, which are even more complicated than the first set, have to be made under the same four methods in order to determine the tax and whether the corporation will be in a position, after providing for taxes, to pay such dividend. The computations follow:

I. Tax computed under schedule II-A:

Adjusted net income	$35,000	
Dividend credit	10,500	
Percentage of dividend credit to adjusted net income—percent	30.0	
Rate of tax, per schedule II-A for above percentage of distribution—percent	27.5	
Tax on adjusted net income of $35,000 at 27½ percent		$9,625.00

II. Tax computed under schedule III:
(A) Computation of tax under schedule I:

Adjusted net income		$35,000.00	
Less:			
Dividend credit	$10,500.00		
Tax under schedule II-A as above	9,625.00		
		20,125.00	
Undistributed net income		14,875.00	
Percentage of undistributed to adjusted net income		percent 42.5	
Applicable tax rate, per schedule I (7.5 55/100 x (42.5−30))		percent 14.375	
Tax on $35,000 at 14.375 percent			$5,031.25
(B) Computation of tax under schedule II:			
Adjusted net income in excess of $10,000		$25,000.00	
Tax thereon at 27½ percent (rate determined under schedule II-A)			6,875.00
Total			11,906.25

III. Tax computed under sec. 14 (a):
(1) Tax under sec. 14 (a) (1):

Adjusted net income		$35,000.00	
Less surplus (before taxes and dividends) at Dec. 31, 1936		20,000.00	
Tax thereon, at 15 percent		15,000.00	2,250.00
(2) Tax under sec. 14 (a) (2):			
Adjusted net income		35,000.00	
Less: Portion of adjusted net income taxed in 14 (a) (1)	$15,000.00		
Tax computed under sec. 14 (a) (1)	2,250.00		
		17,250.00	
Adjusted net income for computation of tax		17,750.00	
(a) Computation of tax under schedule II-A:			
Adjusted net income	$17,750.00		
Dividend credit	10,500.00		
Percentage of dividend credit to adjusted net income—percent	59.1549		
Tax rate per schedule II-A (9¾ (71−59.1549)) —percent	13.4419		
Tax on adjusted net income of $17,750 at 13.4419 percent	2,385.94		
(b) Computation of tax under schedule III:			
(A) Computation of tax under schedule I:			
Adjusted net income, above	$17,750.00		
Less:			
Dividend credit $10,500.00			
Tax under schedule II-A 2,385.94			
	12,885.94		
Undistributed net income	4,864.06		
Percentage of undistributed to adjusted net income —percent	27.4032		
Applicable tax rate, per schedule I (3.5⅝ (27.4032−20)) —percent	6.4613		
tax on $17,750 at 6.4613 percent		1,146.88	

Tax computed under sec. 14 (a)—Continued.		
(b) Computation of tax under schedule III—Con.		
(B) Computation of tax under schedule II:		
Adjusted net income in excess of $10,000, $7,750; tax thereon, at 13.4419 percent (rate determined under schedule II-A)	$1,041.75	
Total	2,188.63	
Applicable tax under sec. 14 (a) (2) the lower of (a) or (b)		$2,188.63
Total		4,438.63
IV. Tax computed under sec. 16 (b): [1]		
(1) Tax under sec. 16 (b) (1):		
Admissible debt at Dec. 31, 1935	$60,000.00	
Surplus at Dec. 31, 1935	(2)	
"Debt excess"	60,000.00	
Tax at 22½ percent on one-fifth thereof ($12,000)		2,700.00
(2) Tax under sec. 16 (b) (2):		
Adjusted net income	$35,000.00	
Less:		
Portion of adjusted net income taxed in 16 (b) (1) $12,000.00		
Tax computed under sec. 16 (b) (1) 2,700.00		
	14,700.00	
Adjusted net income for computation of tax	20,300.00	
(a) Computation of tax under schedule II-A:		
Adjusted net income, as above $20,030.00		
Dividend credit 10,500.00		
Percentage of dividend credit to adjusted net income, percent 51.6241		
Tax rate, per schedule II-A (15½ (55-51.7241)) percent 16.638		
Tax on adjusted net income of $20,300 at 16.638 percent		3,377.51
(b) Computation of tax under schedule III:		
(A) Computation of tax under schedule I:		
Adjusted net income above $20,300.00		
Less:		
Dividend credit $10,500.00		
Tax under schedule II-A above 3,377.51		
	13,877.51	
Undistributed net income	6,422.49	
Percentage of undistributed to adjusted net income, percent 31.6379		
Applicable tax rate, per schedule I (7.5 55/100 31.6379−30) percent 8.4003		
Taxation on $20,300 at 8.4003 percent	1,705.36	

[1] Deficit.

[2] This calculation has been made on the assumption that a net deficit at Dec. 31, 1935, should not be added to the admissible debt to obtain the amount of debt excess.

IV. Tax computed under sec. 16 (b)—Continued.		
(B) Computation of tax under schedule II: Adjusted net income in excess of $10,000	$10,300	
Tax thereon at 16.638 percent (rate determined under schedule II-A)	$1,718.71	
Total	3,419.07	
Applicable tax under sec. 16 (b) (2) the lower of (a) or (b)		$3,377.51
Total		6,077.51

SUMMARY

Tax computed under schedule II-A	$9,625.00
Tax computed under schedule III	11,906.25
Tax computed under sec. 14 (a)	4,438.63
Tax computed under sec. 16 (b)	6,077.51

The applicable tax is, therefore, the tax computed under section 14 (a), $4,438.63.

The surplus of the corporation at December 31, 1936, would now amount to $5,061.37, as follows:

Net income for year 1936 (before tax)		$35,000.00
Less:		
Deficit at Dec. 31, 1935	$15,000.00	
Dividends paid	10,500.00	
Provision for tax on 1936 income	4,438.63	
		29,938.63
Surplus, Dec. 31, 1936		5,061.37

The proposed revenue act will also add to the work of the Bureau of Internal Revenue. If any adjustment is made upon examination of the return, the tax will have to be recomputed, and this involves the use of all four tables in order to ascertain which one of the tables will apply after making the recomputation.

(X) The committee recommends a further change in the provisions of section 115 (c) of the proposed law, to apply the "recognition percentages" to capital gains and losses alike. Under section 117 (a) of the existing law if a stockholder makes a sale or exchange of his stock in a corporation, and has held his stock more than a year, only a portion of the gain is taxable, the portion depending upon the length of time the stock is held. The same principle is applied when bonds are redeemed. However, under section 115 (c) if capital stock is retired, the gain to the stockholder is 100 percent taxable, regardless of how long the stock has been held. If the retirement of stock results in a loss to the stockholder only a portion of the loss is deductible, as in the case of a sale.

The proposed revenue act partially corrects this injustice by making the recognition percentages set forth in section 117 (a) applicable to certain gains on liquidation in additional to all losses. The gains to which the percentages apply are those realized in the case of amounts received under a plan to liquidate the corporations, provided that the plan specifies that the liquidation shall be completed within a certain period not exceeding 2 years from the close of the taxable year during which is made the first of the series of distributions. Thus the inconsistency in the treatment of gains and losses still remains in the case of partial liquidations or of complete liquidations which, under the liquidation plan, take more than 2 years to complete. There is no apparent reason why the same principle should not be applied to partial liquidations or liquidations which require more than 2 years to complete.

The report of the Committee on Ways and Means states that the present rule which requires a taxpayer in the case of a complete liquidation to be taxed on 100 percent of the gain is preventing liqidation of many corporations and that the change recommended in the House bill should therefore bring about a substantial increase in the revenue. It is equally true that the present rule is preventing the partial liquidation of many corporations, and a limitation on the taxable gain in the case of distributions in partial liquidation should likewise increase the revenue. The law already contains a provision to prevent abuses where the distributions have the effect of a dividend (sec. 115 (g)). It is particularly desirable that the

principle be extended at least to redemption of bonds. If the principle is to be confined to complete liquidation it seems essential that the 2-year period be extended to 5 years, since it is impossible to complete many liquidations in 2 years.

A further question arises in the case of corporations which may be the recipients of such distributions in liquidation. There is no apparent reason why the same "recognition percentages" should not be applied in the case of corporations.

(XI) As to affiliated companies, the committee recommends the restoration of consolidated returns. The Revenue Act of 1934 abolished the privilege granted to affiliated corporations to file consolidated income-tax returns, except as to railroad companies. Inasmuch as subsidiary companies are often organized merely in order to comply with the requirements of various State laws or to minimize risk in opening up new territory for the corporation's business, or a new line of business, it is erroneous to treat them as entities distinct from the parent corporation. For all practical purposes, they are branches or departments of one enterprise.

Therefore, when it was considering the Revenue Act of 1934, the one way to secure a correct statement of income from affiliated corporations is to require a consolidated return, with all intercompany transactions eliminated. This conforms to recognized, sound accounting practice. Otherwise, profits and losses may be shifted from one wholly owned subsidiary to another in such a manner that the Commissioner's power to reallocate income is ineffectual, and their separate statements of income do not present an accurate picture of the earnings of particular units. The administration of the income-tax law is simpler with the consolidated return, as it conforms to ordinary business practice, enables the Treasury to deal with a single taxpayer instead of many taxpayers, and eliminates the necessity for examining the bona fides of numerous intercompany transactions.

Likewise, from the standpoint of the taxpayers, in cases in which corporations follow the consistent practice of preparing consolidated financial statements, the preparation of related tax returns is simplified if done on a consolidated basis.

Accordingly, it is suggested that the privilege of filing consolidated returns be restored, with a differential in rate of tax of 1 or 2 percent on corporations availing themselves of this privilege.

(XII) The committee suggests that the provisions of section 117 (a) relative to "recognition percentages" of capital gains and losses be applied to individuals and corporations alike. It has been stated that one of the purposes of the proposed law is "to provide a fairer distribution of the tax load among all the beneficial owners of business profits, whether derived from unincorporated enterprises or from incorporated businesses." In harmony with this objective, the committee believes that equality of treatment should be accorded individuals and corporations relative to capital gains and losses, and to that end suggests that the "recognition percentages" prescribed in section 117 (a) of the proposed act be extended to corporations as well as to other taxpayers.

We direct attention particularly to certain accounting difficulties and attendant injustices which will arise out of the application of the proposed form of tax on undistributed income incident to the statutory limitation of $2,000 relative to capital losses in the case of a corporation. A simple example will demonstrate the subject.

If a moderate-sized corporation were to incur a capital loss of $22,000 (without offsetting gains) its surplus legally available for distribution will be reduced by that amount. However, its statutory adjusted net income will be reduced by only $2,000. As previously pointed out in this memorandum, the term "accumulated earnings and profits" has not been defined in this act, nor has the meaning of that term been established conclusively under prior acts. It is logical to assume that the term may mean an accumulation of "adjusted net income" rather than ordinary corporate surplus determined on the basis of recognized sound accounting principles. Therefore, its statutory "accumulated earnings and profits" may be reduced likewise by only $2,000. The difference of $20,000 may represent the difference between an ordinary corporate deficit determined on the basis of recognized sound accounting principles on the one hand, and from the standpoint of the tax on undistributed profits, an excess of "accumulated earnings and profits" over "adjusted net income" on the other hand; thus presenting a dilemma in which the corporation may not be able to distribute a dividend legally and yet may not come within the technical meaning of section 14 of the proposed act entitling it to the "relief" in respect of "accumulated earnings and profits less than adjusted net income" at the close of the taxable year.

The foregoing example raises the more serious consideration of whether the limitation of net capital losses to $2,000 should not be eliminated and, certainly, suggests the necessity for a conclusive definition of "accumulated earnings and profits" in the proposed act.

Prior to the enactment of the Revenue Act of 1932, capital gains and losses were treated alike. Since 1932, increasing limitations have been placed upon the deduction of capital losses, induced, no doubt, by the fact that falling security prices were enabling many taxpayers to reduce greatly, and sometimes offset altogether, their other taxable income. These limitations have been placed upon all capital losses, without regard to the obvious distinction between losses on securities which, as a matter of choice, may have been taken primarily to offset other taxable income and losses arising from the sale, out of business necessity, of other capital assets. The failure to differentiate between these two types of losses has been the cause of hardship in many cases. We recommend the removal of the provision limiting losses to $2,000. If, however, it is thought that the allowance of a deduction for all capital losses would be injudicious, provision should be made for the deduction of losses arising from the sale, out of business necessity, of capital assets other than securities.

(XIII) As to intercorporate dividends, the committee believes that the existing abuse, if any, should be dealt with otherwise than by measures which apply equally to corporations relative to which no similar abuse exists. Under section 13 of the proposed Revenue Act of 1936, the "adjusted net income" is reduced by the dividend credit provided in section 27 to determine the amount of "undistributed net income." In connection with the corporation credit for dividends paid, section 27 (j) (4) states that if 80 percent or more of the gross income of the corporation is derived from dividends, the credit for dividends paid to a corporation owing 50 percent or more of the stock of the paying corporation shall be allowed only to the extent that they are attributable (proportionately) to the gross income not derived from dividends.

This provision constitutes a drastic intensification of the provision of section 23 (p) of the Revenue Act of 1934, as amended, which, if enacted, will drive out of existence a form of intercorporate relationship used in many instances for the practical convenience of legitimate enterprises in the conduct of businesses involving Nation-wide operations. Such intermediate holding companies are often organized as a convenience to management in controlling the administration of subsidiaries (separately formed to comply with the requirements of varying State laws or to minimize the risk in developing new territories, etc.), all of which are in fact branches or departments of one enterprise. The taxable income of such groups is best determined on the basis of consolidated returns as stated in paragraph XI of this memorandum. Under provisions permitting consolidated returns such intercorporate dividends would not be taxable at all. This latter basis is in accord with recognized sound accounting principles.

(XIV) Our committee recommends the retention of the present form of corporate income tax, at higher rates if necessary; coupled with a modification of the proposed taxation of undistributed income. The committee questions the advisability of abandoning the existing form of corporate income tax which has taken more than 20 years to develop to a reasonably fixed or determinable basis, and considers the adoption of the proposed form of taxation premature, hazardous, and unduly complex. Summarizing briefly the reasons advanced in the foregoing paragraphs, it is believed—

(1) That the potential revenue to be derived from the proposed legislation is conjectural;

(2) That the objective of simplification has not been attained and that the provisions of the bill are, in fact, extremely complex;

(3) That the proposed form of taxing undistributed income will create a new field of problems of accounting and corporate finance which will aggravate the existing difficulties of determining the tax liability;

(4) That the administration of the act by the Bureau of Internal Revenue will be far more difficult than at present with attendant increased costs;

(5) That the proposed act will inflict undue hardship upon a large group of moderate-sized corporations having meager reserves, many of which are struggling to overcome the burden of accumulated deficits.

Assuming that, after the utmost degree of economy has been attained, there remains an urgent need for immediate additional revenue, the committee recommends:

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

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

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

(4) That the principle of taxing undistributed income be applied at a low rate on a fixed base, to avoid the complexities inherent in the House bill arising from the application of variable rates to variable bases. This may be accomplished by subjecting to this form of supertax the excess of "adjusted net income" over the sum of (a) the corporate-income tax on such income and (b) dividends paid during the taxable year.

(5) As an alternative proposal respecting taxation of undistributed income and as an incentive to increased dividends, the following method should be considered: In conjunction with a higher corporate income tax rate (applied directly to the fixed or determinable base of "adjusted net income" as heretofore) a "draw-back" at a fixed rate (applied directly to the amount of dividends paid during the taxable year) may be allowed as a credit against the corporate income tax. This basis also avoids the mathematical complications of a variable rate on a variable base. It would seem logical that the larger the rate of "draw-back" the greater would be the incentive to increased distribution of dividends (within the limits of sound financial practice) resulting in a greater yield from the surtax on individual incomes.

Respectfully submitted.

AMERICAN INSTITUTE OF ACCOUNTANTS,
COMMITTEE ON FEDERAL TAXATION,
VICTOR H. STEMPF, *Chairman*.

STATEMENT OF PAUL P. COHEN, NIAGARA FALLS, N. Y., REPRESENTING THE F. N. BURT CO., LTD., OF BUFFALO, N. Y., AND TORONTO, CANADA

Mr. COHEN. My name is Paul P. Cohen. I am a member of the firm of Franchot Runals Cohen Taylor & Rickert, attorneys at law of Niagara Falls, N. Y.

I am here on behalf of F. N. Burt Co., Ltd., a Canadian corporation that has its plant in the city of Buffalo, N. Y., and that transacts most of its business in the United States, and also on behalf of various Canadian investors in American securities. Before I have concluded, it may appear that I am really here on behalf of American investors in Canadian securities, and perhaps also here on behalf of the United States Treasury itself.

At the present time, Canada treats the income of Americans received from their investments in Canadian securities quite favorably. Since 1933 there has been a tax of 5 percent imposed upon dividends at the source. That tax, however, does not apply to dividends paid by Canadian subsidiaries to parent American companies who hold substantially all of the voting stock of the Canadian subsidiary. Of the total of $220,000,000 that American individuals and corporate investors in Canadian enterprises receive annually, only about one-quarter is actually subject to the 5-percent tax.

On the other hand, the income that Canadians receive from American investments is computed to amount to only $58,000,000, or just about a quarter of the amount of income that Americans get from Canadian sources.

If the United States imposed a 5-percent tax on Canadians receiving income from sources within the United States, it would just about offset the tax that Canada now imposes upon the one-quarter of income received by Americans from Canadian sources; that one-quarter being the only amount that is really taxable. If, however, the

United States were to impose a tax of 10 percent upon dividends and interest paid to Canadians and Canada imposed a similar tax upon the dividends and interest paid to Americans, the United States Treasury would be out of pocket $16,200,000.

The reason for that is perfectly clear when you realize that the movement of income into the United States from Canada is four times the movement of income from the United States to Canadian investors.

The United States, therefore, has a vital interest in trying to keep the tax imposed at the source at the lowest possible figure provided other countries will do likewise. The moment the United States starts out upon a policy of imposing a comparatively high tax at the source, the United States Treasury is simply out of pocket almost 4 to 1, because the figures that obtain in respect of the United States and Canada obtain almost in that same ratio in respect of the income which Americans receive from all of their investments abroad as compared with the dividends and interest that flow out of the United States to foreign investors. If the United States, therefore, could get all of the countries of the world to agree not to tax income at the source at all, the United States would obviously be clearly the gainer.

Senator KING. You do not expect that that desideratum could be obtained; do you?

Mr. COHEN. Not for the present, but the United States can certainly prevent the situation from becoming more damaging, by refraining from any course that is likely to cause countries that are now treating American investors favorably to increase the taxes which they withhold at the source.

Senator KING. Is there any discrimination, what might be challenged as a discrimination, in the plan which you suggest?

Mr. COHEN. The plan which I have suggested is that although the 10-percent rate may be applied in respect of income flowing to residents of countries generally in respect of income generally, in respect of income flowing to Canada or to Canada and Mexico, that is, to contiguous countries, the rate should be not more than 5 percent. It seems to me that such an amendment would be in the clear interest of the United States and would be a step toward assuring increased rather than diminished revenues.

In 1921, at the request of the then Secretary of State, Chief Justice Hughes, different treatment was accorded to residents of contiguous foreign countries. That idea has more or less been present in our tax law for many years, and there are good grounds, economic, social, and political, why the United States should accord a treatment to Canadian and Mexican investors different from that to investors of other countries. The chief and sound tax reason why they should accord more favorable treatment to contiguous countries is that it will redound ultimately to the benefit of American investors and to the benefit of the United States Treasury. There is ample precedent for such an amendment, and there is really no basis upon which other foreign countries can object to a treatment being accorded to Canada and to Mexico different from that given to other countries.

Senator LONERGAN. Mr. Chairman, may I ask a question? Mr. Cohen, can you tell us how many American manufacturers have established plants in Canada in the last 6 or 8 years, and the amount of their investment?

Mr. COHEN. I have very likely the figures in the documents that I have with me. It would take me some time to get out the exact figures.

Senator LONERGAN. Is it a matter of a thousand or two thousand manufacturers, would you say?

Mr. COHEN. I could not offhand state that. I have here a summary made by the Canadian——

Senator LONERGAN. Pardon me, Mr. Cohen. Do those manufacturers receive any special consideration under the tax law of Canada?

Mr. COHEN. Yes; in this sense. If the Canadian subsidiary is wholly owned by an American corporation, or if the American corporation holds all of the voting shares of the Canadian subsidiary, then the dividends paid by the Canadian subsidiary are free from any tax at the source. That is the present law, and it has been reaffirmed in the new budget handed down just 10 days ago.

Senator LONERGAN. Thank you.

Senator BLACK. What was the 5 percent tax you mentioned? I am a little confused on that.

Mr. COHEN. There is a 5-percent tax withheld at the source from dividends paid to foreign holders of Canadian securities, but that tax is limited to dividends paid to persons and corporations other than corporations holding approximately 100 percent of the voting stock of the subsidiary company.

Senator BLACK. In other words, that is a tax on dividends paid at the source which exempts from its operation, dividends which go to the holding companies?

Mr. COHEN. To wholly owning parent companies.

Senator BLACK. In America?

Mr. COHEN. Yes, sir. I have the exact provision of the tax law here, but that is perfectly clear.

It seems to us that in view of the highly favorable treatment that American investors in Canadian enterprises are now receiving it would be dangerous, and it seems to me extremely unwise, to adopt so high a figure as 10 percent in respect of Canada, and even in respect of Mexico, because while Mexico does not treat American investments quite as favorably as Canada, nevertheless even the dividends that are paid by Mexican corporations to American investors are today subjected only to the 2 percent so-called absentee tax if the income flows out of Mexico; really a capital export tax, no tax itself being imposed at the source on such dividends.

Senator KING. Is that true in Bolivia and Peru and in Chile?

Mr. COHEN. I do not know. They, however, are not contiguous foreign countries, and our interests in Canada and Mexico it seems to me are peculiar. They are very great. In Canada we have $3,900,000,000 of investments as against only $950,000,000 of Canadian investments in the United States.

In Mexico we have $635,000,000 of investments as against only $20,000,000 or $25,000,000 of investments of Mexicans here. The flow of income to Mexico is certainly not over $1,250,000. The total tax that you might get on that income would not be over $100,000 or $125,000. To endanger the tax that you are now able to collect from your own American investors on the income that they get from Canada and Mexico by attempting to apparently get a small addi-

tional tax on the income flowing to investors in those two countries is certainly not wise.

There was just one other point, and that is that at the present time most of the Canadian investors in American companies and in the Canadian companies which are doing most of their business here, are small investors who heretofore have had to pay no tax and who if they were American citizens, would pay no tax. As our figures show, out of 1,768 stockholders of the F. N. Burt Co., Ltd., only 9 get dividends of $1,000 or more per year. Ninety-five percent of these stockholders clearly, if American citizens, would not be subjected to tax at all.

It seems to me that it is good business policy, it is good policy in our international relations with Canada not to impose any such tax as 10 percent upon those dividends.

The committee is doubtless perfectly well aware that whatever Canada or Mexico would deduct at the source from the dividends and interest paid to American investors, in the case of the larger American investors, would be deductible as a credit against the tax that the American investor pays to the United States. We are therefore—the United States Treasury is therefore—out of pocket the moneys in the case of the larger investors if those countries impose the higher tax.

Senator BLACK. May I ask you just one question?

Mr. COHEN. Surely.

Senator BLACK. You may or you may not be able to obtain the statistics. You say there is $3,900,000,000 invested in Canada?

Mr. COHEN. Yes, sir.

Senator BLACK. What is the major business enterprise in which those investments are made?

Mr. COHEN. Automobiles, for one thing; oil—the British Imperial Oil Co., is largely American-owned, I understand; and farming machinery. You will find that probably 50 to 60 percent of the larger industrial units in Canada are American-owned or controlled.

Senator BLACK. Mainly automobiles, oil, and farming machinery?

Mr. COHEN. Farming machinery and all types of manufactured machinery and implements, chemicals, textiles, and food products.

I have already submitted to the secretary a printed memorandum which I shall be glad to have incorporated in the record.

Senator KING (presiding). That will be incorporated in the record.

(The matter referred to is as follows:)

MEMORANDUM UPON PROPOSAL TO IMPOSE TAX OF 10 PERCENT AT THE SOURCE UPON INCOME OF NONRESIDENT ALIENS FROM SOURCES WITHIN THE UNITED STATES, WITH SPECIAL REFERENCE TO ITS APPLICATION TO CANADIAN INVESTORS

The proposal to impose a flat tax of 10 percent upon the income of Canadians from their investments in American enterprises seems to us objectionable upon two grounds:

1. It is likely to result in a net reduction rather than a net increase of the income tax revenue of the United States.
2. It is unfair to the many small Canadian investors in American securities.

I

The purpose of the proposal to impose a flat tax of 10 percent upon the income of nonresident aliens from their American investments is to realize additional tax revenue from that source. It seems clear to us, however, that the adoption of

any such proposal will, at least in its application to Canadian residents, tend to defeat rather than to effect that purpose. Both the present and the proposed revenue acts of the United States, as well as the laws of practically all other income taxing countries, recognize the basic equitable principle that if income is to be taxed both by the country of the source and the country of the citizenship or residence of the recipient, the latter country shall allow a credit for the tax paid to the country of the source. The question, therefore, of whether a larger or smaller tax shall be imposed at the source is, in the case of those with substantial incomes, not one of a larger or lesser tax burden upon the recipient. In last analysis it is a question merely of the proper division between the country of the source and the country of the recipient of the total net tax to which such income is subjected.

When it is realized that the annual income of residents of the United States from foreign investments amounts to $153,000,000 while the annual income of foreigners from investments in the United States amounts to only $126,000,000 [1] it is plain that the Government of the United States must proceed cautiously upon any proposal to increase taxes levied upon such income at the source. Manifestly it is in the interest of the United States Treasury that the tax imposed at the source by all income-taxing countries shall be at a minimum. If all income-taxing countries refrained from taxing income of nonresident aliens from investments in those countries, the United States would realize the maximum revenue from inter-national income. If, on the other hand, the United States sets the precedent for a substantial tax at the source upon payments to nonresident aliens, and other countries follow that precedent, the United States will be the net loser rather than a net gainer of revenue.

This is especially true of the respective investments of Canadians in the United States and of Americans in Canada. In 1933 the total investments of Americans in Canadian enterprises amounted to $3,900,000,000,[2] while the total investments of Canadians in the United States amounted to only $989,000,000.[3] The interest and dividend receipts of Americans from Canadian investments in 1931—a year which most nearly approximates the average for the past 10 years—have been computed at $220,517,133, while in that year the interest and dividend receipts of Canadians from investments in the United States amounted to only $58,435,774.[4] If Canada and the United States had each in that year imposed a flat tax of 5 percent at the source upon such payments, Canada would have collected in taxes upon such income approximately $11,025,856. The tax so paid by Americans, however, would actually, in greater part, not have been borne by them but by the Government of the United States, in the form of a credit allowed to American citizens and residents for the Canadian tax so paid at the source. The United States, on the other hand, would have collected upon the $58,435,774 of interest and dividends paid to Canadians upon their investments here only $2,921,788. As compared, therefore, with no tax withheld at the source by either country, the net loss in revenue to the United States from the imposition of a flat tax of 5 percent at the source by both countries would be approximately $8,000,000.

Canada at the present time does collect a 5-percent tax upon dividends paid to nonresident alien individuals and to foreign corporations not owning all of the voting stock (other than directors' qualifying shares) of the payor corporation. The 5 percent tax is not imposed upon dividends received by parent foreign corporations from wholly controlled Canadian subsidiaries. Nor is it imposed upon the greater part of the interest received by foreigners from Canadian sources. (Canadian Income War Tax Act, Sec. 9-B.) The dividends and interest so excepted from the tax constitute more than three-fourths of all of the dividends and interest received from Canadian sources by American investors, individual and corporate.[5] The actual average rate of tax imposed by Canada at the source upon the total dividends and interest received by Americans from their Canadian investments under Canada's present law is, therefore, approximately 1¼ percent.

If the tax imposed by the United States upon dividends and interest received by Canadians from their American investments is not fixed at a rate in excess of

[1] "The balance of international payments of the United States in 1934" (p. 3), by Amos E. Taylor, Assistant Chief, Finance Division, Bureau of Foreign and Domestic Commerce, U. S. Department of Commerce.

[2] "The Balance of International Payments, of the United States in 1933," (p. 54-58), by Amos E. Taylor, United States Department of Commerce.

[3] Business Yearbook for Canada and Newfoundland, 1935.

[4] "The Balance of International Payments and Capital Movements", (p. 62-63), prepared by conference of British Commonwealth Statisticians, September 1935—Dominion Bureau of Statistics, Ottawa.

[5] Statistics compiled by Dominion Bureau of Statistics, Internal Trade Branch, May 1936. See also The Balance of International Payments of the United States in 1933 (pp. 54-58), U. S. Department of Commerce.

5 percent, it is not unlikely that the present provision of the Canadian law, highly favorable to American investors and to the United States Treasury, will continue unchanged—at least for the present. The tax that the United States would collect upon the $58,000,000 received by Canadians from their investments here would then just about equal the tax imposed by Canada upon the presently taxable one-fourth of the $220,000,000 received by American investors from Canadian sources.

If, however, the United States imposes a 10 percent tax upon interest and dividends received by Canadians from sources in the United States, and Canada follows with a similar tax of 10 percent upon the income received by American individuals and corporations from their Canadian investments, the net result will be not to increase the revenue of the United States, but to diminish it—by approximately $16,200,136.

AMERICAN AND MEXICAN INTER-NATIONAL INCOME

The total investments in Mexico of residents and corporations of the United States are computed by the United States Department of Commerce to amount to $635,000,000.[1] While no reliable statistics are available as to the amount of the investments of Mexicans in American securities, the Mexican Embassy at Washington and the United States Department of Commerce have estimated such investments to be between $20,000,000 and $25,000,000.

We may, therefore, fairly estimate the annual income of Americans from Mexican investments at $32,000,000, and the income of Mexicans from investments here at $1,250,000. Mexico, under its present law, imposes a tax ranging upward from 6 percent upon interest paid to nonresident creditors. No tax, however, other than the 2 percent "absentee tax", is imposed by Mexico upon dividends paid to nonresident aliens. In view of the very substantial investment of Americans in Mexican enterprises and the comparatively small investment of Mexicans in American enterprises, it would seem to be sound policy for the United States Government to refrain from imposing upon Mexican residents a tax which, however high in rate, would yield an insignificant amount of revenue but might afford an excuse for an increase by Mexico of its present taxes upon American investors.

II

The proposed imposition of a flat tax as high as 10 percent upon the income of Canadians from their investments here is unfair to the many small Canadian stockholders of American companies and of Canadian corporations transacting most of their business here. Accompanying this memorandum is a schedule analyzing the dividend payments made to Canadian stockholders by F. N. Burt Co., Ltd., a Canadian corporation transacting the larger part of its business in the United States. As that schedule indicates approximately 95 percent of these stockholders receive less than $1,000 per year from all sources within the United States. Under the present act these stockholders owe no tax to the United States whatever, and the total tax collectible from all of the individual Canadian stockholders of that company, both large and small, under the present act, is estimated to be less than 1 percent of the amount of the dividends paid to them.

So radical an increase of the tax upon payments to Canadian investors as one from less than 1 to 10 percent—especially when in most cases no tax whatever would be payable if the stockholder were a resident or citizen of this country—is manifestly unfair to the many small Canadian stockholders who have invested in an American enterprise in reliance upon fair and impartial treatment by the United States.

It seems to us clear, therefore, that the United States cannot afford, at least in the case of Canadian, and perhaps also Mexican investors, to impose so high a tax at the source as 10 percent, either with a view to its own tax revenues, or with a view to the continued fair treatment by those countries of the many American investments there.

It is therefore respectfully submitted that section 143 (b) and section 211 (a) of the proposed Revenue Act of 1936 be amended so as to provide that the rate of tax to be imposed at the source upon dividends and interest received by residents of the Dominion of Canada (or by residents of contiguous foreign countries) shall not exceed 5 percent.

Respectfully submitted.

FRANCHOT, RUNALS, COHEN, TAYLOR & RICKERT,
By PAUL P. COHEN, *Niagara Falls, N. Y.*

[1] The Balance of International Payments of the United States in 1933 (p. 56), U. S. Department of Commerce.

SCHEDULE, F. N. BURT CO., LTD., BUFFALO, N. Y.

Computation based on dividends paid to Canadian individual stockholders in 1935, showing:

1. Tax payable by recipients under Revenue Act of 1934.
2. Amount withheld at the 4 percent withholding rate under Revenue Act of 1934.
3. Amount which would have been withheld at increased rate of 22½ percent.
4. Amount of tax which would be withheld and paid under flat 10-percent rate proposed in H. R. 12395 (Revenue Act of 1936):

Dividends paid to 1,768 Canadian individual stockholders	$187,377.00
Amount withheld at 4-percent rate under 1934 act	7,495.08
Tax collectible under 1934 act (estimated)[1]	944.60
Refunds under 1934 act	6,550.48
Amount which would have been withheld at 22½ percent	42,159.83
Tax collectible at 1934 rates if 22½ percent withheld (estimated)	3,245.31
Refunds if 22½ percent withheld	38,914.52
Proposed flat 10-percent tax, to be withheld and collected	18,737.70
Suggested flat 5-percent tax, to be withheld and collected	9,368.85

[1] Analysis of sums withheld and estimated taxes collectible under 1934 act:

Number of stockholders	Percentage of stockholders	Amounts withheld	Total withheld (approximate)	Tax collectible
Total, 1,768:	Percent			
737	43	$1 or less	$60.00	None
779	44	$1.01 to $5	2,647.50	None
188	8	$5.01 to $10	1,585.00	None
65	4.5	$10.01 to $40	2,247.98	None
9	.5	Over $40	944.60	$944.60

The CHAIRMAN. Mr. Roland C. Zinn, New York, representing the Tanners' Council of America.

Mr. I. R. GLASS. I am here instead of Mr. Zinn, our tax expert, who was to represent the leather industry.

STATEMENT OF I. R. GLASS, REPRESENTING THE TANNERS' COUNCIL OF AMERICA

Mr. GLASS. As economist for the leather industry, I wish to cover one aspect of this tax bill. Our industry is very much concerned, because certain features of this tax bill create the paradox for the industry that a period of prosperity will virtually force tanners out of business. It is no exaggeration and no rhetoric for me to state that a period of prosperity is represented by rising prices, higher prices for raw materials, and 3 or 4 or 5 years will virtually force tanners to liquidate their liquid capital, will virtually force them to go out of business.

Senator KING. Do you represent any considerable number of tanners?

Mr. GLASS. The Tanners' Council is the sole national council of the tanners of the United States.

That proposition, gentlemen, is related to certain very definite and simple facts. I think I can present those to you simply and clearly if I simply summarize the statement which I should like to have permission to incorporate in the record.

Senator KING. It will be inserted.

Mr. GLASS. Our industry processes a raw material, hides and skins. Typically, it is forced to carry very large inventories. The period of processing in several instances is 4 months.

In addition to that, however, a great part of our raw material must be imported, consequently when a draft is paid for material from Timbuctoo or Ceylon or some other far distant place, months elapse before that raw material is available for processing. More months elapse in the actual processing of the raw material into leather. Consequently, in some instances, as much as a year or more may elapse before the money represented in a given investment can be turned over. The period of turn-over, in other words, is extraordinarily large.

The value of that inventory which must be maintained if the tanners are not to go out of business, and our statistics show that the physical quantity of inventories in the tanning industry has changed remarkably little in the past 10 years, that must be maintained if tanners are to continue in business. The value of that inventory is subject to sharp change. The raw material processing of our industry, hides and skins, are notorious as sensitive commodities. That fact, taken in conjunction with the absolute necessity for the maintenance of large inventories and the slow turnover, means one thing—that inventories have an extraordinarily important role in the determination of income. Profits and losses in the tanning industry, in other words, are determined to a very great extent by price changes in the raw material.

Senator GEORGE. Can you conveniently and practically hedge your prices?

Mr. GLASS. No, sir. There is a possibility for hedging in certain instances for the tanners of heavy hides and tanners of goatskins and sheepskins and calfskins, but no facilities whatsoever for hedging upon a given purchase of raw material.

Senator COUZENS. In other words, the higher the price that the inventory is, the more then it will likely be in the taxes, and then when conditions are bad, then you save taxes by the lower price of your inventory; is that correct?

Mr. GLASS. I would agree entirely with your statement, Senator, with this exception, that we do not save any taxes by the lower value of inventory. We have a loss under such circumstances.

Senator COUZENS. Yes. You pay less tax because of the lower inventory, do you not?

Mr. GLASS. Yes, that is true. If I may run through some of these facts, I think I can give you the complete picture.

Senator GEORGE. Can you state approximately how the volume in dollar value of hides imported runs?

Mr. GLASS. The output of the total industry?

Senator GEORGE. Imports.

Mr. GLASS. We import about 20 percent of our goods, 20 percent of our needs in hides. We import 100 percent of our needs in goatskins, and between those two percentages, we import a varying quantity of calfskins and sheepskins and various other raw materials and various other types of hides and skins.

In dollar value, in the kidskin imports that would amount to about $100,000,000, and hides would amount to $60,000,000 or $70,000,000.

Senator KING. Is that annually?

Mr. GLASS. Yes, sir.

Senator KING. Is there any fluctuation from year to year?

Mr. GLASS. Yes, sir.

Senator KING. Is it very great?

Mr. GLASS. No; not to a very great extent. Fluctuation is determined by varying conditions in the world market. The market for hides and skins is one that is a world market, in which the forces of world supply and demand tend to influence the level of imports into the various countries. Our imports may have to be curtailed because we compete with the marching boots of Europe.

Senator GEORGE. Do you not shift your inventory values from cost to market? Have you not that right to take the lower figure?

Mr. GLASS. These are two inventory methods which are allowable under present regulations. Those are either cost, or cost or market, whichever is lower.

Senator GEORGE. You do not have to take the market until you sell, do you?

Mr. GLASS. Our sales can be costed at cost or market, whichever is lower. However, the effect of that as I propose to show in a few minutes, Senator, is simply this, that at the end of the year, following a price rise of some consequence, the tanner may find a considerable profit which is entirely an unrealizable profit, because it is represented only in his inventories. If I may continue, I think I will make that clear.

Under present required methods of valuing inventories, namely, "cost" or "cost or market, whichever is lower", changes in the value of inventory must be reflected in income. On a rising market as low priced material is sold, it must be replaced by higher priced goods. Profits made on the sale of low cost goods are completely absorbed in inventory, since physical inventories in the tanning industry must remain more or less constant. The value of this inventory may be higher, but this increase in value cannot be realized as cash profit short of complete or partial business liquidation. On any downswing in prices such paper profits will be eliminated.

The point I am attempting to establish here is that true income cannot be shown in the tanning industry on an annual basis; in other words, true operating profit is something distinct and apart from fluctuations in the value of inventory which tanners are forced to show under present tax regulations. Annual statement of income does not reflect true income from operating account any more actually than would monthly statements.

Such unrealizable inventory profits are taxed under existing law. However, the proposed corporate taxes would exaggerate what is fundamentally an inequality so far as the tanning industry is concerned. It would exaggerate such an inequality to a tremendous extent.

Unrealizable inventory profits must automatically be included in income according to present tax regulations. They are, therefore, taxable under the present law; but under the proposed law this condition would be aggravated to a condition or degree which might force many corporations out of business. Since inventory profits are not realizable, since they are tied up in physical material which may decline in value just as quickly as it has risen, they obviously cannot be distributed as dividends.

Senator BLACK. I do not like to interrupt you, and I do not know whether the other Senators get the distinction, but I understood in reply to Senator George that you stated that you could take the inventory value or you could take the cost if it was lower. I do not quite understand, therefore—I assume it is correct—but I do not quite understand how if that is true, you continue to state that you are injured because the Government taxes on inventory price. Either you tax on the inventory price or the cost price, it seems to me.

Mr. GLASS. Suppose I make that clear, Senator, by a simple illustration?

Senator BLACK. Yes; if you will.

Mr. GLASS. The tannery company XYZ is in business. They have at the beginning of the year a thousand hides in process, raw material process and finished leather. The price at the beginning of the year is a dollar, market price, and they carry their inventory at that price. Consequently, their inventory is that $1,000. During the year the price rises a hundred percent to $2. That is not an extraordinarily sharp rise; we have had that type of price rise in the past 10 years. At the end of the year, the market price is $2. During the year that tanner has purchased 2,000 hides and sold 2,000 hides at an average price, let us say, of $1.50.

Senator BLACK. Do you mean he has bought or sold them?

Mr. GLASS. Bought and sold them. Let us assume he has made no profit whatsoever. Obviously if he buys and sells those hides at the same price, the average for the year, $1.50, he cannot have made any profit. He has no cash in his till over and above anything that he had at the end of the year, and yet at the end of the year that tanner's inventory will have a thousand hides prices at $1.50. He will have made $500 in inventory profit, even though his purchases and sales during the year were absolutely the same in physical quantity and price.

In other words, what happened there was that the earlier inventory that he had was sold, it was replaced by later material, and his final inventory is as to his last purchases.

That is the basic assumption which is implicit in the current tax regulations. His latest purchases were at $1.50, which was the average price of the year, and therefore he shows an inventory profit of $500 even though common sense dictates that he could not have made any operating profit, since the purchases and sales were made at the same price.

Senator CONNALLY. If he had lost $500 on the inventory, it would be fair to take it off?

Mr. GLASS. Yes, sir, that would be so. If inventory losses and profits could be offset against one another as to operating profits, it would be shown.

Senator HASTINGS. Reverse it now. Suppose the price were $2 at the beginning of the year, and at the end of the year it was $1. What is the result there?

Mr. GLASS. In that case, you would show a very sharp inventory loss.

Senator HASTINGS. Of $500?

Mr. GLASS. Of $500.

Senator HASTINGS. Just like you would show a gain in the other illustration?

Mr. GLASS. Exactly.

Senator CONNALLY. You would take that in that year?

Mr. GLASS. Take the loss?

Senator CONNALLY. Yes. You could take that under the present income tax law.

Senator HASTINGS. If you had any profit to take it from.

Mr. GLASS. Yes. But what happens is that such inventory losses, in the event of sharp price changes, are far greater than any profits that might be made. In the event of declining prices, it is very much more difficult to get a real operating profit.

I was pointing out that unrealizable profits are taxable under the present law. Under the proposed law, that situation would be tremendously aggravated. Those unrealizable profits cannot be distributed through a paper, or a book or a hypothetical or a fictitious profit, and therefore they cannot be distributed as dividends. How can they be taxed?

Senator HASTINGS. Taking that illustration; suppose instead of being a $500 profit it shows a $500,000 profit. You cannot distribute it because you have nothing to distribute except hides which is no good to your stockholders. Then you pay 42.5 percent on $500,000. That is the figure.

Mr. GLASS. You anticipate the illustration I was about to make, Senator.

Under those circumstances, it is conceivable that the taxes on unrealized profits might be so large as to force tanning companies into a highly anomalous situation. Where could they raise the cash to pay the tax of 42 percent in the event that their profit was entirely an inventory profit, as you pointed out, Senator? Where could they raise that cash?

Certainly a bank would not be reckless enough to lend money for their dividends or taxes on a profit which might disappear the following year as quickly as it had appeared.

We have developed in our statement which I should like to submit, an example of that situation. Summarizing that example very rapidly, a company is in business January 1, 1936. It has a declared capital value of $800,000. The raw material price at the beginning of the year is $1; at the end of the year it rises to about $2. The average purchases are made at about $1.53. We assume in this instance that the company makes an actual operating profit, that is realized cash of about $36,000. Its inventory profit on operations under present methods of income statement is $64,000. In other words, $36,000 is available for the distribution of dividends, and $36,000 is available out of which to pay taxes.

Under the present law, that company would pay a tax of $16,760. There would still be available $19,240 for the payment of various dividends.

Under the proposed law, if we assume that no dividends whatever were paid, with a total income of $100,000 of which $36,000 was cash, and $64,000 a paper profit, the tax would be $42,500; the company would retain $57,500. It could not distribute obviously any dividends greater than $36,000 because it had not realized them in cash. In other words, in this instance not only would no dividend distribution be possible, but $6,500 would need to be borrowed or otherwise raised merely to pay the tax. If the tax were to be the

same as under the present law, the following situation would arise: In other words, if the company were to do precisely what it might do under the present law this tax would be $16,760, since there would be available only for taxes and dividends $36,000, and there would have to be borrowed or raised $32,240.

That situation, in other words, represents the paradox of a period of prosperity, a period of rising prices which will create inventory profits. Because they cannot be distributed, they must be taxed under the provisions of the proposed law.

The payment of such taxes will force the liquidation of working capital, the impairment of assets, and eventually force many tanneries into bankruptcy.

Senator KING. Had there been many casualties in that industry?

Mr. GLASS. The industry is notoriously a loss industry. In the past 10 years, our calculations show that there has been lost approximately $200,000,000, not merely in the depression period but prior to the depression period, from about 1924 on. And those losses were occasioned because of the fact that the raw material prices fluctuate so sharply and inevitably has shown that inventory profits are more than offset by inventory losses when the decline begins, and declines are always inevitable.

Senator KING. It would seem that that loss of $200,000,000 during prosperous years, so-called, and during the depression, would mean many casualties.

Mr. GLASS. It has. A great many tanning companies have been forced to go out of business.

In view of that situation, it seems to us that the only logical course which would ameliorate these possibilities is offsetting of profits against losses, and particularly inventory profits against inventory losses. Only that, obviously, can make it possible for tanning companies to show their true income. Income derived from actual operations and profits made from sales over and above the cost of raw material and betterments.

In addition, failing that remedy, we would suggest that the Senate Finance Committee take cognizance of the present tax regulations. Under the present regulations and in the law, section 22 (c), referring to inventories and methods of valuation, reads:

Inventories: Whenever, in the opinion of the Commissioner, the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

It is our recommendation, respectfully submitted to this committee, that section 22 (c) of the bill be amended by adding the following:

including the normal or necessary stock method in those industries in which the taxpayer shall consistently keep his accounts in accordance with such method with the proviso that the taxpayer shall elect his method of stating the inventories in his direct return under this title.

If I may have a moment to dwell upon that method of inventory valuation and make clear its importance.

It is fundamental in the tanning industry, and I may add in many other commodity-processing industries, that the true profit can only be revealed by realizing the sharp distinction between operating

income and inventory accounts. Present-day inventory valuation methods, the methods which are allowable generally by the tax department, do not permit such a sharp distinction to be made in the statement of income. They force inventory profits to be included in the income, and be shown there. There are several methods, however, which make it possible to tanners or for other processors of raw material in which inventories and slow turnover play a very large part, and such methods make it possible to distinguish between true operating account and inventory profits or losses. I refer to the normal stock method, and such variations as the last-in first-out method.

It is our belief that while true income in the tanning industry cannot be shown annually under any methods, the permission to the industry to employ the normal stock method would at least render a far more accurate picture than these present-day methods allowed under present tax regulations.

Senator HASTINGS. Of course, I assume you do not contend that if we change the law so as to eliminate the profit growing out of an inventory, you would not contend also that you might take a loss in case the inventory was less; in other words, if we eliminate the payment of the tax out of that profit, you would not contend that we should also eliminate the possibility of a loss?

Mr. GLASS. I agree with you. We would contend, in other words, that if inventory profits be eliminated from the statement of income, similarly inventory losses be eliminated. And the value of that, so far as the Government is concerned, is this, primarily, that the use of such accounting methods will make it possible for the flow of revenue to be far smoother than it is today. In other words, the peaks and valleys which are incidental to the valuation of inventories under allowable methods today would be eliminated. True operating income would be shown from year to year.

If I may comment for a moment longer on the necessity and value of the methods of inventory valuation. In England, such methods have been allowed to the tanning industry. The assumption made in England is simply this: That assumption that I have been attempting to present to this committee, that because of its large inventories and slow turn-over, it is impossible to derive the true income of the tanning industry during any one year, consequently the English tax regulations permit tanners to keep a great part of their inventories as a fixed asset; in other words, inventories are essential to the continuance of business, and they must be considered therefore in one sense just as much a fixed asset as a building or as a machine would be. No one would think of taxing a building upon an increased value on income tax. Similarly, inventories, being just as essential to the conduct of business as to continued business, cannot be taxed and ought not logically to be taxed whenever they increase in value due to such advantageous circumstances as arise in the price of raw material.

Senator HASTINGS. In your judgment, if we made that change in the old law, without any consideration being given to the new law, would the Government be apt to lose money or to gain money by such change?

Mr. GLASS. I do not know, sir; I am not a tax expert. It would be my opinion, I think that it would in the long run perhaps gain money; in other words, the flow of revenue would be smoother, and since as an

economist I can testify that profits and losses in this industry being determined by price changes are determined to such a great extent by price changes, that since price changes invariably tend to have the pattern of a cycle, peaks always precede declines, and it would be my opinion that the Government would not lose any money.

I should like permission, Mr. Chairman, to submit for the record, our statement, as well as a supplementary article which elaborates some of the possibilities as to the proposed law.

Senator GEORGE (presiding). You may do that.

(The matter referred to is as follows:)

BRIEF OF TANNERS' COUNCIL OF AMERICA, NEW YORK

PROPOSED CORPORATE TAX LAW A SERIOUS THREAT TO BUSINESS EXISTENCE OF MANY CORPORATIONS IN COMMODITY PROCESSING INDUSTRIES

The following eight points summarize the reasons why many corporations may be practically forced out of business under the proposed tax law. Any period of rising prices will make it necessary for unrealized inventory profits to be either distributed or paid out in taxes. Neither of these can be done without increased borrowing, seriously impairing working capital, or business liquidation.

1. *Inventories major part of assets in tanning and other industries; turnover may require 18 months or more.*—Those industries which would be most seriously affected by the law are, typically, commodity-processing industries. In such industries large inventories of raw material as well as material in process must always be maintained and cannot be liquidated since they are essential to a continuation of business. Consequently, a great part of a company's assets will be represented by inventories. In the tanning industry, for example, inventories are normally more than 50 percent of total assets. This is necessary by virtue of the long period which elapses between the purchase of raw material and the sale of finished leather. In the tanning of heavy leathers such as sole, belting, and harness, 10 months or a year may be required to effect a complete turnover. The tanning of kid leather may require a period of 12 to 15 months between the commitment for raw material and payment for finished leather. Almost 100 percent of the kid skins used by tanners, and large percentages of other raw materials must be imported. To the already long process period of tanning, which in heavy leather extends to 4 months, must be added, therefore, the months intervening between the purchase of raw material and its arrival from abroad.

2. *Value of inventory subject to sharp change.*—Forced to carry large inventories by the nature of its business, the tanning industry must bear an exceptional risk. Raw material price levels fluctuate sharply. The data in example I show the extent to which this has been the case in the past 10 years when price changes of from 50 percent to 100 percent were not unusual. Such price changes directly affect the value of the industry's inventories. Huge inventories, in conjunction with sharp price fluctuations, have an extremely pertinent bearing upon the question of profits and taxes.

3. *Profits and losses in tanning industry are determined to a great extent by price changes in raw materials.*—Under present required methods of valuing inventories, namely, "cost" or "cost or market, whichever is lower", changes in the value of inventory must be reflected in income. On a rising market as low-priced material is sold, it must be replaced by higher priced goods. Profits made on the sale of low-cost goods are completely absorbed in inventory, since physical inventories in the tanning industry must remain more or less constant. The value of this inventory may be higher, but this increase in value cannot be realized as cash profit short of complete or partial business liquidation. On any downswing in prices such paper profits will be eliminated.

4. *True income cannot be shown by annual statements in industries with large inventories and slow turnover.*—In the tanning industry real operating income cannot be shown for a 12-month period. In this industry, and in other commodity processing industries, the annual statement of income does not measure true income any more accurately than monthly statements would. With any rising trend in prices, inventory profits which are nonrealizable and speculative must be included in net income. For example, a corporation might buy and sell during a year of rising prices an identical quantity at an identical price. It could not, therefore, have earned any real profits. Yet its income statement for the

year would show profits. The extent to which this is possible is illustrated by the raw material price changes given in example I and the illustration developed in example II which indicate that corporations face impairment of working capital if not bankruptcy under the contemplated law.

In view of the circumstances emphasized above, it is obvious that taxes upon annual income must work a hardship for many corporations unless inventory losses may be offset against inventory profits.

5. *Unrealizable inventory profits are taxed under existing law; proposed corporate tax law would aggravate this inequality and create a disastrous situation.*—Unrealizable inventory profits must automatically be included in income according to present tax regulations. They are, therefore, taxable under the present law, but under the proposed law this condition would be aggravated to a degree which might force many corporations out of business. Since inventory profits are not realizable, since they are tied up in physical material which may decline in value just as quickly as it has risen, they obviously cannot be distributed as dividends. Such profits, therefore, cannot be taxed at the contemplated rates without seriously injuring the working capital of many corporations.

6. *Since unrealizable profits cannot be distributed, proposed taxes could be met by many corporations only through borrowing, impairment of working capital, or liquidation of business.*—On the attached chart, example III, "Price changes and income in tanning industry" the profits and losses of four tropical tanning companies are contrasted with the course of raw material prices. Obviously, changing prices appear to be the most important factor in the rate of profit or loss. During a period of sharply advancing prices it is not unusual in the tanning industry for unrealized inventory profits to constitute the major part of total income. Reversely, a decline in the price cycle will create inventory losses more than offsetting any previous gains. This is plainly the case in the fluctuating income of the four companies shown in example III. If the proposed tax rates were applied to the profits indicated in example III, with no redress for periods of inventory losses, the question may well be asked, "How could such taxes be paid, when profits are largely nonrealizable?"

Example II on the attached chart is an extremely possible illustration of the difficulty which may develop for tanning companies under the proposed law. In this example, a company with capital value of $800,000 has an apparent income of $100,000. It has actually earned only $36,000, but as the result of a rising price trend, its inventory is worth $64,000 more at the end of the year than at the beginning.

In other words, $36,000 is earned, realized income, and $64,000 is unrealized, paper profit. Dividends and taxes can be paid only with the true income of $36,000. Under the existing law this company would pay $16,870 in taxes and would still have available cash profits for dividend distribution. Under the proposed law the maximum this company could retain would be $57,500. Neglecting capital stock and excess profit taxes it would have to pay $42,500. Since actual cash earnings were but $36,000, it would be necessary to borrow from the banks, liquidate inventory, or impair working capital merely to pay the tax. Any dividends would be out of the question unless at the cost of still further borrowing or impairment of assets. Would any bank loan money on inventory profits which might disappear completely the following year with a decline in raw material prices?

7. *Small corporations or corporations with limited resources most adversely affected.*—An additional consideration which cannot be ignored is the effect of the proposed law upon small corporations, or corporations with limited resources. Their competitive position would be severely handicapped in contrast with corporations possessing more ample resources. This would definitely seem to favor monopolistic trends in industry.

8. *Commodity processing industries such as tanning, require modification of law to avoid drastic and dangerous consequences.*—The anamalous situation which must arise from the passage of the proposed law may be relieved principally by permitting profits and losses to be offset for a specified number of years. It has been emphasized above that the true income of commodity processing industries such as tanning cannot be reflected in annual income because of the large inventories and slow turnover in such industries. While the existing law is unjust in this respect, the proposed law would aggravate the situation to a dangerous extent. If losses might be offset against profits, the inequitable consequences of the law might tend to be relieved. Such provision was formerly embodied in the law and is the case in England and France where periods of 6 and 3 years respectively are allowed.

Relief from the inequity of the proposed law may also be extended to commodity processing industries through recognition of their need for certain accounting methods. Such methods of valuing inventories as "normal stock" or "last in, first out" tend to distinguish between true earned income and inventory profit. If the use of such methods were permitted to commodity-processing corporations, by law or tax regulation, it would be possible for them to pay corporate taxes upon actual realized income alone.

EXAMPLE I.—*Percent changes, December to December*

	Heavy native steers	Light native cows	Chicago calf	Average of seven kid prices		Heavy native steers	Light native cows	Chicago calf	Average of seven kid prices
1925-26..	−1.3	−1.5	−16.2	−0.2	1930-31..	−25.5	−13.4	−51.3	−37.1
1926-27..	+62.7	+68.1	+87.3	+1.2	1931-32..	−31.6	−31.0	−17.8	−17.3
1927-28..	−9.6	−14.1	−1.6	+6.8	1932-33..	+83.3	+104.1	+138.3	+72.9
1928-29..	−28.9	−30.3	−29.6	−14.2	1933-34..	+12.1	−16.0	−36.2	−18.9
1929-30..	−33.8	−39.7	−19.4	−17.8	1934-35..	+33.3	+34.3	+57.9	+28.2

EXAMPLE II

Company in business Jan. 1, 1936, capital value	$800,000
Raw material market price:	
Jan. 1, per unit	1.00
Dec. 31, per unit	2.06
Average purchases	1.53
Company has opening inventory Jan. 1, 1936, of 200,000 units valued at	200,000
During year 300,000 units are purchased for	459,000
And 300,000 units are sold for	495,000
Leaving an obvious merchandising cash profit of	36,000
But the "average cost or market" method of valuing inventories and arriving at profit or loss for the year must yield the following results:	
Opening inventory, 200,000 units	200,000
Purchases:	
300,000 units	459,000
500,000 units	659,000
Giving an "average cost" per unit of	1.32
Since 300,000 units were sold, the closing inventory would remain at 200,000 units valued at the average cost ($1.32 per unit) or	264,000
Cost of sales is the difference between $659,000 and closing inventory of $264,000 or	395,000
Since sales of 300,000 units were made for	495,000
The profit under this most conservative of allowable inventory methods would be	100,000
It will be seen that this total consists of:	
Inventory profit of	64,000
Realized income of	36,000

To what extent would the income shown above be taxable under the existing corporate tax law and the proposed law?

Present law. Total tax including capital stock and excess-profits taxes:	
Total income	$100,000
Tax	16,760
Possible dividends	19,240

It is assumed here that there is available for taxes and dividends $36,000 of the total income of $100,000. Since $64,000 included in the total income is an inventory profit it cannot be distributed in dividends.

Proposed law. Neglecting capital stock and excess-profit taxes:

Total income	$100,000
Retained: Maximum which can be retained	57,500
Tax; (this is more than the $36,000 which is available for taxes and dividends. $6,500 must be borrowed merely to pay the tax)	42,500

In this instance not only would no dividend distribution be possible but $6,500 would need to be borrowed or otherwise raised merely to pay the tax. If the tax were to be the same as under the present law the following situation would arise:

Income	$100,000
Tax [1]	16,760
Dividends	51,480
Total tax and dividends	68,240
Available for taxes and dividends	36,000
To be borrowed or raised	32,240

[1] Under the schedule for adjusted net incomes of more than $10,000, in order to pay a tax of $16,760 on the total adjusted net income of $100,000, it would be necessary to pay dividends of $51,480 and retain $31,760.

The tax in this case is exactly the same as would be paid under the 1935 law. In order that this may be done, however, dividends of $51,480 must be paid. The total of dividends and taxes is in excess of the actual earned income by $32,240. That sum would need to be borrowed or inventory and other assets would have to be liquidated.

(Chart, example III on file with committee.)

Tax Proposals Mean Rainy Days for Industry Under Clearest Skies

(By Arundel Cotter)

TAXING FICTITIOUS PROFITS

Given 7 or 8 years of continued prosperity, with gradually rising commodity prices, ordinarily a consummation devoutly to be wished, a heavy tax on undistributed profits such as is now being considered by the Congress of the United States, or the distribution of these profits to avoid the tax, would either of them, practically wipe out many of our largest and most important industries.

This is because it would force the distribution to stockholders of, or the submission to an extortionate levy on profits that are existent only on the books of the reporting companies—profits due solely to inventory price changes.

Strangely this fact appears to have escaped not only the attention of our lawmakers but of the business interests who have opposed and are opposing the measure. Claiming, as they have, that business thus taxed will be unable to face a depression they have overlooked the fact that it will be equally unable to stand a period of prosperity.

ITEMS THAT ARE SELDOM REALIZABLE

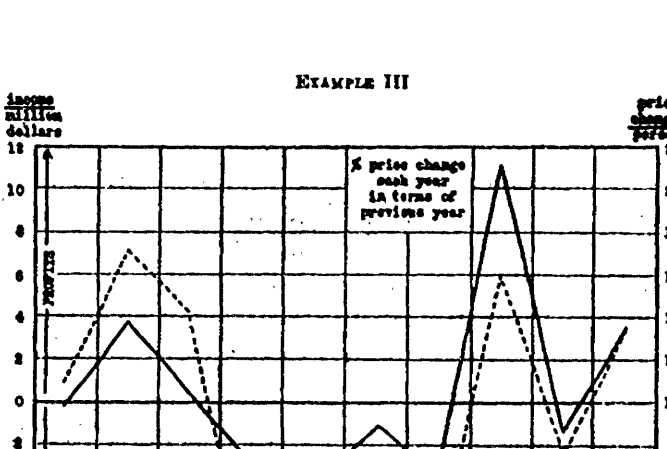
These inventory "profits" constitute, in periods of ascending prices, a substantial part of the reported earnings of many companies; sometimes they constitute all of them. But they are seldom realisable to more than a moderate extent if at all. And they are invariably wiped out eventually when the economic tide ebbs.

But since they are regarded as profits by the average management and, more important, by the Internal Revenue Department, they will, if the measure now pending is enacted into law, have to be paid out in cash either to stockholders or to the tax collector. And this will mean steady erosion of capital assets.

Some company managements have long realized the unreality of such so-called profits and have endeavored to eliminate them in reporting earnings to stockholders. But the Internal Revenue Department has generally refused to recognize this style of reporting and has collected its share of the gains in inventory values.

It is extremely doubtful whether the Government has gained much from this insistence, since it has had equally to recognize the wiping out of these fictitious profits in poor years. Previously, however, companies have been able to regulate their dividend policies with regard to the needs of their business and with consideration of real profits, a privilege that may now be denied them. And it is worthy of note that the companies using methods for the elimination of inventory profits are among the most successful.

EXAMPLE III



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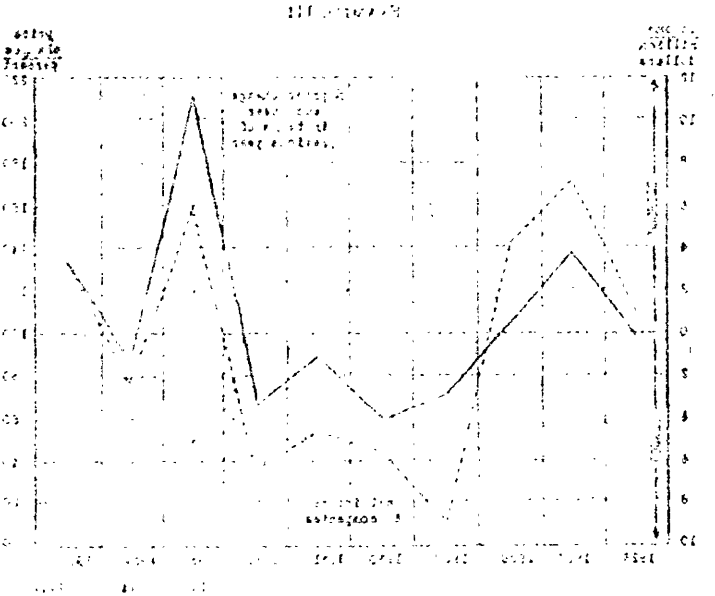


PROSPERITY'S EFFECT ILLUSTRATED

Effect of several years of prosperity and rising prices, combined with enforced distribution of all profits may be simply illustrated. Let us take the case of the XYZ company starting business with $15,000,000 cash and dealing in some volatile commodity like hides or rubber. It invests most of its cash in acquiring plant and raw material and starts its career with a balance sheet approximately as follows:

Plant $5,000,000; inventory (100,000,000 pounds of raw material at 8 cents a pound) $8,000,000; cash, $2,000,000. Liabilities 3,000,000 capital shares of $5 par.

In the course of the first year it manufactures and sells in finished products the equivalent of 100,000,000 pounds of material for an aggregate of $17,000,000, its labor and other costs being $5,000,000. It reports for the year, under the usual method of accounting, as follows:

Sales	$17,000,000
Labor cost, etc	5,000,000
Raw material cost	8,000,000
Depreciation	250,000
Net profit	3,750,000

And its balance sheet, eliminating items inessential here, will read about as follows, assuming that depreciation has been used for plant replacement:

Assets:		Liabilities:	
Plant	$5,000,000	Capital	$15,000,000
Cash	2,750,000	Surplus	3,750,000
Inventory	11,000,000		
Total	18,750,000	Total	18,750,000

During the course of the assumed year average replacement cost of raw material has been 11 cents a pound instead of 8 cents, which accounts for the $11,000,000 inventory item. The company naturally desires to maintain its productive ability.

CASH ADDITION ONLY REAL GAIN

Comparing this balance sheet with that of the beginning of the year, however, we find that the only real gain is the $750,000 addition to cash. Inventory is the same in volume as it was 12 months before. And, as the company desires to continue in business indefinitely, it cannot liquidate, realize on this raw material except in the normal course of its business. Entirely apart from questions as to reverses for the future, provision for expansion, etc. it can pay out not more than $750,000 in dividends without impairing its position as a producer.

Assuming legal compulsion either to distribute all reported profits in dividends, or to pay a 42½ percent tax on them, the management elects the former course. It can only do so by disposing of some of its raw material. It decides not to let cash drop below $1,500,000. After the dividend is paid the balance sheet will look like this:

Assets:		Liabilities:	
Property	$5,000,000	Capital	$15,000,000
Cash	1,500,000	Surplus	None
Inventory	8,500,000		
Total	15,000,000	Total	15,000,000

However, its present supply of raw material having cost it 11 cents a pound on the average it will be able to carry only 77,272,727 pounds. It will start its second year with a loss of $500,000 cash and about 22,227,000 pounds of raw material.

If it had elected to pay out to stockholders only the actual cash gain of $750,000 it would still have, under the proposed tax bill, to pay the Government 32½ percent on earnings as shown, or $1,218,750. It would have the following balance sheet:

Assets:		Liabilities:	
Property	$5,000,000	Capital	$15,000,000
Cash	1,500,000	Surplus	1,781,250
Inventory	10,281,250		
Total	16,781,250	Total	16,781,250

And it would have an inventory, in volume, of 93,466,000 pounds.

HISTORY OF SECOND YEAR

During the second year of the company's history the price rise continues. The XYZ Co. sells the equivalent of the 77,272,727 pounds of material with which it started the year for $17,363,636. Its labor and other costs were the same and it reports a profit of $3,613,636 net. If it paid out all these earnings in dividends again it could, by further depleting cash to $1,000,000 carry an inventory of something over 60,000,000 pounds of raw material, average replacement price of the latter having risen during the year to 15 cents a pound.

Thus, in 2 years of prosperity and ascending prices the XYZ Co. would have cut its cash in half and depleted actual inventory 40 percent. Yet it would not have paid out a dollar in excess of its ostensible earnings, or of the amount which the Government would regard as earnings subject to tax.

Carry on this process for a few more years and cash would have vanished into thin air and inventory would be depleted to a physical point where operation would be impossible. If only actual cash gains were paid out each year as dividends, taxes on the bookkeeping profit on inventory would still deplete cash and other assets, albeit more slowly. In this case the company's assets would simply have been transferred to the United States Treasury instead of to the stockholder's pocket.

In either case, eventual bankruptcy would ensue.

The CHAIRMAN. Mr. Howard McCall, Chattanooga, Tenn.

(No response.)

The CHAIRMAN. Mr. W. H. Mooney, Cincinnati, Oho; president, American Oak Leather Co.

Mr. MOONEY. Yes, sir.

The CHAIRMAN. How much time, Mr. Mooney?

Mr. MOONEY. I think I can get through in 20 minutes.

The CHAIRMAN. You want to discuss this tannery matter, do you not?

Mr. MOONEY. I appear as a member of the Government Finance Committee of the National Association of Manufacturers.

The CHAIRMAN. If you will give your brief to the reporter and discuss the high points that you want to present, we will be glad to hear you.

STATEMENT OF WILL H. MOONEY, PRESIDENT, AMERICAN OAK LEATHER CO., CINCINNATI, OHIO

Mr. MOONEY. My name is Will H. Mooney, president American Oak Leather Co., Cincinnati, and I appear here as a member of the Government Finance Committee of the National Association of Manufacturers. I submit to the clerk a list of the members of the Government Finance Committee.

(The list referred to is as follows:)

NATIONAL ASSOCIATION OF MANUFACTURERS' COMMITTEE ON GOVERNMENT FINANCE

Chairman: A. L. Green, chairman, Farr Alpaca Co., Holyoke, Mass.

Vice chairman: H. Boardman Spalding, vice chairman and treasurer, A. G. Spalding & Bros., 105 Nassau Street, New York, N. Y.

Vice chairman: John H. Minds, general solicitor, the U. G. I. Co., Philadelphia, Pa.

Benjamin Anderson, treasurer, Metal & Thermit Corporation, 120 Broadway, New York, N. Y.

William S. Bennet, 25 Broadway, New York, N. Y.

S. B. Berg, comptroller, Cherry-Burrell Corporation, 427 West Randolph Street, Chicago, Ill.

Howard B. Bishop, president, Sterling Products Co., box 344, Easton, Pa.

R. E. Blake, counsel, International Shoe Co., 1509 Washington Avenue, St. Louis, Mo.

Leroy Brooks, Jr., president, Tool Steel Gear & Pinion Co., Elmwood Place, Cincinnati, Ohio.
C. R. Burnett, president, American Oil & Supply Co., 238 Wilson Avenue, Newark, N. J.
J. E. Butterworth, vice president and treasurer, H. W. Butterworth & Sons Co., 2417 East York Street, Philadelphia, Pa.
G. Carlisle, treasurer, C. E. Jamieson & Co., 1962 Trombly Avenue, Detroit, Mich.
William D. Disston, second vice president, Henry Disston & Sons, Inc., Philadelphia, Pa.
H. H. Eckert, financial executive, Thomas A. Edison, Inc., Orange, N. J.
Ben H. Gangard, assistant manager, Warren-Lamb Lumber Co., Rapid City, S. Dak.
F. M. Hesse, treasurer, National Steel Corporation, Grant Building, Pittsburgh, Pa.
Tracy Higgins, president, Charles M. Higgins & Co., 271 Ninth Street, Brooklyn, N. Y.
H. G. Hook, controller, Bassick Co., Bridgeport, Conn.
Earle O. Hultquist, president, Jamestown-Royal Upholstery Corporation, Jamestown, N. Y.
W. P. Hutchinson, president, the Sprague Meter Co., Bridgeport, Conn.
A. S. Johnston, vice president, Pioneer Cooperage Co., 2212 DeKalb Street, St. Louis, Mo.
A. F. Kletzien, secretary-controller, Fox River Paper Co., Appelton, Wis.
R. H. Knowlton, vice president, Connecticut Light & Power Co., 36 Pearl Street, Hartford, Conn.
Royal Little, vice president, Franklin Rayon Corporation, 86 Crary Street, Providence, R. I.
William N. McMunn, president, Michigan Seamless Tube Co., South Lyon, Mich.
N. R. McLure, vice president, E. J. Lavino & Co., 1528 Walnut Street, Philadelphia, Pa.
E. G. Miner, chairman, the Pfaudler Co., 89 East Avenue, Rochester, N. Y.
Will H. Mooney, president, the American Oak Leather Co., 1401 Dalton Street, Cincinnati, Ohio.
W. H. Pouch, president, Concrete Steel Co., 2 Park Avenue, New York, N. Y.
H. W. Prentiss, Jr., president, Armstrong Cork Co., Lancaster, Pa.
Hugh H. Price, treasurer, General Ceramics Co., 30 Rockefeller Plaza, New York, N. Y.
R. S. Pruitt, vice president and general counsel, Cord Corporation, 105 West Adams Street, Chicago, Ill.
T. Rieber, chairman of board, the Texas Co., 135 East Forty-second Street, New York, N. Y.
Fred Schluter, president, Thermoid Rubber Co., Trenton, N. J.
C. E. Schoble, vice president, Schoble Hats, Inc., 232 North Eleventh Street, Philadelphia, Pa.
Jay Terry, president, the Terry Brothers Co., Kingston, N. Y.
Charles Warner, president, Warner Co., 1616 Walnut Street, Philadelphia, Pa.
Forest L. Williams, secretary-treasurer, Williams Manufacturing Co., Portsmouth, Ohio.

Mr. MOONEY. With your permission, Mr. Chairman, I shall omit the reading of certain portions of my prepared statement and request permission that they be included in the hearings.

INVENTORY PROBLEM

We suggest that special allowances should be made in the form of either tax exemptions or specially low tax rates for undistributed earnings which actually exist in accounts receivable, inventory or less liquid assets. This is always true in a period of expanding sales. The Treasury Department, as you are aware, now requires that inventory should be valued at cost or market, whichever is the lower. This means in effect that when the price on raw material is rising the lower-priced material sold out of inventory is replaced by higher-

priced goods. Assuming that the physical amount of inventories remained the same, the profit made on the sale of low-priced goods is completely absorbed in new inventories. Such profit is not in reality actual operating profit. But under the present tax law and the regulations for determining income, inventory profits are taxable.

There is a more or less general belief that increases in inventory valuation through a rising price level result in large profits for manufacturing companies, and that these profits are available for distribution in dividends, the payment of debts, or the purchase of additional plant and equipment. The following discussion shows that this belief is a fallacy. It is difficult to believe that companies whose inventories have had a big increase in value have not as a consequence made a large profit. The truth of the matter is that generally speaking such a profit is merely a paper profit which will disappear when the price level declines to the point at which the advance started.

I submit herewith a schedule which attempts to represent approximately what takes place in the inventory during a rise in prices and a subsequent decline to the point at which the rise began. On this schedule the method used in computing profits and losses is the one generally used by corporations and is approved by the Treasury Department.

The schedule differs from the ordinary manufacturing operations because no manufacturing expenses or sales expenses or manufacturing profit has been included. It has been simplified in order to bring out the basic principle, and any one who wished to add the above items to the schedule would find that the same general principle was still present although it would be more difficult to see just what was taking place.

Purchases	Inventory	Sales	Profit	Loss
		Cents	*Cents*	*Cents*
1. 11 cents.....	10 cents, 10 cents, 10 cents, 10 cents.....	11	1	.....
2. 12 cents.....	11 cents, 10 cents, 10 cents, 10 cents.....	12	2	.....
3. 13 cents.....	12 cents, 11 cents, 10 cents, 10 cents.....	13	3	.....
4. 14 cents.....	13 cents, 12 cents, 11 cents, 10 cents.....	14	4	.....
5. 15 cents.....	14 cents, 13 cents, 12 cents, 11 cents.....	15	4	.....
6. 13 cents.....	15 cents, 14 cents, 13 cents, 12 cents.....	13	1	.....
7. 11 cents.....	13 cents, 15 cents, 14 cents, 13 cents.....	11	.....	2
8. 10 cents.....	11 cents, 13 cents, 15 cents, 14 cents.....	10	.....	4
9. 10 cents.....	10 cents, 11 cents, 13 cents, 15 cents.....	10	.....	5
10. 10 cents.....	10 cents, 10 cents, 11 cents, 13 cents.....	10	.....	3
11. 10 cents.....	10 cents, 10 cents, 10 cents, 11 cents.....	10	.....	1
12. 10 cents.....	10 cents, 10 cents, 10 cents, 10 cents.....	10	.....	.....
			15	15

Let us start with line 1 of the schedule. We have four units of inventory priced at 10 cents per pound. We purchase one unit at 11 cents and sell one unit at 11 cents. The difference between the inventory value at 10 cents and the sale price of 11 cents is one cent per pound, so that there is a profit of 1 cent a pound which we show under the profit column. In line 2 the 11 cents purchase is moved into the inventory and is priced at a cost of 11 cents. The 10-cent unit has moved out so there are only three 10-cent units left. We now make a purchase at 12 cents and a sale at 12 cents. There is a 2-cent profit from the sale and the third line illustrates what happens when the unit sold moves out and the unit purchased moves into inventory.

Senator HASTINGS. Mr. Chairman, don't you think it might be helpful to get the Treasury's reaction to the discussion of these two witnesses?

The CHAIRMAN. The Treasury experts are here and they are taking notes of all of these suggestions.

Mr. MOONEY. Let us now drop down to line 7 which marks the end of the profits and the beginning of the losses. In the first line there are four units priced at 10 cents per unit, or a total of 40 cents. In the seventh line there is a unit priced at 13 cents, one at 15 cents, one at 14 cents, and another at 13 cents, or a total of 55 cents. This is an increase in inventory valuation of 15 cents. There have been profits of 15 cents. It is obvious that if the inventory value returns to the 10-cent level all the profits will vanish, and that is what happens. At the end of the operations, profits and losses are even and inventory values are the same at the end as they were at the beginning.

It is obvious that if all of the profits from the sale of inventory are put back into increased value of inventory all of the additional cash has been plowed back into the business and remains at the risk of the price level. If the inventory declines to the original point all the profits are lost. This indicates that inventory appreciation is not a real profit and should not be accounted for as such.

Now the question comes up as to how profits or losses actually come about. The comparison makes this fairly obvious. Profits and losses come about not from changes in price level and inventory valuation, but from the difference between the average cost of purchases and the average value of sales. For example, if an additional 1 cent per pound is added to each one of the sales, or 1 cent per pound deducted from each one of the purchases, the operation would come out with a profit.

If the bill embracing the regulations now pending before this committee is enacted, the situation would be aggravated, since in periods of rising prices inventory profits, which are really fictitious gains, would be taxed much higher than is the case today, or a company would soon have insufficient capital to carry on if it distributed these profits.

It is economically unsound to consider manufacturing profits without realizing in this connection the importance of inventories, accounts receivable, and their relation to both profits and losses. A taxable profit should not be created by fiat of law regardless of whether or not actual operating profit has been made, and we therefore suggest that further consideration should be given the necessity and practicability of making special tax allowances for undistributed earnings which actually exist in nonliquid assets or earnings.

The tax bill recently passed by the House and now before your committee for consideration is apparently an attempt to carry out the suggestion made by the President in his message to Congress of March 3, 1936. In that message the President proposed that the present taxes on corporate net income, the capital-stock tax, the related excess profits tax and the present exemption of dividends from the normal tax on individual incomes, be repealed, and that there be substituted in their place a tax on corporate income which is undistributed as earned. The President further stated that this form of tax "would accomplish an important tax reform, remove two major inequalities in our tax system and stop 'leaks' in present surtaxes."

The two major inequalities to which the President referred are: First, that under existing corporate and personal income taxes stockholders of small incomes are taxed much more heavily than they would be if the business was conducted as a partnership or by an individual; and the second inequality is the reverse thereof, namely, that stockholders of large incomes are taxed under existing laws at a much lower rate than they would be if the business were conducted as a partnership or by an individual.

While it may be debatable how serious in practice these alléged inequalities actually are, I shall, for the purpose of the argument which I wish to make, admit their existence. I shall further admit that it is possible for corporations to be organized and operated with the objective of decreasing the surtax burden on their principal stockholders. Does the bill passed by the House remove these inequalities? It does only if all of the net profits in each 12-month period are paid out to the corporation's stockholders. Whenever any part of the net profits are not paid out during the period in which they are earned the same inequalities that exist in the present tax laws will remain and in fact be increased with respect to stockholders of small incomes if the amount of net income undistributed exceeds 30 percent of the total earned in the accounting period.

In sections 14, 15, and 16 partial relief is given to corporations where for certain reasons specified in those sections the entire net earnings cannot legally be distributed, but by imposing relatively high rates of taxation on that part of the earnings which cannot legally be distributed, the bill is perpetuating the same inequality against stockholders of small incomes as they are subject to under the existing laws, thus failing to carry out one of the major objectives for the proposal in the President's message.

There is unfortunately a widespread misconception respecting the character of the item entitled "surplus" on a corporation's balance sheet, and also the character of a corporation's "net profits."

The meaning of the word "surplus" as used by accountants on a corporation balance sheet is simply the title of the amount necessary to add to the corporation's other liabilities including the par or stated value of its capital stock in order that the total shall equal the total assets of the corporation. The size of this surplus or its proportional relationship to the other liabilities including the stated or par value of the corporation's capital stock is never in the case of a manufacturing or business corporation a measure of its ability to pay dividends or even of its ability to meet its contractual obligations to its creditors. It is entirely possible for a corporation to have a very large surplus and yet be insolvent in the sense that it cannot meet on their due dates its contractual obligations to creditors. The significant items of a corporation's balance sheet are the debit items namely, the assets, and it is the character of the assets and the proportional relationships of the several classes of assets that have any significance from a business standpoint in determining whether a corporation may pay dividends or even meet its contractual obligations to its creditors.

Any assumption that surplus represents sums available for distribution as dividends whenever the directors decide to so use the amount is fully refuted by Robert R. Nathan, chief of the income

section of the Economic Research Division of the Department of Commerce, who says (Survey of Current Business), November 1935:

"Insofar as surplus is concerned, there are many factors other than the volume of business savings or losses which effect changes in the surplus accounts of business enterprises. The revaluation of capital assets, profits from the sale of capital assets, corporate reorganization, and the capitalization of surplus are some of the important ways in which changes in surplus can be brought about other than by the transfer of business savings or losses to surplus."

It is sometimes earnings and dividends assumed that the entire amount of net profits determined in accordance with approved accounting procedure is available for distribution to its full amount as dividends. From this assumption, which I shall show in a moment is a false one, arises the idea that it is within the arbitrary discretion of the directors whether or not to distribute all or only a part of the net profits, and at least suggests that the controlling motive why all is not distributed is because the board of directors are dominated by stockholders of large incomes who desire to thereby escape surtaxes. It is true that in a legal sense directors possess discretionary power as to the proportion of net earnings to be distributed, but it is untrue that the boards of the great majority of manufacturing and mercantile corporations do not distribute in dividends the entire net profits because of a desire to escape surtaxes.

With rare exceptions dividends taxable to individual stockholders must be paid in cash, and unless therefore the net profits of a corporation have been realized in cash, dividends to the full extent of the net profits cannot be paid. It is well known to anyone familiar with the operation of manufacturing and mercantile corporations that it may frequently be the case that such corporations will have for periods of several years substantial annual net profits only a very small portion of which is represented by an increase in its cash balances. It may even have earnings accompanied by an actual decrease in cash balance or an increase in its liability to creditors. This is exactly what happened to my own company last year. To enact a tax law which imposes a heavy tax on those corporations unable to distribute their entire net profits in dividends is a complete negation of the principle of ability to pay and will have the most far-reaching and harmful effect upon the business of the country.

Senator HASTINGS. Are you going to tell us anything about your own company and how it affects it?

Mr. MOONEY. We had last year what we thought was a pretty substantial profit, and it was wholly an increase in the value of the inventories.

Senator HASTINGS. What was it?

Mr. MOONEY. It was just slightly under $500,000.

The CHAIRMAN. What was the capitalization?

Mr. MOONEY. $3,400,000 common and $890,000 preferred.

Senator HASTINGS. What did you do in the way of dividends? Did you declare dividends?

Mr. MOONEY. Last year we declared 1 percent dividends during the year.

Senator HASTINGS. That took how much of your profit?

Mr. MOONEY. That took $34,000. We paid all of our dividends on the preferred. That took about $45,000, and we paid 1 percent on the common which took $34,000.

Senator HASTINGS. Would you have any objection to putting in the record your annual statement?

Mr. MOONEY. No, I do not think I would. I would have to send it over. I do not have it with me.

Senator HASTINGS. I think it may help in these things to get examples like that.

Mr. MOONEY. I think so, too.

(Mr. Mooney subsequently submitted the following:)

THE AMERICAN OAK LEATHER CO.,
Cincinnati, May 7, 1936.

Mr. FELTON M. JOHNSTON,
Clerk, Committee on Finance, United States Senate,
Washington, D. C.

DEAR SIR: We are enclosing our balance sheets as of December 31, 1934, and December 31, 1935. They are to be included as part of the testimony of Mr. W. H. Mooney, the president of the company, who appeared before the Senate committee this morning.

Yours very truly,

THE AMERICAN OAK LEATHER CO.

Consolidated balance sheet at Dec. 31, 1935

ASSETS

Current assets:		
Cash	$186,595.83	
Accounts and notes receivable	509,198.62	
Inventories	3,233,933.66	
Total, current assets		$3,929,728.11
Investments in other companies		149,672.63
Land, plant, and equipment:		
Land	$196,658.51	
Pland and equipment, less depreciation	1,057,850.55	
Total, land, plant, and equipment		1,254,509.06
Deferred charges		68,367.52
Total, assets		5,402,277.32

LIABILITIES

Current liabilities:		
Accounts payable	$179,040.08	
Notes payable	250,000.00	
Federal income tax	66,780.16	
Federal capital stock tax	7,000.00	
Accrued accounts	28,814.27	
Total, current liabilities		531,634.51
Net worth:		
Preferred stock, outstanding	$1,206,100.00	
Less treasury stock	316,600.00	
Net preferred stock, outstanding	889,500.00	
Common stock	3,399,700.00	
Reserve for securities owned	31,000.00	
Reserve for inventory price equalization	446,461.38	
Earned surplus	55,720.93	
Share purchase surplus	48,260.50	
Total, net worth		4,870,642.81
Total, liabilities		5,402,277.32

Consolidated balance sheet at Dec. 31, 1934

ASSETS

Current assets:		
Cash	$286,843.50	
Accounts and notes receivable	400,025.29	
Inventories	2,451,166.95	
Total, current assets		$3,138,035.74
Investments in other companies		139,980.97
Land, plant, and equipment:		
Land	$196,658.51	
Plant and equipment, less depreciation	1,109,206.39	
Total, land, plant, and equipment		1,305,864.90
Deferred charges		67,975.80
Total, assets		4,651,857.41

LIABILITIES

Current liabilities:		
Accounts payable	$46,147.97	
Federal income tax	26,400.00	
Federal capital stock tax	4,070.00	
Accrued accounts	25,854.97	
Total, current liabilities		102,472.94
Net worth:		
Preferred stock, outstanding	$1,206,100.00	
Less treasury stock	316,300.00	
Net preferred stock, outstanding	889,800.00	
Common stock	3,399,700.00	
Reserve for securities owned	53,500.00	
Earned surplus	158,197.47	
Share purchase surplus	48,187.00	
Total, net worth		4,549,384.47
Total, liabilities		4,651,857.41

Senator HASTINGS. And see exactly what would happen to you under this bill. For instance, do you happen to remember how much of your $500,000 was in cash?

Mr. MOONEY. I would say there was not any of it in cash, because at the end of the year—we started last year without owing any money at all to banks, and at the end of the year we owed them $250,000, and our cash balance, as I recall it, was slightly less at the end of the year than it was at the beginning, and yet according to this cost or market method, whichever is lower, we made about $500,000.

Senator BLACK. Was it all attributable to that, or did you make some investments of some kind?

Mr. MOONEY. No.

Senator BLACK. Did you increase your capital?

Mr. MOONEY. No. We just ran along in the usual way and that was the result.

The CHAIRMAN. All right, you may proceed.

Mr. MOONEY. It may be true that there were particular instances during the more or less recent past where directors have withheld from distribution in dividends earnings which the corporation might have safely distributed at the time, although had this been done during the period of prosperity it might have still further decreased

dividend disbursements which stockholders have enjoyed during the period of depression when there were no net earnings. I know that the proponents of this bill argue that the withholding of such dividends which could and which in their opinion should have been distributed at the time they were earned was a contributing cause to the depression from which we have been suffering during the past 5 years. I am not here going to debate whether that argument is sound or unsound.

Assuming it, however, to be sound, it is clear that it applies only to dividends which could have been distributed and which were not distributed. This is a far different matter, however, and the amount of such undistributed dividends is a far smaller amount than the total net earnings which, because they had not been realized in cash, could not have been distributed. At the present time the determination of the amount of the net earnings which a corporation can distribute is discretionary with the directors of each individual corporation and is properly made discretionary because it required for its determination the application of sound business judgment upon a number of detailed facts and circumstances existing in each individual case. I presumably know of no way by which a general rule embodied in a statute of Congress can be substituted for that discretion but if anyone believes that such a substitute can be made the burden is certainly upon him to embody such substitute in a law that can be examined and tested. Certainly the present bill, which takes no account of the real business factors which must be considered in determining how much may be distributed as dividends, in no way meets the test of a sound alternative to the exercise of discretion now imposed upon directors.

Throughout the bill there have been adopted legalistic rather than sound concepts for determination of the tax burden. In section 14 a partial exemption is allowed "if the accumulated earnings and profits of a corporation as of the close of the taxable year are less than the adjusted net income." Stated in another way: If a corporation had a deficit instead of an earned surplus at the beginning of the taxable year, its net earnings to the extent that they do not exceed the amount of said deficit are taxed at a flat rate of 15 percent. The limitation of the tax to such 15 percent may or may not be of some slight benefit to the corporation which has a deficit. The point that I want to make here is that the granting of this exemption is based upon a legalistic conception—namely, the existence of a deficit. So long as that deficit exists dividends may not legally be paid out, but it is possible through the taking of appropriate statutory proceedings to wipe out the deficit by a reduction in the state or par value of the capital stock, thus removing the legal impediment. When we apply, however, business concepts to whether or not dividends may be paid, the existence of a deficit or surplus is a relatively minor factor. It is the assets of a corporation and its outstanding liabilities to creditors which have to be considered in determining if a dividend can be paid—in other words, is there enough cash available to meet both the contractual liabilities to creditors and a dividend disbursement?

ALLOWANCE FOR DEBTS

In section 16, subdivision (b), the extent of the debts with respect to which partial relief is provided, is limited to the amount thereof that such debts exceed the accumulated earnings and profits of the

corporation as of the day before the first day of its first taxable year beginning after December 31, 1935. Here again we have embodied in the law the popular misconception of the nature of earned surplus. Is there any explanation for this limitation on debts, unless it is assumed that the earned surplus is there ready and available to pay debts to the extent of such earned surplus. It seems unnecessary to reiterate that debts can only be paid with assets of a corporation, usually its cash balances, and that the amount of its earned surplus has not the slightest relation to its cash balances or any other liquid assets.

It is difficult to understand the purpose of the limitations placed upon debts for which partial exemption is provided by section 16. First there is the limitation that the indebtedness must have been in existence on March 3, 1936, and evidenced by bonds, and so forth, issued prior to March 3, 1936. Suppose a corporation issues subsequent to March 3, 1936, evidence of indebtedness in payment of a pre-existing debt obligation? What reason exists for discriminating against such a corporation? Second, the debt must have a maturity at the time of issue of 3 years or more. Why this limitation? An early maturity should not be a more insistent obligation to be met out of the company's cash surplus than a later maturity.

CONTRACTS NOT TO PAY DIVIDENDS

Section 15 provides a partial exemption where there exists written contracts executed prior to March 3, 1936, prohibiting the payment of dividends or placing limitations upon the amount which may be paid. Can it be assumed that the same reasons which existed for the making of such contracts in the past will never exist in the future? If they do come into existence will they subject the corporation to the heavy penalty tax imposed by section 13? The usual circumstances under which restrictions on payment of dividends arise are in shortage indentures given to secure bond issues and in a company's contract with its preferred stockholders embodied in its certificate of incorporation.

The CHAIRMAN. In that connection may I ask Mr. Parker whether the R. F. C. gave any expression on this?

Mr. PARKER. No, sir.

The CHAIRMAN. Did they appear before the Ways and Means Committee?

Mr. PARKER. No, sir.

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

Mr. MOONEY. These contractual restrictions are to some extent adverse to the interests of the company's stockholders who are junior to either the bond issue or the preferred stock. They are assumed only because they are a necessary requirement to the obtaining of the capital through either bond issues or preferred stock issue. The prior obligation of the bond or preferred stock issue is frequently a heavy prior charge on the company's earnings. Are its junior stockholders to be further penalized by a penalty tax exceedingly heavy even under the provisions of section 15, and still heavier if the obligation is incurred subsequent to March 3, 1936, under the provisions of section 13. This legislation will, if enacted in its present form, force greater future reliance upon bank loans and security issues for

necessary corporate financing—it has frequently been necessary in the past to make indentures restricting payments of dividends to secure such funds.

If the bill is enacted as it stands you will either force corporations to pay heavy interest rates or make other special concessions to secure needed funds if these indenture provisions are not included, or if they are included will impose heavy additional tax penalties upon holders of junior security issues. Corporation financing and the conduct of corporation business will be rendered more difficult and more burdensome if you pass this bill with section 15 in its present form.

Let us now suppose that a corporation has a written contract made before March 3, 1936, obligating it not to pay dividends. Suppose the contract expires a year after the bill is enacted and the only way the obligation contained in the contract can be met is by refinancing. Under section 15 the refinancing could not contain the same indenture, at least without a heavy additional tax being imposed upon the stockholder. We submit that section 15 should be amended to provide the same credit now allowed in the case of antidividend contracts entered into prior to March 3, 1936, which are renewed upon expiration after the date.

We further submit that section 15 does not cover all of the situations which its authors presumably intended. We believe the section was intended to prive special treatment for corporations which cannot, because of contract obligations, pay out all or part of their net incomes as dividends. But we do not believe section 15 as now worded accomplishes this result. It refers only to contracts "expressly dealing with the payment of dividends." There are, however, many contracts not "expressly" preventing the payments of dividends which actually have that result. For example, contracts obliging a corporation to maintain net assets at certain amounts or ratios, or providing that net tangible assets shall at all times be maintained at certain amounts, or providing that preferred stockholders may demand calling of their stock if assets are not kept at a certain rate, or providing that certain sinking funds must be set aside to retire either debt or preferred stock—these are instances of contract obligations which may legally prevent the payment of dividends but because they may not "expressly" limit dividend payments would have no protection under section 15.

This proposed tax is not a tax depending on the size of the company's earnings, but it is a tax which depends on the disposition made by the directors of those earnings. It is not correct that the corporation may retain 30 percent of its earnings and pay no greater tax than it does at present. In its practical application if the directors wish to retain 30 percent they will be confronted with the fact that they must pay in a tax an amount equal to 50 percent of the sum retained, or if they are under contract made prior to March 3, 1936, to retain 30 percent then they will have to pay a tax equal to 22½ percent of the amount retained. Suppose this contract is for maintenance of sinking funds for retirement of preferred stock before common dividends can be paid. Suppose there are substantial accumulated unpaid dividends on the preferred stock. Then in a year or two you go to your stockholders and submit to them a proposition to amend the certificate of incorporation with the objective of funding accumulated unpaid dividends, and in general to introduce a greater degree of flexibility in capital structure than now exists. That would pre-

sumably, under the terms of section 15, be a new contract made subsequent to March 3, 1936. Obviously, the preferred stockholders are going to have some rights to bargain with respect to the terms of the new certificate and it certainly is not improbable that they will insist either on a continuation of the sinking-fund provisions or place some other alternative restriction on payment of dividends. Then and thereafter any amount of the earnings which you were by contract with the preferred stockholders unable to distribute in dividends would become subject to the full rates provided by section 13. How this would work out is, of course, impossible to say. It would depend, of course, in part upon the terms of the contract, but more importantly it would depend upon the size of the net profits, the larger the net profits the smaller would be the rate of tax on the amount which by contract we were unable to distribute; the smaller the net profits the larger would be the rate of tax; in other words, the less our ability to pay taxes the larger tax would we have to pay.

WINDFALL TAX

The President in his message of March 3 proposed the so-called windfall tax to be paid by taxpayers who either had their processing taxes impounded when these were supposedly due and subsequently had them returned following the Supreme Court's decision on the A. A. A., or who had refused to pay the taxes at all. The President further stated that these taxpayers should justly pay the taxes because they were in unequal position to the vast number of taxpayers who did not resort to such court action and who paid their taxes to the Government. It was stated that the group of taxpayers who, in one way or another, had challenged the constitutionality of the processing taxes, were unfairly enriched by the return or nonpayment of this Federal excise.

Before discussing the difficulties of administering this tax we respectfully submit that any such windfall tax is entirely unsound in principle. We recognize that individuals may justly be penalized for failure to observe Federal tax laws, but we submit that the taxing system should not be used as a penalty measure. We are opposed to a tax which in substance says to the taxpayer that he might as well pay the tax which is imposed regardless of its unconstitutionality because if he challenges the unconstitutionality of the tax and is successful in sustaining that challenge in our courts, he will then be assessed the amount of the unconstitutional tax in the form of a new tax. A taxpayer who challenges the constitutionality of a tax is entirely within his rights and should not be penalized as compared with the taxpayer who pays the unconstitutional tax without challenging its validity.

Title III of the proposed legislation is entitled "A tax on unjust enrichment" imposing a tax of 80 percent of that portion of the net income from the sale of articles with respect to which a Federal excise tax was imposed upon such person but not paid which is attributable to shifting to others the burden of such Federal excise tax.

It will be observed that this tax is not confined to processing taxes, but affects all Federal excise taxes and is to continue permanently. A similar 80 percent tax is imposed on [reading]—

that portion of the net income from reimbursement for Federal excise tax burdens received by such persons from vendors, which is equivalent to the amount of such Federal excise tax burden which such persons in turn shifted to vendees.

For the purpose of determining "the extent to which the taxpayer shifted to others the burden of a Federal excise tax" a standard is set up which states that "from the selling price of each article there shall be deducted the sum of (1), the cost of such article plus (2) the average margin with respect thereto." The balance is stated to be "the extent to which the taxpayer shifted to others the burden of such Federal excise tax with respect to such article." The "average margin" is described as "the average difference between the selling price and the cost of similar articles sold by the taxpayer during the 5 taxable years preceding the initial imposition of the Federal excise tax in question", or under certain conditions "the average margin, as determined by the Commissioner, of representative concerns engaged in a similar purpose and similarly circumstanced."

The term "cost" is described as "the cost to the taxpayer of materials entering into the article." In other words, there is here established a prima-facie rule to determine the extent to which the taxpayer is alleged to have shifted "to others the burden of such Federal excise tax." We do not believe that any prima-facie rule can possibly take into account the multitude of factors existing in individual companies and we respectfully submit that the rule established in section 501 (d) and (e) is entirely inadequate, complicated and would be extremely costly in operation.

In the first place, it seems impossible to determine "prices" and "average margins" in any such simple manner as is proposed. Just to mention a few considerations to be taken into account. The manufacturer has, in the majority of cases, a great variety of products. They are sold in different markets, under different sales conditions, to different classes of customers. Aside from the fact that there are all types of sales, such as liquidation sales, agency sales, and the like, they will vary in the same type of business with concerns that are "similarly circumstanced."

In the second place, even if ascertaining cost were a simple problem it certainly should be limited to the "cost to the taxpayer of materials entering into the article." No consideration is given to direct labor, indirect labor, factory burden, indirect burden, and general divisions of overhead of a factory. It has been my experience that even in the accounting profession, which is supposed to be known as an exact science, it will give various answers on the cost of a product according to what theories are applied and what fine lines of distinction are made in departmental indirect burden in factory costs.

In the third place, suppose that a firm does not maintain extensive accounting records which would contain the desired data. Then the duty of determining a satisfactory quota is thrust upon the Commissioner; he would have that apparently simple duty of determining the "average margin" of "representative concerns", and then determining what companies are "similarly circumstanced." It can be seen that this would cause enormous delays and costly disputes on the amount of tax involved and further complicate the problems confronting the Commissioner of Internal Revenue. We submit that it would be almost impossible for the Commissioner to obey the law as it is written, and yet if he establishes an arbitrary rule for the determination of suh a comple consideration it will be unfair to the taxpayer.

It may be pointed out in connection with the definition of the term "cost" that apparently if an article is sold for $100 there should be

deducted from such $100 the "cost of the article", which is defined in the act to consist only of "cost of materials entering into the article", which, for the purpose of this example, we will assume to be $50, and also the "average margin" for the "average difference between the selling price and the cost." In other words, if the so-called "average margin" during the full 5-year period, as determined by the Commissioner of Internal Revenue, was $30, then the total deductions in this particular instance would be $80 and the taxpayer would have shifted $20 of the cost to others.

It would be just as logical to say that if the average margin was figured at $70, the total deduction would be $120, and then the Government should reimburse the taxpayer because he had not charged enough for his article. As a matter of fact the whole problem of determining "selling price" is so complicated by changes in all factors entering into such selling price, including not only the cost of materials but also the cost of labor, insurance, taxes, etc., that it is entirely unsound to base any tax upon such an "average" or to arbitrarily define "selling price" in such a way as to magnify the importance of some particular factor entering into the final selling price. The question of determining whether any particular tax or any other element of cost has been passed on to consumers is almost impossible to determine on any sound accounting basis, and certainly cannot be fairly determined by any arbitrary or prima-facie rule.

CONSOLIDATED RETURNS

We advocate the reestablishment of the provision of making consolidated returns with a small special tax for the privilege of doing so.

Regardless of the advisability of making provisions for consolidated returns under the existing tax laws, we believe that the heavy tax at rates now proposed makes more advisable and necessary than ever before from an economic standpoint provision for such consolidated returns.

Let us assume, for example, the case of a manufacturing company which owns two subsidiaries; one supplying the chief source of raw materials, and the other handling sales. Subsidiary A shows a profit on the year's operation of $200,000. Subsidiary B, on the other hand, shows a deficit of $100,000. Subsidiary A distributes its earnings to the parent company, and there is no tax on company A, but the parent company must use $100,000 of the earnings from company A to offset the losses of subsidiary B and keep it in operation. If the parent company wished to distribute the entire remaining $100,000 to its stockholders, it would still be subject to a tax of 35 percent on the entire $200,000. In other words, because the company must use $100,000 to keep company B going, this amount would be credited as undistributed net income. The corporation would therefore be taxed 35 percent or $70,000 on the entire $200,000, leaving only $30,000 available for its stockholders. Inasmuch as many manufacturing companies which have subsidiaries must perforce use the earnings of one to keep others in operation, the heavy tax proposed would make it difficult, if not impossible, to adequately finance many weak companies without extreme tax burdens on stockholders, and it is for this reason that we believe your committee should give serious consideration to the restoration of the privilege of making consolidated returns.

Such a plan seems consistent with the President's message of March 3 when he stated, "as the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends." Under the pending bill the dip would be deeper in many instances.

DEFINITION OF CAPITAL ASSETS

We further direct your attention to the definition of capital assets contained in section 117 (b). In the act, as it now stands, this provision repeats the language of the Revenue Act of 1934. The limitations on capital losses from sales or exchanges of capital assets were so worded as to apply to those assets which are normally subject to depreciation allowances. This provision is obviously unfair, and we believe its inclusion in the 1934 Revenue Act was unintentional; we therefore recommend that there be added at the end of section 117 (b) the following words [reading]:

Or property normally subject to depreciation allowances.

READJUSTMENTS

I now direct your attention to sections 271, 275, 321, and 322, all dealing with the subject of tax readjustments on earnings for years subsequent to those for which the return was made. We suggest that these paragraphs should be revised to definitely provide that where a corporation is subsequently held to have had a net income in a prior year for which no net income was reported, or a larger net income than was reported, the taxpayer should have an option of paying out the entire additional amounts in dividends, or of adding the amount to net income reported for the year in which such finding is made and having his tax liability based thereon, instead of the amount being added in with the income of the year in which the so-called "new income" for the earlier year is found. Assuming that the taxpayer is not intentionally endeavoring to defraud the Government, but that he is held, for example, to have made a mistake in claiming certain credits, it seems unfair to penalize him for such mistakes.

Senator BLACK. May I ask in that connection, does your company have subsidiaries?

Mr. MOONEY. We only have one. We have one in Boston. We have a plant that operates in Boston, Mass.

Senator BLACK. Is your company a subsidiary of any other company?

Mr. MOONEY. No, sir.

Senator BLACK. No interlocking relationship except for the one?

Mr. MOONEY. That is all.

Senator BLACK. I assume it would be impossible for us to get the full picture that would be desired from the one statement, unless we had both?

Mr. MOONEY. Well, it would be consolidated.

Senator BLACK. It is consolidated?

Mr. MOONEY. Yes; it is consolidated.

Senator LONERGAN. The parent company owns all of the stock except the shares necessary to qualify for the directorship?

Mr. MOONEY. Yes; that is right.

The CHAIRMAN. All right, thank you very much, Mr. Mooney.

STATEMENT OF NOEL SARGENT, NEW YORK CITY, ECONOMIST, NATIONAL ASSOCIATION OF MANUFACTURERS

The CHAIRMAN. Mr. Sargent, I notice you are the economist for the National Association of Manufacturers?

Mr. SARGENT. Economist and secretary.

The CHAIRMAN. Following you will appear Mr. Emery?

Mr. SARGENT. Yes.

The CHAIRMAN. Both of you appeared before the Ways and Means Committee?

Mr. SARGENT. Mr. Emery did not, sir.

The CHAIRMAN. But you did?

Mr. SARGENT. Yes. It is my privilege to present before your committee the National Association of Manufacturers and by specific request the Government Finance Committee composed of the following members:

A. L. Green, chairman, Farr Alpaca Co., Holyoke, Mass., chairman.

H. Boardman Spalding, vice chairman and treasurer, A. G. Spalding & Bros., New York, N. Y., vice chairman.

John H. Minds, general solicitor, the U. G. I. Co., Philadelphia, Pa., vice chairman.

Benjamin Anderson, treasurer, Metal & Thermit Corporation, New York, N. Y.

William S. Bennet, New York, N. Y.

S. B. Berg, comptroller, Cherry-Burrell Corporation, Chicago, Ill.

Howard B. Bishop, president, Sterling Products Co., Easton, Pa.

R. E. Blake, counsel, International Shoe Co., St. Louis, Mo.

Leroy Brooks, Jr., president, Tool Steel Gear & Pinion Co., Cincinnati, Ohio.

C. R. Burnett, president, American Oil & Supply Co., Newark, N. J.

J. E. Butterworth, vice president and treasurer, H. W. Butterworth & Sons, Co., Philadelphia, Pa.

G. Carlisle, treasurer, C. E. Jamieson & Co., Detroit, Mich.

William D. Disston, second vice president, Henry Disston & Sons, Inc., Philadelphia, Pa.

H. H. Eckert, financial executive, Thomas A. Edison, Inc., Orange, N. J.

Ben H. Gangard, assistant manager, Warren-Lamb Lumber Co., Rapid City, S. Dak.

F. M. Hesse, treasurer, National Steel Corporation, Pittsburgh, Pa.

Tracy Higgins, president, Charles M. Higgins & Co., Brooklyn, N. Y.

H. G. Hook, controller, Bassick Co., Bridgeport, Conn.

Earle O. Hultquist, president, Jamestown-Royal Upholstery Corporation, Jamestown, N. Y.

W. P. Hutchinson, president, the Sprague Meter Co., Bridgeport, Conn.

A. S. Johnston, vice president, Pioneer Cooperage Co., St. Louis, Mo.

A. F. Kletzien, secretary-controller, Fox River Paper Co., Appleton, Wis.
R. H. Knowlton, vice president, Connecticut Light & Power Co., Hartford, Conn.
Royal Little, vice president, Franklin Rayon Corporation, Providence, R. I.
William N. McMunn, president, Michigan Seamless Tube Co., South Lyon, Mich.
N. R. McLure, vice president, E. J. Lavino & Co., Philadelphia, Pa.
E. G. Miner, chairman, the Pfaudler Co., Rochester, N. Y.
Will H. Mooney, president, the American Oak Leather Co., Cincinnati, Ohio.
W. H. Pouch, president, Concrete Steel Co., New York, N. Y.
H. W. Prentis, Jr., president, Armstrong Cork Co., Lancaster, Pa.
Hugh H. Price, treasurer, General Ceramics Co., New York, N. Y.
R. S. Pruitt, vice president and general counsel, Cord Corporation, Chicago, Ill.
T. Rieber, chairman of board, the Texas Co., New York, N. Y.
Fred Schluter, president, Thermoid Rubber Co., Trenton, N. J.
C. E. Schoble, vice president, Schoble Hats, Inc., Philadelphia, Pa.
Jay Terry, president, the Terry Bros. Co., Kingston, N. Y.
Charles Warner, president, Warner Co., Philadelphia, Pa.
Forest L. Williams, secretary-treasurer, Williams Manufacturing Co. Portsmouth, Ohio.

I shall consider in detail the proposal for a tax based on undistributed net income of corporations, presenting such consideration from the following major viewpoints, namely—

(1) The fundamental nature of the present proposal.
(2) Basic economic objections to such a tax.
(3) Objections to specific features of the proposed act.
(4) Arguments advanced in support of the tax.
(5) Foreign experience with similar taxation.

NATURE OF THE TAX

The measure before your committee cannot be considered merely as a tax proposal. It must also be considered as a regulatory measure and as a form of deliberate national economic planning. It is a further step toward Government regulation and regimentation of business corporations, since it sets up a basic standard amount which should be retained as reserves and puts a tax penalty upon reserves beyond such arbitrary fixed standards. Thus we find that the report of the majority of the House Ways and Means Committee declares:

> Under the plan, a small corporation can accumulate approximately 40 percent of its net income without paying a greater tax than it pays under existing law. Even a large corporation can accumulate 30 percent of its net income without paying more tax than it does under existing law.

Similarly Mr. Helvering has stated to this committee (transcript of hearings, p. 47) that the pending bill would permit—

> the small income corporations * * * to retain up to approximately 40 percent of a year's earnings for capital purposes and still pay less than they pay now. Corporations with large incomes will be enabled to retain about 30 percent without paying as much in taxes as are paid under the present law.

This language can only be interpreted to mean that corporations are invited and expected to keep their tax rates within the present schedules by disbursing as dividends in the one case 47 percent of their net income as dividends, and in the case of the larger corporation 55 percent of such net income. We believe it is fundamentally unsound to take any actual or assumed average of income retention and apply this as a standard for all corporations beyond which their taxes shall be increased above the present rates. We are opposed to such economic planning by decree or legislative fiat, for if Congress can establish one so-called desirable standard of income retention one year, it can establish another such standard in any succeeding year.

Any attempt to substitute the judgment of commissions or legislators for that of industrial executives as to the percentage of earnings which can be properly distributed as dividends is economically unsound and fraught with dangers alike to employees, stockholders, and the public. A statutory standard of financial management upon the part of business enterprises, which vary enormously in their ability to comply with such standard and continue to remain as going concerns, will prove dangerous to the economic welfare of this country.

We submit for your consideration at this point a chart showing the wide fluctuations of profits in different industries; it fully demonstrates the economic folly of assuming that because all corporations retain a certain average percentage of earnings that it is either logical or just to base a tax policy upon any such average.

Senator GEORGE. It may go into the record, if charts are being printed.

Mr. SARGENT. I understood they would be printed in the final record but not in the preliminary print, Senator.

Senator GEORGE. It may be filed with the secretary.

Mr. SARGENT. If you will examine this chart you will see the wide fluctuations in different industries. Here is the meat-packing industry, for example, which in 1930 had profits 175 percent as great as its profits in 1927, but in the following year it has losses 207 percent as great as its profits in 1927, and you can see similarly with other industries the very wide fluctuations from year to year in the amount of earnings.

(The chart referred to is on file with the committee.)

Mr. SARGENT. Not only is this true, Mr. Chairman, but we know that even if you should decide after careful consideration to base a tax policy upon an average retention of corporate earnings that you have been supplied in this proposal with a statistically fallacious base.

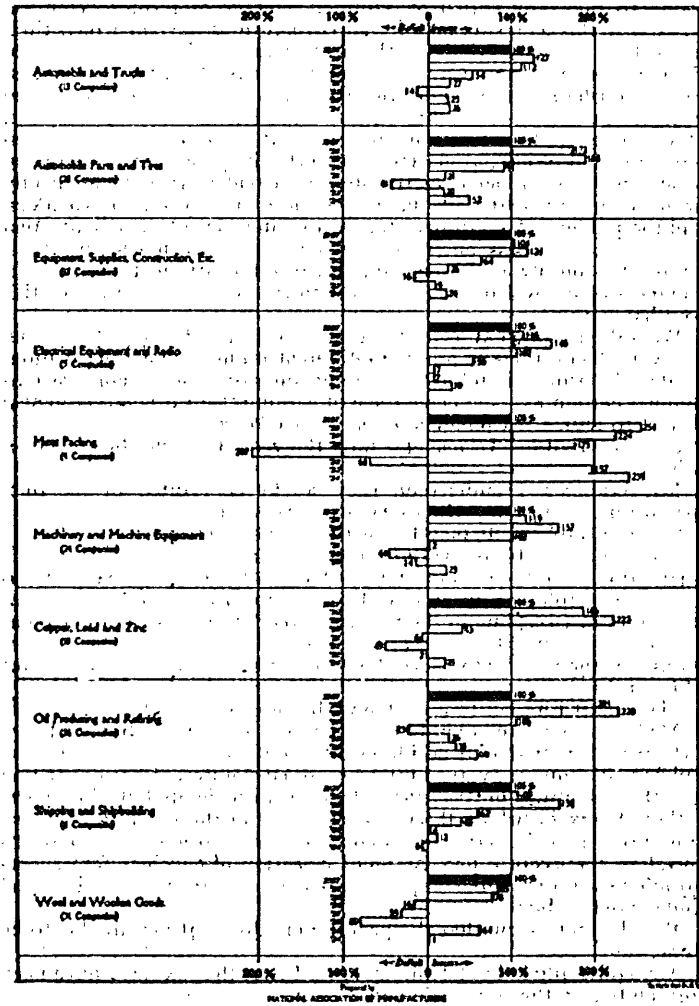
The theory on which the rates suggested in the pending bill have been predicated is that it is economically wise to allow corporations to retain the average percentage of retention of earnings for all corporations without higher corporate income-tax rates than are imposed under existing law.

But the facts show that the pending bill does not permit this to be done.

Mr. Helvering in his testimony agreed that the tax rates have been formulated on the assumption that—

a study of the distribution of dividends over a period of approximately 10 years indicates that on the average corporations normally retain about 30 percent (transcript of hearing p. 47).

PROFIT VARIATION IN DIFFERENT INDUSTRIES
AND THE RESULTING EFFECT ON
AMOUNTS AVAILABLE FOR REINVESTMENT OR DISTRIBUTION IN DIVIDENDS
BASE 1937 = 100%



Prepared by
NATIONAL ASSOCIATION OF MANUFACTURERS

I do not know just what period of years may have been used by Mr. Helvering; I am sure, however, that the only logical method is to have such average on a succession of fairly normal or good years.

But I find that if we take the 7-year period 1923–29, inclusive, that all corporations retained 35.7 percent of their earnings, and that manufacturing corporations retained 31.2 percent of their earnings, which is pretty close to the 30 percent figure for average retention which has been presented by Mr. Helvering.

While there is some discrepancy between these 7-year averages and Mr. Helvering's 10-year average this is not the major objection to the formula used.

The major criticism is that the Treasury average is apparently based on an average for all corporations. From a sound economic standpoint the only logical base to use for such average is the retention made by corporations showing profits since (with a very few exceptions) they are the only ones which pay income taxes and are the only ones which can actually make any retentions from earnings.

If we use the figures for all corporations with net incomes for the period 1923–29 we find that the average retention was 45.4 percent; the average retention by manufacturing corporations during the same period was 44.9 percent.

The only logical period to take for compiling an average of earnings retained by corporations is a series of fairly normal or good years; we use the years 1923–29 as the best recent period of such years. Moreover, any such average is of service only if it is confined to corporations with net incomes. If the authors of this bill wish to draft a measure containing tax rates which will actually permit corporations with earnings to make an average retention of such earnings without higher taxes than are now imposed this will necessitate practically complete revision of the rate schedules in the bill now pending before this committee.

We submit further that there is serious reason to believe that many advocates of this bill desire it as a step toward Government control of the amount of money which can be invested in any industry and, indeed, in any company in any industry.

Thus Professor Tugwell in his book The Industrial Discipline, written in 1933, states that there must be "planning for equilibrium" (p. 200). This would mean, it is stated, that "the flow of new capital into different uses would need to be supervised" (p. 202). Dr. Tugwell then goes on to analyze what he terms "the situation presented by the problems of controlling the allocation of capital and of fixing prices" (p. 203). As his primary argument for "capital allocation" Professor Tugwell states that, "industries, at present, are, many of them over-equipped" (p. 203), and that they "have been able to get hold of enough investment funds to build more plants and install more machinery than they ever use."

Reference is then made to "the system of planning" which would allocate to "specific industries" and under which "the surplus investment capital could then be assigned to other industries" (p. 204). Such capital allocation, it is stated, "would depend on knowledge from some planning agency, of how much for a measured future ought to be put to one use rather than to another" (p. 205).

The first step in such allocation, it is said "would be to limit self-allocation" (p. 205), namely, the extent to which industries in their own discretion "expand their own activities." The idea, however,

goes much further, for it is said "along with this is another problem. In each industry there are many businesses. There is not only the problem of knowing what the industry's output will be or ought to be, but also that of knowing how much of the business will go to each firm involved", and it is stated that this determination "would be the function of another sort of administration" under which "some principle of apportionment would have to be adopted" (ibid).

Dr. Tugwell then becomes practical and asks, "How then would the problem be attacked?" (p. 206). And he says in reply to himself that "in general the principle invoked would be to drive corporate surpluses into the open investment market" (ibid). This would be accomplished, it is said, through tax imposition on funds "which are kept for expansion purposes" (ibid).

It is said that "if taxation forced these funds into distribution as dividends, they would have to seek reinvestment through the regular channels." But it is further stated that "once all funds were forced into the investment market, however, some other means of supervision their uses would be needed" (ibid).

Professor Tugwell then concludes that—

> Control of investment is not so complex a matter, at least in principle, as it might at first seem. The principles involved would be only two; the forcing of all investment funds into an open market, and the regulating of new capital issues (p. 207).

I think these quotations are fully sufficient to demonstrate that if the minds of many who advocate a tax based on undistributed profits is a means to Federal control of all industry through substituting Government discretion for that of management as to the amount of earnings which should be retained in businesses, adding this form of control to Government control of new security issues and labor policies of manufacturing operations.

Corporations are groups of individuals who have invested their savings in a joint business enterprise. If we once start the policy of using taxation to prevent accumulation of corporate savings there is grave danger that we will be embarking on a road that will lead to the use of taxation policies to control individual savings.

SPECIFIC ECONOMIC OBJECTIONS TO PROPOSED TAX

(1) A tax based on undistributed profits would tend to prevent industrial growth through the reinvestment of "plowing back" of earnings.

Such reinvestment has been chiefly responsible for industrial expansion in the past century and unless prevented by arbitrary legislation should be looked to as the major source of future business expansion and employment—unless we wish to take a completely defeatist attitude in this country and assume that business production and employment can never expand beyond the present level.

You are, of course, well aware that prophets of gloom have taken this attitude in every previous major depression in which this country has been involved, and in each case their prophecies have collapsed in the face of ever-increasing national progress.

As to the basic economic importance of encouraging such financial reinvestment instead of penalizing it, as this tax measure would do, I call your attention to a most illuminating article by Carl Snyder,

economist of the Federal Reserve Bank of New York and former president of the American Statistical Association... In this article (from the September 1935 issue of Weltwirtschaftliches Archiv, published at Jena, Germany), Mr. Snyder says in part (the full article by Mr. Snyder is reprinted as an appendix to my remarks before the House Ways and Means Committee):

We have for the United States unique research material on the great industrial development of the past century, viz, on a process in which, out of a group of undeveloped colonies without a capital reservoir, there grew the greatest industrial economy in existence. These sources show that parallel to this considerable growth went a steady increase in invested capital, which came mainly, even if not entirely, out of industry itself, while other sources of savings were of comparatively small importance.

When the country is adjusted to a certain rate of growth, complete and general employment depends on a corresponding offering of new capital and the utilization of this capital for the expansion of productive capacity. As capital offerings are decided by the size of industrial returns and therefore increase with the rise of returns, it follows that all tendencies to the diminishing of returns have the effect of slowing down the growth of economy, which in turn means a simultaneous slowing down of the growth of welfare, which necessarily is contrary to the general interest.

As to the practical importance in at least one large industry of the utilization of industrial profits for industrial expansion and increased employment, I submit a chart revealing that up to the end of 1926 approximately 80 percent of the tangible invested capital assets of the right leading automobile companies came from reinvestment out of the surpluses of the corporations themselves.

Senator BLACK. Mr. Sargent, would it bother you if I asked one question about the first chart?

Mr. SARGENT. No, sir.

Senator BLACK. I just wanted to be absolutely clear. Does this mean that over on the right-hand side of the column, over this way [indicating], that is the percentage of profit made over and above 1927?

Mr. SARGENT. We took the year 1927 as 100 percent in each case, except, for example, we could not take the bituminous coal industry which had a loss in 1927 and we could not show that at all, so we took only the industries that had profits in 1927. For instance, if you take the "Automobile and trucks", that was 100 percent in 1927 and their profit in 1928 was 127 percent.

Senator BLACK. The packing industry, as I read that, their profits in 1933—I want to be sure I am correct—was 404 percent more than their loss was in 1931, and in 1934 it was 446 percent more than it was in 1931.

Mr. SARGENT. I do not think that would be quite correct. You cannot add the figures in that way.

Senator BLACK. That is what I was trying to get at.

Mr. SARGENT. You would have to get a base and start down. You would have to make a mathematical computation and see what that computation would be. I would be glad to do that for you if you wish.

Senator BLACK. That 197, does that mean the profit was 97 percent more in 1933, for instance, than it had been in 1927?

Mr. SARGENT. That is right; yes, sir.

Senator BLACK. They made 139 percent more profit in 1934 in the packing business than they did in 1927, in meat packing?

Mr. SARGENT. Yes, sir.

Senator BLACK. You do not have 1935?

Mr. SARGENT. No, sir. You must bear in mind that these are only for four companies, because they were the only four companies on which we could get the figures for the 4 years.

Senator CAPPER. Do you have the Big Four figures?

Mr. SARGENT. I think they are among the larger group. I want to check that up before I state definitely.

The CHAIRMAN. What four companies?

Mr. SARGENT. I would be glad to send that information in for the record. I do not have the information here now. If you would like to have me do it shall be glad to do it for you.

The CHAIRMAN. I think it would be indicative.

Mr. SARGENT. All right; sir.

Senator KING. You do not have any figures showing the profits and losses of some six or seven or eight hundred small packers throughout the United States?

Mr. SARGENT. No, sir; I do not. It was impossible to get all the figures for every year for every company. That is the reason it was impossible to put those in.

Now, I am submitting my second chart.

(The chart referred to is on the following page.)

Mr. SARGENT. As you see in this chart relating to the automobile industry, their original capital investment of eight major companies, including the Ford Co. was approximately $305,000,000. Up to the end of 1926 they reinvested out of their earnings $1,322,000,000, or 80 percent, of the total invested capital of the industry at the end of 1926.

Senator HASTINGS. Do the figures include the Ford plant?

Mr. SARGENT. Yes; the eight major companies include Ford. Then I have put Ford in separately, because I thought it might be of some interest.

I would like to say, in connection with the Ford figure, there are some people who put the original investment at $28,000 instead of $40,000, but I thought it safer to put in the larger figure.

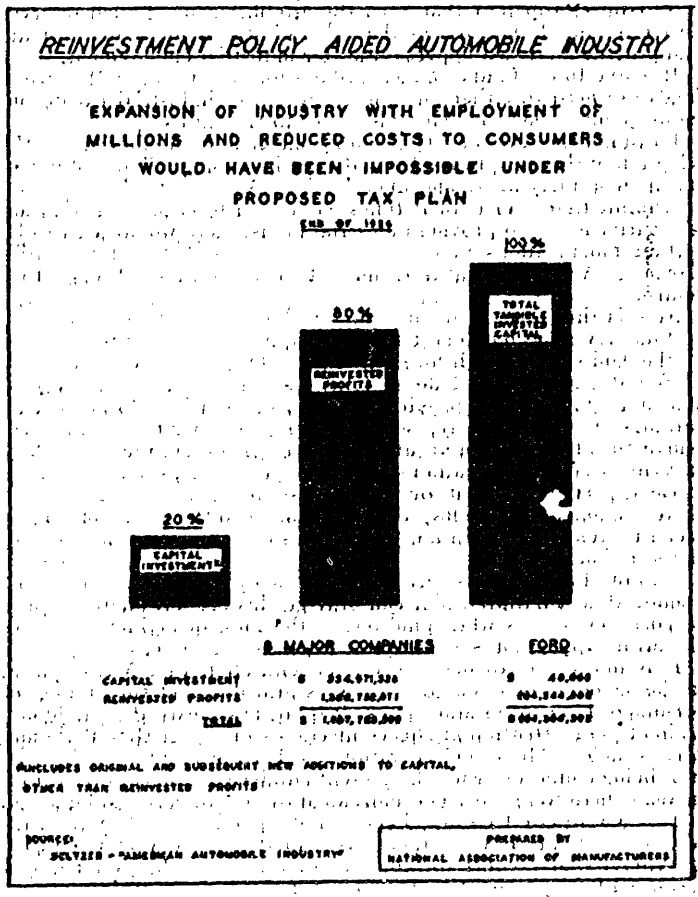
The distinguished Senator from Michigan and other members of the committee, I assume, are well aware that the most striking instance in this connection is the Ford Motor Co., which with $40,000 originally invested capital increased its total to $694,000,000 merely by plowing a very large portion of the profits constantly back into the business.

I imagine that no member of this committee believes that if these undistributed profits in the automobile industry had been heavily taxed in relation to their nondistribution that the automobile industry would have grown to the extent it has, and that it could have provided the vast amount of direct and indirect employment which exists as a result of this development.

We submit that a tax system which penalizes the setting aside of any substantial part of corporation net income for industrial reinvestment is economic folly.

Senator KING. In preparing these figures did you have before you the fact that the Ford Automobile Co., because of a change from the old style to the new, had to scrap property of the value of perhaps $50,000,000 to $60,000,000?

Mr. SARGENT. These figures only went to the end of 1926. I talked to the author of those figures, the man who gathered figures, and he said he never made any effort to compile them since 1926, which would cover the period you had in mind, Senator.



(2) A tax based on undistributed profits would force greater reliance for corporation funds upon security issues and bank loans, both of these being very difficult sources of funds when they would be most needed.

There are only three main sources of capital. These sources are reinvestment or "plowing back" of funds earned into industry, the raising of funds by security issues, or the securing of funds from banks.

It seems clear from the arguments made in defense of the pending proposals by Commissioner Helvering before the House Ways and Means Committee that the only recognized legitimate function of corporation reserves is for the "ordinary operating reserves, such as those for depreciation, depletion, obsolescence, bad debts, and the like." It is, of course, apparent that even the establishment of such reserves does not provide increase in the value of stockholders' investments and provide increased opportunities for industrial employment.

If reinvestment funds are not available for industrial use, then when funds are needed, either for emergency use or industrial expansion, industry must look to security issues or to the banks.

I think there can be little doubt but that in normal times the adoption of this tax proposal would force increasing reliance of industry upon security issues and upon banks. As a practical proposition we submit that if in normal times we wished to encourage flotation of security issues to provide industrial funds, there would need to be certain modifications in the present Securities Act and Securities Exchange Act, which make it difficult to secure funds through that source.

At this time I wish to comment on the statement recently made on this very point by Robert H. Jackson, Assistant Attorney General of the United States, before the Young Democratic Club of New York City, March 18, 1936. Mr. Jackson stated that the average stockholder is unfairly penalized when a corporation plows back its earnings in the company, since he gets no advantage from such reinvestment. Such an argument ignores or forgets the elementary fact that when a corporation creates a large surplus, whether it exists in cash, plant equipment, or inventories—and I might mention that there is apparently a widespread confusion as to the nature of surplus and an erroneous belief that all surpluses exist in cash—the value of the shareholders' stock also tends to increase so that he can collect his share of the surplus any time he wishes to sell the stock. To assume that the shareholder can only get his proportionate share of corporation surplus when paid out in the form of dividends ignores the primary question as to what determines stock prices.

It is interesting to observe in this connection that Mr. Jackson, in the same address, stated that "it is probable that the number of persons owning corporation stock does not much exceed 2½ million." I direct your attention in this connection to the fact that Berle and Means, in The Modern Corporation and Private Profits, both gentlemen being connected with the present administration, estimated that in 1928 there were 7,000,000 individual owners of corporation stock.

The Twentieth Century Fund, in its publication The Security Market, issued in 1935, estimates that in 1930 there were 10,000,000 individual shareholders (p. 50) and that in 1932 this number had increased to approximately 11,000,000 (p. 53).

Mr. Jackson further says that such a tax would present "greater inducement to stock ownership", since the corporation by distributing dividends "should have no difficulty in financing itself with stock issues." This contention has been presented before you by Mr. Haas. Now, regardless of whether the additional funds are secured through stock issues or bond issues, the fact remains that such bonds or stocks would have less in the way of reserves to increase their value.

or safety, and that each share of stock would become progressively less valuable as existing or future surpluses are dissipated and it is necessary to issue more securities. But even if we should admit for the sake of argument that in normal times a corporation could secure adequate funds, either through security issues or through banks, the fact remains that under such a system there would be a tendency to have less reserves, and that the net effect of this would be most felt in times of depression—when the company needs the money most. It is exactly then that it will become most difficult to raise funds either through security issues or through the banks. We must conclude, then, that this tax proposal would in normal times force a greater reliance for funds upon security issues and bank loans, but that it would make it most difficult, either to pay bond interest or bank loans, when business becomes less profitable, and would make it more difficult to secure funds needed to keep the plant operating when the funds are most needed.

(3) Such a tax, by tending to deplete corporation reserves, would lessen the security back of bond issues and stocks.

If this tax works as its principal advocates desire, it would unquestionably tend to reduce corporate surpluses as a whole. This is evidently desired, since it has been stated by its advocates that it would "discourage unwieldly and unnecessary corporate surpluses" (Presidential tax message, June 19, 1935).

Largely because of the existence of corporate surpluses it has been possible to maintain dividend payments in many companies during a period when earnings were not sufficient to permit such payments. In other words, there has been a security back of stock issues which would not exist if corporate surpluses as a whole are discouraged. Moreover, the security of many bonds has been the existence of surplus accumulations, and implied doubt of future surplus accumulations would unquestionably destroy some of the sense of security which has in the past contributed to the prestige of bond issues of particular companies, particularly in industries subject to extreme fluctuation in earnings.

If the tax burden should have the effect of discouraging the accumulation of surplus, then the question of the future value of bonds in an industry, together with the prospect of wide fluctuations in the market price of such bonds, becomes extremely serious for both individual and semipublic holders of such bonds. The results would be detrimental to all individuals and institutions which are now holders of such industrial bonds.

Senator HASTINGS. Mr. Sargent, may I interrupt you? I do not think there is anything in the record—I remember asking some representative of the Treasury Department what they knew about it—to show on the matter which you are now discussing, with respect to the necessity of changing the Securities Act in order to permit this to be done—there is nothing to show the difficulty confronting a corporation when it wants to get the money back into its treasury. Are you able to state just what that is? If you are not, would you give us a summary of the difficulties?

Mr. SARGENT. I do not recall the exact percentage at the present time, Senator, but I think the average amount of funds secured now is around 8 percent of the normal for the years prior to the depression,

through the flotation of security issues. I shall be glad to check that up and send you definite figures on that.

Senator KING. However, are not most of the flotations now for the payment of maturing bonds?

Mr. SARGENT. I think the majority are; yes, sir.

Senator KING. The overwhelming majority?

Mr. SARGENT. Yes, sir.

Senator HASTINGS. The point I had in mind—would a corporation which wanted to offer new securities to get back into the treasury the amount that it had distributed to its stockholders—would it have to go through a lot of red tape and a lot of difficulties with the Securities Commission to get authority to do that?

Mr. SARGENT. This tax would necessitate the raising of additional security issues and already many companies are finding it difficult to do so under the Securities Act.

We believe, for example, it might be desirable to amend the Securities Act and the Securities Exchange Act to eliminate provisions in connection with these acts which defeat new capital issues. These amendments should simplify registration statements and prospectus requirements, and should require as prerequisite to the right of the recovery proof of reliance on statements or prospectuses, and proof of damages caused by such reliance; should clarify the provisions fixing corporate and personal liability of issuers, distributors and their agents, and should allocate more equitably the burden of proof.

We believe it might be desirable to amend it to grant to member banks of the Federal Reserve System, under licenses to be issued by the Federal Reserve Board, the right to engage in security and underwriting of the British type, while continuing the prohibition upon their banks to engage in the public distribution of securities by solicitation of purchasers.

Senator HASTINGS. In short, you think it ought to be rewritten.

Mr. SARGENT. I should not say you should abandon it, but I think there ought to be a number of amendments, Senator.

Senator HASTINGS. I say "rewritten."

Mr. SARGENT. Yes; it should be rewritten in a number of respects.

As of June 30, 1934, for example, the licensed banks of the United States held over $4,750,000,000 of corporation bonds, representing 21 percent of their investments. Moreover, we find that 25 percent of the assets of life-insurance companies are in railroad, public utility, and industrial bonds.

Senator KING. Twenty-five percent you say of the securities of all the insurance companies of the United States?

Mr. SARGENT. Just life-insurance companies.

Senator KING. Just life-insurance companies?

Mr. SARGENT. Yes, sir. I have no figures for the other class of insurance companies.

The backing of these industrial bonds held by banks and insurance companies would, in many cases, be deterimentally affected by such a tax as is now proposed.

(4) Such a tax policy by encouraging increased dividend distribution would tend to deplete the working capital of corporations.

General Counsel Oliphant of the Treasury Department is quoted as having said to this committee April 29 that he could not accept the

idea that it was any purpose of the pending bill to "force the distribution of income." (Wall Street Journal, Apr. 30, 1936.) We concede that it is not the purpose of this bill to compel legally the distribution of dividends, but we believe most advocates of the bill favor it on the ground that it will, from an economic standpoint, force a greater distribution of dividends. Thus Assistant Attorney General Robert H. Jackson (address Mar. 18, 1936) declared that this tax proposal "lets the funds move to those who own them." I am inclined to agree with advocates of the measure who believe that it would cause many corporations to distribute a larger part of their current earnings in dividends, but I believe that in many cases such distribution would be distinctly unsound. It would tend not only to deplete corporate reserves, but would also tend to deplete the working capital of corporations.

A study of corporation accounts for the 8-year period, 1926 to 1933 (as given in the statistics of income published by the United States Treasury Department) shows that cash and bank deposits needed to pay for raw materials and to meet other day to day expenses, such as pay rolls, rent, and interest charges, runs somewhat over 20 percent of current assets (current assets includes inventories and notes and accounts receivable within a year). It is obvious that without this margin of cash and bank credit business could not be carried on efficiently.

There is great danger that a tax which seeks to force greater distribution of corporation earnings in the form of dividends would in many cases result in corporations unwisely distributing a part of the cash actually needed for working capital; that this would result either in the carrying on of current business on the slimiest of margins or in proportionate reduction of the business carried on, with consequent reduced purchasing of unfinished material, reduced distribution of finished products, and reduced opportunity for employment.

We submit that a tax program which penalizes and discourages the retention of adequate funds for working capital is completely unsound; that not only would this spending measure tend to reduce working capital, but it would tend to prevent accumulation of increased working capital in order to provide for increased work and employment.

Corporations with their stockholders and employees will suffer when business executives get to fooling around with corporation surpluses; we submit that it is particularly wrong to subject directors to the temptation to pay out as dividends profits which are really needed to extend or maintain the business, to encourage corporations to do things which from the standpoint of sound economic policy they ought not to do, to tax prudence.

You are, I am sure, aware that the 1928 report of the Joint Committee on Internal Revenue Taxation concurred in by the Advisory Committee, composed of Dr. T. S. Adems and other experts, declared with reference to the proposal for taxation based on undistributed corporate income that—

> The most obvious objection to such a tax is the burden which it places on legitimate and proper business expansion. As a business expands not only does its plant and property increase but a larger working capital is required and it is desirable that reasonable accumulations of profits necessary for the expansion and stability of corporations should not be unduly burdened. A tax placed only

upon the unnecessary accumulation of capital instead of upon the total accumulation involves many of the difficulties inherent in section 220 and is certainly an impracticable solution of the problem. It is believed that a tax on the total accumulation of profits by corporations is not desirable, because in many cases it might cause the making of unwise distributions and prevent the accumulation of a reasonable and proper surplus. (Rept., vol. I, p. 54.)

Senator KING. Do you refer in the statement there to the report submitted by the Joint Committee on Taxatoin?

Mr. SARGENT. That was an extract from this report submitted in 1928.

Senator KING. By Mr. Parker?

Mr. SARGENT. Yes, and concurred in by the Advisory Committee consisting of Dr. Adams, Mr. May who testified yesterday and a number of other distinguished authorities in this field.

As a very practical example of the manner in which the proposed tax program would tend to deplete working capital by inviting unsound dividend policies, that is to say, uneconomic distribution either out of current earnings or from surplus, I submit statements made by the chairman of the Industrial Loan Advisory Committees of the New York and Minneapolis Federal Reserve banks.

W. H. Pouch, chairman of the Industrial Loan Advisory Committee of the New York Federal Reserve Bank declares (telegraph of Apr. 1, 1936):

During past 18 months acting as chairman industrial loan advisory committee Federal Reserve bank, second district, I have personally reviewed over 1,000 applications for loans from small and medium-sized companies and partnerships. I am firmly convinced the major cause for their unsound financial condition necessitating their demand upon Government for working capital was due to policy of paying dividends out of proportion to their earnings during years 1930, 1931, and 1932 thus depleting their liquid adequate working capital to meet their financial needs when increased volume of business was presented to them. Due to their distressed financial condition they sought Government relief through section 13B for necessary funds to carry on their business. Only practical way for small business man to grow is to lay aside excess earnings for future growth.

S. V. Wood, chairman of the industrial loan advisory committee of the Minneapolis Federal Reserve Bank declared (letter of Apr. 13, 1936):

In my mind and judging from the several hundred reports which I have reviewed in the past year and a half as chairman of the industrial loan advisory committee of this district, I can say that it is my feeling that the great majority of applicants are in need of funds due to an unsafe distribution of their earnings or surplus in the years when they were making profits.

A great many of the applicants had wonderful earnings in the past, and had they used good judgment and followed sound business principles in those days, would have accumulated a surplus cushion that would have tided them over such a period as we have been going through in the past few years.

The National Association of Credit Men states that tax policies very definitely affect credit responsibility, and we therefore urge that further consideration be given as to the manner in which every proposal which tends to deplete working capital may result in greater credit risk and impair the volume of business which may be done in this country.

We direct attention of the committee to the fact that section 1206 of the War Revenue Act levied a tax on undistributed profits, although this fact has apparently been completely forgotten. The tax prescribed was 10 percent of such amount of the new income of corpora-

tions as remained undistributed 6 months after the end of the taxable year. But I direct your attention to the fact that when Congress levied this act it apparently considered as entirely sound the principles which we are now advocating, because it also specifically provided that the tax was not to apply to the portion of undistributed net income which was actually invested or employed in the business, or was retained for employment in the reasonable requirements of the business.

Senator KING. Do you recall whether the reports of the House Committee on Ways and Means and in the Senate accompanied the bill?

Mr. SARGENT. I do not recall that, Senator.

I also direct your attention to the fact that the Senate Commerce Committee has approved the merchant marine bill, S. 3500, and that this bill contains a provision (sec. 530B) specifying:

> That there shall be set aside from earnings before the payment of any dividends or bonuses or the distribution of profits, a reserve fund to provide for the payment of any mortgage debt and the replacement of vessels and a reasonable operating reserve fund, and the Authority shall prescribe the amount of such reserve funds. That such reserve funds shall be maintained for these purposes with appropriate provisions permitting their proper investment and the use of the operating reserve fund to meet the operating requirements of any subsequent fiscal year.

Here we have one committee of the Senate approving the idea that reserves are necessary to provide ample working capital and another committee of the same body having before it legislation which would penalize corporations finding it necessary to set aside large portions of their earnings in reserves.

The complexity involved in the question of determining the condition of business can, we believe, be best met by the judgment of directors entrusted by stockholders with that responsibility. The difficulty when it is attempted by legislation or through governmental administration to determine such requirements was well pointed out in 1928 in the Report of the Joint Committee on Internal Revenue Taxation. This report declared that the proposal of proving—

> what constitutes the reasonable needs of the business * * * is generally beyond the power of the Bureau, at least in the case of operating companies." (Report, vol. I, p. 11).

We believe it is just as much beyond the power today as it was then.

I direct your attention further to the fact that the report of the joint committee, which was concurred in by the advisory committee, consisting of Dr. T. S. Adams, A. A. Ballantine, George G. Holmes, George O. May, and Dr. Thomas Walker Page, fully recognized the necessity of preventing what it termed "forced unwise distribution." It therefore suggested a provision which in its opinion would "give some incentive to corporations to make reasonable distributions, without going to the extent of forcing unwise distribution." "The principle", said the committee, "could be stated as follows:"

> Allow the corporation a deduction in computing net income equal to, say, 20 percent of the excess of dividends paid over dividends received, the deduction in no case to be more than, say, 25 percent of the corporation's taxable net income before such deduction. In the computation no account should be taken of stock dividends (Report, vol. I, p. 11, explained in full on pp. 55 and 56 of the report).

We further submit that even if this committee should endeavor to provide for allocation of some portion of earnings for maintenance

or increase of working capital that it would be administratively impossible to do so on any fair basis. The working capital requirements of corporations vary constantly and the necessity for measuring the amount that a corporation might retain out of its undistributed income for working capital would inevitably lead to both involved and protracted controversies between taxpayers and the Bureau of Internal Revenue. The proposals involved in the determination of reasonable additions each year to working capital would be simply enormous—the problem cannot in my opinion be adequately met in any revision of the proposal now pending before this committee, but if not met will certainly tend to hamper business progress and the providing of increased industrial employment.

(5) Such a tax would tend to result in more receiverships and reorganizations with consequent increased hardships upon both stockholders and industrial employees.

Mr. Jackson in his address previously referred to says that if this law should become operative "receiverships would be less frequent and reorganizations less common." It is my firm belief that if this tax becomes operative it would tend to result in more receiverships and more reorganizations and greater hardships upon both industrial stockholders and employees. This situation would arise because—

(a) Inability to secure funds from security issues or banks in times of depression coupled with inadequate reserves would certainly tend to force receiverships and reorganizations.

(b) Less security back of bonds would tend to force more receiverships and more reorganizations.

(c) Inadequate working capital would result from this act and would also tend to cause more receiverships and reorganizations.

Dr. E. R. A. Seligman, former president of both the American Economic Association and the National Tax Association, one of America's outstanding tax authorities, says (New York Times, Mar. 22, 1936) that under the proposed tax if the corporations "set aside nothing for reserve and then have a succession of bad years they may be forced into bankruptcy."

(6) The proposed tax policy would tend to intensify both booms and depressions.

The result of increased dividend distribution in prosperous times would obviously be to increase stock prices. The result would be stimulation of speculation of all sorts upon the part of those receiving the dividends. Contrariwise during periods of depression dividend distribution would be curtailed because corporation reserves out of which to pay them would be less. The result would be that stock prices would decline in even greater proportion than they have during the recent depression. This would cause even more widespread fluctuation in security prices than has occurred during recent years. This in turn would result in intensifying both booms and depressions.

We therefore submit that if would be particularly necessary if a tax on undistributed earnings should be enacted to repeal the present capital gains and losses provision. Otherwise you will simply have a double leverage working to create artificial booms through inflated stock prices and at the same time working in the other direction to unduly depress stock prices when corporations find themselves unable, because of lack of earnings or surplus, to pay dividends.

We have been advised, moreover, by congressional tax experts that over a 10- or 15-year period the Government would lose nothing by repeal of the present law on capital gains and losses; we submit, therefore, that the capital gains and losses provision should be forthwith repealed as an unproductive drawback to trade and employment and as an artificial creator of unsound speculation.

As specific objections to the present capital gains and losses provision, we cite the following:

(*a*) Such capital gains or losses have no relation to taxpaying ability. When they occur they usually represent a shift of investment. Such investment shifts should be made neither more difficult nor less fluid; the present tax provisions do tend to restrict fluidity of investment changes.

(*b*) By discouraging sales of securities when prices rise above real value the provisions encourage unsound speculation by those not fully informed as to real values. We observe that Charles R. Gay, president of the New York Stock Exchange, declared (Chicago Tribune, Oct. 18, 1935) that the Federal tax on capital gains was a contributory factor to the 1929 inflation of stock prices, since it gave some stocks an artificial scarcity value because large blocks were taken out of the security market.

(*c*) The existing provisions cause extreme shifts in revenue yield.

(*d*) Where property is held over long periods the administration difficulties are very great.

(7) The proposed tax policy would be especially burdensome upon the durable goods industry, in which reemployment is most needed.

In every major argument presented to justify the pending tax proposal emphasis has been placed upon the extent to which it is alleged to benefit the average stockholder. But so far as I am aware no stockholder has appeared as such before this committee or the House Ways and Means Committee to advocate the enactment of this legislation which is alleged to be in his interest. It may be pointed out that the position taken by the advocates of the legislation is in marked contrast to that taken by advocates of the graduated corporation tax last year, where all efforts to stress the welfare of stockholders were ignored, while this year they substantially ignore employees as they have been affected by the pending program.

In both normal times and particularly in time of depression this pending tax proposal would tend to penalize the industrial employees of the United States. You will recall that Mr. Snyder in the remarks previously quoted declared that "all tendencies to the diminishing of returns have the effect of slowing down the growth of economy" and that "this is contrary to the general interest." In other words, since in normal times increased employment in this country has largely come about through industrial reinvestment, tendencies to discourage industrial reinvestment at least render more precarious the possibility of increased industrial employment in the future.

In times of depression, or periods of emergency from depression, which we hope we are now in, the effect of this policy would be most felt in the durable goods industry. Unemployment is now worst in these industries, which have practically exhausted their own reserves, and which under this tax policy would be subject to greater tax penalties than other industries in trying to build up reserves as

business improves. Not only is this true but if established concerns are unable to finance equipment additions and replacements from undistributed profits, the usual source of such financing, the durable goods producers and their employees will suffer the consequence. It must not be forgotten that while surplus or undistributed profits assist in providing reserves upon which the stockholders may rely to a considerable extent for the payment of dividends during depression, they are also reserves upon the basis of which plants can continue operations and maintain at least a fair degree of employment.

An attack therefore on the policy of accumulating reserves is to a considerable extent an attack upon the best interests of labor. During 5 years, 1930–34, the business enterprises of this country drew upon their existing reserves to the extent of over 26 billion dollars to maintain stockholders, creditors, and employees.

Illustrating the extent to which corporation reserves benefit industrial employees I direct your attention to the fact that, according to studies published by the United States Department of Commerce in 1931 and 1932 the manufacturing corporations of the country paid out $4,889,000 more than they produced. During the same period they disbursed in dividends $2,944,000 and disbursed interest of $438,000,000, or a total of $3,382,000,000. The balance of $1,507,000,000 can be fairly said to be the minimum amount disbursed to industrial employees from accumulated reserves.

I am aware that Mr. Haas has stated before this committee that the actual figures "are strikingly at variance with this contention or belief" (hearings transcript, p. 130) that business losses "represent the amounts which corporations have had to pay out, in excess of their receipts, to workers, suppliers of material, bondholders," and so forth. That is an exact quotation from the testimony of Mr. Haas.

I direct your attention in this connection to the following statements in a Department of Commerce article on the national income during the years 1929–32, appearing in the February 1934 Survey of Current Business, published by the United States Department of Commerce. This Government statement declares:

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

We submit that instead of a Government policy which threatens to reduce the possibility of using business reserves to sustain salaries, wages, and interest in times of depression, that consideration might, indeed, be given to the possibility of providing definite tax credits for employers who give new work. I direct your attention in this connection to the fact that the recent report of the Association for Improving the Condition of the Poor, page 31, says that it would be [reading]—

> in accord with sound economy to attempt to encourage employment through the normal channels * * * by offering some form of reward to employers to increase the volume of employment.

(8) Such a tax policy would tend to reduce dividend payments when they are most needed.

One of the most appealing arguments made in behalf of the pending tax measure is the so-called purchasing power argument.

Mr. Jackson in his previously noted address said that forced distribution of dividends to the small investor "if paid to him will help buy comforts of life." The distinguished chairman of the Rules Committee of the other branch of Congress declares in radio address of March 15, 1936, that a tax on undistributed profits "would enlarge the purchasing power of the general public by reason of dividends distribution." In connection with this argument we remind members of the committee that the purchasing-power theory was also advanced as an argument justifying the enactment of N. I. R. A. Following examination of the actual operation of the N. I. R. A., the Brookings Institution study on the subject reports that (National Recovery Administration, pp. 759–760) [reading]:

> The N. I. R. A. purchasing-power theory * * * in practice did not work out as planned.

The underlying economic theory of the N. I. R. A. was that it would force employer disbursement from capital payments to labor payments; apparently the underlying theory in the minds of those advocating the adoption of an undistributed earnings tax is that it will shift employer disbursements from capital payments to dividend payments. I therefore direct your attention to the fact that the Brookings Institution report (ibid., p. 765) declares:

> It cannot be inferred that a shifting of employer disbursements from capital payments to labor payments will, in the absence of an increase in the aggregate for both purposes argument the total spending of the community.

We may observe also that the practice of withholding dividend payments in good times in order to permit the accumulation of funds for plant expansion, contingency reserves, and future dividend payments, does actually result in a greater distribution of funds at a time when funds for spending purposes are most needed.

Professor Seligman well observes upon this point in New York Times, March 22, 1936, that accumulated [reading]—

> Corporate reserves are of significance in rendering possible, after the outbreak of a crisis a partial continuation of enterprise, of sales at the required lower prices and of purchasing power to wages and dividends. Instead of discouraging this tendency, would it not rather be the part of wisdom for Government to induce, an perhaps ultimately compel, an extension of this practice?

We do not advocate or favor Government control of the extent to which available earnings should be paid out in dividends, but there would certainly be more logic in compelling corporations to retain sizable reserves than in penalizing them for doing so; in any event we consider unsound a tax which must proceed either on the basis that there will be no more business ups and downs in the future, or else that there will be created a vast permanent R. F. C. for all businesses in distress.

(9) A tax policy such as proposed in a monopoly promoter.

Mr. Jackson in his previously cited address declared as another virute of a tax based on undistributed earnings was that whereas the present system "encouraged monopolies," a tax based on undistributed earnings would tend to discourage "monopolistic practices."

It is my belief that exactly the contrary situation exists. It would doubtless be constitutionally impossible, and it is not now proposed, to tax existing surpluses of industrial corporations. What will inevitably happen, therefore, is that older companies with a well-entrenched financial position will be given a very substantial economic advantage as compared with the less well financially entrenched existing companies, or with new companies that seek to start in business.

I know of one manufacturer, for example, who tells me that this company and one other in his industry are in a sound financial position and that the pending proposal would drive their weaker competitors out of business.

I now direct your attention to this statement made by Charles J. Bullock, professor of economics, Harvard University, and former president of the National Tax Association (1920 proceedings, pp. 268–271). [Reading:]

If you want to get up a system of taxation that is going to bear with the great possible hardship upon growing successful, young industries, you will adopt such a system as that. A man who established an industry and makes a success of it ordinarily finds himself obliged for the first 10, 15, or 20 years to put back into it a large part of the profits, in order to keep the thing going, to provide for its development. It was suggested in this discussion that this tax or undistributed profits should be made a progressive tax which should bear heavily on the concerns earning a large percentage of profit on their invested capital.

Now, if you want to find a tax that will tend to entrench in its dominating position a monopolistic or quasi-monopolistic large industry, you cannot devise a better tax. We now know what we ought to have known in 1917, but Congress did not know, that the large percentages of income are earned in the smaller enterprises. I called attention to that in the address I made on the subject at our Atlanta conference in 1917. If you will look through that Senate document in which corporation incomes are reported, and the percentages of incomes to the invested capital stated, you will find almost invariably that where you go above 50 or 60 percent of return on invested capital you run into the small concerns. It is true of every class of business on the list.

A large concern, as it grows and establishes itself in a dominating position in an industry, earns a very modest percentage on its invested capital in ordinary years. That is true of every industry in which I have any knowledge of the facts. The large concern in a dominating position—I am speaking now of manufacturing business—ordinarily earns a very moderate rate of return on its invested capital.

On the other hand, a young competitor, coming in and succeeding—particularly in a mechanical industry where a man of brains and ingenuity can perfect an invention that enables him to develop a profitable specialty—that concern in good years will earn a very large rate of return, and the progressive tax on undistributed profits will crucify it.

Let me direct your attention to this statement made by President Roosevelt in June 1935:

The drain of a depression upon the reserves of business put a disproportionate strain upon the modestly capitalized small enterprise. Without such small enterprises our competitive economic society would cease.

I submit that if the President's tax message recommendations made 8 months after his statement just quoted were adopted in exactly the form proposed they would definitely tend to put even more of a "disproportionate strain upon the modestly capitalized small enterprise"—a reversal of policy in less than a year. The President in his April 13 address said that we need to "cushion depressions." If so, let us not deliberately enact legislation which will lessen industrial ability to "cushion depressions" and force more, instead of less, governmental aid in periods of depression.

I might say, Mr. Chairman, that that seems to be somewhat similar to the question you propounded to one of the witnesses yesterday.

The CHAIRMAN. I do not understand that that establishes a principle.

Mr. SARGENT. I realize that. We believe that a tax policy which puts a "disproportionate strain upon the modestly capitalized small enterprise" is economically unsound, that it tends to discourage new enterprise and initiative with consequent determent to our entire social fabric. Since a tax on undistributed earnings discriminates against new enterprises, we therefore suggest for the consideration of this committee that any legislation embracing this principle should provide that new corporations be permitted to accumulate earned surplus up to, let us say, 25 percent of paid-in capital at a low tax rate on earnings, perhaps 12.5 percent, if no dividends are paid.

Objections to specific features of the proposal:

(1) We believe that both from an administrative and economic standpoint any tax based on undistributed corporate earnings and any other form of tax on earnings, should be on a flat rate and not on a graduated rate.

A graduated rate tends to penalize the profits earned upon the investment of some stockholders as compared with other stockholders. Let us suppose that one corporation management, for example, finds it necessary from a sound business basis having a net income of over $40,000 to retain only 10 percent of its adjusted net income; there is a net tax on net earnings of this corporation of only 4 percent, but in another corporation with the same earnings, which has been going through a period of bad years and in which it is necessary to create substantial reserves to restore the company to a sound financial condition, it is necessary to withhold 50 percent of the earnings from distribution; the profit earned upon the investment of this corporation is to be taxed 35 percent.

It would seem that a flat rate tax would be much less unfair to to large numbers of stockholders, and as I shall subsequently point out in every foreign country which has such a tax, it is levied at a flat rate.

As a very practical proposition we direct your attention to the fact that Mr. L. H. Parker, of the joint tax committee, declared in September 1932 that—

> No satisfactory system of applying the graduated-rate principle to the next income of corporations has, as yet, been devised. (Report of the "Double taxation", printed for the use of the House Ways and Means Committee, 72d Cong., 2d sess., p. 240.)

I do not believe that such a satisfactory basis was found in the graduated corporation income tax enacted last year, nor do I believe it exists in the pending proposal for a graduated tax based on undistributed net income.

I direct your attention to the fact that Prof. Harley L. Lutz, of Princeton University, former president of the National Tax Association, pointedly says:

> I consider a graduated tax on corporations or other business net income as utterly unsound and unscientific; the proposition is based on total misunderstanding of the principle of ability in taxation. (Telegram of June 29 1935.)

Dr. Paul Haensel, formerly of Russia and Austria, now at Northwestern University, is one of the world's outstanding tax authorities. He says with reference to this proposal (letter of Apr. 17, 1936):

As far as the latest proposals of President Roosevelt are concerned, they are based on insufficient knowledge of the whole problem. Progressive rates are simply a contradiction to all theory behind taxing corporations. The whole plan is absolutely wrong. * * * The plan of President Roosevelt in this respect is harmful for future recovery. Accumulations are particularly necessary at the present time and only income destined for immediate consumption should be taxed.

(2) Other representatives of the association have dealt with specific difficulties involved in connection with special debt contract and dividend provisions of the pending proposal.

(3) Section 27 (c) in the bill now pending before this committee, provides in substance, that if a corporation pays out dividends in excess of adjusted net income, the excess shall be allowable as a deduction in computing the undistributed net income of the succeeding tax year, and may to some extent, and under certain conditions, be allowable as a deduction in the second succeeding tax year.

This is apparently a recognition that corporation reserves may be justifiable, at least to some extent, for the purpose of providing future dividend payments when a corporation is not earning a profit; it neglects to consider the fact that accumulated reserves may also be used (when a company is not earning a profit) for equally meritorious purposes such as the payment of bank and bond interest to keep a company in existence, and the payment of wages to permit continued operation and employment.

We, therefore, urge that the committee extend its practical recognition of the justification of reserves in section 16 (c) of the bill to cover constructive purposes to which industrial corporations may put such reserves. We would go even further, Mr. Chairman; we believe, as previously stated, that profits of 1 year should be credited against losses of preceding years. I direct your attention in this connection to the following observation made by Professor Bullock in 1920:

No one has so far considered how it would affect industries in which there is great variation of the results from year to year. There are many industries in which, in a series of years, you find a few years in which very large profits are realized, you find some years where there are losses, and you find some years where they break even or make a very small profit. If the Government undertakes to collect a tax of 20 or 30 percent of the undistributed profits of good years, it will absolutely bankrupt some concerns. Conceivably the difficulty can be met by averaging profits over a period of years, but that is going to introduce some new and difficult problems.

I have here, Mr. Chairman a chart, which I would like to show the committee and put in the record, to illustrate the way in which that situation might be met.

This shows, Mr. Chairman, that if you applied the 3-year-average-principle of taxation to corporate income taxation, it would not reduce the total amount raised by taxes at all, but it is a proposal which would, we believe, benefit both the Government and industrial concerns.

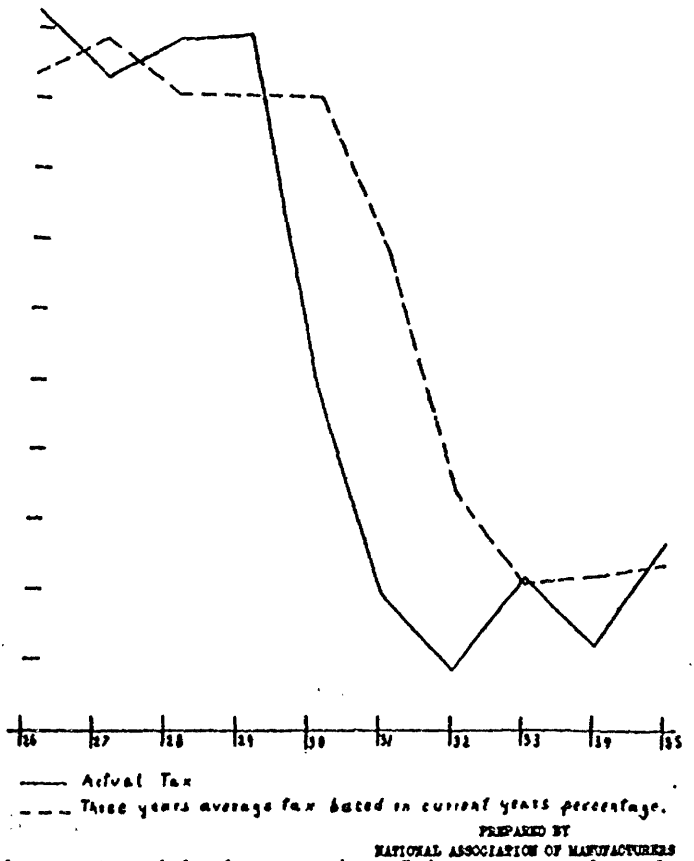
(The chart referred to is on the following page.)

Mr. SARGENT. This is a proposal which, in substance, would do this: If a corporation has a loss of $100,000 this year and a loss of $100,000 next year and then earns $300,000 the following year, instead

of being taxed on $300,000, it will be taxed on one-third of $100,000, or its net profit for the 3 years.

That is applied in Norway exactly in the form I have suggested, and, as will be seen from this chart, its effect will be to regularize the amount of income received by the Government and also the amount

PRACTICAL RESULT OF 3 YEAR AVERAGE ON CORPORATION INCOME TAX REVENUE



PREPARED BY
NATIONAL ASSOCIATION OF MANUFACTURERS

of payments made by the corporation. It is not a proposal to reduce the amount received at all. Holding company tax:

(4) We now direct your attention to section 27 (i) of the proposed legislation. This section provides in substance that any corporation

which gets 80 percent or more of its income from dividends will receive no tax exemption for paying these dividends to another corporation which owns 50 percent or more of the stock of the disbursing corporation.

To illustrate, if a so-called first holding company receives $1,000,000 dividends from its operating companies, and distributes the entire income to another corporation, this "first degree" company would still have to pay a tax of 42.5 percent or $425,000 on its dividend income. The same system would be applied to all holding companies which might be in a "chain."

Thus in the case illustrated, if the "first degree" holding company wishes to distribute the entire $1,000,000 to a "second degree" holding company, there still would remain a tax of $425,000. The "second degree" holding company would receive $575,000 or even if it wished to pass the entire sum along to its sole stockholder, the "third degree" holding company, there would nevertheless be a tax of $255,375, leaving a net of only $335,625 out of the actual earnings of $1,000,000 available for distribution to the stockholders of the "third degree" holding company. This proposal certainly seems inconsistent with the Presidential message of March 3 in which stress was laid on the need of increased dividend distribution to shareholders.

The net effect is to impose drastic penalties—almost prohibitions—whenever there are holding companies beyond the "first degree" by placing a heavy tax penalty on retention of income from corporate dividends and imposing an equally heavy penalty if the money is distributed as dividends.

This provision would particularly affect industrial holding companies as well as public utility holding companies.

From such a tax policy it seems obvious that it is an attempt to write into tax law provisions to the same effect as the public utility holding company bill enacted by a narrow margin in the last session of Congress would have if held constitutional. Perhaps it is designed to accomplish through taxation a form of regulation which is deemed of doubtful constitutional validity in the present holding company act. We are opposed to the use of the taxing system as a means of forcing economic regulation rather than the primary purpose of raising revenue.

According to our reports public-utility companies in particular are in such a state of confusion and uncertainty as to governmental policy and its effects upon them that they have refrained from spending the normal amount of $750,000,000 annually on improvements and extensions and this lack of normal expenditures is one of the causes of the curtailment of the durable-goods industries.

Believing that major attention in the problem of unemployment reduction must be centered on the durable-goods industries, we are opposed to governmental policies which will tend to impede further reemployment in that field.

Our complex taxing system, from the standpoint of the various State taxes, is one of the causes of the necessity for many industrial enterprises to be continued on a holding-company basis.

The proposed legislation would unquestionably tend to force operating companies to distribute such a large percentage of their earnings to the holding companies for the benefit of the underlying stock-

holders, that there would be little, if any, money available for the replacement and extensions which should be made.

We realize that the motive advanced for section 27 (i) in the report of the House Ways and Means Committee majority is "to prevent the delay or avoidance of the undistributed profits tax by means of chains of holding companies." We believe such an aim could be much better and more soundly achieved by providing for compulsory distribution of dividends received by successive holding-company groups within a reasonable period after their receipt, with a further provision that if there are any more than three such distributions there should then be a special tax levied.

It is possible that special contract provisions might make such a plan for compulsory distribution of so-called holding company dividends impossible or unwise, and we therefore advance the suggestions that it seems simpler and more practical to provide in such case for consolidated returns by the entire holding company group, subject to a small special tax levy for the privilege of making such returns.

Argument advanced in support of the proposed tax:

(1) We have already considered the argument that a tax based on undistributed profits is justified because it will increase purchasing power, and because it will discourage monopolistic practices.

(2) Another argument used to support the proposal for a tax on undistributed earnings has been thus stated by Representative O'Connor, chairman of the House Rules Committee (Mar. 15, 1936, radio address):

> The tax would put a brake on the over-expansion of productive facilities.

Substantially the same position has been presented before this committee by Mr. Haas (hearings transcript, p. 129).

The contention has, indeed, been frequently advanced that from 1900 to 1930 we experienced in this country an enormous overexpansion of productive facilities and that this has been a major contributing cause either of the depression itself or of its continuance. It is therefore decidedly worth observing in connection with the anti-expansion argument made in behalf of the distributed earnings tax that according to the conclusions of the Brookings Institution (America's Capacity to Produce) the margin of unutilized plant capacity in the several branches of industry (agriculture, mining—except for dislocation caused by the war—manufacturing and electric power utilities) did not expand during the period from 1900 to 1930 (p. 421).

(3) Another argument which has been used to justify the proposed graduated tax based on undistributed corporate profits is that it will "eliminate the present inequalities in our taxation of business profits as between incorporated and unincorporated business." (From statement of Mr. Helvering before the House Ways and Means Committee, Mar. 30, 1936.) Mr. Mooney in his argument presented on behalf of the National Association of Manufacturers has very effectively shown how specific provisions of the pending measure would have the effect of either continuing or creating inequalities.

It would seem, Mr. Chairman, that if it is designed to give relief to individuals or partnerships who voluntarily choose to leave some portion of earnings in the business, such earnings now being subject to normal and income surtaxes upon the partnership, or the indi-

vidual enterprises, that the remedy should be by exempting from additional income surtax a certain portion of the net income left in the business. Certainly it is not a constructive or real remedy to penalize a corporation for not distributing earnings which might or might not make the individual subject to surtax and which may indeed be vitally necessary for the continued preservation of the business enterprise.

Moreover, I direct the attention of the committee members to the fact that the 1927 report of the National Tax Association Committee on Standardization and Simplification of Business Taxes declares on this very important point of alleged inequity and discrimination in favor of corporations:

> It seems to us that if the corporation does have some special privilege, its value is undoubtedly reflected somewhat in its net income. We must not forget either that the benefit is not altogether on the side of the corporation. If government did not create corporations, many businesses now in existence would never have been organized or developed and society would have lost the benefits of large-scale production, as item of much more importance than the taxes which the State could hope to collect on the privilege of limited liability.

We direct your attention also to this statement made by the President in June 1935:

> Scientific invention and mass production have brought many things within the reach of the average man which in an earlier age were available to few. With large scale enterprises has come the great corporation drawing its resources from widely diversified activities and from a numerous group of investors. The community has profited in those cases in which large-scale production has resulted in substantial economics and lower prices.

Now it is apparently proposed to inaugurate a tax policy which will tend to discourage future growth of business enterprises.

Last year we opposed a tax policy which from an economic standpoint would penalize efficient and successful corporations which succeeded in growing because of their ability to sell large quantities of goods at a price consumers would pay. This year we appear before you opposing a tax policy which would penalize the small business which is trying to succeed and get ahead. We believe that the Federal tax policies should neither penalize efficiency nor should they promote monopoly.

Senator METCALF. Mr. Sargent, have you any concrete proposals or amendments?

Mr. SARGENT. I have the suggested bases for such amendments in my New York office, which I shall be glad to send you, if you are interested, sir.

The CHAIRMAN. You have made a good many suggestions as you went along.

Mr. SARGENT. I tried to, sir; not only to show what I consider economic errors in this bill but also to make suggestions at certain points for its improvement, Mr. Chairman.

The CHAIRMAN. All right, proceed.

Mr. SARGENT. Foreign experience.

I now direct the attention of committee members to the extent to which foreign countries have resorted to taxation of undistributed earnings. According to the best information we could obtain, only three countries have ever applied such tax: Belgium, Sweden, and Norway.

We thus far have been unable to obtain any information as to the economic effects of the tax as applied to Belgium, and there is, in fact, some disagreement as to the exact nature of the Belgian tax. It is, however, worth observing that the tax as applied there is a flat-rate tax and not a graduated one as proposed to this committee.

The Norwegian tax is likewise a flat-rate tax of 8 percent, introduced, I believe, in 1921.

The CHAIRMAN. That is along the same theory that the Senate passed a bill in 1924.

Mr. SARGENT. I believe so. I have not been able to see it. Theirs is a flat rate tax, as I say, imposed on top.

The CHAIRMAN. Have you read that discussion?

Mr. SARGENT. I tried to get a copy a week or so ago and I was told that they were not able to locate it at that time. I understand since, however, it has been possible to secure copies, but I have not seen it, Senator.

The CHAIRMAN. It is in the Congressional Record. It can be very easily obtained. That is another thing that escaped your attention.

Senator CONNALLY. Mr. Sargent, what would you say to an increase in the flat rate? Assuming that we have got to get so much more additional revenue out of a corporation, what would you say as to an increase in the flat rate and then the superimposition on top of that of, say, 8 or 10 percent, or some pertinent amount, on that portion of the income undistributed?

Mr. SARGENT. Well, our Government Finance Committee has not had time to consider that proposal.

Senator CONNALLY. I am asking you.

Mr. SARGENT. You are asking my personal opinion and not the opinion as a representative of the association?

Senator CONNALLY. I would rather have your own unbiased opinion.

Mr. SARGENT. I would be glad to give you my personal opinion, with the understanding it is such. I believe, if you gentlemen consider it necessary to raise additional revenue, that with the practice of rigid economy and making allowances for the fact that an increased volume of business in the country would give an increased income under present tax rates, that it could be done by either a change in the rates or the bases of the present Federal taxes. I have in mind there both the income taxes, individual and corporation, and the sales taxes which are now levied by the United States Government.

Senator CONNALLY. You are covering too much territory. I am asking you just about the corporations. Now, this need not be your assumption, it is our assumption: Assuming we want to get six or seven hundred million dollars more out of the corporations—we will take care of the income taxes in a different manner—how would you get it? Would you raise the normal rate, say, to 18, 19, or 20 percent and then put on top of that a 10 or 15 percent levy, on that portion of the income undistributed?

Mr. SARGENT. It is my belief on that specific point, Senator, that the better procedure would be to increase the present corporation income tax and not to levy any superimposed tax on undistributed profits.

Senator CONNALLY. Thank you very much.

Mr. SARGENT. I have conferred with Norwegian businessmen who are subject to this tax and who make the following general observations: First, that one of the results of the tax is to create too great a distribution of earnings to stockholders and a reduction in both the quantity and quality of depreciation reserves. Second, that such a tax is economically unsound unless it is possible for industrial management to use or set aside out of earnings as much as may in the opinion of the management be necessary for the replacement of obsolescent equipment. Norway has one of the largest merchant marines in the world, but is today unable to build more than a small percentage of its own ships. This is, it is stated, due to the distributions made under the undistributed earnings tax, and without any accompanying adequate provision for replacement of obsolescent machinery and equipment. Third, in their opinion any such tax is especially unfair, unless accompanied by provisions allowing the employer to offset losses against profits, a proposal which has not been advanced in connection with the tax under consideration by this committee.

Sweden adopted a tax on undistributed profits in 1919 which was subsequently abandoned in 1926. In 1933 a "compensation tax" was enacted which applies a flat rate tax of 25 percent in certain cases on undistributed earnings of Swedish companies engaged solely in the real estate and marketable securities business. It does not apply to other corporations.

With reference to the Swedish tax on undistributed profits abandoned in 1926, this was a graduated rate tax. Dr. Eric Lindahl, of Stockholm University, states (cablegram of Apr. 3, 1936) that the "tax was enacted in 1919 and removed in 1926. Such a tax is unpractical and unsound as it diminishes the accumulation of capital."

Members of the committee may be interested in the fact that Holland has exactly the reverse of an undistributed earnings tax, namely, a tax levied on profits distributed by companies to those entitled to a share of them, with no tax at all levied upon undistributed profits; this may be an example of the Dutch idea of inculcating thrift in industrial companies, as well as in the home.

CONCLUSION

In conclusion, Mr. Chairman, we respectfully point out that the advocacy of one new tax policy one year, and the advocacy of another new tax policy less than a year later, which contemplates abandonment of the tax policies of the previous year, is not exactly the way to promote business confidence in stability of Government policy—and at least a reasonable amount of such confidence is really necessary to sound business recovery and reemployment.

We direct your attention in this connection to the fact that the distinguished Senator from California when Secretary of the Treasury addressed the chairman of this committee as follows:

> Business and industry and individual initiative and enterprise are entitled to know in advance the basis of taxation upon which all the activities of the Nation must be conducted. Prosperity cannot be maintained if business is kept in uncertainty as to taxation (letter of Nov. 14, 1918 to Senator Simmons; p. 58 of 1918 Treasury Department report).

We point our furthermore that in connection with the enactment of increased tax burdens little, if any, attention has apparently been

given to new tax burdens which have already been enacted in the Social Security Act, a progressively increasing tax upon industry, a tax which will compel the manufacturing industry to pay out during the 1937 fiscal year approximately $87,000,000 in taxes, and to set aside reserves of at least $89,000,000 during the same period, a total new burden of $176,000,000, to which there is now proposed to be added large additional taxes. I mention that because there has been an almost complete lack of consideration of the extent to which additional taxes have already been imposed upon the manufacturing industry.

In view of existing tax burdens, already enacted additional tax burdens, is it any wonder that industry, conscious of its responsibility and relationship to investors, employees, customers, and the public is vitally interested in tax burdens which affect returns to stockholders, taxes received by Government, prices paid by consumers, and employment opportunities available to workers?

We respectfully submit that a tax on undistributed earnings is fundamentally unsound from the standpoint of economic principle, that it would be rendered less burdensome from the economic standpoint if certain modifications and amendments were included, but point out that in many cases such modifications would add new administrative difficulties to the administratively difficult, if not impossible, act now before you.

We, therefore, oppose enactment of the graduated tax on undistributed corporate earnings now pending before this committee.

The business and individual tax problem being studied is so complex, and involves such vital interrelationships between the welfare of individual shareholders, employees, and industrial creditors and customers, that is entirely unreasonable to expect either this Congress or the country as a whole to properly evaluate in any short period of time the merits of a novel tax proposal and tax principle so radically different from any previously applied in this country.

We suggest that this committee consider the desirability of the appointment of a Federal commission to study and report to the next Congress as to changes, if any, which, in its opinion, should be made in our present national tax policies. We suggest that such a committee, if appointed, should be composed of representatives of both branches of Congress, of the Treasury Department, of finance, of major branches of productive enterprise, and independent tax economists.

In connection with endeavors to simplify tax structure I direct your attention to the fact that Winston Churchill, when Chancellor of the Exchequer 8½ years ago, appointed a committee on income-tax codification. This committee has just completed its report comprising 826 pages.

The problem of developing uniformity and simplicity in tax structure is extremely difficult at the best. We doubt if it is possible for for this committee or any other committee to develop a simplified and sound tax system in any brief 3-month period.

The appointment of such a commission as we have suggested would admirably supplement the investigation of Federal expenditures already authorized under S. Res. 217, introduced by the junior Senator from Virginia; it would be, it seems to us, highly desirable to have available for consideration at one and the same time the reports

of commissions investigating both Federal expenditures and methods of obtaining Federal revenue. We believe that such a commission should endeavor to present constructive suggestions for elimination of what the President in his tax message described as "inequalities in our tax system"; that it should endeavor to make recommendations for coordination of taxation between the Federal, State, and local governments in order to prevent tax duplications, which now operate to prevent a fair distribution of tax burdens.

In this connection, we direct your attention to the fact that Mr. L. H. Parker, chief of staff of the Congressional Joint Committee on Internal Revenue, said last year in an address before the Second Interstate Assembly on Taxation, March 1, 1935, that while in 1932 the subcommittee on double taxation of this committee found 326 incidents of double taxation between the Federal and State Governments, a rough count in the spring of 1934 showed 883 incidents of this nature. We presume that a tabulation as of the spring of 1936 would show an even greater number. We believe that this would be one of the most valuable studies to be made by the suggested commission.

A carefully drafted tax plan, such as might be proposed by the special tax commission to substitute for the catch-as-catch-can system now in use, would greatly stimulate business activity and tend to eliminate the necessity for widespread unemployment relief. Encouragement of business through sound taxes at reasonable rates would do more to stimulate industrial activity and reemployment than our present system of conflicting taxation and yearly proposals for fundamental revisions of the national tax system, all of which tend to discourage initiative and to prevent the reabsorption into productive enterprise of millions of unemployed persons.

The CHAIRMAN. You do not mean that committee to report back to this session?

Mr. SARGENT. Not in the way of introducing new tax principles at least, Senator. That concludes my presentation.

The CHAIRMAN. Thank you very much, Mr. Sargent.

Senator LA FOLLETTE. Mr. Chairman, in fairness to the Joint Committee on Internal Revenue Taxation, and particularly to Mr. Parker, inasmuch as a portion of his report has been quoted by Mr. Sargent, I think that there should be inserted in the record at this time an additional part of that report found on page 55, and entitled "Partial Deduction for Corporations on Account of Cash Dividends." That shows Mr. Parker recognized the loophole in the tax mechanism, and I think it should go in the record.

The CHAIRMAN. All right, that will be incorporated following Mr. Sargent's remarks.

(The excerpt referred to is as follows:)

PARTIAL DEDUCTION FOR CORPORATIONS ON ACCOUNT OF CASH DIVIDENDS

A third method, and the one which is recommended, is to allow the corporation a deduction in computing net income equal to, say, 20 percent of the excess of dividends paid over dividends received, the deduction in no case to be more than, say, 25 percent of the corporation's taxable net income before such deduction. In this computation no account should be taken of stock dividends. This method appears to be of such a nature that it can readily be applied to the present structure of our revenue act.

STATEMENT OF JAMES A. EMERY, GENERAL COUNSEL, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. EMERY. Mr. Chairman, Mr. Mooney, on behalf of the committee of the association, has presented the general views of manufacturers with relation to specific points involved in this measure. Mr. Sargent has given you a view of the economic analysis of the legislation itself. It is my purpose, very briefly, to undertake to summarize the views of the committee as a whole, but particularly to call your attention to certain general considerations that lie in the minds of manufacturers with respect to this proposal.

We approach the consideration of the measure from the standpoint of its operating effect upon the manufacturing industry. We have an interest in its effect upon all other corporate activity, for manufacture serves and is served by every form of business. Our Nation ranks first in manufacture and through that art, representing the continuing application of the results of scientific research, it is the chief producer of new wealth and serves the convenience and comfort of our people. The corporations operating in that field constitute about one-fifth of the whole, produce nearly half the corporate revenue for the Federal Government, provide normally about 30 percent of our direct gainful employment and, between 1934 and 1936, contributed 80 percent of our gains in employment in private enterprise. Manufacture is, by its nature, an operation of continuing but varying risk. Its growth has been due to its continuous entrance into new fields, the experimental development of new forms of power, new tools, new enterprises, new industries. During the first 30 years of this century, despite continuous technological advance, decreasing the unit cost of operation and enlarging individual output, it has enlarged investment, raised wages, and added an annual average of 100,000 new wage earners to its pay rolls.

We presume it to be the desire of your committee to develop a tax policy that, by its rates and terms, will not unduly add to the very great burdens of taxation already carried but will, in the language of the President, undertake to simplify and equalize rather than complicate the difficulty of determining and settling tax returns and accounts and make the fixed cost of the tax element reasonably predictable as the basis of prices, expansions, and plant maintenance.

We venture, therefore, to direct the committee's attention to the background against which this measure is projected. For 1935, our national tax burden, Federal, State, and local, equals one-fifth of the national income and the same governmental expenditures one-third of it. The difference in public expenditure in all its forms represents the use of public credit, which is merely deferred taxation. In addition to Federal corporate taxes, three-fourths of the States assess net corporate levies at rates varying from 2 percent to 8 percent, making the existing corporate rate at present approximately from 18½ percent to 24 percent of statutory net income.

Senator CONNALLY. That is State, county, municipal, and all?

Mr. EMERY. I am dealing only with income taxes levied by 29 States on corporations. Let me say in that connection, Senator, if you please, that 9 States levying such taxes do not permit the deduction of the Federal tax debt in determining the corporate income for the purpose of taxation.

In addition, all forms of industrial employment confront this year a Federal pay-roll tax under the Social Security Act of 1 percent. The ratio of this tax to gross sales will differ with the form of business. It is assessed without any measure of ability to pay, falling alike on profitable and nonprofitable operations, and in representative corporations the initial 1-percent tax on the pay roll is authoritatively estimated to equal from 2 to 4 percent of probable earnings. That tax will rise to 3 percent in 2 years, and thereafter an additional 3 percent will gradually fall upon the same pay rolls. These special taxes are to provide a security fund of vast proportions to provide reserves protecting individuals against unemployment and the enervation of age.

If it be good policy for Government to compel reserves for security against the hazard of individual employment and age, it must be equally sound business policy to encourage rather than discourage the voluntary creation of corporate reserves against the continuous hazards of industrial operation, the casualties of which are written daily in the columns of business obituary.

The pending proposal would repeal a long-standing Federal method of taxing net corporate income at a flat percentage, a graduated arbitrary excess-profits tax, and the capital-stock tax. As an ostensible major amendment, it would substitute therefor a tax on what is termed adjusted net income, the rate of such tax to be determined by the amount of the corporation's undistributed net income. The distribution of income must be effected by the corporation during its taxable year and the credit to be received for this distribution in determining the tax is obtained by a series of complicated computations dependent upon numerous factors involving the debts, the dividends, the contracts, the deficits of the corporation, and its relation to other corporations which, in themselves, are not practically determinable with even approximate certainty within the corporation's taxable year. While the progressive rates are so severe as direct penalties or as to subsequent deficiencies for error in computation as to create great and mortal liabilities.

The purpose of this hasty and revolutionary change in the Federal system of corporate income taxation is—

(1) To prevent avoidance of surtax by individuals through the accumulation of income by corporations, (2) to remove serious inequities and inequities and inequalities between corporate, partnership, and individual forms of business organization, and (3) to remove the inequity as between large and small shareholders resulting from the present flat corporate rates.

It is particularly urged that the change would effect simplification in tax procedure and corporate accounting and be a practical step in tax reform.

We submit:

1. That there is no simplification of administration. On the contrary, the numerous examples and the evidence continually submitted disclose that the proposal violates the first maxim of a sound system that the tax be certain and its determination fairly within the taxpayer's power. The evidence conclusively demonstrates that an accurate return of "undistributed net income" cannot be made within the taxable year as distinguished from a practical determination of earnings and profits upon which a reasonable dividend policy may be predicated. The collector will have 3 years in which to de-

termine deficiencies, which thousands of taxpayers cannot know with legal accuracy at the time of return. There will be no remedy against subsequent deficiencies for credit will be unobtainable against the year in which erroneous distribution occurred. Nor can credit be obtained for deficiency due in the year of correction. It will mean a continuous hang-over save in cases of total distribution.

2. The evidence of avoidance of surtax by individuals through withholding of accumulation of income by corporations is not shown as beyond the reach of the drastic penalties for the improper accumulation of surtax and the surtax on holding companies. It is not reasonable to revolutionize a system applying to half a million corporations for the purpose of reaching a comparatively small group of either individuals or corporations.

3. The evidence does not disclose serious inequities and inequalities, certainly in the field of manufacture, between corporate, partnership, and individual forms of business organization. There is no competitive inequality in that field, and, if it existed, incorporation is inexpensive and easily obtainable. On the contrary, the evidence is that in the whole field of the smaller corporations alleged to be the special beneficiaries of this proposal the individual and the partnership has a distinct tax advantage:

A business of small profit costs less tax if done by the individual without incorporation. If the net profit of a business is under about $18,000, it now costs more in taxes to be incorporated than to operate as an individual. A partnership is cheaper in taxes than a corporation, if the share of profits of each partner is less than $18,000 a year.

Now, that is the highly qualified testimony of the Honorable Robert Jackson, formerly General Counsel of the Bureau of Internal Revenue, and at the present time Assistant Attorney General of the United States in charge of tax matters.

Senator CONNALLY. Each partner's share is less than $18,000?

Mr. EMERY. Less than $18,000. Mr. Jackson's view is that if an individual has less than $18,000 net profit he pays less taxes than he would pay by incorporating, and that a partnership, unless it had less than $18,000 per partner, would not gain anything by incorporating. That is the statement made by him in his address to the Young Democratic Club of New York shortly after the delivery of the President's message.

There are, furthermore, other remedies readily provided for the individual or partnership in business which do not involve the subversion of the corporate tax structure. Thus, there was suggested as early as 1920, when the corporate rate was 10 percent, an exemption for the individual or the partnership of 20 percent of income reinvested in taxables. That was proposed by Dr. Adams. The fact of the matter is that substantial competition in the field of manufacture, for example, does not exist between individuals, partnerships, and corporations. The remedy for any alleged inequality is within the hands of the individual himself, but government ought not to undertake to exert pressure in favor of one form of business organization rather than another.

4. Alleged inequity between large and small shareholders is enenhanced, not remedied. Millions of small shareholders are found in corporations with the larger incomes. The small shareholder with a beneficial interest in the corporation of larger income will thus be

assessed at a higher rate, while the large shareholder in the corporation with lower earning power will be assessed at a lower rate.

5. The necessity for reserve accumulations is not confined to a single purpose. In the newer enterprise, the experimental enterprise, or that of higher risk, the necessity for reserve is greater than the corporation with a reasonable accumulation, a lower risk or a standard product. No doctrine of averages determines taxable capacity or reserve requirements. All corporations look alike to this proposal, irrespective of their variations in income, risk, and reserve need.

6. Under this proposal the revenue of the Government will not depend upon net corporate income but upon corporate distributive policy. It is not, therefore, a reliable source of revenue, for it is subject to the variations of business policy rather than the net income of the business itself. The mature corporation with adequate reserves would avoid the taxat on it is sought to assure by a high percentage or distribution, while the new, the progressive, and the growing corporation will pay enormous penalties for the reserves essential to the maintenance of its growth, expansion, and, particularly in a new industry, for the risks of novelty.

7. The attempt is made to minimize the effect of unduly high surtax on investment in productive business as against the security of low returns in tax-exempt securities. Sixteen years ago, Dr. T. S. Adams, a well-known tax authority, emphatically declared:

> You cannot collect surtaxes rising to 65 percent in a country where perhaps $10,000,000,000 or $12,000,000,000 of tax-free securities are held out alluringly every day to the wealthier investors.

The annual report of the Secretary of the Treasury showed, on June 30, 1935, $31,285,000,000 of Federal, State, and local securities outstanding, wholly exempt from normal income and surtax, and $17,135,000,000 additional exempt from normal income tax. If so eminent an authority as Dr. Adams is fairly correct, how can you assume that a revolutionary change in the technique of taxation will not create an equally radical change in investment, with a volume of wholly or partially exempt securities existing in amount substantially equal to the market value of all stocks registered on the New York Stock Exchange?

8. The facts demonstrate that corporate dividend payments over the past 14 years are substantially 25 percent in excess of earnings, and this has been particularly true in the field of manufacture. This has been made possible only through accumulations during high earning periods which cushioned the lean years and provided not merely income for shareholders but assured employment to wage earners. But to predicate a tax policy upon averages rather than actualities is to ignore the essential practical operation of reserves during depression years, with 20 percent or less of corporations showing any profits and several of these years displaying a concentrated deficit.

7. The Treasury calculations unduly minimize the probable increase in revenue consequent upon an enlarging volume of business, which can go forward on some predictable certainty as to its future commitments, and they magnify both alleged inequities and the evasions of surtax.

Senator CONNALLY. You are speaking particularly in behalf of the manufacturing industry?

Mr. EMERY. Yes, sir.

Senator CONNALLY. Do you feel that their income, the net adjusted income, during 1936 will be sufficiently higher than that in 1935 to materially increase the revenue?

Mr. EMERY. Yes, sir.

Senator CONNALLY. You do?

Mr. EMERY. It looks like that if the present volume of business continues to increase. Of course it varies greatly with the manufacturing industries, but I think that is true, particularly in comparison with the recent years, Senator, because we hope we are emerging from the depression.

Senator CONNALLY. Well, do you have evidence of that in your industries?

Mr. EMERY. Yes, sir; in many industries.

Mr. CHAIRMAN. The reports show that, do they not, Mr. Emery?

Mr. EMERY. Yes, sir; the reports of many industries show it, but they show also one of the things which I think is unfortunately but frequently misunderstood with respect to the difficulty of getting new capital for industries of high risk. When I speak of industries of high risk I mean industries in which the variations, or the probability of return, or in a new industry which must search for a market and must pass through the period of experimentation, makes it difficult to obtain money.

Take the mining industry, for example. I noticed almost with sadness that the very distinguished official of the Treasury Department, Mr. Haas, had a view toward the difficulties of the mining industry that I fear colored his expression when he speaks of the ease with which new capital can be obtained under the proposal pending. I notice, in response to a question of Senator King who referred to the case that Mr. Haas had explained of new corporations acquiring additional capital, and Senator King said:

> Are you quite certain about that? You take a mining company, the investment market is not, as a rule, open to it, because it is so much of a gamble.

To which Mr. Haas replies:

> Where do they get their money, Senator?
> Senator KING. They get it out of the people who want to invest in it.
> Mr. HAAS. Those who are gullible enough to go into a risky enterprise.

Gentlemen, it is the men who are gullible enough to go into risky enterprises that have made the whole industrial progress of the United States possible, from the day Mr. Ford first frightened horses on the streets of Detroit, or old Mr. Bell wandered around looking for cash for his cumbersome and inconvenient telephone, or Mr. Goodyear undertook to discover the secret of rubber, or Morse was trying to find capital to send a message through wire. Today businesses or enterprises in America that are new, that are not yet through the period of research, will need the trust and faith of men in the possibility of development. It is the gullible gentleman that is ready to do it. That is the foundation of progress and it aids in the enlargement of employment.

We submit, gentlemen, in conclusion, that the policy proposed in this bill increases the complications and nowhere simplifies an already unscientific tax structure.

The business of the country has at least made accommodations to its difficulties. To scrap a fairly reliable instrument of revenue for a revolutionary system of accounting, with all its perplexities of administration, is a step backward and not forward. It is least favorable to the weaker corporation and more favorable to the stronger. It drastically penalizes the repair of a business structure wracked by 5 years of unparallelled strain. It creates new and heavy burdens and multiplies the uncertainties of tax cost. It will immensely increase the cost of closing tax accounts and lessen the predictability of the future against which business commitments must be made. It will discourage new enterprise and lessen the incentive to investment in productive effort. It carries in every feature the circumstantial evidence that it is less a revenue measure than a drastic regulation of corporate earnings and the substitution of the legislative judgment for that of responsible management in the determination of the most serious of corporate problems, the distribution of earnings, the accumulation of reserves and the obtainment of new capital.

The CHAIRMAN. Thank you, Mr. Emery. I want to put into the record a letter received from the head of the Federal Housing Administration with reference to title III on mortgages, so the committee can read it and we can consider it when we get into the executive session.

(The letter referred to is as follows:)

FEDERAL HOUSING ADMINISTRATION,
Washington, May 6, 1936.

Hon. PAT HARRISON,
Chairman, Senate Committee on Finance,
Washington, D. C.

MY DEAR SENATOR: I strongly urge that you introduce a provision in the revenue bill of 1936 which will provide for the taxation of national mortgage associations in such a manner that they will not be penalized for setting up a reserve as required by the National Housing Act.

Title III of the National Housing Act provides for the organization of national mortgage associations and section 303 of that act provides that these associations shall maintain such reserves as the Administrator shall prescribe. These institutions are instrumentalities of the United States, and are empowered to act as depositaries of public money and financial agents of the Government. The object of these associations is to provide facilities to enable private investors to participate in home mortgage financing without the risks incident to mortgage participation certificates or the burden of mortgage liquidation, by investing in obligations of these associations which are supervised by the Government. These obligations may be issued only to a limited extent and cannot exceed in amount the aggregate face value of mortgages insured by the Federal Housing Administrator, cash, and Government securities, held by the association. In order to provide additional safety to the investor, it is essential that a substantial reserve be build up by each association as soon as possible. Under the proposed revenue act the creation of such a reserve would be heavily penalized by taxation.

The principle of encouraging the creation and maintenance of large reserves to protect the investing public is already recognized in those provisions of the revenue bill concerning insurance companies and banking institutions. We suggest that a provision be inserted in the revenue bill exempting from taxable net income that portion of the income of national mortgage associations prescribed by law to be set aside for legal reserve. This will encourage a speedy creation of the required legal reserve and will facilitate the organization and operation of national mortgage associations as provided in the National Housing Act.

I shall be pleased to present to you any further information available in connection with this proposed amendment, and in the event that your draftsman needs assistance in preparing such a provision, the services of Mr. J. W. B. Smith of our legal department are available.

Very truly yours,

STEWART MCDONALD, *Administrator.*

The CHAIRMAN. Also some presentation of views on certain provisions that are in the bill, by the American Bankers Association.

(The letters are as follows:)

THE AMERICAN BANKERS ASSOCIATION,
Washington, D. C., May 6, 1936.

Hon. PAT HARRISON,
Chairman, Finance Committee,
United States Senate, Washington, D. C.

MY DEAR SENATOR HARRISON: The proposed Revenue Act of 1936 (H. R. 12395) levies the normal income tax upon all dividends received by individuals, including dividends received on investments in bank stocks.

We believe this action will slow up considerably the process now under way in many sections of the country, whereby banks are attempting to sell common stock locally and to use the funds raised thereby in retiring the preferred stock or debentures now held by the Reconstruction Finance Corporation. Repayment of the Reconstruction Finance Corporation investment would place over three-quarters of a billion dollars in the United States Treasury, where it would be available for the general expenses of the Government.

We would appreciate it if you would place the enclosed memorandum, dealing with this subject, in the record of the hearings before your committee. May we also urge that it be given favorable consideration.

Yours very sincerely,

CHARLES H. MYLANDER,
Chairman, Committee on Taxation.

RE SECTION 25 (a), H. R. 12395, NORMAL TAX ON BANK DIVIDENDS

The American Bankers Association believes that the Congress and the Treasury should give serious consideration to the continued exemption of dividends paid on bank stock from the normal income tax.

The reason is that there are only two ways for banks to retire the Reconstruction Finance Corporation investment of $878,000,000 in bank stock and debentures—first, through the slow process of accumulating earnings into a retirement fund, or, second, through the sale of additional stock to residents of the community in which the bank is located.

In order to stimulate the second method, the Congress, in passing the Banking Act of 1935, removed one of the objections to the ownership of national bank stock by abolishing the double liability thereon.

Bank earnings, at present, are necessarily at a low point, due to the low interest rates commanded by the type of commercial paper and investment securities in which banks are permitted to invest. This condition has caused many banks, particularly the smaller ones, to reduce or to suspend dividends entirely.

Such action has not added to the attractiveness of bank stock as an investment, and in the smaller communities, especially, it is increasingly difficult to dispose of bank stock at any price.

The proposed requirement that dividends from bank stock be made subject to the normal tax would, we feel, do much to discourage the program, now under way in many places, looking toward a replacement of Reconstruction Finance Corporation owned capital by locally owned capital. After all, prospective investors in bank stock are interested, primarily, in the net yield to them on the amount invested.

Both from the standpoint of the depositor, who needs the added protection which adequately capitalized banks will bring, and from the standpoint of the Treasury, which could use the funds now tied up in preferred stock and debentures of banks, should the Congress now put further obstacles in the way of the rapid retirement of these obligations through the sale of bank stock locally by making bank dividends subject to normal income taxes.

THE AMERICAN BANKERS ASSOCIATION,
Washington, D. C., May 6, 1936.

Hon. PAT HARRISON,
Chairman, Finance Committee,
United States Senate, Washington, D. C.

MY DEAR SENATOR HARRISON: In many parts of the country, holding companies have been organized which own all or nearly all of the stock of a number

of banks. These companies were placed under the supervision and regulation of the Board of Governors of the Federal Reserve System by the banking acts of 1933 and 1935. As part of this regulation, these holding companies are forbidden to pay dividends in excess of a specified amount and must use earnings to build up certain reserves.

Under the proposed Revenue Act of 1936 (H. R. 12395) these holding companies would be faced with a destructive tax upon their earnings caused by their compliance with the regulations of the Government supervisory agencies. This is set forth in the enclosed memorandum which we would appreciate your placing in the record of the hearings before your committee.

We trust favorable consideration will be given to the problem thus presented.

Yours very sincerely,

CHARLES H. MYLANDER,
Chairman, Committee on Taxation.

IN RE (H. R. 12395), SECTIONS 26 OR 27, CONFLICT WITH BANKING ACTS RELATIVE TO HOLDING COMPANIES

Under the bill there is treated as undistributed income subject to tax, income which bank holding companies are required to retain, either by Federal law, by Federal supervisory and regulatory authorities acting pursuant to law, or by agreements made with the Reconstruction Finance Corporation. This treatment defeats the purpose of the statutory and regulatory provisions.

For the reasons hereinafter set forth this purpose would be better served if the part of the net income of bank holding companies which cannot be distributed by reason of these requirements were treated as distributed income.

There are in the United States approximately 100 bank holding companies whose affiliated banks have approximately $5,000,000,000 in deposits. They are located principally in the South, in Florida, Georgia, and Tennessee; on the Pacific Coast; in the Northwest, centering about Minneapolis and St. Paul; in the Central West, in Wisconsin and Ohio; and also in Utah, New York, and Massachusetts.

The Banking Act of 1933 dealt with bank holding companies principally in three respects. (See sec. 19, revising sec. 5144 of the Revised Statutes.)

(1) By requiring them to build up reserves of readily marketable assets and limiting the payment of dividends by them to 6 percent per annum while such readily marketable assets are below specified amounts.

These reserves were intended to be used for three purposes:

(a) To replace capital in affiliated banks;

(b) To pay losses incurred in such banks;

(c) To meet individual liability imposed on any shares of stock held by the holding company.

Actual experience has shown that it has been necessary for these holding companies in many cases to save their affiliated banks by contributing funds to them for new capital, taking out losses, et cetera. In some cases where the assets of holding companies were practically exhausted by these contributions, they have borrowed from the Reconstruction Finance Corporation to secure the necessary funds to protect the depositors of these affiliated banks.

(2) By providing that holding companies cannot vote the stock owned by them in member banks without first obtaining voting permits from the Board of Governors of the Federal Reserve System.

The issuance of such voting permits is conditional upon agreements made with the Federal Reserve Board, which provide for examinations by the Comptroller, the Federal Reserve Board, and compliance by the holding companies and their affiliated banks with recommendations made following such examinations.

The result is that under such agreements, said supervisory authorities can, in practical effect, prevent the distribution of income by the holding companies to their stockholders.

(3) By providing for the purchase by the Reconstruction Finance Corporation of preferred stock of the banks themselves and loans by the Reconstruction Finance Corporation to the holding companies, under agreements between such banks or companies and the Reconstruction Finance Corporation.

Unless such part of the net income of holding companies as cannot be distributed by reason of these statutory and regulatory provisions under existing Federal laws is treated as distributed income, bank holding companies will find themselves in this position: Their affiliated banks will have paid the 15-percent tax, the holding companies will pay a tax on the bank dividends received by them

to the extent the same are not distributed (which may make the holding companies liable for 42½ percent on the very reserves which the Federal law requires them to set up) and thus the very purpose of the banking acts and what Federal supervisory authorities are seeking to accomplish under such acts will be defeated.

To avoid this result under the new tax bill, and in fairness and justice to the bank holding companies which otherwise would have to pay a tax on undistributed income on the theory that it could be distributed by way of dividends to their stockholders, but which in fact by law they cannot so distribute, the following amendment is suggested:

"That such part of the net income of any 'holding company affiliate' of a member bank of the Federal Reserve System as defined by section 2 of the Banking Act of 1933 (U. S. C. title 12, sec. 221a) shall be treated as distributed income, (1) which such affiliate retains and invests in readily marketable assets in compliance with, or in anticipation of compliance with, the provisions of section 5144 of the Revised Statutes (U. S. C., title 12, sec. 61) or (2) which such affiliate by direction or under the advice of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency or the Federal Deposit Insurance Corporation, so invests, retains, or contributes toward the strengthening of the capital structure of any affiliated bank, (3) which such affiliate retains as required by agreement with the Reconstruction Finance Corporation restricting the dividends of such affiliate."

It would seem that this amendment might properly be incorporated in section 26 of the bill, "Credits of corporations against net income", in section 27, "Corporation credit for dividends paid", or by the addition of a new section.

THE AMERICAN BANKERS ASSOCIATION,
Washington, D. C., May 6, 1936.

Hon. PAT HARRISON,
Finance Committee,
United States Senate, Washington, D. C.

MY DEAR SENATOR HARRISON: H. R. 12395 (the proposed Revenue Act of 1936) as it passed the House of Representatives exempts banks and trust companies from the tax on undistributed earnings, but places a tax on all of their net income at the flat rate of 15 percent.

The reasons for this special treatment given to banks and trust companies are apparent when statutory requirements for building up bank surplus and reserve accounts out of earnings for the protection of depositors are considered. These reasons are fully set forth in the memorandum transmitted herewith.

I would appreciate it if you would place this memorandum in the record of the hearings before your committee. We trust the committee will make no change in this provision.

Yours very sincerely,

CHARLES H. MYLANDER,
Chairman, Committee on Taxation.

RE SECTION 104 H. R. 12395, BANK SURPLUS AND RESERVES

The American Bankers Association urges that the taxation of banks on a flat percentage of their net income (as provided in sec. 104 of the proposed Revenue Act of 1936 as it passed the House of Representatives) be not changed.

The flat rate of 15 percent upon the net income of the banks is a tax burden to which no exception is taken by the banks. The drastic penalty upon the unwarranted accumulation of surplus beyond the needs of the business (sec. 102) is continued as to banks in the pending bill, and to this treatment the banks also take no exception.

In accordance, however, with the settled policy of this administration, to build up and maintain a sound banking structure in this country, banks have been exempted, in the pending bill, from the tax which is designed to compel the distribution of earnings and the disintegration of surpluses.

The special treatment thus given these organizations is in the public interest and not in the interest of the banks themselves.

The security of depositors—the general public—depends upon the integrity of the capital structure of the bank. That integrity in turn depends upon the accumulation and the preservation of the bank's surplus.

This is recognized by the national banking laws which provide that before it begins business, a bank must have a surplus equal to 20 percent of its paid-in capital. The bank then must build a surplus out of its annual earnings until that surplus equals the capital. The laws of many States contain similar provisions.

Thus government for the protection of depositors has required that bank earnings, instead of being distributed to stockholders in their entirety, should be conserved, in some part at least, and held in reserve or surplus accounts.

The entire endeavor of this administration since March 4, 1933, has been to restore banks to the soundest possible position—in order that the banks might do their part in aiding the recovery of business and industry. In this it has succeeded, and its success in the rehabilitation of the banking structure is one of its outstanding achievements.

To this end, the Federal Deposit Insurance Corporation was organized. Officials of that agency have been untiring in their efforts to compel banks to conserve earnings for the rebuilding of surplus and reserve accounts. In fact, it is not too much to say that the ultimate solvency of the Federal Deposit Insurance Fund will depend upon how well the corporation can succeed in its program of building up the reserve and surplus accounts of its member banks.

Again, in order to provide many banks with an adequate capital structure following the heavy losses of the panic, the Reconstruction Finance Corporation invested over a billion dollars in preferred stock and debentures of banks—878 millions being still outstanding. To obtain this investment, the banks agreed with the Reconstruction Finance Corporation that until the debentures were paid or the preferred stock retired, the banks would credit 40 per cent of their annual earnings or one-twentieth of the amount of the stock or debentures, whichever was lower, to a fund for their retirement. Thus it is seen that in the case of those banks in which the Reconstruction Finance Corporation has an investment, the Government now is requiring that a substantial part of bank earnings be withheld from stockholders.

It is now the well-settled policy, not only of the Federal bank supervisory agencies but also of most State supervisors, that banks must have a capital structur (i. e., capital and surplus) bearing a direct ratio to their deposit liabilities. With increasing deposits, bank capital also must be increased. It has been established, however, that no bank should be overburdened with capital stock as distinguished from surplus and reserves, since a large surplus offers a cushion for the absorption of losses which frequently occur without the impairment of true capital.

There are 22 sections in the National Banking Act alone which definitely limit the activities of bank in one way or another to certain percentages of their capital and surplus. Several of these prohibit the payment of dividends unless certain percentages of surplus to capital have been attained.

To penalize the banks, therefore, for doing that which the Congress, by specific law, already has required them to do is certainly contrary to accepted practice. And since the Congress and the Administration have been bending every effort, through the changes recently made in the banking laws, and through the regulatory activities of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Reconstruction Finance Corporation, to compel banks to conserve their earnings and to build up their surplus and reserves, we feel that banks should be given the status provided in the House bill.

Then the banks will be able to plan their business, and to comply with the orders of the supervisory branches of Government. This compliance, in turn, will contribute largely to the speedy repayment of the advances made by the Reconstruction Finance Corporation, to the continued solvency of the Federal Deposit Insurance Fund, and to the safety of the bank depositors' funds.

THE AMERICAN BANKERS ASSOCIATION,
THE RIGGS NATIONAL BANK,
Washington, D. C., May 6, 1936.

Hon. PAT HARRISON,
Chairman, Finance Committee, United States Senate,
Washington, D. C.

MY DEAR SENATOR HARRISON: Section 104 of H. R. 12395 (the proposed Revenue Act of 1936) defines the term "bank." As the bill passed the House of Representatives two important classes of banking institutions are excluded from this definition, all of which is fully set forth in the enclosed memorandum.

We believe the Senate will desire to correct this manifest omission. I would appreciate your placing the enclosed memorandum in the record of the hearings before your committee, and hope you will urge its favorable consideration.

Yours very sincerely,

CHARLES H. MYLANDER,
Chairman, Committee on Taxation.

RE SECTION 104 (a), H. R. 12395, DEFINITION OF BANKS

Section 104 of the proposed Revenue Act of 1936 omits, in its definition of the term "bank" two important classes of banking institutions, both of which, it is believed, should be included.

The section, as passed by the House of Representatives (104 (a)) reads:

"*Definitions.*—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."

(1) This definition fails to include those banks and trust companies located in Washington which are incorporated under the laws of the District of Columbia. There are several such and manifestly if all other banks are to be included, these should be also. To accomplish this there should be inserted after the word "Territory" the words "or of the District of Columbia."

(2) The definition also excludes certain "trust companies" located in various States, which companies, either because of State laws or of management policy, do a purely trust business and neither receive deposits nor make loans.

These trust companies, however, are subject to the supervision and regulation of the State banking authorities. They are compelled, by law, to maintain certain definite amounts of capital and to build up, out of earnings, certain surplus and reserve accounts.

In addition, because of the peculiar liabilities which they face as a trustee, they are compelled to place large amounts of high grade securities on deposit with the State authorities as a guaranty that they will faithfully perform their duties. In some States the amount is fixed in proportion to their capital; in others, in proportion to the trust assets under their control. In either case increasing business demands larger capital which, in turn, demands further conservation of earnings for surplus and reserve accounts.

There are 55 institutions of this general character, 51 located in 23 States and 4 in the Territories. Of the 55 institutions, 23 do either a small deposit business or a small portion of their business in the making of loans and discounts, the large proportion of their business being purely trust business.

The 55 institutions are located as follows:

Arizona	1	Oklahoma	1
California	8	Oregon	2
Colorado	1	Pennsylvania	3
Illinois	3	Rhode Island	1
Kansas	1	Tennessee	2
Maryland	1	Texas	1
Massachusetts	1	Vermont	1
Michigan	8	Virginia	1
Minnesota	1	West Virginia	1
Missouri	1	Wisconsin	5
Nebraska	8	Wyoming	1
New York	3	Hawaii	4

Provision should be made for their inclusion in the definitions. This can be accomplished by either striking out the words "a substantial part of whose business is the receipt of deposits and the making of loans and discounts" or striking out the period after the word "discounts" and adding "or trust company incorporated under the laws of the United States or any State or Territory or the District of Columbia which does a general trust business."

The CHAIRMAN. I have received a letter and memorandum from Mr. John H. Nelson, 721 Southern Building, on behalf of Electric Ferries, Inc., relative to the proposed legislation, which will be printed in the record at this point.

(The matter above referred to is as follows:)

WASHINGTON, D. C., *May 1, 1936.*

Hon. PAT HARRISON,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

SIR: On behalf of Electric Ferries, Inc., a New Jersey corporation, I respectfully request that the enclosed memorandum on the proposed tax on undistributed income of corporations as recommended by the Ways and Means Committee of the House of Representatives be incorporated in the records of the hearing

now being conducted by the Senate Finance Committee on the proposed tax bill as recently passed by the House of Representatives and now under consideration by the Senate Finance Committee.

Respectfully,

JOHN H. NELSON.

MEMORANDUM ON THE PROPOSED TAX ON UNDISTRIBUTED INCOME OF CORPORATIONS AS RECOMMENDED BY THE WAYS AND MEANS COMMITTEE OF THE HOUSE OF REPRESENTATIVES, ILLUSTRATING THE DISASTROUS EFFECT ON CORPORATIONS WITH FUNDED DEBT AND THE INEFFICACY OF THE SO-CALLED RELIEF PROVISIONS OF THE BILL

To the Finance Committee of the Senate of the United States:

Electric Ferries, Inc., has paid Federal income taxes in the last 5 years in the amount of $65,114.27. Should the proposed bill for a tax on corporate "undistributed income" be enacted into law, the inevitable result will be twofold. The stockholders of the company will lose their investment, and the Government will lose this source of tax revenue. The position of this company illustrates so clearly the inequities of this bill, that we deem it not out of order to state the facts showing how this particular company would be affected.

Electric Ferries, Inc., a New Jersey Corporation, was organized in 1926 to operate a fleet of new ferry boats between New York City and Weehawken, N. J. The line has carried in excess of 1,000,000 automobiles per year at low rates and is a great public convenience, if not a necessity. The company was originally financed with a $1,500,000 bond issue and $1,000,000 in preferred stock. Under the provisions of the indenture of mortgage on the boats securing the bonds, the company is obligated to pay (and has paid for 10 years) $100,000 per year in monthly installments into a sinking fund to retire the bonds. The company's net earnings after taxes, have not reached the above amount for 4 years, but payments into sinking fund have been maintained, with the result that the company's cash reserves are limited and sufficient only for proper working capital. Assuming that the company were to earn $100,000 in this taxable year, the entire amount must be paid into the sinking fund, unless the company is to default in its obligations. Obviously, there would be no earnings available for dividends, yet the penalty for failure to pay dividends is appalling, as the following figures will show. Assuming, still, net earnings of $100,000.

Tax under present law	$15,000
Tax under proposed law:	
$28,000 taxable at 22½ percent	6,300
$72,000 taxable at 42½ percent	30,600
	36,900

The computation was made to take advantage of the debt allowances contained in the House of Representatives' bill and indicates clearly that in many cases these provisions will not afford sufficient relief to prevent financial ruin.

Bonded indebtedness of the company as of Mar. 3, 1936, was	$390,000
Surplus (representing accumulated earnings and profits) as of Dec. 31, 1936 (estimated)	250,000
Balance (debt excess dividend)	140,000
Minimum year divisor	6
Amount taxable at 22½ percent	$28,000
Amount taxable at 42½ percent (assuming no dividends paid)	$72,000

The penalty incurred by the company in keeping its contractual obligation rather than defaulting and paying dividends with its profits is approximately $37,000 per annum or two and one-half times its present taxes.

If the principle of this tax on undistributed corporate earnings is to become ingrained in our Federal tax structure, then it will be more advantageous to the Government in the long view to permit such corporations as this to continue to exist while paying off their funded debts so that in later years earnings will be available for stockholders and for taxation purposes.

It is respectfully submitted that this tax as a whole is unfair to small corporations and fosters monopolies, that it will cause appalling losses and even bankruptcy in many cases, and therefore should not be enacted into law in any form. If, however, the Finance Committee of the Senate should be advised to report

out some bill containing this principle, real relief should be given corporations honestly paying off their legitimate obligations by fixing a rate not in excess of the present 15 percent maximum on all earnings used in liquidation of indebtedness.

Respectfully submitted.

ELECTRIC FERRIES, INC.,
CLARENCE H. WALKER,
Vice President and Treasurer.

APRIL 29, 1936.

The CHAIRMAN. At the request of Senator Truman, of Missouri, I desire to place in the record a letter received by him from Mr. George K. Conant, vice president, Sligo Iron Store Co., St. Louis, Mo.

(The letter above referred to is as follows:)

SLIGO IRON STORE CO.,
St. Louis, March 31, 1936.

Hon. HARRY S. TRUMAN,
Washington, D. C.

DEAR MR. TRUMAN: In reply to yours of the 26th, I am afraid my letter was not as concise as it might have been, but I would like to have you take up with the Finance Committee the fact that many small companies who operate their fiscal year the same as the calendar year, cannot tell accurately their standing until after the physical inventory has been taken and priced. With us, this is a very considerable job; and it is usually 2 or 3 months after the close of our year before our results for that year are known, and it seems to me that in any tax bill, corporations such as ours should be allowed the privilege of declaring dividends within 3, 4, or 6 months after the close of their year—these dividends to be considered out of the profits of the year previous.

Once or twice we have declared dividends during a year thinking we have made money, and then when we got our figures we found we had not made sufficient money to cover our dividends. Likewise if we had a profitable year we might like to declare more dividends, but would not dare to do so until we knew what our figures were.

Therefore, in any new tax legislation, I think it is very desirable that a company have the privilege of declaring dividends, say, during the first 6 months of this year out of the profits of last year, and have the income tax department handle it on that basis.

If you care to present this letter to the Finance Committee I would be glad to have you do so.

I thank you for your interest.

Sincerely,

GEO. K. CONANT.

The CHAIRMAN. A brief has been submitted by Mr. Allen R. Cornelius, of Nashville, Tenn., on behalf of the National Association of Manufacturers of Self-Rising and Processed Flours, and will be placed in the record.

(The brief above referred to is as follows:)

BRIEF SUBMITTED BY ALLEN R. CORNELIUS, NASHVILLE, TENN., IN BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS OF SELF-RISING AND PROCESSED FLOURS, DIRECTING THE COMMITTEE'S ATTENTION TO THE PRACTICAL APPLICATION OF TITLES III AND IV OF THE REVENUE BILL OF 1936 (H. R. 12395)

On April 4, 1936, I appeared before the Ways and Means Committee of the House (p. 506) in my capacity as secretary of the National Association of Manufacturers of Self-Rising and Processed Flours, an organizationcomposed of second processors and rehandlers of flour. Our members did not pay the Federal excise tax direct to the Government, but the tax was included in the price of the flour which they purchased from the first processors of wheat.

In my statement before the House committee I attempted to show (p. 507) that our members had a substantial taxable interest in the recommendations then before the committee. This interest now attaches to the bill before your committee.

I also attempted to show (pp. 508-509) that the loss in reducing the price of their floor stocks the amount of the tax, was not the only loss our members sustained by reason of the termination of the tax. The other losses referred to were the adjustments made to their customers on shipments en route on the first moment of January 6, 1936, and on flour delivered on open accounts prior to January 6, 1936, which accounts their customers refused to settle for until adjustments were made. These losses are, in the aggregate, substantial, and the experiences sufficiently broad to warrant the consideration of your committee.

The bill obviously provides for refund of losses in the matter of the floor stocks, but we fail to understand the bill as providing for the losses sustained by adjustments made on shipments en route and on open accounts. To better illustrate the application of titles III and IV as we interpret the provisions, we will use a hypothetical case as to how these provisions will apply to one of our members.

This member, let us assume, on the first moment of January 6, 1936, had on his floor 1,000 barrels of flour, the price of which included the tax. He had on contract (entered into prior to Jan. 6, 1936) 2,000 barrels of flour in the price of which he had agreed to pay the tax, 1,000 barrels of such contracts was en route to him on the effective date of the refund provision. This member's claim for refund will be for the loss on 3,000 barrels of flour. However, assuming that he was reimbursed by his vendor on the 2,000 barrels on contract his claim will, in reality, be equal to the loss on the 1,000 barrels he had on the floor at the effective time, as this member, by the provisions of the bill, is to be considered unjustly enriched to the extent that he was reimbursed on his existing contracts. However, this enrichment can be offset by similar reimbursement made by him to his customers.

However, on the first moment of January 6, 1936, this member himself, had en route to his customers 1,000 barrels of flour which had been drawn from his stock a short time prior to January 6, 1936, the price of which included the tax. Therefore, when his vendees refused to accept the shipments until adjustments were made, our members sustained an out-of-pocket loss to the extent of these adjustments. The same being equally true on the adjustments made on his open accounts. For these losses we fail to see that the bill provides any relief.

The fact that the bill provides that such shipments be considered in the hands of the vendee will not give the proper relief to our member, for the reason that he had no accumulation of taxable funds against which these reimbursements might be charged. This provision is however, workable as to the first processor who did have an accumulation of funds.

The conflict arises when we consider that the position of the dealer in flour on January 6, 1936, was not analogous to that of the first processor. The processor, by including in the price of his flour, an amount equivalent to the tax, accumulated a fund from which he could make reimbursements on his shipments en route on the effective date without actual loss to him, and for which he can take credit against his enrichment tax liability. The dealer however, had no such accumulation of funds, or tax-free flour and the adjustments made on his shipments were, as we have said above, as much an actual loss as was the loss sustained on the floor stocks. The transferring of the enrichment to his vendee does not reimburse the dealer for this loss as he has nothing against which he can apply these adjustments as credits.

We are of the opinion that relief for this situation can be had by amending section 602 (g) of the bill by adding a proviso to the effect that in cases where dealers had en route on the first moment of January 6, 1936, shipments of articles, the price of which included the tax and where the price of such articles were reduced on or before delivery, that such shipments be considered in the hands of the consignor at the effective time of the refund provision; and a further proviso added to permit a dealer to add to his floor-stock claim any adjustment made to his purchaser on any article in the price of which he had paid an amount representing the tax.

These provisions need not apply to processor for the reasons stated above, nor will these provisions effect the enrichment of the vendee of the dealer, but will only refund on actual loss to the dealer whose property is involved.

We feel that such provisions are necessary in order to remove these inequities and inasmuch as it is one of the purposes of the bill to remove the inequities caused by the termination of the tax, we respectfully ask your consideration to the end that adequate provisions are made for the refund of the losses referred to above.

ALLEN R. CORNELIUS,
In behalf of the members of the National Association of Manufacturers of Self-rising and Processed Flours.

The CHAIRMAN. The committee is in receipt of a brief submitted by Mr. G. E. Holloway, Buffalo, N. Y., which will be placed in the record.

(The brief above referred to is as follows:)

APRIL 30, 1936.

Re H. R. 12395, involving the revenue bill of 1936.

The FINANCE COMMITTEE,
United States Senate, Washington, D. C.

GENTLEMEN: As the revenue bill of 1936 is now engaging your earnest consideration, I respectfully request the privilege of submitting the following comments as an independent and private citizen for such value as they may contain in conjunction with others as an indication of opinion or otherwise.

BASIS FOR CONCLUSIONS SUBMITTED

First, let me say that I wish to avoid any unfounded theory or prophecy regarding the measure under consideration, as I feel that there has already been some unwarranted excesses in that direction by both supporters and opponents. My purpose is rather to draw upon my own experience and observations with a group of representative taxpayers and specific representative tax cases over a period of the past 15 years. As a public accountant I have been privileged with confidential relationships which have permitted me to observe the varying reactions and effect of the provisions of numerous revenue acts upon the taxpayers and upon the amount of tax paid into the Treasury. These personal contacts involve all of the several types of taxpayers, taxpayers with large and small incomes, taxpayers engaged in many lines of business and various activities and connection with tax cases before the Treasury Department, the United States Board of Tax Appeals, and the Federal courts. Included in the cases mentioned were issues arising under the act of August 5, 1909, the Revenue Act of 1913, and each succeeding revenue act to date. In addition to the above, I have dealt with various State- and foreign-tax matters.

The approach to my comments is not for the purpose of representing myself as an authority but simply to point out that there are grounds for there aching of conclusions which may conflict with popular opinion. In other words, there are important facts affecting taxation, which are evident from contacts with individuals and groups upon their tax problems, which are not reflected in statistics from which much theory emanates.

GENERAL APPLICATION

I have reviewed H. R. 12395, with amendments as passed by the House. To gain some idea of the effect of the new provisions of title I (income-tax provisions) I have applied them to the income status and financial structure of clients and other taxpayers concerning which I have detailed and specific information. The net result to the corporation and its stockholders considered as a unit has been estimated where possible. The facts developed indicate no uniform trend, but the new provisions unmistakably forecast unwarranted reduction of tax liability for certain taxpayers and units of taxpayers and added and excessive burdens for others not consonant with abilities to pay, benefits received, or other measures usually made the justification of tax levies.

Taking into consideration possible protective adjustment in organization and investment holdings, it does not appear likely that these representative taxpayers would pay in the aggregate any greater amount of tax under H. R. 12395, as it now stands, than they would under the present revenue act. Individual cases, however, present some odd situations. In the midst of the mixed result of benefits and penalties, it would be totally impossible to favor or oppose the new income-tax provisions in the direct interest of taxpaying clients. The unequal burdens, burdens inconsistent with ability to pay and unwise changes in financial policy (which appear certain to follow enactment of the new provisions), are, however, undesirable from the standpoint of the average citizen. As such I am respectfully submitting my comments with assurance that it is not done directly or indirectly for, or in the interest of, any particular taxpayers.

QUESTIONABLE FEATURES OF THE NEW INCOME-TAX PROVISIONS

Underlying H. R. 12395 there appears to be some conceptions which are of questionable accuracy. Common among these are:

1. The belief that corporate surplus or accumulated earnings bear evidence of ability to pay dividends to stockholders.
2. The belief that there is a widespread accumulation of corporate earnings which could and should be distributed in dividends.
3. The belief that, with three exceptions, current earnings are distributable.
4. The belief that the ratio of indebtedness to accumulated earnings provides a measure for the taxpaying ability.

With regard to corporate surpluses there seems to be just reason for confusion in the public mind. Corporate surplus means to the average citizen an excess of liquid funds over and above business requirements. In actual cases it is seldom found to be such. In the sense of excess liquid funds corporate surplus would constitute a reasonable basis for taxation or the imposition of penalty measures to force liquidation. Positive and effective provisions are contained in the Revenue Act of 1934, and preceeding taxing acts, for dealing with this type of surplus when it actually exists. It is alleged by persons favoring the new income-tax provisions that the present surtax on corporations improperly accumulating surplus has been ineffective, due to the difficulty of providing proof of unreasonable accumulations. In those cases where the abuse was found, the imposition of the tax has been upheld. The few assessments made and sustained on account of improper accumulations is clear evidence that few such cases actually exist. My own observations, as well as the records of cases, show that when generalities are abandoned for study of actual requirements of individual specific corporations, unreasonable accumulations are rarely found.

The accounting fiction of corporate surplus is, however, confused with excess liquid funds, and upon this error it is proposed to revise a tax system. The surplus item (or account) appearing in financial statements is no indication of a corporation's ability to pay dividends or make distributions. The term is a misnomer and poorly chosen. Surplus and accumulated earnings is nothing more than a classification of capital invested or capital employed. The portion of the capital designated "surplus" may be in the form of assets which could not be distributed without liquidation of the business. The same may be true of current income.

The fiction of a surplus is so misleading and so devoid of value as an indication of taxpaying ability that a system of taxation designed to prevent further accumulations is as undesirable from the standpoint of government as from the standpoint of corporations and their stockholders. The capital requirements and the actual capital employed (including surplus) alone determine the ability of a corporation to pay dividends. So widely does the significance of a surplus vary that a corporation with a surplus for tax purposes may, in fact, be without liquid funds or bankrupt, while another corporation with a deficit and no surplus may have liquid funds and be in a position to make taxable distributions to shareholders.

The purpose of the new income-tax provisions is to force payment of current income in dividends and to apply penalty rates of tax graduated according to the ratio of noncompliance. At this particular time, many corporations unable to distribute current income would be penalized in a sum far exceeding any amount of revenue which would be produced from the taxing of the entire income to the stockholders in case of complete distribution. Upon entering the depression period many corporations carried large amounts in accounts receivable and inventory. With declining sales a smaller amount of capital was maintained in these items and the capital released was consumed in unprofitable operations.

With increasing sales, the current income in reflected in the added accounts and increased inventory and is not in many instances in a form available for distribution. No relief is provided for this situation in sections 14, 15, or 16 (or elsewhere) of H. R. 12395.

The graduated penalties for addition of current income to surplus erroneously presupposes that such action is a voluntary matter and that earnings are inherently liquid funds capable of distribution. Nothing could be further from fact in actual business practice. For accounting and statement purposes, the earnings are accumulated and transferred at the close of the year, but keep in mind that this is merely the record of earnings. The earnings themselves automatically appear throughout the year in varying forms of assets and additional capital employed. It is not a matter of adding such earnings to surplus or employed capital, for they are in fact already there. To relieve corporations with available liquid funds

and penalize corporations without them is to reverse the theory of "ability to pay." Judging from the effect upon specific corporations, I can see no more logic in the use of undistributed earnings as the principal yardstick for tax than would exist in a graduated tax upon automobiles or real estate based upon color. Many businesses are too complex to conform to the new plan, and unjust discrimination must necessarily result from its operation if used as the prime measure for levying tax.

An attempt is made in sections 14 and 15 to provide relief based upon certain types of contracts and debts existing on March 3, 1936. These provisions will prevent a certain amount of discrimination and will give unwarranted tax reduction in other cases. Corporations may be overfinanced or underfinanced, and that fact will not be adequately dealt with by the method of considering the amount of debts, surplus, or deficits under sections 14 and 16. Conditions in the ordinary course of business after March 3, 1936, will give rise to the same causes for relief as are now provided to cover conditions previously existing. It is evident that the limiting of relief to conditions existing on March 3, 1936, would work at cross purposes the aim of the Direct Loans to Industry Act. Such loans are being made to stimulate employment, etc., and conditions are imposed precluding the payment of dividends. Loans of this character made after March 3, 1936, would subject the borrower to the maximum rate of tax, while the earnings if distributed might be subject to little or no tax in the hands of stockholders.

In the case of domestic corporations with foreign individual stockholders the Government would collect 10 percent if all the income is distributed and a possible 42½ percent if it is retained. This is too great an inducement for the withdrawal of working capital.

Instances of unreasonable penalty or advantage will be found if specific cases are substituted for generalities. It is apparent that the needs and conditions of various enterprises differ so materially that the proposed new provisions cannot be justly applied. There are no reliable facts available today by which the net effect on the revenue can reasonably be estimated. The distribution of the stock holdings and the devices possible for evasion are not now ascertainable. It is certain that many corporations which now pay tax upon their earnings have stockholders who are not taxable and stockholders who would pay normal and surtax rates aggregating less than the present corporation rates. The operation of the new plan is the only means of determining its effect and because of the uncertainty it seems unwise to relinquish a more or less uniform tax and one providing a dependable source of revenue. As an experiment the plan may have merit, if applied as a tax in addition to the plan now in force. A more reasonable approach to the solution of alleged improper accumulations would be to retain the present form of corporate tax and apply the proposed new taxes at rates not exceeding 5 percent on corporate income. Such a procedure would maintain the present revenue, provide additional revenue, encourage dividend payments where reasonably possible, avoid severe penalty where distributions are not possible, provide information as to the extent of possible corporate distributions, and determine the practicability of further extension of the plan.

One of the arguments advanced for the new plan as set forth in H. R. 12395 is that it will require the proprietary interests of a corporation to bear the same burden in taxes which the proprietary interests of individual business and partnerships now pay. When actual cases are examined it will be found almost universally that the individuals and partnerships go to the corporate form of doing business whenever it would result in lower tax burdens. Legal difficulties commonly prevent incorporated businesses from obtaining the benefits of change to a partnership or individual form of enterprise. The fact that businesses are continued in individual or partnership form is clear evidence that as a general proposition they are bearing lower burdens for their respective classes. Limited exceptions exist, in the case of professions, etc., but such cases are not extensively important and among those of consequence many would be subject to the present tax upon improper accumulations if operating under corporate form without distribution.

SUMMARY

To summarize my comments I would say that—

(a) Undistributed earnings do not form a reasonable distinction for classification of taxpayers.

(b) The improper accumulation of earnings may be grossly overestimated.

(c) The proposed new taxing provisions will not protect many businesses against severe penalties and discrimination and will not prevent evasion of reasonable burdens in other instances.

(d) The yield of the new plan is uncertain as a substitute for the present corporate tax.

(e) Applied at low rates in addition to the present tax the new taxing provisions would be productive of additional revenue, be less disturbing to business, and avoid severe discrimination during an experimental period of tax reform.

These comments are offered in good faith with the request that they receive the consideration of your committee.

Respectfully submitted.

G. E. HOLLOWAY,
Liberty Bank Building, Buffalo, N. Y.

The CHAIRMAN. I am in receipt of a memorandum prepared by Mr. Benjamin Graham, lecturer in finance, Columbia University, New York City, relative to the pending bill.

(The memorandum above referred to is as follows:)

MEMORANDUM PREPARED BY BENJAMIN GRAHAM, LECTURER IN FINANCE, COLUMBIA UNIVERSITY, NEW YORK CITY, FOR SUBMISSION TO THE FINANCE COMMITTEE OF THE SENATE RE REVENUE BILL OF 1936

This memorandum intends to consider briefly the theory and technique of the proposed taxes on corporate incomes. It will not consider related questions of the Government's fiscal policy or such matters as the adequacy of the proposed schedules to raise the required income.

1. GENERAL THEORY OF THE NEW PLAN OF CORPORATE TAXATION

I favor the underlying policy embodied in the bill insofar as it tends (a) to equalize the tax status of corporate and noncorporate business and, (b) to remove the tax-avoidance inducement to the accumulation of corporate surpluses.

If the effect of the bill were to compel distribution in cash of all corporate earnings, I should strongly oppose it; for while the accumulation of corporate surpluses may have some objectionable aspects, the proper remedy lies elsewhere than in prohibitory or punitive legislation. However, while the effect of this bill would undoubtedly be to promote a larger distribution of cash earnings, I do not think it will compel such distributions on any very large or dangerous scale, since corporations will have available a number of means by which they may be able to reinvest earnings without paying a penalty tax thereon. These means will include (a) the sale of additional stock simultaneously with the payment of cash dividends, (b) the payment of dividends in the form of preferred stock—which will undoubtedly be held to be a taxable dividend—and (c) the payment of optional dividends either in cash or common stock in a form which will result in the acceptance of stock.

The most suitable method of capitalising reinvested earnings and making them taxable to the stockholders, would be through the declaration of taxable dividends in common stock. While the decision in *Eisner* v. *Macomber* stands in the way of this ideal arrangement, I believe that in view of the different philosophy of taxation embodied in the pending bill, this decision might be overcome by treating such stock dividends as an administrative vehicle for allocating earnings to the various taxpayers.

Retention of present corporate income tax in part.—While I favor the theory of the bill in endeavoring to raise the greater portion of present corporate taxes from the individual taxpayers, I believe it desirable to retain a flat tax on corporate incomes calculated as at present but at a lower rate, say 5 percent. The revenue raised through such a tax would permit the application of a more liberal policy of calculating corporate income subject to penalty taxes. As will be pointed out below, the technique of imposing such penalty taxes is far too stringent in many respects.

2. DETAILS OF PROPOSED REVENUE ACT

I believe the bill is unnecessarily complicated and unduly stringent in a number of its provisions. I would suggest modification along the following lines:

(a) The sliding scale schedules should be replaced by a flat rate, say at 30 percent or at 35 percent on undistributed net income above exemptions; or at such other

rate as would be calculated by Treasury experts to yield the same aggregate results as are intended by the present schedules.

I do not believe that any theoretical or practical advantages of a sliding scale arrangement can offset the elements of extreme complexity which they introduce.

(b) Provide an exemption from undistributed-earnings tax of $2,000, or 10 percent of net earnings—whichever is higher.

The $2,000 exemption would adequately take care of small corporations, now favored by a separate schedule. The 10 percent exemption would recognize the fact that a substantial portion of earnings, as now reported, turn out after a lapse of time not to be true earnings, but to be consumed by obsolescence and other concealed factors operating during the period of the reported earnings.

(c) If this flat 10 percent exemption is not adopted, I would suggest that corporations be permitted to set up, out of earnings, reserves for obsolescence in addition to the depreciation reserves now permitted and in an amount not exceeding the annual allowance for depreciation.

(d) Corporations should be allowed greater flexibility than at present in valuing their opening and closing inventories. Either the "last in, first out" method or the "normal stock" method—both of which are now considered sound accounting policies—should be permitted in calculating income subject to tax.

(e) For purposes of undistributed-earnings tax—but not for purposes of the proposed continued regular corporation income tax—a company should be permitted to deduct capital losses from total income.

Section 117, as it now stands, creates an intolerable situation in that corporations having a net loss for the year from every accounting standpoint, may still be required to pay out dividends in order to avoid a penalty tax on nonexistent net income.

The above suggestions are made not to lighten the burden of corporate taxation, but to prevent unfair taxation in many individual cases through a miscalculation of the true income which should be subject to tax. Losses to the revenue through the elimination of such unfair provisions should be offset by the proposed retention of a flat tax on all corporate incomes.

(f) The punitive tax on intercorporate dividends provided in section 26J should be eliminated, in my opinion. This endeavor to destroy holding companies by imposing special taxes thereon is ill-considered.

(g) The special category of corporations subject to a 22½ percent flat tax is open to serious objections. The effect on the whole is to subject weaker corporations to a higher degree of tax than will be borne by stronger ones. In lieu of these arrangements (in sections 15 and 16) I would suggest that corporations be permitted to place themselves (by adoption of an appropriate bylaw) in the status of personal holding corporations under the War Revenue Acts—in other words, to make their undistributed income taxable to the individual stockholders. This would be an extension of the mechanism provided in section 102e under which corporations may avoid penalty taxes if their shareholders include in their gross income their pro rata shares of the retained net income of the corporation.

(h) I believe that the Revenue Act as now drawn still permits a considerable amount of tax avoidance through formation of foreign corporations to hold shares of stock now owned by large stockholders. I would suggest that taxpayers be required to file information on their tax return with respect to their holdings of foreign corporation shares, thus permitting the Treasury to determine instances of the use of such foreign corporations for tax avoidance.

(i) I am convinced, however, that the surtax rates on individual incomes running up to 75 percent, are too high to be really productive, as they practically compel the various devices of tax avoidance. In my opinion, a maximum surtax rate of 50 percent is likely to be both more equitable and more effective, in conjunction with the endeavor of the present bill to tax stockholders as far as possible on their pro rata shares of the corporate earnings.

BENJAMIN GRAHAM,
Lecturer in Finance, Columbia University, New York City.

Mr. PETTIBONE. Mr. Chairman, I desire to submit for your consideration a statement on behalf of my own company, the Chicago Title & Trust Co., and other trust companies in the Middle West and on the Pacific coast.

(The statement is as follows:)

STATEMENT OF HOLMAN D. PETTIBONE, PRESIDENT, CHICAGO TITLE & TRUST CO., CHICAGO, ILL.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is Holman D. Pettibone. I am president of the Chicago Title & Trust Co., of Chicago, Ill. I appear on behalf of my own company and of a number of other trust companies located in the Middle West and on the Pacific coast, all of which companies receive and manage trust funds as fiduciaries but do not do a banking business or accept commercial bank deposits.

I desire to address the committee on the very limited point that the language of section 104 of the revenue bill under consideration should be slightly changed so that it will correspond to the definition of "deposits" contained in the Federal Deposit Insurance Corporation Act and will apply to trust companies which receive and manage trust funds as fiduciaries but which do not do a general banking business.

As now drafted, section 104 will apply only to those trust companies which are engaged in banking. It will not apply to those trust companies which handle only trust moneys. Many of the States do not have statutes permitting trust companies to conduct a business of receiving banking deposits but under the laws of such States, trust companies are authorized to and do receive, invest, handle, and manage trust funds. Trust companies which are not banks have in their custody and control and are responsible for moneys which are not strictly bank deposits but which are in every sense analogous to such deposits and which, as such, are covered by the Federal Deposit Insurance Corporation Act.

The reasons for the suggested change are these:

(1) The Federal Deposit Insurance Corporation Act covers both bank deposits and trust funds;

(2) It seems probable that the House intended section 104 to apply both to banking and nonbanking trust companies;

(3) There is no distinction in principle or public policy as between deposits held by a trust company and moneys held in trust by such a company;

(4) Trust companies which handle only trust funds are under the regulation of State governments to the same extent as are banking trust companies and are under the supervision of State officials who control the amount of surplus which shall be maintained;

(5) As to nonbanking trust companies, there exists the same need of maintaining reserves as is recognized by the pending bill with respect of banking trust companies.

The suggested change in the language of the pending bill can be accomplished either by adopting the definition of "deposits" contained in the Federal Deposit Insurance Corporation Act or by adding to section 104 (a) of the pending bill the words necessary to include trust companies whose business is the receipt, investing, handling and managing of trust funds as fiduciaries.

To consider very briefly the reasons which I have enumerated:

THE FEDERAL DEPOSIT INSURANCE CORPORATION ACT COVERS BOTH BANK DEPOSITS AND TRUST FUNDS

In its present form, section 104 of the bill which you are considering defines the term "bank" to mean a bank or trust company "a substantial part of whose business is the receipt of deposits and the making of loans and discounts." The bill contains no definition of the term "deposits." As used in the bill, the term "deposits" clearly means bank deposits and excludes trust moneys held by trust companies. Therefore, the section as now drafted would not operate upon those trust companies which do not accept technical bank deposits but which have in their custody and control trust cash which is strictly analogous to bank deposits. The definition of "deposits" contained in the Federal Deposit Insurance Corporation Act (12 U. S. C. A. 264 (c) (12)) recognizes this analogy and includes as deposits under that act both moneys held as bank deposits and trust funds held by a trust company whether retained or deposited in any department of the institution holding the trust moneys or deposited in another bank. The pending bill should be made harmonious with this act and should therefore include as deposits both kinds of money; namely, bank deposits and moneys held in trust, and section 104 should apply to both banking and nonbanking trust companies.

THE INTENT OF THE HOUSE

It seems probable that the term "deposits" was understood by the House of Representatives to include both bank deposits and moneys held in trust. In the report of the House Ways and Means Committee, no distinction was pointed out as between banking and nonbanking trust companies which handle only trust funds, but the House was informed by the report that "banks and trust companies are not brought within the new plan." In explaining the bill on the floor of the House, Congressman Vinson said:

"* * * banks and trust companies occupy a peculiar situation in our economic structure. They are under supervision of either the State or Federal Government. They are required by law and by regulations to maintain certain reserves and because of such restrictions they are unable to pay out dividends and consequently they would be injured if they were subjected to the maximum rate.

"Again if they were to pay out in dividends their earnings and profits, it might be only the next day thereafter the bank inspector, either State or Federal, would require them to strengthen their financial structure in assessments upon the stockholders involved.

"There is another angle to it—the deposits in most of the banks of the country are insured, and it is thought necessary not only for the benefit of the depositors and stockholders, but for the Government as well, that the reserves provided for by law and regulations be securely and strictly maintained." (Congressional Record, p. 6437, Apr. 27, 1936.)

All that Mr. Vinson said applies with equal force to trust companies which accept bank deposits and to those which operate under the laws of States which do not permit trust companies to engage in a general banking business but which handle only trust cash as distinguished from bank deposits. However, should I be mistaken in the view that this is what was intended by the House, may I invite your attention briefly to the following reasons why the suggested change in language should be made:

THERE IS NO DISTINCTION IN PRINCIPLE OR PUBLIC POLICY AS BETWEEN DEPOSITS AND TRUST FUNDS

One of the manifest purposes of the exemption provided for in section 104 is to enable, if indeed not to induce, banks and banking trust companies to create a surplus in order to protect and safeguard the funds of their depositors. There is the same need for a suitable corporate surplus in the case of a nonbanking corporate trustee. There is no difference in principle or in public policy between a trust company which receives deposits within the strict meaning of that term and a trust company which, not being a bank of deposit and therefore having no power to accept deposits in the strict sense of that term, is engaged in the business of administering trusts and, in that connection, of receiving money either for the purpose of immediate investment or to hold, pay out, or distribute to beneficiaries, according to the nature and requirements of the trust. The beneficiaries of such trusts are identically in the same position with regard to their need for protection as are the depositors of a trust company operating under laws authorizing it to accept deposits.

Consider, for example, any large nonbanking trust company authorized to do business under the laws of a State which prohibits such trust companies from accepting banking deposits. Such a corporate trustee acts as court receiver, administrator, guardian, conservator, trustee, or in similar fiduciary capacities. It may have in its hands millions of dollars of uninvested trust moneys which are not strictly bank deposits but which are subject to call at any time. Or take, for example, trust companies, which operate under the statutes of those States which expressly authorize trust companies, though having no banking powers, to act under orders of court as trustee depositary for trust funds held by individual trustees, receivers, and other individual fiduciaries. Under such statutes the funds so held are subject to the order of the court so designating the corporate trustee as a trust depositary. Does not prudence and business necessity require the same protection for the funds of such nonbanking trust companies as in the case of bank deposits?

In the case of a bank deposit the relation between the depositor and the bank is simply that of debtor and creditor, while in the other example a true trust relationship exists. Is a mere creditor entitled to greater protection than a trust beneficiary? Is the mere technical distinction between a deposit and a trust to

control? Or is "deposit" to include trust cash balances as provided in the Federal Deposit Insurance Corporation Act? Every reason would indicate the latter.

So far as the need of protection is concerned, it is immaterial whether the money held by the trust company is held as a bank deposit or held impressed with a trust. The depositor in the one case and a beneficiary in the other are equally entitled to protection so far as the protection may be secured by the building up of an adequate surplus.

THE NEED OF SURPLUS BECAUSE OF STATE REGULATION AND CONTROL

The statutes of most States, if not of all, provide that trust companies, whether they are empowered to accept general deposits or not, shall be subject to State regulation and control. Such statutes generally prescribe a definite minimum relationship which must at all times be preserved as between capital and surplus on the one side and the amount of trust deposits or trust funds on the other. They subject trust companies to State inquisitorial powers and to the supervision of State officials who are charged with the duty of causing such companies to maintain sound financial conditions and surpluses adequate to fully safeguard the trust funds under the administration of such companies. If in the judgment of the officials charged with this duty surpluses fall below an amount deemed adequate, power is given to require their replenishment or to cause the institutions to cease doing business. This furnishes a clear recognition, if any is needed, of the general principle of public policy which demands safeguards and security in the matter of trust funds and trust investments by corporations having trust powers, and in this respect places such trust companies in the same category as banks with or without trust powers.

NO DISTINCTION BETWEEN BANKING AND NONBANKING TRUST COMPANIES

By reason of the very nature of the business there can be no rational distinction made in the matter of having surplus between a bank or trust company engaged in the business of receiving general deposits on the one hand and a trust company without such banking powers, a substantial part of whose trust business is the holding, use, investment, and disposition of trust funds. Protection through surplus is clearly no less justified or demanded in the one case than in the other.

Banks having trust powers and trust companies having banking powers or powers of deposit both commingle trust funds with their own funds and invest trust balances belonging to their beneficiaries. If it be proposed, as it is, to exempt these principal kinds of institutions last mentioned, the result will be to create an unjustifiable discrimination between two classes of trust companies. Protection will be given to one class of beneficiaries which is denied to the other class, both being equally entitled to the same protection.

In some States, such as Illinois and Oregon, trust companies, though not banks of deposit, are given the same statutory rights relative to the use and management of cash balances of trusts awaiting distribution or investment as are national banks under the Federal Reserve Act. In the case of banks doing a trust business, uninvested trust funds of trust beneficiaries are deposited in the bank's own banking department, not as special deposits but as general deposits, and are made use of by the bank accordingly and are likewise insurable under the Federal Deposit Insurance Corporation Act. There is no substantial difference in this respect between a bank and a trust company without banking powers. The latter, instead of making with itself a technical deposit of trust funds, subject to check withdrawal, credits these funds on its books to its beneficiaries and then uses, holds, invests, and distributes these funds identically as does a bank trustee in the handling of its trusts.

SUGGESTED CHANGE IN LANGUAGE

In view of these considerations, I suggest that section 104 (a) should read (part italicized is present exemption in sec. 104 of 1936 act) as follows:

"*As used in this section the term 'bank' means a bank or a trust company* doing a general trust business *(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,* or the receipt, investing, handling, and managing of trust funds as fiduciary."

Mr. ALVORD. Mr. Chairman, I would like to present for the consideration of the committee a statement on behalf of the Title Insurance & Trust Co. and the Title Guarantee & Trust Co., both of Los Angeles, Calif., in support of a clarifying amendment to section 204 of the Revenue Act of 1934.

(The statement is as follows:)

STATEMENT BY E. C. ALVORD, WASHINGTON, D. C., ON BEHALF OF TITLE INSURANCE & TRUST CO. AND TITLE GUARANTEE & TRUST CO., BOTH OF LOS ANGELES, CALIF., IN SUPPORT OF A CLARIFYING AMENDMENT TO SECTION 204 OF THE REVENUE ACT OF 1934

In the case of an insurance company other than life or mutual, section 204 (b) (1) of the Revenue Act of 1928 provided as follows:

"(1) *Gross income.*—'Gross income' means the sum of (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, and (B) gain during the taxable year from the sale or other disposition of property;"

This definition was substantially the same under previous acts. It will be observed that such a company was required to include in its gross income only insurance income and gain from the sale or other disposition of property.

On March 14, 1932, the Supreme Court decided the case of *United States* v. *Home Title Insurance Company* (285 U. S. 191). That case involved a claim of exemption from capital stock tax on the ground that the corporation was an insurance company. The Supreme Court sustained the exemption even though nearly 25 percent of its income was derived from noninsurance business (*cf. Bowers* v. *Lawyers Mortgage Company*, 285 U. S. 182). Under that decision certain title insurance companies would qualify as insurance companies under section 204 (a) of the Revenue Act of 1928, and yet the definition of gross income contained in subsection (*b*) (1) of that section would not necessarily include all of their income.

In order to meet that situation, Congress, in the Revenue Act of 1932, changed the definition of gross income to read as follows:

"(1) *Gross income.*—'Gross income' means the sum of (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, and (B) gain during the taxable year from the sale or other disposition of property, and (C) *all other items constituting gross income under section 22*;". (Italics ours.)

The definition as so amended was carried forward without change in the Revenue Act of 1934.

The purpose of this amendment is explained in the Senate Finance Committee Report (S. Rept. 665, 72d Cong., 1st sess., p. 37), as follows:

"SECTION 204 (b) (1). *Definition of gross income—insurance companies other than life or mutual.*—Some question has arisen as to the adequacy of the definition in prior acts of the gross income of insurance companies other than life or mutual. Under a recent decision of the Supreme Court, some of the title guaranty and mortage guaranty companies are taxable as insurance companies, and since a substantial part of their income might not be classed as either underwriting or investment income, it might not come within the definition of gross income contained in this section. *As such companies are allowed the same deductions as are allowed ordinary corporations, in addition to the purely insurance deductions provided in section 204, they would be in the highly favored position of being taxed upon only part of their income while being allowed all of their expenses, losses, and other deductions.* Moreover, this definition, even in the case of the other type of insurance companies taxable under this section, may not include some miscellaneous forms of income which should be subject to tax. The bill accordingly requires the inclusion in gross income of insurance companies taxable under section 204 of all items constituting gross income under section 22 other than items of the character already specified in section 204." (Italics ours.)

It will be observed that the committee acted under the assumption that such insurance companies were allowed the same deductions as ordinary corporations and were escaping tax upon part of their income. Upon this assumption Con-

gress made no change in the provisions of subsections (c) (4) and (c) (6) of section 204 of the 1928 act dealing with certain deductions.

Section 204 (c) provides in part as follows:

"(c) *Deductions allowed.*—In computing the net income of an insurance company subject to the tax imposed by this section there shall be allowed as deductions:

* * * * * * *

"(4) Losses incurred as defined in subsection (b) (6) of this section;

* * * * * * *

"(6) Bad debts in the nature of agency balances and bills receivable ascertained to be worthless and charged off within the taxable year;"

It will be noted that the deductions authorized in the above quoted provisions are limited in their scope and are not entirely appropriate to provide for the deduction of losses sustained and bad debts incurred in the earning of non-insurance income. In other words, losses, in order to be deductible under subsection (c) (4), must be incurred on insurance contracts as defined in subsection (b) (6). Deductions for bad debts are similarly limited to agency balances and bills receivable. These provisions were reenacted without change in the 1934 act.

Because of the limitations contained in subsections (c) (4) and (c) (6) of section 204, examining officers of the Bureau of Internal Revenue in the audit of returns of certain title insurance companies for 1932 and subsequent years have disallowed deductions which would otherwise be allowed to ordinary corporations. A few illustrations will suffice.

Some of these companies maintain trust departments and charge fees for certain services, which fees are not strictly insurance income. Typical of such charges would be escrow fees. Such charges are accrued and included in the income of the insurance company by virtue of section 204 (b) (1) (C). However, if for any reason the insurance company is unable to collect such fees and they are charged off as a bad debt, it has been proposed to disallow the amount thereof as a deduction under subsection (c) (6) because of the restriction contained in that section upon the deduction of bad debts. In other words, if the fees had been earned in connection with the insurance business, they would be allowable as bad debts, but not having been earned in connection with the insurance business, examining agents of the Bureau of Internal Revenue have taken the position that they are not deductible.

Again, a similar question has arisen in connection with bad debts resulting from the foreclosures of mortgages and trust deeds. In many instances, such companies loan money upon the security of real property. Where the mortgages are foreclosed, the companies frequently sustain losses. In such cases examining agents of the Bureau of Internal Revenue have taken the position that the loss is in the nature of a bad debt on account of the money loaned, and that it is not in the nature of an agency balance and not strictly within the category of bills receivable and, therefore, not deductible under subsection (c) (6). If, however, the mortgage security had been sold, the deduction would be allowable as a loss resulting from the sale of property under subsection (c) (5).

These companies frequently have occasion to acquire stock in other corporations. Cases have arisen where such stock became wholly worthless and where the State insurance commissioners have directed that the cost thereof be written off on the books of the taxpayers. Such losses have been disallowed on the theory that they were not incurred on insurance contracts under subsection (b) (6) and because they were not sustained from the sale or other disposition of property as provided in subsection (c) (5).

I am informed that the Treasury officials are fully aware of the problem, and I am quite certain that they will agree that a clarifying change in the law would be helpful to the administrative officials, as well as to the title insurance companies. Since, under section 204 (b) (1) of the Revenue Act of 1932 and under the same section as reenacted in the Revenue Act of 1934, title insurance companies are required to include in their gross income not only insurance income and gain from the sale or other disposition of capital assets, but "all other items constituting gross income under section 22", it is obvious that they should be entitled to the same deductions with respect to their ordinary income as are allowed to ordinary corporations.

TENTATIVE DRAFT OF A PROPOSED CLARIFYING AMENDMENT TO SECTION 204 OF THE REVENUE ACT OF 1934

Amend section 204 (c) by adding the following new paragraph:
"(10) To the extent of the gross income provided by subsection (b) (1) (C) of this section, all other deductions provided by section 23 of this title."

The CHAIRMAN. The committee will recess until 2 p. m.
(Whereupon, at the hour of 12:15 p. m., the committee recessed until 2 p. m. of the same day.)

AFTERNOON SESSION

(The hearing was resumed at 2 p. m., pursuant to adjournment.)
The CHAIRMAN. Is Mr. Howard McCall here?
(No response.)
The CHAIRMAN. Mr. A. G. MacKenzie.
Mr. MACKENZIE. Yes, sir.

STATEMENT OF A. G. MACKENZIE, SALT LAKE CITY, UTAH, REPRESENTING UTAH METAL-MINING COMPANIES

Mr. MACKENZIE. I am A. G. MacKenzie of Salt Lake City, Utah, and have been engaged in the mining business in Utah for many years. I am the executive officer of the State association of metal-mine operators and appear as their representative. I am generally familiar with mining conditions in other Western States, as well as my own, and the conditions to which I invite your consideration exist in the western metal-mining States generally.

The principal metal products of our State are gold, silver, copper, lead, and zinc, which almost invariably occur in association with each other in the same ore. Under normal conditions, about 47 percent of the population of the State depends upon the production of these metals. The metal-mining industry's pay rolls constitute about 30 percent of the total industrial pay rolls of the State. It furnishes more than 50 percent of the originating railroad freight tonnage of the State and is the principal home market for the State's agricultural products. These figures are cited to demonstrate the importance to the State of this industry, which has attained that importance through methods of financing and developing such as I am about to describe.

Mining properties in the West are customarily brought into operation through the formation of corporations to develop claims presumed to contain metals in commercially recoverable quantities. The process begins with the location by a prospector of mining claims which indicate to him the presence of recoverable metals. He may have, and usually has, spent years in search for the claims and is, therefore, probably not a young man. In most instances, he must spend more time and much hard labor to uncover a showing which will warrant the next step in the development of his ground. Such a showing having been made, he faces the necessity of spending money, which in all likelihood he does not possess, to prove and develop his discovery. So he brings his proposition to the attention of his friends and others, and if the showing impresses them favorably a corporation is formed to develop and operate the claims.

The corporation contracts to expend a specified amount of money in the equipment and development of the property within a specified

period and pay the owner a specified price for the claims out of the earnings of the corporation as and when earnings are realized. Such payments take precedence over dividend distributions by the corporation as the objective of the whole arrangement, as far as the owner of the claims is concerned, is to consummate the sale of property which he is unable to develop himself or to sell outright.

The hazards of the venture are thus shared by the owner of the claims and by the corporation. Both parties rely upon the property itself to produce its purchase price. If it fails to do so, the corporation loses what it spends to equip, develop, and operate the enterprise, turns the claims back to the owner, and dissolves. If the enterprise proves sufficiently productive, the claims pass into the ownership of the corporation, the development agreement terminates, and the corporation proceeds to operate the property as owner.

It is evident that this procedure involves the expenditure of large sums of money in the development of the property before it is ready for production or before any money is available to pay for the property.

Senator KING. Is it not true that some of the mining companies have spent as much as $10,000,000 to $25,000,000 before they took out a pound of ore?

Mr. MACKENZIE. That is true, Senator; yes.

Those who take stock in such corporations do not expect immediate individual profits and usually expect several years to elapse before profits accrue to shareholders. It is quite obvious that the hazards of such undertakings are many.

One of three conditions must result:

First. The venture may prove a total failure.

Second. Sufficient earnings may be realized to pay for the property and for its initial development without return to the stockholders; and the fact that the corporation may realize some funds which it uses in development or payment for the property does not necessarily indicate that the stockholders will ever receive anything for themselves.

Third. The venture may develop a large body of good ore and prove highly profitable for all concerned, including the Federal and State treasuries.

In the first instance, nobody profits except those who have received employment from the corporation and those who have sold supplies to it. In the second instance, it would seem only fair that the stockholders should be made whole as far as the property is concerned without the imposition of excessive taxes, as the owner of the property will pay his proper tax on what profit he may have made in the transaction. In the third instance, that of a profitable venture, the property and the stockholders should and will pay proper taxes to the Government and the State.

It would be especially unfortunate to prohibit this manner of handling prospects at this time when it is so difficult to sell such properties outright. Arrangements along the lines I have indicated afford about the only present hope for owners of such ground to initiate its development or for investors of moderate means to enter the industry with possibilities for future gains commensurate with the hazards they assume. The plan is long-established, residents of the

mining areas themselves engage in it largely and it is doing much at present to provide employment for men unable to obtain other work.

After my many years of contact with and observation of this industry, I feel that I can assure you that you need worry little about such corporations withholding dividends in undue measure from the stockholders. In fact, the tendency often is to distribute earnings too lavishly and all those familiar with the history of western metal mining know of many instances where companies have suffered greatly through failure to retain sufficient reserves to meet emergencies. Usually it requires considerable resolution on the part of directors of young mining companies to retain sufficient earnings to constitute even reasonable safeguards against the adverse circumstances that frequently arise.

I believe the enactment of this bill in its present form would greatly discourage and possibly extinguish investment in such enterprises as I have discussed. I am unable to analyze the bill or to engage in a technical discussion of its various provisions, although I have read it and have heard some of the discussions of it before this committee in the last few days. I find my own uncertainty as to its effects is shared by men much more qualified than I to comprehend such matters. One fact, however, has very definitely impressed itself upon me as the bill affects our industry, and that fact is that a tax of 42½ percent may be levied upon earnings from a property which must actually be applied to payment for the property itself and for the development without which the property is worthless. This is one of the provisions of the bill that will not fail to impress itself upon all those interested or likely to become interested in our industry, even though they gain little or no further knowledge of the bill and its application, and that fact alone will be a tremendous deterrent to mineral development in the Western States.

It is not a matter of theory with us but of actual results. These will be harmful to our metal-mining industry and to our communities. That is the one thought we wish to leave with you, as we believe you do not wish to be unfair to us and harm us in this way.

Senator HASTINGS. What effect do you think it will have upon competition, for instance, in the copper industry? Would it not tend to prevent new development and new discoveries of ore, and therefore give to the present owners, for instance, these large corporations, pretty nearly a monopoly in that particular ore?

Mr. MACKENZIE. Yes, Senator. As I tried to indicate, it will seriously affect, in our judgment, the development of new deposits of any description.

Senator HASTINGS. And that of itself, of course, narrows the competition and gives to the well-established company an opportunity to increase its price and earn more profit?

Mr. MACKENZIE. It would have that tendency; yes.

Senator KING. For every mine that operates and produces ore, how many efforts are there and experiments that fail? Will you get one operating mine out of 500 ventures?

Mr. MACKENZIE. Locations, you mean?

Senator KING. Yes. Or 1,000?

Mr. MACKENZIE. Senator, I do not know of any definite statistics. An attempt was made by some of my friends several years ago to make a computation on that. It was in no sense official, but was the

best that they could make with the available data. Their conclusion was that one dividend-paying metal mine in the West results from 22,000 locations.

Senator HASTINGS. What do you mean, Mr. Mackenzie, by "locations"? Is that a thing upon which they have spent money?

Mr. MACKENZIE. Just the cost of acquisition, Senator. Under the law, a person is allowed to locate mining claims which constitute a surface area 600 by 1,500 feet.

Senator HASTINGS. That does not cost much money.

Mr. MACKENZIE. No; the location does not.

Senator KING. He has to work on it and pay every year an assessment, and has to do a certain amount of work to get title.

Mr. MACKENZIE. $100 worth of work a year.

Senator KING. Have you any data on the number of companies that have spent real money upon trying to develop a location that has not succeeded? What proportion of those fail?

Mr. MACKENZIE. I could not answer, Senator. They are not of record, you know, but of course a great number.

Senator KING. I suppose the percentage of failures is very great.

Mr. MACKENZIE. Oh, yes. From the nature of things, it just has to be.

Senator KING. Thank you very much.

The CHAIRMAN. Mr. Donald A. Callahan, Idaho Mining Association.

STATEMENT OF DONALD A. CALLAHAN, WALLACE, IDAHO, REPRESENTING IDAHO MINING ASSOCIATION

Mr. CALLAHAN. My name is Donald A. Callahan, of Wallace, Idaho. I represent the Idaho Mining Association, which numbers among its members practically all of those who are interested in mining in the State.

I concur in the statement made by Mr. Mackenzie, of Salt Lake City. The conditions surrounding the development of mining properties in Utah and Idaho and throughout practically all of the western country are as he described. Mining has always been and always will be a pioneering industry. In the development of mining properties man is brought face to face with the resistance that nature makes to the discovery and exploitation of her hidden resources. In the State of Idaho we have large operating mines that have been developed to their present point of production within the last 50 years. We have the largest lead mine and the largest silver mine in the United States located within our borders.

I am not here to talk to you about the effect of this tax bill upon our large producing companies. It so happens that most of these companies have ample reserves with which to carry on their business. It is quite possible that this tax bill will relieve these companies, as such, of considerable taxation. I do not mean by this that these operating companies approve of this bill, because they do not. They believe it is fundamentally wrong. The managements of these properties have developed them to their present efficient status through the exercise of good engineering and business judgment. They feel a perfect confidence in carrying on their business and do not relish the idea of a system of taxation which will dictate to them, through the imposi-

tion of what we regard as penalties, the policy of distributing or retaining earnings for the benefit of both the stockholders and the corporation as an entity.

If you should take a poll of the mining industry, including both management and individual stockholders, you would find an overwhelming majority opposed to the policy contained in this bill.

But I am here especially to plead with you on behalf of the smaller corporations which are engaged in the development of mining properties. I am here to ask that you do not blanket the entire Nation with a system which is designed to correct what some people regard as an economic and social evil. I make the assertion that this blanket policy will affect most adversely the corporations which are fighting for existence and seeking to establish themselves in the position where they will in time become contributors to the Nation's revenue.

In the State of Idaho we have vast undeveloped areas which contain minerals. It may surprise you to learn that in central Idaho there is a primitive area upon which the foot of a white man has never trodden. From the upper reaches of the Salmon River through a vast mountainous country there lie hidden treasures which man today is seeking to recover from forbidding nature. Hundreds of small corporations today are prospecting and developing these areas. They are the companies which will be most adversely affected by the passage of this bill. Mr. Mackenzie has told you of the method by which mine financing is accomplished and it must be quite clear that to impose the maximum tax provided in this bill upon earnings of these corporations which are devoted to payment for properties and the erection of operating and reduction plants, will make it a practical impossibility to finance future operations.

The mining industry already is suffering from obstacles placed in the way of financing by the Federal Government. The Securities Act as administered by the Securities and Exchange Commission is making it practically impossible to do the initial financing which is required under the system which has been described to you. The other day a representative of the Treasury at these hearings, in response to a query of Senator King, made reference to "gullibility" upon the part of those asked to invest in mining securities. We of the mining areas of the West resent such an attitude. We are the first to recognize and condemn the promoter of worthless mining stocks.

We do that because he is our enemy. He makes it just that much harder to secure funds for legitimate mining development. But we know at the same time that this class of salesman is not confined to the sellers of mining stocks. We find the fakir in all lines of business. As I listened to this reference to the "gullibility" of those who might invest in mining stock, I could not help but think that the gentleman who made the reference had probably written his statement for the committee under electric lights which had only been made possible because somebody had invested in mining stocks, and that he rode up to deliver this statement in an automobile which could never have been built if certain "gullible" individuals had not been foolish enough to invest their funds in mining securities for his benefit and the benefit of all who enjoy the conveniences of this machine age.

The mining industry is one of the oldest in the world. It was the first industry of the West. It is still most important not only to the West but to our industrial and agricultural sections as well. This is a metal age, and we must keep on finding out the secrets of nature through the slow plodding process of opening up forbidding ground, building roads through almost impassable forests, across rushing streams, along trackless canyons.

I want to give you an example of a little gold property located near where I live in Idaho which will serve as an example of what this bill would do to such enterprises. This corporation took an option on a gold property for $122,500 and paid $1,000 in cash, which was all it could raise at the time. It borrowed money to build a plant and there is still due more than $40,000 on that note. It has been obliged to incur other indebtedness to the extent of $2,700 and the directors of the corporation have personally advanced $10,000 to carry on operations. Interest has accrued on these obligations in the amount of $7,000.

The company has a good prospect of paying out these obligations and making money for its stockholders.

The CHAIRMAN. When was this company organized?

Mr. CALLAHAN. It was organized probably 5 or 6 years ago.

Senator KING. And has been struggling along ever since trying to develop the property?

Mr. CALLAHAN. The property was partially developed before it was taken over, but not to where production started.

The money thus far subscribed has been spent in developing and equipping the property and it is now at a point of production. Up to date it has made sales approximating $250,000 and under its contract the property has paid royalties to apply on the purchase price out of these sales to the amount of $37,500. It now owes $144,800 for the property and on the notes which it has been obliged to issue in its rather long struggle to reach the point of production. Last year its total sales of ore amounted to $35,900. It paid out in wages $11,350 and for materials and supplies, $9,500. It is on the road to success.

Now, having this situation in mind, I endeavored to read the bill with a view of ascertaining how this company, in the event it has future net earnings, might enjoy some of the much discussed "relief" provisions of this bill. It was then that I began to realize that this little company which was formed primarly for the purpose of mining gold ores must step out of character temporarily toward the end of the taxable year and resolve itself into an organization for the purpose of working out plans under these complicated provisions for keeping some of its earnings to apply in payment of its indebtedness. Its directors would be obliged to consider: (1) Provisions of section 14 relating to accumulated earnings and profits less than the adjusted net income. Here the rather puzzled gold miners would become involved in the question as to whether they had accumulated earnings and profits. Naturally, they would scratch their heads and see if they could understand what the term "earnings and profits" means.

According to the testimony already before this committee, this is something that neither lawyers, accountants, Congressmen, Treasury officials, nor other Government bureaus and departments agree upon so it is doubtful if there is anything here which will give relief.

These gold miners were not farseeing enough when they entered into this undertaking to mine gold to make contracts not to pay dividends. They were naive enough to believe that under the laws governing the corporations of Idaho, they wouldn't need to make such contracts or agreements. They knew they would find themselves in rather a predicament under the laws of our State if they had attempted to do such a thing. So I could find no relief in section 15.

I then turned to section 16 relating to debts, which has a number of divisions and subdivisions, using up several of the integers and a number of letters of the alphabet, some of them in caps and some in lower case. The bill is quite artistic in this respect because it employs parentheses, cross-references, and practically everything known to those who make a specialty of writing bills for Congress which to the ordinary layman mean "confusion worse confounded."

I am not going to say to you that somewhere in these three sections there isn't some relief of some kind for this company in the event it makes money and wants to pay its debts. I am not going to say it because I don't know and if there is anybody that can tell me, I'll pass the word on to the directors of this company and they may be able to take advantage of the situation. Even then, can you tell me whether there is any assurance that this will be the decision of the Bureau when they come to deal with the matter? I am certain the obligation to pay for a property out of earnings in the form of royalties does not come within the relief provisions.

Are you going to pass a tax bill which will place mining corporations incurring such obligations in this position? If you do, you will destroy incentive to prospect and develop the mining resources of the United States. And in doing that you will retard unquestionably an industry which should be always a concern of an industrial nation, or you will drive the promising mining prospects in this country into the willing hands of the large operators who have sufficient funds with which to purchase and develop such properties. I do not believe you would seriously contemplate such a policy.

Let me call your attention to another case, where the stockholders in a corporation paid in $50,000 for their stock. The corporation spent, in equipment, development, and payment for the property, $500,000. When the mine was exhausted, the company had $20,000 left for distribution to its stockholders. Can it be said that the stockholders were in any way enriched by apparent earnings of this corporation, that in any particular year were expended for purchase of the property or for equipment and development, when the net result was the stockholders lost $30,000? These are the rounded figures of an actual case and are typical of many others.

These are but typical examples. I could cite hundreds of them in my own State alone. I know that the great majority of such enterprises never will yield any return at all. Men who purchase mining securities realize the hazard of all such enterprises. The point is that honest efforts to develop mining resources should not be penalized by excessive taxes upon profit actually expended in payment for properties and for the erection of operating and reduction plants.

Something has been said here, in fact it has been repeated very often, that taxes for the support of Government should be levied upon those best able to pay. That maxim of taxation was enunciated by Adam Smith. If the authors of this bill are willing to accept the

first maxim of Adam Smith with relation to taxation, they should be equally willing to accept the second. Accordingly, I would like to have your consideration of this second maxim which is as follows:

> The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person; where it is otherwise, every person subject to the tax is put more or less in the power of the tax gatherer.

And you should be equally willing to consider another of these maxims as follows:

> Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury in the four following ways. First, the levying of it may require a great number of officers whose salaries may eat up the greater part of the produce of the tax, and whose perequisites may impose another additional tax upon the people. Secondly, it may obstruct the industry of the people and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so. Thirdly, * * * the law (meaning a law providing for excessive rates, penalties, and forfeitures) first creates the temptation and then punishes those who yield to it; and it commonly enhances the punishment due in proportion to the very circumstances which ought certainly to alleviate it, the temptation to commit the crime. Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax gatherers, it may expose them to much unnecessary trouble, vexation, and oppression. * * * It is in some one or other of these four different ways that taxes are frequently so much more burdensome to the people than they are beneficial to the sovereign.

I submit that the evidence before this committee clearly indicates that all four of these objections will apply to this particular bill. It strikes at those who are not able to pay. You may be aiming a blunderbuss at some high and mighty potentate in the world of finance but the blunderbuss of taxation scatters its slugs indiscriminately and this particular blunderbuss is going to hit the small, struggling, poorly financed corporation. I hold no brief for the taxpayer whose income takes him into the far reaches of the upper brackets of income taxation. I don't know anybody in that class and I have no concern with him at all because he is usually able to take care of himself. I might suggest, however, that in taxation there is always a point of diminishing returns, and high rates do not always yield the greatest revenues.

As I sat here and listened to some of the testimony offered, I marveled at the ramifications of this bill. I marveled that there are to be found men with brains sufficiently convoluted to devise such a measure. I am afraid if the bill had to be approved by the Securities and Exchange Commission under the truth-in-securities law it would not pass muster. It is more complicated than any prospectus issued by a fraudulent promoter that I have seen. It is represented that it will get the taxes from the taxpayers in the high brackets and will force corpulent corporations to disgorge their hoarded earnings. That assumption, at best, is only a half-truth and under the Securities Act half-truths are frowned upon even more than outright falsehoods because they may be more deceptive.

But I have shuddered too as I have listened to this testimony. Ever since the income tax law was first passed, mining corporations have been engaged in tax controversy because of the Bureau's in-

genuity in devising new regulations and rulings which would yield more taxes. Recently we haven't been obliged to do as much of our mining business in Washington as we formerly did. Now, however, I am appalled to think that we will have to start all over again under an entirely new theory of corporation income taxation. We will have to set our experts to work figuring out our returns. We will have to employ counsel at home to advise us before we make our returns and counsel in Washington in the many controversies which are bound to arise before this law is fully settled and determined. We ask you gentlemen to bear in mind that the mining people of the West wish to carry on their operations out there and send you a reasonable and perhaps, if we must, even an excessive sum to support this tremendous machine you have built up in Washington. But we do ask you to especially consider that you place no obstacles in the way of development of potential tax-paying corporations which will bring out of the earth for the use of this and future generations the metals which our civilization must have.

In conclusion, I wish to attach to this statement a resolution adopted by the Idaho Mining Association in a meeting at Lewiston, Idaho, on April 24. It expresses sentiments of all who were present representing practically the entire mining fraternity of our State.

The CHAIRMAN. You have that permission.

Mr. CALLAHAN. This is the language of the resolution: "We urge upon our representatives in Congress that in the matter of new revenue legislation they use the utmost diligence in protecting the interests of corporations engaged in mining in Idaho. The recommendations of the subcommittee of the Ways and Means Committee, if carried out, would impose such a burden upon corporations engaged in developing mining properties as would seriously cripple the industry in our State. This is particularly true of the corporations which are endeavoring to pay for properties and erect reduction plants and other improvements through the proceeds derived from the properties themselves. Practically all mining properties in Idaho have been developed in this manner. To impose the maximum tax or the so-called relief rates provided in the bill upon earnings which are devoted to payments for properties and for capital improvement would be most destructive. In the same connection we strongly urge the repeal of the capital-stock and excess-profits tax, particularly because the fair application of the law to the mining industry is almost impossible unless provision be made for periodical revision of the declared value."

The CHAIRMAN. Mr. Julian D. Conover, representing American Mining Congress.

Mr. Conover, how much time do you desire?

Mr. CONOVER. About 20 minutes, but I should like to surrender 6 or 7 minutes of my time to Mr. Peloubet, a certified public accountant, who can explain an important matter in regard to the treatment of inventories.

The CHAIRMAN. Put your brief in the record, and just give the high points, because these two witnesses who have just preceded you have covered this question quite thoroughly. We want no repetition, so far as we can prevent it.

STATEMENT OF JULIAN D. CONOVER, WASHINGTON, D. C., SECRETARY, AMERICAN MINING CONGRESS

Mr. CONOVER. My name is Julian D. Conover, of Washington, D. C. I am secretary of the American Mining Congress which represents the various branches of the mining industry of this country. I am a mining engineer and am not a lawyer or tax expert.

I should like, first, to discuss very briefly the general features of this tax bill and then to make a few specific suggestions for constructive changes.

From the standpoint of the mining industry as a whole, we endorse the statements just presented to you by Mr. Mackenzie and Mr. Callahan. What they have said as to the hurtful effect of this proposed tax bill upon the development of mines applies not only to the States of Utah and Idaho but throughout the western United States, and, in fact, wherever mines are developed. It applies to metal mines, to coal mines, and to mines producing the various nonmetallic minerals. It is our belief that the bill would seriously hamper and interfere with the development of mining properties and curtail the production of those minerals and metals upon which our modern industries are dependent.

Many of our mining people are much disturbed over the complexities and uncertainties of the proposal and the principle of imposing heavy taxes on earnings which mining companies are not in a position to distribute to their stockholders within the taxable year. All too frequently the terms of the bill will result in unbusinesslike distribution of profits in order to save a heavy tax, or will impose an excessive levy if earnings are not distributed because of a desire to pursue a safe business policy.

When a mine has reached the stage of full development, its depreciation and depletion reserves may be sufficient to maintain existing plant and equipment and to develop ore reserves to keep pace with current operations. Under such circumstances it may be able to distribute each year its net earnings. This is not true, however, for a mine in the process of development or a mine which has not reached full production. Earnings of such mines must be used for building up, developing and equipping the property.

If earnings so used are to be subjected to a tax that may run as high as 42.5 percent, it is certain to retard mining operations and cause unemployment.

This depression has shown how essential it is that mining companies have adequate financial reserves. During depression periods the heavy industries, into which the products of mines largely go, are affected first and most severely. Metal and mineral prices fall, and mine products become a glut on the market. It is then necessary for the operator to decide whether he shall keep on shipping ore and exhausting his resources, or cut down his production and perhaps close his mine, thereby causing unemployment.

The closing down of a mine will mean disruption of its organization and great hardship in the mining community. A mine closed down can only be reopened at heavy and sometimes prohibitive expense. In recent years mining companies have had to draw heavily on reserves to preserve their properties and to provide employment in their communities.

Mines are not businesses which can select a locality for their operations, perhaps with a general supply of labor available from which they may draw employees as occasion demands. The mining company must conduct its operations where the mineral is found. It must build up its mining community there. The mine is frequently the sole support of that community. If the mine is shut down or operations curtailed, everyone in the community suffers.

We of the mining industry take pride in the fact that the depression was marked, so far as our industry was concerned, by a discontinuance of dividends for the sake of maintaining employment.

If a mining company is sufficiently fortified with reserves, periods of depression may constitute a time in which to continue development work, to prospect properties which have promise, or to stockpile the product instead of shipping it—all of which serves to continue employment and alleviate hardship. Such a practice cannot be carried out unless the mining corporation has been given an opportunity to fortify itself with sufficient cash to meet periods like this. It cannot be done if the corporation is subjected to the heavy tax penalties of this bill.

Another great difficulty with this bill, from our standpoint, is its complexity. As mining men we find ourselves rather overwhelmed with the problems it creates. Under existing law we find plenty of difficulty in computing taxable net income, but we do know definitely what the rate of tax upon that income will be. Under this bill, however, we have to compute not only the taxable net income itself but also the rate which is to be assessed against it, and both of these computations must be made upon an arbitrary and uncertain basis.

In order to arrive at the tax rate we must know both the "net income" and the "earnings and profits" as these terms will be interpreted and construed under the law. As I have stated, I am not in accountant and cannot discuss in detail all the problems involved in making these computations, but in the last few weeks I have been exposed to enough abstruse argument on this matter to appreciate that there are many complicated and uncertain questions that cannot be avoided—questions on which we shall have to make the best guess we can, because both the taxable income and the very rate of tax depend upon the answer.

I hardly need say that the increased uncertainties and risks in determining our taxes will be a substantial deterrent to mining enterprise.

I should now like to make a few specific suggestions as to changes which we believe would clarify and improve this tax bill, although they do not go to the heart of its general principles. These relate to:

(1) The time for making distributions upon which dividend credits are based.

(2) The treatment of inventories.

(3) Simplification of corporate structures.

Senator KING. Do you offer amendments in concrete form?

Mr. CONOVER. These are not all in exact language, but we have some very specific suggestions here which I am sure the drafting experts can readily put into concrete form.

Senator KING. Very well.

Mr. CONOVER. *As to the time for making distributions upon which dividend credits are based:*

It is generally difficult and sometimes impossible for a mining corporation to determine its income with any degree of accuracy before the close of the year. Final returns from ore shipments to the smelters may be delayed 60 to 90 days, and other items entering into the net income are not determinable for a similar period. As a result, the corporation cannot distribute its earnings before the end of the tax year without a great amount of speculation and guesswork.

Senator KING. Is it not true that often the ores may be of such a complex character, requiring different fluxing ores, therefore they are not passed through the smelter or reduction works for months and months, so that you could not get your returns for perhaps 6 or 7 or 8 months?

Mr. CONOVER. That may come into the picture, although usually the smelter will make return upon the basis of assays. However, the assays are subject at times to differences and umpiring has to be resorted to, and it may take considerable time to reach an agreement and make a final settlement.

The CHAIRMAN. These suggested changes are applicable to the mining industry?

Mr. CONOVER. They are, of course, applicable to the mining industry, because that is what we know most about, although some of them probably are of more general application.

Senator KING. There might be factors there in connection with the determination of your expenditures and your assets and so on in the mining industry different from that in the other industries?

Mr. CONOVER. That is entirely possible of course; if similar circumstances exist in other industries, it would follow that similar treatment should be given. We are speaking particularly as to the situation in our own industry.

If it is not felt that some such period as 2½ months after the end of the year could be allowed within which to make full distribution of income, there should in any event be an additional period, possibly 3 months, within which to make distribution of at least one-fourth of the amount of income for the year. Allowing for the time of realization of income by the mining companies, if any company before the end of the year distributed three-quarters of its year's income, we believe this should be all that the Government should ask.

A further and very serious problem arises in respect to the review of tax returns and assessments of additional taxes—a problem which we urge be carefully considered with a view to corrective action.

The corporate taxpayer, when it comes to make its return, figures as closely as it can what its tax liability is; but the complicated provisions of the law and the regulations thereunder make it exceedingly difficult for the taxpayer to have any confidence that this determination will be acceptable to the Commissioner of Internal Revenue. As a matter of fact, very few if any returns involving substantial tax payments are found acceptable to the Commissioner and controversies are likely to arise. The settlement of such differences often requires months if not years, during which time the company is extremely uncertain as to what its final tax liability may be.

This situation, of course, exists under the present law. The company may have great trouble, difficulty, and expense before its taxable net income is finally determined, but it then has to pay simply the amount of the usual tax, approximately 15 percent, with interest

Under this bill, however, any additional determination of net income will carry a heavy penalty, raising the rate of tax upon the entire net income. In many cases the additional tax will be equal to one-half of the additional income so determined.

Under the new plan, if the company had in the first case known what the liability would be, it might have made full distribution even though that meant special hardship. The provisions of this bill seem to leave the company subject to a heavy penalty tax because of its failure to understand all the questions involved in the bill and the pertinent regulations.

To avoid this unfair treatment and to enable the taxpaying corporation to proceed with its operations with reasonable assurance that these excessive penalties will not be assessed, we urge that the corporation be accorded the right, within a reasonable period after final determination of additional statutory net income, and except in case of fraud, to distribute to its stockholders an amount equivalent to such additional income, and in case such distribution is made, that no penalty tax be assessed. We feel that this is a matter of simple justice, is sound public policy, and is vitally needed in view of the complexity of the law and the utter impossibility of its being sufficiently understood by the taxpayer to enable him to prepare his return with any certainty that it will be accepted.

Treatment of inventories: Mining concerns, and more particularly those engaged in processing or metallurgical treatment of mineral products, commonly require large quantities of materials in process. As suggested by Senator King just now a smelter requires 60 to 120 days to produce refined metal from crude ore and must, therefore, keep from 2 to 4 or more months' production constantly in process in the roasters, sintering machines, furnaces, and so forth.

The stock of such material in process together with a suitable reserve against contingencies which might produce a shortage of supply is usually referred to as the "normal stock", which must be carried at all times and without which operations could not be conducted.

If, as metal prices vary, the metal contents of this material in process are constantly revalued and such changes in value are reflected in income, wide fluctuations in income may result from this factor although the physical character of the normal stock and its function as an integral part of the operating plant has in no way changed. To avoid such distortion of earnings statements, a method has come into common use under which this normal stock is carried on the books at a constant price. It becomes a stable, fixed asset in the accounts just as it is in the actual operations.

Up to date this method of valuing inventories for tax purposes has not been recognized in our income-tax administration, but if the proposed bill is to be adopted, it becomes vastly important that it be so recognized. This subject is a rather technical one, and I should like permission to have it briefly presented by Mr. M. E. Peloubet, an eminent member of the accounting profession, who is familiar with all its aspects and can explain it fully and clearly.

As to simplification of corporate structures: In our testimony before the Committee on Finance during its consideration of the revenue bill of 1935, we pointed out the desirability of a specific statutory provision permitting the liquidation of subsidiary corporations. Our principal

purpose was to bring about a method by which corporate structures could be simplified by the elimination of subsidiaries, without risk of uncertain and unknown tax consequences.

The necessity for such a provision resulted from the refusal of the Bureau to rule definitely that a merger of a subsidiary into a parent corporation is a tax-free reorganization and not a liquidation subject to tax. Clearly the inherent nature of the transaction is a mere change in corporate form on which gain or loss should not be recognized.

In the 1935 act Congress clearly recognized the desirability of thus encouraging simplification of corporate structures and intended to enact a provision which might be availed of to that end. Accordingly section 112 (b) (6) of the 1934 act was added by section 110 of the 1935 act. This section—112 (b) (6)—however, has not been effective for the following reasons:

(1) Generally in the case of intercorporate transfers on which no gain or loss is recognized, property is carried over to the transferee on the same basis which it had to the transferor. However, in the case of a liquidation under section 112 (b) (6) as the present law is written, the basis is to be determined under section 113 (a) (6), which under the Bureau regulations requires an allocation to the assets acquired by the parent of its basis for its stockholders in the subsidiary. This requirement presents many difficult questions of allocation and involves so many uncertainties as to make section 112 (b) (6) almost unworkable. The simple provision—and the one which we believe would be more in accord with the real intent of Congress in this matter—would be one prescribing that the subsidiary's basis should be carried over without any change by reason of such intercompany transaction, in the same way as would apply under sections 113 (a) (7) and (8).

(2) As section 112 (b) (6) passed the Senate last year, it required only that the parent should own at least 80 percent of the voting stock. As enacted into law, the additional requirement was prescribed that the parent company should also own 80 percent of all other classes of stock. Frequently, the parent company does not own 80 percent of all classes of stock. It is submitted that since control is not an essential requirement of a tax-free reorganization, and since the provision for nonrecognition of gain or loss applies only as to the stock owned by the parent company; its ownership of 80 percent or more of the voting stock should be an adequate requirement.

(3) Section 112 (b) (6) is limited to those cases where the parent was in control of the subsidiary on or before August 30, 1935. This is an unnecessary restriction. The simplification of corporate structure is desirable. There is no reason why the benefits of the section should be limited.

We respectfully urge that such changes as we have indicated be made, so that this section will be fully available for the purpose of bringing about the simplification of corporate structures. We feel certain that these changes will in no way prejudice the interests of the Government.

The CHAIRMAN. If you desire, you and your associates can talk to Mr. Kent, one of the experts here, with reference to your suggestions.

Mr. CONOVER. I appreciate that very much; I will be glad to do that.

STATEMENT OF M. E. PELOUBET, CERTIFIED PUBLIC ACCOUNTANT, REPRESENTING AMERICAN MINING CONGRESS

Mr. PELOUBET. I am M. E. Peloubet, member of the firm of Pogson, Peloubet & Co., certified public accountants, New York City. I am speaking for the American Mining Congress.

As Mr. Conover has indicated, I am here to suggest the adoption of an administrative provision in the bill now before this committee with respect to inventories. Our suggested provision will have the effect of preventing in years of declining prices the escape from taxation of actual realized profits, and will insure in years of rising prices that all realized profits are taxed, in those industries where the processing period is long and where a constant normal stock of raw material must be maintained. The purpose is not to minimize or reduce taxes but it is intended to provide for the regular collection of taxes on actual realized income as and when such income is realized, in place of the present method employed in the taxation of industries producing, smelting, and refining nonferrous metals and other industries similarly situated, where taxes are levied on incomes which are largely fictitious in periods of rising prices, and where losses are allowed against actual realized incomes in periods of declining prices.

Section 22 (c) of the Revenue Act of 1934 carries the following provision in regard to inventories:

> Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

An identical provision is contained in the proposed bill now before the Senate Finance Committee (sec. 22 (c)).

Senator KING. Did you approve of that provision?

Mr. PELOUBET. As far as it goes. I intend to suggest a clarifying addition to it.

Inventories are the most important single factor in the determination of income in those industries in which the processing period is comparatively long—among which are those engaged in the smelting and refining of metals and the metal and other products produced therefrom. The quantities of the metals and metal products in the inventories are fairly constant and must be maintained as long as the industries are in operation. The inventories could be sold and disposed of only upon cessation of business by the smelting, refining, or manufacturing plants and the liquidation of the enterprise.

The use of the normal or necessary stock method of valuing such inventories, whereby the quantities of materials required at all times to be kept on hand and in process for the conduct of the business are valued at a constant cost or price, is not permitted under Treasury Department Regulations. (See art. 22 (c) 2 of regulations 86.) The effect of this has been in the past, and will be in the future, to increase arbitrarily by amounts which are neither realized nor realizable taxable income during periods of rising metal prices and to show correspondingly erroneous losses in periods of declining metal prices.

Under previous laws taxes were paid on unrealized income caused by such arbitrary increased valuations of inventories constantly tied

up in the process, but such taxing of unrealized gain did not jeopardize the existence of the taxpayer. However, under the law now proposed which makes the tax contingent upon the payment of dividends to the amount of taxable income, a corporation would be forced in many instances either to borrow money to pay dividends on such unrealized gain or to pay the increased tax upon such gain because it remained in the business. In many cases that tax would be somewhat more than the actual cash profits.

The British revenue authorities have for many years permitted the use of the normal stock method in trades and in industries to which it is applicable. The method has been in use in the British Isles for upward of 50 years. I do not know the exact date of its recognition by the British revenue authorities but I do know that it was referred to in the memorandum in connection with controlled munitions establishments prepared in June 1917 as a method which was then well recognized and long established in British income-tax practice. In that memorandum it was referred to as a method which was already well established and permitted by the British authorities.

The income-tax laws of prior years have recognized in general the principle of not taxing unrealized gains. See particularly sections of the 1934 Revenue Act beginning at section 111. Particularly in the case of a sale of capital assets and securities.

Taxpayers should not be forced to pay taxes on unrealized gains due to arbitrary valuations under the present regulations on inventories which are necessary in the business and on which gain cannot be realized until such assets are disposed of.

Senator KING. Under the present law, taxing the net gains of corporations, of course it becomes necessary to ascertain the profits.

Mr. PELOUBET. Yes, sir.

Senator KING. Have there been any insuperable objections to reaching correct conclusions or reasonably correct conclusions which became the basis of settlement with the approval of the corporations?

Mr. PELOUBET. Oh, yes; there are many cases where companies employ this method which it is easy to demonstrate makes the book income equal the cash income. There are many cases where that has been disallowed by the Treasury Department and where the Treasury Department insists upon the first-in-first-out method, which assumes that what you have in your inventory at the end is what you last purchased, which we know in the case of a smelter is physically impossible to a large extent, and financially impossible entirely.

Senator KING. Has that not been litigated to the disadvantage of the Treasury?

Mr. PELOUBET. It has been litigated to the disadvantage of the taxpayer, unfortunately.

In order to make it possible for taxpayers to report as taxable income the income which is realizable rather than income which is the result of arbitrarily writing up, or loss on arbitrary writing down, assets which cannot be disposed of, it is respectfully urged that section 22 (c) of the Revenue Act of 1936 be amended by adding the following:

Including the normal or necessary stock method in those industries in which the taxpayer consistently keeps his accounts in accordance with such method, provided that the taxpayer shall elect his method of stating the inventories in his first return under this title.

Senator KING. I suppose he may confer with Mr. Kent, Mr. Chairman?

The CHAIRMAN. Oh, yes.

STATEMENT OF WILLIAM MASON SMITH, VICE PRESIDENT, TOWNE MINES, INC., NEW YORK CITY

Mr. SMITH. I am appearing as vice president and a director of the Towne Mines, Inc., not to oppose this bill but to ask you to modify section 27 (i) so that it will not go beyond the legitimate purposes of that section and will avoid giving us what might be a fatal blow to our foreign industry carried on in Mexico.

Towne Mines, Inc., is a Delaware corporation organized under the supervision of a United States district court in connection with the reorganization of a prior corporation which before 1917 owned many mines in Mexico directly or through subsidiaries. By its charter it is compelled to distribute currently all of its earnings, so that it carries out the general purpose of the bill, but as a result of section 27 (i) as now drawn, it will not get a divided credit by reason of the fact that it has only two stockholders, both of which are corporations. One stockholder is the industry which put up the money to reorganize Towne Mines, Inc., and the other is the Towne Securities Co., which represents the original creditors of the former mining company.

So our company is in a position where it may declare out all of its profits in dividends and yet as a result of this section as it is now drawn, it will be subject to what we figure as a 36-percent tax on its profits. For the first 10 years after it was organized, it made no money, but it was able to borrow money to meet its deficits. Now it is beginning to make money under favorable conditions, and if it has to pay 36 percent of its profits in taxes, it is quite clear that in the end it will be very seriously damaged.

This is the typical situation with all companies that carry on mining businesses in foreign countries.

We operate in Mexico. Since the amended constitution of that country in 1917, an American corporation cannot acquire title to mining properties, but those that held title prior to that date can continue to hold them; so that Towne Mines, Inc., in order to carry on there, had to take over the stocks of the subsidiary companies owning the titles to these mines, which it now holds. It is therefore a holding company, and comes directly within that section which is so harsh in its effect upon us.

Senator KING. It is compelled to be a holding company by reason of the Mexican laws?

Mr. SMITH. Yes. And we cannot get out of that position. Whatever we do, we are stuck. You can readily see that a mining company which is dependent on operating profits, and which has to give them when earned to people who advanced money during the bad years, cannot give 36 percent of them up in taxes. We could not carry on if that continues.

We have suggested that this section might be amended if it is kept in the bill by adding a new section which we have put at the end of our memorandum, designed to relieve corporations which are situated as we are, operating in a foreign country and having to meet the laws of that country.

Senator KING. Have you examined the laws in Chile and in Peru and in Bolivia to see the parallel between the provisions there and in Mexico?

Mr. SMITH. Personally I have no knowledge of those laws, but I understand they have similar questions in those countries. Our industry is operating only in Mexico.

Senator KING. Did you leave your memorandum?

Mr. SMITH. Yes, sir.

The CHAIRMAN. Are you a stockholder?

Mr. SMITH. As a fiduciary, I have a large stock interest under a will.

Senator KING. You are holding the stock as a fiduciary?

Mr. MASON. My particular interest is a fiduciary interest. But the reason for Towne Mines, Inc., is that the original creditors organized the Towne Securities Co. under the court's direction. Another mining industry was induced to put up new money. In order to put the company on its feet again and to protect this holding company, Towne Mines, Inc., was formed, the Towne Securities Co. owning about one-half interest, roughly, and the new money getting the other interest. There are corporate provisions for reducing the interests as the new money is paid back, and profit-sharing, which are quite important and quite useful.

The CHAIRMAN. Was this matter presented to the House Ways and Means Committee?

Mr. SMITH. No, sir. I think not. We did not know of this section until after it was reported out by the House.

The CHAIRMAN. You might talk to Mr. Kent about it.

Senator BLACK. You just have one subsidiary?

Mr. SMITH. No, sir; we have several subsidiaries. The company has five or six mines in different parts of Mexico, and a subsidiary manages each.

Senator BLACK. Each one of them is directly under the top holding company?

Mr. SMITH. Yes, sir.

Senator BLACK. The Towne Securities Co. is an American corporation?

Mr. SMITH. They are all American corporations formed prior to 1917. We cannot make any change in the titles in Mexico, because the Mexican laws prevent it.

Senator KING. You have to have those subsidiaries?

Mr. SMITH. We have to have them.

Senator BLACK. Do you have to have two or three?

Mr. SMITH. We have to have them in the sense that we had them before 1917 when the constitution was amended. We cannot transfer the titles in Mexico to another American company. We cannot switch from one company to another.

Senator BLACK. What I was trying to get at was this: Do you have two subsidiaries, or one for one mine?

Mr. SMITH. We have one for each mine.

Senator BLACK. But you really have one top holding company and another holding company, and then a mining company?

Mr. SMITH. We have the top holding company as you call it, owned by the original creditors of this old enterprise. Then the creditors arranged with this other mining industry to put up the

money and take over the operation of the companies working the property.

Senator BLACK. Who is that?

Mr. SMITH. The American Smelting & Refining Co., who are experienced people, and who put quite some money into our properties. We are so fixed that we cannot get out of this difficulty we find ourselves in if this section becomes law. We would just be subject to 36 percent tax. Whatever we do, we distribute every dollar.

Senator BLACK. I thought you said that they were organized as Mexican companies?

Mr. SMITH. No, sir. If they acquired title after 1917 they had to be, but these corporations are old subsidiaries.

Senator BLACK. And you must keep them to maintain the status?

Mr. SMITH. That is exactly it.

(The brief submitted by the witness is as follows:)

Towne Mines, Inc., a Delaware corporation owning the stocks of corporations engaged in operating mines in Mexico, may be subject to an inescapable tax of 36 percent of its net earnings, if subsection (i) of section 27 of the proposed revenue bill of 1936 is enacted without modification, even though, as required by its charter it distributes all its net earnings.

This result, which obviously is a more severe tax than is intended by the Act except in cases where the corporation fails to distribute its earnings, can be obviated by the omission of subsection (i) or by the addition of a new subsection (j) in the form suggested at the end of this memorandum.

Towne Mines, Inc., was incorporated in 1923 under the laws of the State of Delaware, pursuant to a decree of the United States District Court for the Southern District of New York, to carry into effect the reorganization of the Compania Metalurgica Mexicana, a New Jersey corporation, which, together with its subsidiaries, was engaged in the mining and smelting business in Mexico. The bonds and stocks of the Compania Metalurgica Mexicana were owned in the United States and its reorganization was necessitated by the foreclosure of the mortgage securing its bonds.

Under the decree of the court in the reorganization proceedings, the bondholders and stockholders of Compania Metalurgica Mexicana and the owners of the preferred stock of its subsidiaries, which was guaranteed by that company, were to turn in their securities to a new corporation, Towne Securities Corporation, for stock in the latter. Towne Securities Corporation was to exchange the securities so received for the entire preferred stock and 40 percent of the common stock of Towne Mines, Inc. The entire debenture stock and 60 percent of the common stock of Towne Mines, Inc., was issued to the American Smelting & Refining Co. for cash and other considerations.

Because the Mexican Constitution of 1917 prohibits the acquisition since its adoption of mining property in Mexico by foreign corporations, Towne Mines, Inc., could not dissolve Compania Metalurgica Mexicana and its subsidiaries and acquire their properties, nor could any subsidiary transfer its titles to any other. Therefore, the old companies have been continued, and Towne Mines, Inc., is merely a conduit, or convenient mechanism, for dividing the profits of the Mexican mining operations among the interests entitled thereto.

Towne Mines, Inc., cannot escape the difficulty by dissolving and distributing the stocks of its subsidiaries to its two stockholders—not only because of the expense involved in taxes and otherwise—but because any such distribution would not preserve the relative interests of the two profit-sharing stockholders, which changes with the retirement of the debenture stock as hereinafter explained. The reorganization directed by the court would be defeated by any such action.

The charter of the Towne Mines, Inc., expressly provides that its net earnings shall not be accumulated but shall be currently distributed to stockholder, either in the form of dividends or by retiring the debenture stock, but any dividend paid by Towne Mines, Inc., is paid either to American Smelting & Refining Co.—owning all of the debenture stock and some of the common stock—or to Towne Securities Corporation owning all of the preferred stock and the rest of the common stock.

Under the plan of reorganization as approved by the court, and under the charter of Towne Mines, Inc., after its debenture stock is retired (the completion

of which is expected sometime next year), the entire amount of the earnings is distributable 50 percent on the preferred stock, which is held by Towne Securities Corporation, and 50 percent on the common stock which is held 60 percent by A. S. & R. Co. and 40 percent by the Towne Securities Co. The relative interests of these two stockholders shift with the return of its advances to A. S. & R. Co. by the retirement of the debenture stock.

Based on the theory heretofore asserted by the Bureau of Internal Revenue regarding intercorporate relationship, the application of subsection 27 (i) to Towne Mines, Inc., is understood to mean that only 20 percent of dividends actually distributed will be allowed as a dividend credit and the ratio of dividend credit to adjusted net income will be only approximately 13 percent. Thus it appears that the company would have to pay a tax of 36 percent on its adjusted net income even though it distributes all its earnings currently and its subsidiaries and stockholders do likewise.

For the first 10 years of the company's existence, it operated at a substantial loss. Not until 1933 did it begin to make profits. In 1935 the consolidated earnings were approximately $700,000, and, on that basis, the company would be subjected to a tax of $250,000.

Yet it is clear from the following statement contained in the first paragraph on page 4 of the Committee on Ways and Means report that it was their intent that corporations which distribute all their net earnings annually shall be relieved from the tax altogether:

"The bill proposes to remove many of these inequities by relieving from tax corporations which distribute all their net earnings annually as earned. * * *"

Although Congress may deem it necessary to prevent the evasion of tax through the use of chains of corporations, it is respectfully submitted that the provision closing this loophole should not be framed in such a manner as to penalize so severely companies which the framers of the bill as passed by the House of Representatives intended to relieve from the tax altogether.

It might be suggested that the company could protect itself against section 27 (i) by absorbing its subsidiaries. Unfortunately, however, this cannot be done because, under Mexican laws, title to mining property may not since the adoption of the Mexican Constitution of 1917 be conveyed to an American corporation.

CONCLUSION.

It is respectfully submitted that the section should be amended, either in the manner suggested in this memorandum or in some other manner so as to avoid penalizing a corporation which is organized for no improper purpose and which currently distributes all of its net earnings.

Respectfully submitted.

TOWNE MINES, INC.,
By WM. MASON SMITH,
Vice President.

Suggested new section:

"(j) For the purposes of subsection (i) the term "gross income" does not include dividends received from a corporation existing prior to March 3, 1936, if at least 80 percent in value of its total assets is located in a foreign country and employed in the business of mining, smelting, or milling ores."

STATEMENT OF H. W. STORY, MILWAUKEE, WIS., REPRESENTING ALLIS CHALMERS MANUFACTURING CO.

Mr. STORY. Mr. Chairman and members of the committee, you have been listening for a number of days to various explanations of the details of this bill. I am not going to bore you with any more details, but will merely attempt to give you a bird's-eye view of the theory and effect of this bill, as I see it, as the vice president of a fair-sized corporation, engaged in the manufacturing of a wide range of durable goods.

From the report of the Ways and Means Committee of the House of Representatives, I understand the primary purpose of the bill to be the ironing out of certain inequalities and inequities of various taxpayers under the present tax law. I shall attempt to show that

this bill creates more inequalities and inequities than exist under the present law, and that, in fact, it would be difficult to conceive a bill which would create more inequalities among different taxpayers.

The fundamental theory of the bill is to fix (by inducement) for every corporation a dividend policy of 65 percent of its annual net income (upon a Federal-tax basis) with a resulting tax rate of 15 percent, which is the present rate for corporations of moderate earnings.

But, within the range of possible dividend policies from zero to 100 percent of full earnings, there is a possibility of a variation in rate of tax from 42.5 percent to zero.

What would be the effect of this theory of taxation upon the various classes of corporations in industry? It would have no present effect upon a well-financed company which has reached the height of its expansion desires, having sufficient funds for working capital, plant rehabilitation, and the like, and thus being able to pay out all annual earnings without inconvenience. The management of that kind of corporation would be able, under the proposed bill, to present a most attractive annual statement of earnings, because such statement would not reflect the payment of any Federal-income tax, even the present 15 percent.

On the other hand what would be the effect (1) upon small and fair-sized companies which, for competitive reasons, desired to expand their operations, and (2) upon companies of any size which had debt obligations for the payment of which a large proportion of current earnings must be utilized? Upon both groups, the bill imposes drastic and destructive penalties, by way of Federal income taxes, payable at rates which may go as high as 42.5 percent.

Thus, you have the anomalous situation of liberal, and in fact generous, treatment of the class of corporations representing large aggregations of capital and having excellent cash positions, and on the other hand, the placing of a destructive burden of taxation upon corporations representing small aggregations of capital and corporations more or less burdened with debt.

Hence, it is clear that, even if inequities under the present tax law were cured, new situations grossly more unfair and inequitable would be created under this bill.

So much for the effect of the bill upon individual companies. Now, what about its general economic effect?

The bill would have the definite tendency to stabilize industrial expansion at present levels of large, well-financed corporations. As to the smaller companies, which are striving to increase their corporate size in order to make themselves more capable of meeting the competition of larger companies, the bill would tend to stifle such expansion and tend to make less effective the competition of this group. Accordingly, on an over-all basis, it will tend to create a condition of monopoly and a centralization of power in the larger corporations. It might be parenthetically stated at this time that all large corporations became big through the utilization of earnings for the purpose of capital expansion.

Senator KING. What would its effect be on enterprises just starting, or enterprises to be started, rather modest in proportion, with limited capital and with no Santa Claus nearby to aid them in meeting the competition from the larger ones and competition among themselves?

Mr. STORY. It would definitely retard the growth of small companies. It is to be borne in mind, however, that a corporation could, if it chose, pay its 42.5-percent tax and still retain the balance of its earnings for expansion. But with the normal pressure upon management by stockholders for the payment of larger dividends, it would become more difficult for management to pursue a conservative policy of utilizing a large proportion of its earnings for the purpose of promoting the growth of the company.

Senator KING. Have you made any investigation to determine the proportion of corporations that have plowed back their profits to those that have not done so, with a final view to ascertaining the casualties that have resulted on the one hand and the successes on the other?

Mr. STORY. I think it may be stated, as a general proposition, that all successful companies have plowed back their earnings for the purpose of expanding and thus making them more potent, competitive factors.

This bill, however, would have the opposite effect: namely, of stifling the growth of normally strong small companies. Is this a desirable economic condition? It seems to me that expansion of industry is most desirable in our present economic situation in this country. By expansion, I mean, of course, the building of new buildings, the acquisition of new machinery, all for the purpose of providing new productive facilities. I would like to inject the thought at this time that there has been much loose talking and thinking on the subject of over capacity and over production. Much of the present so-called capacity and production now existing is obsolete. What we need is the development of new capacity, that is, new facilities for producing articles for which there is an undeveloped demand; in other words, for which a market may be created. This kind of expansion is sound. It is merely industrial progress and will inevitably create employment.

Our company is now considering an expansion program. It may or may not decide to go ahead with it regardless of the passage of this bill, but in any event the passage of the bill would indeed be a vital, if not controlling, factor in the determination of its policy in this regard.

Last year we started an expansion program involving two new buildings, one in La Crosse, Wis., and the other at La Porte, Ind., for the purpose of creating new productive facilities. At our La Porte plant we are manufacturing a small combine, which is a new agricultural development and for which, on account of its low price, there is likely to be an excellent market. Last year we paid no dividends, although we had earnings—before taxes—of $3,000,000. We paid a tax of approximately 15 percent on this amount, or $450,000. If this bill had been in effect at that time we would have paid a tax in excess of $1,000,000. In other words, we would have been penalized to the extent of $550,000 because of expansion and enlarged production programs.

Industry has been criticized for failing to absorb all the unemployed. I believe this criticism is unwarranted, but, in any event, industry can increase employment in two ways: (1) By the erection of new buildings and (2) by the creation of new productive facilities. Erection of buildings would give employment to the building-trades

group, even now suffering greatly from unemployment. The operation of newly created productive facilities would stimulate reemployment upon a permanent basis.

Accordingly, the most serious effect of this bill is the obvious interference with and retarding of reemployment, which in our locality is proceeding at a rapid rate. For example, we have about 10,000 employees at this time.

Senator KING. In your company?

Mr. STORY. In my company. We have put on 1,800 employees since January 1. If we are not able to utilize a fair percentage of our earnings for expansion and production programs, without a drastic tax penalty, it seems fair to state the belief that we would not be able to keep as many men permanently employed, and certainly will not be able to add as many new employees as we otherwise would.

I wish to make a particular point in the matter of current inventory. Assume that a corporation engaged in mass production makes a bad guess as to its ability to sell all of its manufactured products and as a result has substantially all of its cash resources invested in inventory. Assume that its earnings were substantial, but actually invested in the unsold inventory. The company would be confronted with a most difficult problem. Conservatively, it should probably pay no dividends, but if no dividends were paid a tax of 42.5 percent would result. What would you, as executives, do under such circumstances? And what would be the attitude of your bankers?

In view of the fact that executives of concerns engaged in mass production have serious problems even under normal business circumstaaces, it is difficult to perceive why there should be placed upon them the unnecessary, additional complicated problems which would be set up by the proposed tax bill.

It would be a rather normal and simple matter for me to urge this committee to adopt amendments that would lighten the onerous burdens of this bill. For example, I might urge the setting up of a credit for the payment of existing indebtedness, and a credit for funds used in capital expansion. But, I am not here for that purpose. I am here merely to point out that the bill is fundamentally wrong in principle, because it transgresses every rule of sound taxation.

I would like to point out at this time that some of us, who have consistently supported the fundamental principles of this administration (and incidentally, I personally, have been in favor of about 95 percent of such principles), are bewildered at the apparent inconsistency of the theory of the tax bill of 1934, and that of the proposed bill. In 1934, we had a graduated tax on bigness; in other words, a tax intended at least to discourage substantial aggregating of corporate capital. In the proposed bill we have a drastic tax on littleness, and a definite penalization of expansion and of financial weakness.

I believe that the theories of both bills are wrong. We need large aggregations of capital—which we classify as bigness—for efficient mass production. We need mass production in order to produce at low price levels. Certainly, there is no better example of efficient low price production than that of the automotive group. On the other hand, we need new blood in industry. We need the aggressive new ideas of young companies, many of which would normally grow to be the big companies of tomorrow.

The theory of the present bill is wrong, because it presupposes that stabilization; namely, curtailment of expansion of productive facilities, is a desirable economic condition. The history of the industrial development in this country shows conclusively that progress is based upon thrifty expansion. Unsound stabilization can only create stagnation, which is the first stage of industrial retrogression.

Why cannot we approach the problem of taxation with just plain, everyday realism? Assuming that we need $600,000,000 additional tax revenue, why is it not possible to ascertain what additional increase in existing rates is required to raise this sum? The problem should be relatively simple. Although no company welcomes increased taxation, nevertheless industry realizes that the expenses of Government must be met. They desire to meet these expenses on a pay-as-you-go basis, and are willing to assume the responsibility of paying their fair share of necessary Government expenses. The responsibility of determining necessary expenses must, of course, rest upon Congress.

I have not talked about governmental economies. That is an easy thing to talk about, and difficult to accomplish. I choose to approach the matter in a different way. I suggest that you first consider all available tax sources and determine what revenue can be obtained through rates which will not be destructive and will not, in themselves, be the cause of drying up the sources of revenue. When you have determined such figure, then, in accordance with your official responsibility, go about the job of adjusting governmental expenditures to fit the figure so determined.

Inasmuch as the estimated income of all corporations for 1936 is approximately $8,000,000,000, it is apparent that you must look to other sources of income for a substantial portion of the cost of government.

Casual, common-sense analysis indicates that you may be forced to reach out—in accordance with some provisions of this bill—with an increased surtax on dividends. In addition, you may find it necessary—by way of lower exemptions—to dip into the earnings of that great number of individuals who at the present time pay no tax, and whose aggregate income is estimated at $20,000,000,000.

It is your responsibility to decide upon a fair basis of taxation, but in any event, with a careful study, and with this approach to the problem, I am certain you will find a solution which will not be destructive to industry, and which will not place an undue burden on any group of our citizens. I am just as confident that when the problem becomes clear from this angle, you will find ways and means to adjust Government expenses to the revenues of sound system of taxation so established.

Senator KING. Without asking you to commit yourself, what would you say about a measure of this kind: Increase the corporate tax to 17 or 18 percent, striking out the intermediate steps, then increase the surtax from 4 to 6 percent.

Senator COUZENS (interrupting). You mean the normal tax?

Senator KING. The normal tax; and then increase the income tax from the lower brackets on up, particularly increasing it in the brackets from $20,000 and $40,000 and $50,000 where there seems to be a little substance, in order to raise the 5 or 6 billion dollars which it is claimed—I do not say it will—this bill will raise; would

that be preferable to this bill? Would you care to express yourself on that?

Mr. STORY. Certainly I would. That is the approach from the angle which I mentioned. The question of rates of taxation is, of course, a matter for your tax experts to determine, but the theory of flat-rate taxation, applied constructively to corporations and to individuals, is the proper way to handle the problem.

Gentlemen, I appreciate the opportunity of making this statement, and I apologize for having taken more than my allotted time.

Senator KING. Thank you very much, Mr. Story.

STATEMENT OF HUGO W. NOREN, PITTSBURGH, PA., HENRY GEORGE SCHOOL OF SOCIAL SCIENCE

Mr. NOREN. My name is Hugo W. Noren. I am ostensibly here to represent and speak for a local Pittsburgh branch of the Henry George School of Social Science.

Senator KING. How much time do you desire?

Mr. NOREN. Fifteen minutes, and of that I will require probably less, but I would like to have 8 minutes, uninterrupted, for reading a statement.

Senator KING. You may have 8 minutes uninterrupted, and then we will give you a little more.

Mr. NOREN. If you want to ask any questions I will try to answer them, providing you do not make them too hard.

Senator KING. You think you are one of the survivors of the Henry George School?

Mr. NOREN. We had 400 graduates in Pittsburgh this semester of lawyers, architects, accountants, physicians, and that class of men, so I am not so discouraged about that.

I am afraid that I have the wrong statement to read, when I see the good humor of this committee. You know I read the tax bill and the further I read it the madder I got, and when I was through with it I sat down and wrote this statement, and it is written in that kind of a humor, which does not correspond with you gentlemen.

Senator KING. Assume that we are all very angry. Proceed.

Mr. NOREN. This may seem irrelevant, but it is not. I am presenting this idea from an entirely different viewpoint. In fact, I have been sitting here since this morning, and hearing all this technical testimony I felt somewhat out of place and I had almost decided to run away, that I would not be in harmony with anything that had been said. I am not going to take your time with any further introduction, however.

Having been a Democrat for 38 years it pains me to be under necessity to condemn this proposed tax bill. The bill is inconsistent with democracy and with the canons of taxation. The canons of taxation should be familiar to statesmen, but there is no hint either in the President's message of March 3, to the Congress, or in the bill itself, that the authors of this bill ever heard of them.

A revenue bill should conform to the following conditions:

That it bears as lightly as possible upon production so as least to check the increase of the general fund from which taxes must be paid and the community maintained.

That it be easily and cheaply collected and fall as directly as may be upon the ultimate papers—so as to take from the people as little as possible in addition to what it yields to the Government.

That it be certain—so as to give the least opportunity for tyranny or corruption on the part of officials, and the least temptation to law breaking and evasion on the part of taxpayers.

That it bear equally—so as to give no citizen an advantage or put any at a disadvantage, as compared with others.

The bill under discussion violates all of these canons.

I am aware that mere condemnation of this particular bill is of no consequence if we have nothing better to offer. I approve the minority report suggestion to cut expenditures to make these taxes unnecessary, but I would count my time and expenses to come here lost had I nothing else to propose.

There is a natural economic law for Government revenue. It is plainly to be seen in all places and at all times. This economic law is as much a part of the order of things as are the laws of mathematics, physics, or chemistry. It is the simplest of all the natural laws so that none need be in ignorance of the Creator's intention.

This is the law: Where two, three, or more persons come to dwell together, there rent arises, a fund for their common use. This fund is the rent of land, known as economic rent. It is always sufficient. It is the surplus of superior sites. Unlike taxes, it confiscates no man's earnings. We can take it all this year and a like or larger amount is available next year.

The bill under discussion bears no relation to this natural law. This bill is a part of a rapid process that will destroy this Republic. It is not in any sense a revenue measure. It is a punitive law invoked against persons and corporations in proportion to their success in producing wealth for the well-being of the people.

We maintain government as our agent to do certain things for all of us, so that we may have more time for ourselves to conduct our own individual affairs. This tax bill reverses our aim; it fails to collect any part of the very revenue that natural economic law provides for government. Then it lays heavy penalties upon us for doing the things we reserved to do for ourselves. By this kind of tax laws the Government, our agent we employ to help us, engages to destroy us.

This bill is based on the indefensible assumption that the agent, our Government, has a proprietory right to confiscate whatever the agent sees fit out of what individuals produce. Under the assumption of this and like tax bills the producer has no right to his own product, save what the agent graciously allows him to keep. This is pure communism.

We have witnessed the deplorable spectacle of the Government's professorial advisers chase all over Asia and Europe to gather communistic nostrums to experiment with. This tax bill is, I believe, one of the choice morsels of what they brought us. Had it not been for the Supreme Court we would now be all but swallowed up in a flood of legislation destructive of individual freedom heretofore so highly prized.

Could a greater tragedy come to a people who can boast of Henry George as their own native son? Henry George, who as an economist has no peer in all the world and whose published works rank him so high that to find anyone comparable we must go back to Moses.

What shall you do with this tax bill? Send it back to those who brought it forth. Until you can agree on a revenue measure based on natural economic law, cut expenditures to make these new taxes unnecessary. You can start anywhere. Abolish the W. P. A. If you permit that corrupting institution long enough, it will put us all in the bread line with none left to produce the bread. Abolish the Department of Labor that hangs like a millstone round the workers' necks. Abolish the so-called Department of Commerce, so that commerce may revive. Abolish the Department of Agriculture and let the farmers be free to function on their own. I am told there are hundreds of bureaus that you can dispense with to our great relief.

Senator KING. I suggest when Senator Byrd's committee begins to function for the purpose of unifying the organizations and cutting off the heads of a lot of them, that you ask to be heard.

Mr. NOREN. Draw up a revenue measure. You will find a good one in article VIII of the Articles of the Confederation. That article VIII was of native United States vintage It bears no relation to the communist confiscatory program embodied in the tax bill here under discussion. The article referred to conforms to natural economic laws.

I wish to say one more word. I totally disapprove of this idea of levying taxes in accordance with ability to pay. Government should be conducted on a business basis, and if it does not earn its own revenue it should be abolished. If it does not earn its own wages, there is something wrong, but it should be, first of all, conducted on a business basis. How in the world would a businessman succeed if he tried to do business on the principle of ability to pay? A poor woman would come in and she would buy a can of milk for 10 cents, and then a rich woman would come in and he would charge her $10. I think he would lose his two eyes if he did that.

That is what is wrong with our Government. You cannot levy taxes on gains and capital; you can only confiscate capital. When you take it the one who had it has less of it. That is a natural product of human society.

Senator KING. The committee thanks you for your very interesting discussion.

Mr. Louis Kaplan, Pittsburgh, representing the National Retail Furniture Association.

STATEMENT OF LOUIS KAPLAN, PITTSBURGH, PA., REPRESENTING THE NATIONAL RETAIL FURNITURE ASSOCIATION

Mr. KAPLAN. Mr. Chairman and gentlemen, my name is Louis Kaplan. I am from Pittsburgh, and I am not a member of the school that Mr. Noren spoke of just a minute ago.

I am appearing here on behalf of the National Retail Furniture Association, an organization of 4,000 retail furniture dealers scattered throughout the United States and operating largely on the long-term credit basis. These stores are, for the most part, engaged in the selling of furniture for the home, that is in the sale of necessities. The annual volume of business of the members of this association in the year 1933, which is the last year for which I have the statistics with me, was approximately $1,700,000,000, out of a total of sales of such merchandise in the country of about $2,000,000,000.

Senator KING. Does that embrace the small furniture houses in the towns and cities throughout the United States?

Mr. KAPLAN. Yes, sir.

Senator KING. I may say I have received a very large number of letters from them during the last 2 weeks urging some modification of this law, and I did not quite understand the particular grievance which they registered.

Mr. KAPLAN. I should like to say, first of all, that this association is not here to oppose or condemn the bill. We believe when the bill finally comes out of the Congress, if it should come out, it will represent the considered judgment of the men who pass it. But assuming that the bill will pass, we should like to call attention to the need of the retail furniture dealers for some amendment, and that that need is based primarily upon the fact that about 70 percent of all the business of these furniture dealers, which includes a great many small dealers, about 70 percent of all of the business is credit business, furniture sold on terms as long as 3 years, preferably 1 year.

The outstanding accounts receivable of the members of this association range from 68 to 90 percent. So that on the basis of the business that they did in 1933 they have approximately $1,500,000,000 of credit business on their books.

Senator KING. Do you propose to discuss the question of the ability of these merchants to make an honest inventory and an honest return as to their profits or losses?

Mr. KAPLAN. We propose to present to this committee this question: Shall the retail furniture dealers of this country, largely the small dealers, be permitted to retain a fair portion of their earnings for the purpose of enabling them to extend the necessary credit to the home owners of this country to buy furniture with which to furnish their homes, or shall they be compelled, if the bill in its present form stands, to pay out that money in dividends in order to avoid excessive rates of taxation?

The country at the present time is just emerging from a depression that has very seriously affected the small home and the small-home owners. The furniture demand is increasing daily. The business of the members of this association increased about 12 percent during 1935, and one reason that the members of this association were able to take on this additional business and to give this necessary credit to the hundreds of thousands and millions of citizens of this country was that they were able to plow back or to keep in their business a fair amount of the earnings of that business.

Now our proposition is based upon the request that the needs for credit expansion in the retail furniture business be met in this bill by an amendment that will enable us to meet the requirements of extending credit to the small-home owners who must necessarily buy their furniture on credit.

Senator KING. Are not their greater losses, in proportion to the business done, by these retail dealers in the furniture business than in almost any other business by reason of the nonpayment, or the shifting of the population, because many of those who purchase furniture are migratory, going from place to place?

Mr. KAPLAN. There are necessarily substantial losses in business of this kind that cannot be avoided. Credit is given very freely, and while there is some security by way of title retention instruments,

necessarily there must be more than the normal amount of losses in carrying on a business of this kind.

Senator GEORGE. What is the amendment that you suggest?

Mr. KAPLAN. I have prepared an amendment. This amendment is largely for the benefit of the mass of our membership which consists of the small furniture dealers throughout the country.

We propose an amendment to the revenue act by which the amount that is reasonably required in the merchant's business for credit expansion, for business expansion in a proper manner, shall be taxed at the rate of 22.5 percent, in the same manner as the bill provides for the taxation of debts created prior to March 3, 1936.

There are only one or two ways by which we can take care of this need for credit expansion. One is to get some relief by way of taxation in this bill so that we may retain a larger percentage of our earnings, and the other is by borrowing money. Inasmuch as the bill in its form freezes the date as of which loans may be considered under the relief provisions of the bill as March 3, 1936, it is obviously impossible to borrow money in the future and have the benefits of that relief provision.

We are not asking that money plowed back into the business be relieved entirely from taxation. We are not asking that it be taxed at the present rate of 15 percent. We are simply asking that the money required to meet the reasonable needs of credit expansion in order to meet the requirements of the small-home owners of this country be taxed at 22.5 percent in the same manner as the bill provides for debts created prior to March 3, 1936.

Senator CONNALLY. In other words you defend the flat rate 22.5 percent?

Mr. KAPLAN. Only as to such of the earnings of the corporation as the Commissioner of Internal Revenue shall determine are reasonably necessary for the expansion of that business by way of investment in inventories and by way of investments in accounts receivable and other assets.

Senator CONNALLY. If you make it a question of policy as to each individual taxpayer, there would be some difficulties in administration, would there not?

Mr. KAPLAN. There would be some difficulties in administration. I will admit that is one of the difficulties that I think the Commissioner could well meet. He has met other difficulties of this kind in the past, and it has been possible for other revenue laws to be administered. I think that is done in a great many instances. For instance, the Commissioner very often has to determine, in each individual case as a matter of administrative policy, the question of reserves for bad debts, the question of depreciation rates, and things of that kind. We submit these are administrative matters.

Now above the part of the earnings that is reasonably needed for this purpose we propose that the other sections of the bill shall apply in full force. Our whole request is that we be given the opportunity, in a business which furnishes credit to the country, to use a part of our income for the purpose of sustaining and retaining the ability to give credit.

Now I should like to add just this other thing, and that is that the earnings of these companies, when the year is over, are represented largely by the very credit instruments that we are talking about at

the moment. That is to say, their earnings are not in cash to a very large extent, they are represented by accounts receivable or title retention instruments of some kind. So if these concerns have to pay out in cash a tax based upon the rates in this bill they will be draining their resources, or they will have to find some method of raising this cash for the purpose of paying the tax. In addition to which they will be handicapping themselves, if not make it impossible for themselves to continue giving this vast amount of credit which is required in the country.

Now I simply want to summarize our position.

Senator WALSH. Do some of these companies carry an enormous amount of credit paper?

Mr. KAPLAN. A tremendous amount.

Senator WALSH. So you are in the position of having your surpluses, to an enormous amount, in credit paper, and if a heavy tax is laid on you you cannot raise money?

Mr. KAPLAN. I can give you some statistics on that very point. In 1933 the members of this association did $1,700,000,000 of business. At the end of that year, according to the data that I have here, their outstanding accounts receivable—that is, credit accounts—totaled approximately $1,530,000,000.

Senator CONNALLY. Almost 100 percent of the business?

Mr. KAPLAN. About 85 percent of the sales.

Senator CONNALLY. Some of it came over from former years, though?

Mr. KAPLAN. Some of it came over from former years, yes, sir, that is correct. This business is done on the basis of 1 to 2 years' credit.

Senator CONNALLY. A dollar down and a dollar a week?

Mr. KAPLAN. Something like that. This deals only with home furnishings.

Senator WALSH. Do you pay a tax now on these credit accounts?

Mr. KAPLAN. Under the revenue act as it now exists we are permitted to make installment returns—that is, to pay the tax on the basis of cash receipts and disbursements.

Senator GEORGE. You are already favored?

Mr. KAPLAN. We are not favored.

Senator GEORGE. You have a measure of relief that other corporations do not have.

Mr. KAPLAN. We have a measure of relief, that is correct, but that would not help us under the present situation.

Senator CONNALLY. You do not know what the profits will be until you get them?

Mr. KAPLAN. Under the present revenue act that is correct.

Senator GEORGE. That is not changed?

Mr. KAPLAN. That is not changed. That would take care of us, I should say, if we were to freeze the amount of business we could do and limit ourselves to what we are now doing. In other words, if the 1933 or 1934 basis is to be the maximum business we shall ever do, or that shall ever be done again by these stores, that would be some relief.

Senator GEORGE. But it does not permit of expansion?

Mr. KAPLAN. It does not permit of expansion and does not take care of the business. When I say "expansion" I mean expansion back to the business that was being done even before 1933.

I should like to summarize our position. We believe that a provision such as we propose would afford the following advantages:

First, a reasonable expansion of the volume of sales will be permitted without forcing corporations to imperil future operations by obtaining funds by borrowing.

Second, it permits, to a reasonable extent, a reinvestment of net income in the business and thus gives assistance in financing current operations.

Third, it permits the small thriving corporation to continue to grow and avoids the compulsory dissipation of capital that is sorely needed by such corporations.

Fourth, it avoids the depletionary aspects of the bill since it permits a corporation reasonable expansion of sales in accordance with the demands of customers and it does not force a contraction of the volume of the business being handled.

Fifth, it prevents the impairment of corporate assets through injudicious distributions based solely on the amount of net income without regard to the ability of the corporation to make the payments.

Sixth, it protects both creditors and stockholders, since it will avoid the forced distribution of cash that may be imperatively needed to finance operations.

Now we have prepared an amendment which I will either read into the record or submit as an amendment.

Senator GEORGE. Just submit it to the reporter. He will put it in the record, Mr. Kaplan. We understand what your amendment is, the sense of it, the purpose of it.

(The amendment offered is as follows:)

SEC. 17. Reinvestment of adjusted net income in assets reasonably required in the conduct of the busines of the corporation. (a) General rule: If any amount of the adjusted net income for the taxable year is reinvested in assets reasonably required in the conduct of the business of the corporation as defined hereinafter, 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 amount of the adjusted net income reinvested in assets required in the conduct of the business of the corporation; and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (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.

(c) Definition of assets reasonably required in the conduct of the business of the corporation: As used in this section the term "assets reasonably required in the conduct of the business of the corporation" means an asset the retention of which is required to conduct the business of the corporation as shown to the satisfaction of the commissioner except—

(1) Shares of stock in any corporation,

(2) Rights to subscribe for or to receive such shares, or

(3) Bonds, debentures, notes, or certificates or other evidences of indebtedness issued by the United States or instrumentalities thereof, any State or political subdivision thereof, or by any foreign government or subdivision thereof, or by a corporation, domestic or foreign, except such bonds, notes or certificates or other evidence of indebtedness received in settlement of a bona-fide transaction in the usual course of business, or

(4) Certificate of profit or of interest in property or accumulations in any investment trust or similar organization holding or dealing in any of the instruments mentioned or described in this paragraph, regardless of whether or not such investment trust or similar organization constitutes a corporation within the meaning of this act.

STATEMENT OF RICHARD F. BURGES, REPRESENTING THE SOUTHWESTERN PORTLAND CEMENT CO., AND THE SOUTHWESTERN CEMENT ASSOCIATES

Senator GEORGE. Give your name, please.

Mr. BURGES. Richard F. Burges.

Senator GEORGE. For whom are you appearing and in what capacity?

Mr. BURGES. I am appearing as attorney of the Southwestern Portland Cement Co. and the Southwestern Cement Associates.

I wish to speak to the committee briefly on section 27 (j) of the revenue bill. Section 27 (j), which relates to intercorporate dividends, provides that if 80 percent or more of the gross income of a corporation is derived from dividends, then the dividend credit shall only be in four classes, which are then enumerated:

(1) Individual stockholders; (2) such certain classes of corporations that are otherwise taxed under the bill; (3) the portion of the dividend payment which is made to a corporate shareholder owing less than 50 per centum of the class of stock with respect to which the dividend is paid; and (4) another class which we need not consider for the moment.

Now, in order to make the point, I would like to explain the structure of the corporations which I am representing. The Southwestern Portland Cement Co. is a manufacturing corporation engaged solely in the manufacture and sale of portland cement. It might be properly described here as the operating company. The founder and builder of the company, Mr. Carl Leonard, of Los Angeles, Calif., incorporated his own individual business, his interest in the Southwestern Portland Cement Co., and his other business interests in what might be called a holding or family corporation for the benefit of himself, his wife, and his children.

Subsequent to Mr. Leonard's death the stockholders of the Southwestern Portland Cement Co. organized the Southwestern Cement Associates, which is nothing more nor less than a voting trust to continue the policy of management of the company under which Mr. Leonard had founded it and built it up.

The Southwestern Cement Associates issued to its stockholders one share of stock to represent each share of stock of the Southwestern Portland Cement Co. When the Southwestern Portland Cement Co. pays a dividend, 54 percent of its dividend is paid to the Southwestern Cement Associates. That is passed on immediately to the stockholders of the Cement Associates.

The complication comes under the bill in this way: 71 percent of the stock of the Southwestern Cement Associates is owned by Mr. Leonard's family—that is, by C. Leonard Improvement Co.—and all of the income of the Cement Associates is the dividend it receives from the Southwestern Portland Cement Co. It is nothing more nor less than a voting pool of stockholders of the Southwestern Portland Cement Co. Therefore its entire income is derived from the dividends earned by the Southwestern Portland Cement Co. It in turn disposes every dollar of that to its own stockholders, but one of its stockholders is Mr. Leonard's family, who owned 71 percent of the stock.

Senator GEORGE. And the family is a corporation?

Mr. BURGES. Yes; the family is incorporated for distribution among themselves of their properties.

Now, if I have clearly outlined, as I have endeavored to do, the situation which is presented, it seems to me that the object which the bill seeks to attain is being done, as I shall demonstrate from the figures in a moment, in a case such as ours, and it seems to me that it could be met by a simple amendment or addition to section 27 (j), which I believe is in no way inimical to the purposes and operation of the bill. It is very brief and I would like to read it. You will bear in mind that this is describing the credits which shall be allowed on dividend payments, and the third one was the portion of such dividend payment made to a corporate shareholder owning less than 50 percent of the class of stock with respect to which the dividend is paid.

Now the proposed amendment which I call 3 (a) just for the purpose of clarification, would add:

The portion of such dividend payment paid to a corporate shareholder owning more than 50 per centum of the class of stock with respect to which the dividend is paid, provided, the dividend so paid to such corporate shareholder be forthwith distributed to its shareholders in the same proportion which they would have received had there been no intermediate distribution.

The net effect of it is, of course, to pass the money on without delay and without withholding any portion of it, but, as in this case, where it is expedient and we think necessary to have a voting pool or trust which takes the form of being an incorporated one, instead of merely a voluntary signed agreement, the mere fact that it passed through the voting pool forthwith to the individuals who would receive it would carry out the purpose of the bill, as we understand it, and at the same time would not wreck the organization under which we are operating, and which we conceive to be a sound business operation.

Now, in order to demonstrate how it is actually operated I would like to read into the record the past record of this corporation beginning with 1930.

For the year 1930 the Southwestern Cement Associates—that is, the voting pool—received dividends from the operating company amounting to $235,809, and it distributed to its shareholders exactly the same amount of money.

For the year 1931 the Cement Associates received in dividends—and that is its sole and only source of revenue—received from the operating company $202,122, and it distributed the same identical sum to its shareholders.

For the year 1932 the Cement Associates received in dividends from the operating company $151,691.60, and that year it distributed $149,705. That is the first time when there is a slight divergence, and that amounts to less than $2,000, which I understand was due to a tax imposed by the State of California in that year.

For the year 1933 the Cement Associates received from the operating company $134,748, and it distributed $134,040, or $708 again being necessary to meet a California tax.

For the year 1934 the Cement Associates received from the operating company $168,435, and distributed to its shareholders $167,691, again a deduction of less than a thousand dollars was made to meet the State tax.

For the year 1935 the Cement Associates received from the operating company in dividends $190,893, and distributed to its shareholders exactly the same sum; the State tax in that respect, I believe, has been repealed.

Now that illustrates, I think, definitely and clearly the idea that we had in mind. This voting pool or voting trust is simply a means of continuing the management of the corporation under the policy established by its founder. It does not detain or arrest the distribution of the dividends, but passes them promptly on to the same people in exactly the same proportion.

Senator CONNALLY. Mr. Burges, have you your proposed amendment there?

Mr. BURGES. Well, I read that amendment, and I gave one to the secretary of the committee.

Senator CONNALLY. Did you discuss this with Mr. Stam of the joint committee?

Mr. BURGES. I did. If I may be permitted to say, he thought the principle was sound and should probably be embodied in the act. I gave him a copy of the proposed amendment.

The CHAIRMAN. Thank you very much, Mr. Burges. Mr. O'Neal.

STATEMENT OF JOHN R. O'NEAL, WASHINGTON, D. C.

Mr. O'NEAL. Mr. Chairman, I want to talk about an institution that is the biggest in the United States. It has about 30,000,000 workers and producers of raw material in this Nation.

The CHAIRMAN. I understand you are going to talk on the packing proposition.

Mr. O'NEAL. Yes; the farm and packing proposition.

The CHAIRMAN. You represent the farmers?

Mr. O'NEAL. I am a retired farmer, sir.

The CHAIRMAN. All right, proceed.

Mr. O'NEAL. Gentlemen, I want to talk to you about the average price on the farm of hogs for 25 years, beginning with 1910.

In 1910 the average price of hogs on the farm was $6.65. In 1911 it was $6.26. In 1912 it was $7.41. In 1913 it was $7.60. In 1914 it was $6.70. In 1915 it was $7.40.

Senator BLACK. The hogs were that much per hundred?

Mr. O'NEAL. Yes, sir; the average price on a farm. In 1916 it was $11.06.

Now, gentlemen, I have cut out the 3 years of the war, 1917, 1918, and 1919. I do not want to discuss that price, because I do not want ever to see another war or war prices.

The hog price on the farm in 1920 was $8.91. In 1921 it was $8.10. In 1922 it was $7.41. In 1923 it was $6.85. In 1924 it was $10.15. In 1925 it was $11.16. In 1926 it was $10.28. In 1927 it was $8.59. In 1928 it was $9.28. In 1929 it was $8.95.

Now, gentlemen, we had a discussion by the packer people here yesterday and they told you that the hog price on the farm, on account of the A. A. A., was too high. I do not think the hog price on the farm has ever been too high, except during the war. The average price from 1910 to 1916 was $7.58½.

Now during that period of time the buying power in America was at least 25 percent below that which it is now. In only one year

between 1925 and 1930 have hogs been as low as $8.59. They sold those hogs to the consumer at a profit and we heard nothing about it. Then from 1920 to 1929 the average price for hogs was $9⅛. They were sold then at a profit. We heard very little about the packers breaking up.

The hog year starts in October, the 15th. Now when it says 1931 that means 2½ months in 1931 and the rest is in 1932.

In 1931 hogs were $3.78. In 1932 they were $3.36. In 1933 they were $3.73. In 1934 they were $6.97, and in 1935 they were $9.17, on March 15.

The packer claims we should never have passed the processing tax, that he could not buy hogs with that tax on and make a profit. Well, suppose he did add it? A man that watched the prices would know that he did add it. If the packer did not add it the retailer did. If he paid the farmer $3.36 and added the processing tax the hogs would have still been lower than any time in 25 years, except one year.

The trouble was we had political propaganda against the farmer. He was cussed in the drug stores, in the meat shops and everywhere else. There is where you got your meat riots. It was not from high-priced meat, it was from political propaganda.

In 1934, when it was $6.97, hogs were a little less than 9 cents on the farm, with the processing tax added to it. They claim they did not pass it on then, and they kept the money.

When the processing tax was kicked out, January 6, from that time on for 3 months hogs were a fraction less than $9, and it cost the packer and the retailer more in those three months after it was kicked out by the Court than it did in 1934 with the processing tax added to it, and still the packer told you here yesterday that he cut the price 20 or 25 or 30 percent.

Now if a packer is in distress it is due to a lack of business ability. If he will cut the price when they are 3 cents a pound, that is business ability. That is not the farmer's price. Hogs have never been too high on the farm under the A. A. A., and they would not have been as high as they were under A. A. A. if it had not been for the drought.

The packers exported in 1934 and 1935 meat to Europe, to England and Germany, and if they had the welfare of the American people at heart they would not have exported meat out of this country in 1934 and 1935, they would have kept it for the benefit of their consumers, and they had a good chance of making a profit by charging for $3 hogs $3.36 in 1934. It looks to me like they did not know whether the processing tax was on or not.

I am a father of 10 children, or, rather, I had 14 but raised 10. If I had a boy in the seventh grade, or if he graduated, I would say, "Here, boy, I am going to sell you a 105-pound hog." That is the amount of meat we eat in America, averages about 83 pounds. It does not vary. In 25 years it has varied but very few pounds. Suppose I say to my boy, "I will sell you a 105-pound hog. You butcher it and sell it." Then the next day he sells it, and I say, "Look here, I am going to sell you a 100-pound hog, but I am going to charge you $2.25 for processing that hog for you", and if he did not come back the next day and tell me that he did not know that the processing tax was $3, I would have taken him to a doctor the next day.

Now, this wheat proposition is along the same line. Wheat ran around about a dollar a bushel or less, and the price of wheat on the farm in 1934 and 1935, with the processing tax added to it, was just about 5 cents ahead of the market through 1910 to 1920.

Now, in 1929 we had a pretty good crop of wheat. Now my son would not sell that wheat. He said, "Pop, they are going to put the farm bill through." I said, "Yes." He said, "I will keep a couple of thousand bushels of wheat over." He did, on one of his farms. They passed that bill, and it took a half billion dollars to control the wheat crop.

Our average wheat crop in America is about 850,000,000 bushels a year, and we export about 25 percent of that. They were going to peg the price of wheat with a few million dollars, and the price of cotton. We could have gotten $1.35 for the wheat when the bill passed. We kept it until the next year, to 1930, when we had our great drought in America, except the one we had in 1934. He pegged it down and we got 83 cents for it, and they kept pegging it down until it got to 30 cents in America.

Now, gentlemen, the farmers in this country are raising bread and meat for the average of about 1 cent a day for the consumer in America. I have got the statistics here and I am going to put them in the record.

(The tables referred to are as follows:)

Monthly farm prices of hogs, 1910–36

[United States averages, dollars per 100 pounds]

Year beginning	Oct. 15	Nov. 15	Dec. 15	Jan. 15	Feb. 15	Mar. 15	Apr. 15	May 15	June 15	July 15	Aug. 15	Sept. 15	Weighted average
1910	$6.98	7.61	7.16	7.44	7.04	6.74	6.17	6.72	6.46	6.92	6.54	6.53	6.65
1911	6.90	6.96	6.72	6.74	6.79	6.84	6.78	6.79	6.68	6.84	7.11	7.47	6.96
1912	7.30	7.05	6.89	6.77	7.17	7.52	7.94	7.45	7.61	7.77	7.79	7.68	7.41
1913	7.60	7.33	7.15	7.45	7.75	7.80	7.80	7.62	7.62	7.77	8.11	8.11	7.60
1914	7.63	7.00	6.67	6.87	6.34	6.83	6.48	6.77	6.80	6.84	7.32	6.79	6.70
1915	7.18	6.35	6.02	6.32	7.07	7.86	8.21	8.37	8.21	8.40	8.47	9.22	7.40
1916	8.67	8.74	8.76	9.16	10.23	12.32	13.61	12.78	12.50	12.85	14.24	15.08	11.00
1917	16.14	15.31	15.73	15.26	15.08	15.58	15.76	15.64	15.57	15.88	16.89	17.60	15.72
1918	16.80	15.92	15.63	15.69	15.63	16.13	17.39	18.00	17.60	19.22	19.20	15.81	16.70
1919	13.88	13.26	12.66	12.36	12.62	13.89	13.73	12.44	13.13	13.65	12.89	12.96	13.48
1920	13.37	11.64	8.90	8.72	8.58	9.11	7.96	7.62	7.73	8.09	8.73	7.51	8.91
1921	7.31	6.66	6.89	6.98	6.94	6.98	6.83	6.66	6.11	6.18	6.44	6.28	6.40
1922	8.33	7.75	7.65	7.75	7.68	7.49	7.45	7.13	6.97	6.98	6.53	7.61	7.41
1923	7.23	6.66	6.30	6.59	6.54	6.63	6.70	6.88	6.55	6.50	6.54	6.50	6.55
1924	9.45	8.68	8.39	8.31	8.62	11.35	11.64	10.78	10.88	12.03	13.19	11.60	10.14
1925	11.16	10.66	10.51	10.98	11.76	11.65	11.49	11.97	12.80	12.69	11.66	12.07	11.35
1926	12.06	11.43	10.97	10.97	11.19	10.97	10.41	9.41	8.40	8.68	9.34	9.78	10.28
1927	10.18	8.99	8.14	7.80	7.61	7.46	7.75	8.83	8.70	9.04	10.01	11.17	8.92
1928	9.55	8.81	7.85	8.18	8.63	10.09	10.37	9.96	9.80	10.32	10.36	9.53	9.28
1929	9.19	8.54	8.53	8.93	9.48	9.87	8.17	8.98	9.19	8.88	8.11	8.44	8.85
1930	8.79	8.20	7.44	7.25	6.81	6.82	6.92	6.72	6.70	6.90	6.85	5.44	6.96
1931	4.70	4.36	3.78	3.76	3.53	3.80	3.88	3.96	2.69	4.28	4.08	3.78	3.73
1932	3.35	3.05	2.73	2.68	2.94	3.22	3.21	3.85	3.96	3.98	3.79	3.73	3.36
1933	4.17	3.70	2.97	3.06	3.57	3.85	3.49	3.17	3.57	3.97	4.41	6.04	3.73
1934	8.20	8.04	8.18	8.87	7.10	8.10	7.68	7.92	8.36	8.40	10.22	10.20	8.07
1935	9.56	8.84	8.72	8.91	9.34	9.17							

Wheat: Price per bushel received by farmers, United States, 1908–36

Year beginning July—	July 15	Aug. 15	Sept. 15	Oct. 15	Nov. 15	Dec. 15	Jan. 15	Feb. 15	Mar. 15	Apr. 15	May 15	June 15	Weighted average[1]	Per capita consumption
	Ct.	Ct.	Ct.	Ct.	Ct.	Ct.	Ct.	Ct.	Ct.	Ct.	Ct.	Ct.	Ct.	Bu.
1907							88.8	89.1	88.5	88.6	90.8	90.9		
1908	96.0	89.6	89.4	91.6	92.2	98.2	94.0	99.8	105.4	111.4	119.7	122.2	94.8	
1909	114.0	104.2	94.9	97.2	99.2	101.0	104.2	105.0	104.8	102.2	98.8	96.4	100.7	
1910	97.1	97.4	94.8	92.1	89.6	88.4	86.2	87.6	84.6	84.2	88.4	83.2	91.7	
1911	83.8	83.8	86.6	86.8	86.4	87.7	88.2	90.0	91.6	96.1	101.2	100.9	88.1	
1912	94.4	87.8	84.6	83.6	78.9	74.1	73.0	80.2	79.8	80.0	81.8	82.0	83.8	
1913	78.9	77.1	77.5	77.4	77.4	80.1	81.3	82.4	83.6	84.0	84.5	84.8	79.8	
1914	76.7	84.9	93.4	95.4	97.9	105.2	118.8	131.2	122.6	135.6	135.4	117.7	99.4	
1915	104.6	100.8	93.0	92.0	93.8	97.4	108.6	108.4	100.2	100.6	101.2	96.4	98.2	
1916	100.0	119.2	133.8	147.4	180.4	155.3	157.6	164.6	172.2	213.0	247.2	224.3	144.4	
1917	224.5	219.3	205.2	200.2	200.4	201.4	201.6	202.0	202.8	203.1	203.0	202.8	205.5	
1918	208.6	208.0	208.7	208.9	208.1	204.8	208.2	207.6	211.1	222.6	226.8	226.2	208.7	
1919	219.6	211.4	207.6	211.4	214.0	223.4	233.8	231.2	230.9	242.6	250.8	254.0	216.3	
1920	242.9	226.4	216.8	201.2	165.8	146.4	140.2	145.2	140.4	122.1	119.0	119.8	182.6	
1921	106.5	103.0	103.4	99.0	98.4	93.0	95.2	97.6	117.0	119.0	118.8	108.6	103.0	
1922	90.8	92.6	89.2	94.1	99.4	103.2	104.6	104.4	105.0	105.4	105.2	100.8	94.6	
1923	89.6	88.4	91.0	94.2	93.7	94.4	94.7	98.0	98.2	95.8	95.8	98.6	92.6	4.26
1924	105.8	118.8	114.2	138.7	133.6	141.1	142.1	139.8	134.0	140.8	139.1	142.7	124.7	4.20
1925	140.3	150.6	144.4	138.4	138.8	133.7	136.1	135.5	146.0	142.2	142.1	138.9	143.7	4.32
1926	137.7	125.1	117.7	121.4	128.6	122.8	122.2	122.2	120.9	117.2	122.2	120.1	121.7	4.22
1927	127.3	122.2	119.2	113.7	111.4	113.9	114.2	113.2	111.6	120.2	114.3	122.0	119.0	4.25
1928	118.1	96.2	94.4	98.7	97.1	98.9	98.8	104.2	104.7	98.8	99.1	98.8	99.8	4.26
1929	103.4	110.7	112.1	111.5	103.4	103.1	107.6	101.3	91.9	93.4	87.5	87.9	103.4	4.15
1930	70.6	74.0	70.2	68.6	69.0	61.3	59.1	55.7	58.2	58.9	59.9	51.9	67.0	4.21
1931	48.3	48.4	45.7	46.1	46.6	44.1	44.1	44.0	44.3	43.1	42.4	37.8	39.8	4.06
1932	35.6	33.5	37.4	34.6	32.8	31.6	32.9	32.3	34.5	44.8	50.0	55.7	38.0	4.16
1933	80.9	74.7	71.1	63.0	71.1	67.3	68.4	73.0	70.9	66.7	69.4	78.9	74.1	3.70
1934	78.8	89.6	92.2	85.5	88.1	90.6	89.3	87.9	85.6	90.2	87.8	77.3	84.7	3.93
1935	78.4	81.5	86.2	96.3	88.8	90.1	93.0						[2] 83.8	

[1] Crop year average prices, by States, weighted by production to obtain weighted averages for the United States, 1919–35.
[2] Preliminary.

United States: Per capita consumption of pork and lard, 1910–34

Calendar year	Pork, excluding lard	Lard	5-year average	Pork, excluding lard	Lard
	Pounds	*Pounds*		*Pounds*	*Pounds*
1910	67.1	11.4	1910–14	61.7	11.6
1911	64.5	11.5	1911–15	62.2	11.8
1912	61.8	11.3	1913–16	61.3	12.6
1913	63.0	11.4	1912–17	58.6	12.4
1914	62.3	12.7	1914–18	57.2	12.7
1915	59.5	13.9	1915–19	55.7	13.9
1916	60.1	13.6	1916–20	54.9	12.6
1917	48.3	11.7	1917–21	54.6	12.4
1918	54.8	13.3	1918–22	56.9	13.9
1919	54.8	12.8	1919–23	53.9	12.8
1920	59.5	13.8	1920–24	57.9	13.9
1921	62.8	11.8	1921–25	60.3	12.9
1922	60.1	14.2	1922–26	60.8	14.2
1923	74.7	16.3	1923–27	70.9	14.9
1924	72.7	15.4	1924–28	73.1	14.1
1925	67.6	13.2	1925–29	68.7	13.9
1926	65.7	13.5	1926–30	70.0	14.0
1927	68.5	13.8	1927–31	70.6	14.2
1928	73.9	14.7	1928–32	71.6	14.6
1929	72.8	14.8	1929–33	71.4	14.5
1930	68.3	13.8	1930–34	70.0	14.4
1931	69.6	14.4			
1932	72.2	15.2			
1933	73.1	15.0			
1934	65.9	13.7			

Division of Statistical and Historical Research.

Mr. O'NEAL. Now the consumer gets his meat for 2 cents a day, his hog meat, and his bread for 1 cent a day. If the farmer is not giving this country a dole then this country never has a had a dole.

I want to give you my experience on the farm. I commenced farming in 1874. We had then what was generally called the Cleveland panic. I bought a binder when I commenced farming, a second-hand binder. I do not recall the name of it, but in 1898 I bought a binder for $110. I could have bought it for a little over 100 bushels of wheat then. Then the price went up between that time and 1915 to $125 for a binder, and it stayed at $125 until we went into the war. I bought two or three binders in that time. We went into the war and the price of wheat was set at $2.20. That changed the price of the binder from $125 to $225. I bought a binder at that price. The price of the binder was put up when our wheat was put up, but when out wheat was put down the price of the binder kept up.

Now I want to see this bill enacted. I am in favor of it. I would like to offer one amendment to it, and that amendment is gentlemen:

Every corporation that has an employee, regardless of his name or his position, that is drawing over $75,000 a year, to tax that corporation 99 percent.

I would like to add that to it. I would like this tax to be not only a tax bill but to regulate big business. Now I am in favor of regulating big business. Any man who has ever fed hogs on a farm knows that it has got to be done.

STATEMENT OF GORDON BUCHANAN, WASHINGTON, D. C., C. P. A. DIRECTOR, REPRESENTING THE NATIONAL ASSOCIATION OF CREDIT MEN

Mr. BUCHANAN. Mr. Chairman and gentlemen: I am present as a member of the board of directors of the National Association of Credit Men, a nonprofit organization, with the knowledge and consent of the directors and the administrative committee.

Our association, for about 40 years, has been sponsoring business legislation. It has not been the practice of this association to offer general or indiscriminate opposition to tax measures, but it recognizes the need for Government revenue as well as the increased need for Government economy.

It is our opinion that the budget should be balanced with some consideration to expenditures as well as receipts and that additional taxes should not be levied without corresponding economy being effected in expenditures.

It is our opinion that no legislation has ever been passed on the basis of such radical departure from previous tax legislation, and we believe it should not be hastily enacted as now proposed.

It is apparent that this bill may alter credit lines in both the banking and commercial fields. It will undoubtedly materially affect the basis of corporate credit and our association is very apprehensive of the far-reaching effect it may have on the corporate credit structure of this country under this type of legislation.

The tax application of this bill is predicated upon a false assumption of the use and function of surplus in corporations.

It is a regulatory measure coupled with a tax measure that creates an incentive to distribute current earnings to a greater degree than

heretofore, before consideration is given to sound financial management.

Any legislation that presumes to dictate unsound principles in the fiscal management of corporations is bound to have its destructive effect on credit.

Conservation of capital and stability of credit in good corporate financial management must be adhered to before distribution of dividends.

The equity of banking and commercial credit in any corporation must be preserved before the rights and privileges of shareholders, with regard to receiving dividends, is considered.

This is a principle that has, for years, been taught in schools of business administration. It is a commonly accepted principle of good financial management in business.

This is not a theoretical principle. It is a basic fact and in some cases it is a recognized point of law. As a matter of fact, previous acts of Congress have recognized this principle. (Farm Loan Act, Jan. 23, 1932, sec. 23, Reserves and Dividends of Land Banks.)

We ask that the passing of this bill be deferred for further study and research and recognize that it is possible to develop an equitable bill capable of practical application in the light of experience gained from the present and future hearings, as it seems apparent that this legislation is a radical departure from previous tax legislation and it should not be hastily enacted as now proposed.

It should come into effect by a process of evolution rather than revolution.

Under present economic conditions, it would seem more practical to continue the present method of corporation tax with the exception of an increase in flat rates as now existing if required.

In any event, if this bill is reported favorably by your committee, we ask your consideration to an amendment to Section 105 with the provision that any corporation operating under a contract of extension or amortization of indebtedness with banks or commercial firms may, upon the approval of the Commissioner of Internal Revenue, continue to pay a tax equal to 15 percent of the net income during the term such extension agreement is operated.

I would like to submit the following amendment:

Every Federal land bank shall semiannually carry to reserve account a sum not less than 50 percent of its net earnings until said reserve account shall show a credit balance equal to the outstanding capital stock of said land bank. After said reserve is equal to the outstanding capital stock 10 percent of the net earnings shall be added thereto semiannually. Whenever said reserve shall have been impaired it shall be fully restored before any dividends are paid. After deducting the 50 percent or the 10 percent herein directed to be deducted for credit to reserve account, any Federal land bank may declare a dividend or dividends to shareholders of the whole or any part of the balance of its net earnings, but only with the approval of the Farm Credit Administration. In the case of Federal land banks the requirements of this paragraph shall be in lieu of the requirements of the first three sentences of the first paragraph of this section and in lieu of the requirements of the first sentence of the second paragraph of this section." (Added by Act of Jan. 23, 1932, sec. 3 (a), 47 Stat. L. 18 and amended by Executive Order No. 6084, Mar. 27, 1933.)

Senator CONNALLY. Have they contracted that all the earnings should go into the indebtedness, that no dividends should be paid?

Mr. BUCHANAN. That all the earnings should stay in the business. Of course the earnings are, as a matter of fact, relatively small, but in some companies they have extension agreements, and if those profits

remain in the business it enables them to make distribution to the creditors.

The CHAIRMAN. I will read a letter which I have received from the Secretary of the Treasury:

THE SECRETARY OF THE TREASURY,
Washington, May 7, 1936.

Hon. PAT HARRISON,
Chairman, Senate Finance Committee.

MY DEAR SENATOR: Yesterday, part of the statement which I made before your committee on April 30 was challenged. The particular part of the statement was the following:

"The Department has also estimated that under the present law more than four and one-half billion dollars of corporation income in the calendar year 1936 *will be withheld from stockholders* and that if this income were fully distributed to the individual owners of the stock represented in these corporations, the resultant yield in additional individual income taxes would be about one billion three hundred millions."

I can see that the phrase "withheld from stockholders" was possibly open to misunderstanding inasmuch as the figure $1,800,000,000 was arrived at after we had deducted from the $4,500,000,000 an amount equal to the existing corporation taxes.

What I have just said about a possible ambiguity in the use of this term relates to one of my arguments on the merits of the proposed corporate tax, not at all to my statement of the Treasury's estimate of what this tax would yield. That estimate is 623 million dollars additional revenue.

Sincerely yours,

HENRY MORGENTHAU, JR.,
Secretary of the Treasury.

Senator METCALF. Mr. Chairman, I desire to have placed in the record a letter addressed to me by Mr. Richard B. Watrous, executive secretary, the Providence Chamber of Commerce, of Providence, R. I. Also, I would like to have placed in the record a brief presented by Mr. J. H. Doyle, general counsel, National Board of Fire Underwriters, New York City.

(The matter referred to follows:)

THE PROVIDENCE CHAMBER OF COMMERCE,
Providence, R. I., April 24, 1936.

Hon. JESSE H. METCALF,
United States Senate, Washington, D. C.

DEAR SENATOR METCALF: I am giving to you, herewith, a resolution adopted by the board of directors of the Providence Chamber of Commerce last evening, April 23, in reference to the taxation bill now before the House and which we understand will very soon go to the Senate for hearings and action. The resolution is as follows:

Resolved, That the board of directors of the Providence Chamber of Commerce oppose the new Federal tax bill as introduced in the House April 21 on the ground that it would encourage unsound business practices; would operate in favor of old, long-established and wealthy corporations; would prevent the development and growth of new industries; and would tend to governmental control of private business.

The chamber further recommends as an immediate procedure for Congress that it give time for study in devising means of reducing public expenditures and if additional taxes are necessary that, rather than pass hurriedly prepared emergency legislation, it devise and present for public hearings a comprehensive program to meet present and future needs.

May I say that this action was taken on the recommendation of our committee on national legislation which had given the subject very careful consideration and had been following the hearings before the House Ways and Means Committee. It could anticipate what would be the nature of the bill that was finally introduced. The committee and the board of directors are deeply impressed with the injury that may be done to smaller industries, that have been wise enough to accumulate reserves which would be available in times of stress, if a

taxation bill of this character is passed. We sincerely hope that you will exert your best influence to resist the passage of a bill which proposes to tax corporations on the amount of net income not distributed in dividends.

I enclose also a copy of the report of our committee on national legislation which was approved.

We shall be very glad if you will pass this letter on at once to the Senate committee that is holding hearings on the subject.

Very truly yours,

RICHARD B. WATROUS,
Executive Secretary.

BRIEF PRESENTED BY J. H. DOYLE, GENERAL COUNSEL, NATIONAL BOARD OF FIRE UNDERWRITERS, NEW YORK CITY

There seems to be some feeling that insurance companies are not required to include their total income from all sources for Federal income tax. This is erroneous. There is a statutory formula provided for insurance companies by which the tax is computed on the accrued and incurred basis according to the system of accounting prescribed for use in all of the States of the United States. This formula, however, includes every item of income, both investment income and underwriting income, and gain during the taxable year from the sale or other disposition of property, and all other items constituting gross income. The deductions allowed insurance companies under this section are the same as those allowed other corporations and the formula correctly portrays the financial result of their operations.

In the case of companies writing property insurance, which are the companies included under section 204, there is imperative need for the maintenance and building up of reserves to meet unusual and extraordinary losses. These companies write against catastrophe and conflagration perils, such as earthquake, tornado, hurricane, flood, and fire. It is not to be expected that there will be an annual occurrence of earthquakes, tornado and hurricane of sufficient intensity to create a real catastrophe and seriously endanger the ability of the companies to pay, but that they will eventually occur is more than probable. When they do occur restoration of the devastated area must in the major part be had from the insurance companies issuing contracts of indemnity against such perils. During the years in which they do not occur, there is much profit derived from the premium income on contracts issued against the perils, and unless this profit be conserved and available, then there will be no funds to meet these extraordinary losses when they occur.

In the San Francisco earthquake of 1906 more than $350,000,000 of property loss was experienced. A similar loss in the same area at this time would probably amount to a billion and one-half dollars, or two billion dollars, due to the increased congestion of values within the area affected.

In 1906 the loss was sufficient to exhaust the surplus of the companies and necessitated a large amount of capital assessment on the part of domestic companies and remittances from home offices on the part of foreign companies.

Credit relations may not be maintained excepting only with adequate insurance facilities available in companies with outstanding ability to meet extraordinary demands. To insure this ability the various States do not permit such insurance companies to distribute their dividends at will, but the right to distribution is highly restricted. In New York State, companies doing business there may not declare a dividend except in compliance with the following statutory provision:

"No corporation may declare dividends exceeding 10 per centum on its capital stock in any 1 year unless, in addition to the amount of its capital stock, such dividend, all outstanding liabilities and the amount of all unearned premiums on unexpired risks and policies, it shall have and be in possession of a surplus to an amount equalling 30 percent of its unearned premiums or 50 percent of its capital stock, whichever shall be greater."

It is not only illegal and inexpedient to distribute the earnings as dividends, but highly prejudicial to the public interest, for no one can foretell the extent of damage that may arise at any time due to adverse manifestations of nature, all of which are insured against by these companies.

The field of insurance taxation has been largely usurped by the States and municipalities. This probably is but a natural sequence—first, for the reason that in many States there is but little industry from which to secure sufficient taxes to meet State and municipal needs, and second, the States have felt a predominant interest due to the fact that the supervision and control of insurance

rest with the State and not vested in the Federal Government. It is quite impossible to outline all of the requirements of the several States, but I attach hereto a list of taxes imposed in the State of Mississippi, which is typical.

In some States municipal taxes, in addition to State and Federal taxes, are imposed in an amount equal to 5 percent of our total income, without deduction, and regardless of profit or loss from our transactions.

In some States, such as Illinois, in addition to the very high premium taxes imposed upon our total income, our total income is again taxed at the same rate, and in the same manner that personal property is taxed.

In Florida the taxes imposed upon insurance companies more than equal the total tax imposed upon public utilities, automobiles, transportation companies, railroads, chain stores and banks.

These State and municipal taxes, you understand, are in addition to the usual and customary ad valorem taxes upon real and personal property, as well as being in addition to franchise taxes, income taxes, etc.

The business is subject to the keenest competition not only from corporations and other institutions operating not for profit but also from self-insurance funds and nonadmitted carriers. Loading the premium income to care for these excessive tax burdens only serves to drive the business into self-insurance funds or nonadmitted carriers, thus depriving the companies of the business, and also depriving the States and municipalities and Federal Government of that tax that accrues from the transaction of the business.

In passing it may be well to observe that there is a constitutional right given to insureds, whether individuals or corporate, to purchase their insurance wherever they see fit, and this results in a very tremendous volume going across the water to nonadmitted insurers which are beyond reach of the taxing powers of the United States.

We have never sought to escape a just contribution to the tax burden necessitated by the activities of the Federal Government, but we feel that in the distribution of this burden to taxpayers generally, consideration should be given not only to the needs of the Federal Government, as such, but to the needs and requirements of the several States and municipalities in respect of taxation and to the importance of the industry and its relation to the public. So closely related and so imperative is the need of insurance to the public welfare that the courts hold it to be charged with a public interest and not only is our rate controlled but likewise our contracts are made the subject of individual State control.

To the end that the solvency of these companies might not be impaired and their ability to meet their contractual obligations maintained during the years just passed, it was necessary for the companies to merge and retire many of their institutions, to augment their surplus by drastic reductions in capital stock, and in many instances to apply to Federal institutions for aid. The Reconstruction Finance Corporation advanced something more than $137,000,000 to insurance companies, and in one case authorized a subscription of preferred stock of $100,000.

In view of the above, we feel that such companies are entitled, by reason of the nature of their business and the possibilities of unusually large and extraordinary demands made upon them through the happening of contingencies insured against, to special treatment from the exaction of the proposed act, applied to corporations generally, for the circumstances surrounding the transaction of the business are extraordinary and unusual as compared with corporations generally.

To meet these extraordinary demands it is also required that companies writing property insurance—being companies taxed under section 204—maintain a very great portion of their assets in liquid securities, listed on the various exchanges, for in the event of extraordinary loss they must, under the contractual obligations, be paid within 60 days, and it becomes necessary immediately to convert their assets into cash to meet the payments.

This necessitates maintaining a very large portion of their assets in the listed securities, and necessarily results in a great deal of their income being received as dividends. Heretofore these dividends have not been included as income, and their inclusion at this time will result in a very tremendous increase in the Federal tax burden and seriously retard the rehabilitation of these companies, since to put the increase in the premium charge can only serve to drive a large portion of the business away from the companies into self-insurance funds, nonadmitted and therefore nontaxable entities, and into companies which operate without profit and restrict themselves to the more desirable single units of property without attempting to furnish full facilities for indemnity to the public at large,

and without endangering themselves to the perils of extraordinary losses in areas of highly congested property values.

We respectfully request that companies subject to section 204 be credited with dividends received from corporations subject to the income tax, if and when the distributing corporation pays upon its net income (from which the dividend is declared) an amount of tax equal to that which would be paid by the insurance company if the income of the distributing corporation was not taxable. To do this, I suggest that section 204 be amended by adding a new subsection to the permissible deductions, numbered (7), reading as follows, and renumbering (7), (8), and (9) accordingly:

(7) The amount received as dividends from a domestic corporation where the tax on such corporation under this title equals 15 percent or more of its net income.

If this be done and the declaring corporation pays a tax of 14 percent upon its net income, then the insurance company will pay a tax of 15 percent on the same income, and the Government will have received a maximum of 29 percent on that income and in no event will the Government receive less than 15 percent on that income. This in itself will increase the tax burden upon insurance companies very materially but it will afford a much needed measure of relief and will not create a high sales resistance in favor of nonadmitted and other carriers.

TAXES IMPOSED ON FIRE INSURANCE COMPANIES IN THE STATE OF MISSISSIPPI

Mississippi, like other States, depends very largely for its revenue upon taxes imposed upon insurance companies. So far as fire-insurance companies are concerned the State of Mississippi exacts 3 percent State tax upon the gross premium income for States purposes; one-half of 1 percent for municipal firemen's and policemen's pension disability and relief fund; 2½ to 6 percent graduated income tax on net income; and one-half of 1 percent fire marshall tax on gross fire premiums.

In addition they pay the following fees: $15 for filing the annual statement; $9 for publishing the annual statement; $200 to $350 annual license fee for each company; $350 if a company operates separate or distinct agency plant; $3 for each general or special agent; and $2 for each local agent.

In addition to the above a fee of $50 is imposed upon fire-insurance agents in municipalities of classes 1, 2, and 3; $30 in municipalities of classes 4 and 5; and $15 in municipalities of classes 6 and 7 and elsewhere.

These fees are imposed upon each employee of a person, firm, or corporation, who solicits the sale of fire insurance, directly or indirectly.

Incorporated agencies pay double this sum.

Each incorporated company, firm, or association adjusting fire-insurance losses pays a fee of $200 and each person engaged in the business of adjusting fire-insurance losses pays a fee of $50. This latter applies to every employee of a person, firm, or corporation who adjusts fire-insurance losses, other than special or local agents.

You probably are acquainted with the authority given to the Yazoo Delta Levee Board to exact taxes and fees equal to those exacted by the State. It exacts the same identical fees and taxes from companies and their adjusters and agents as are exacted by the State, and apparently they simply reenact as an ordinance for the Delta district a copy of the Revenue Act adopted by the State.

Unemployment tax of 1 percent of the total pay roll of companies, which will be increased in subsequent years as the Federal tax is increased under the Federal Social Security Act.

The CHAIRMAN. We will recess until 9:30 in the morning.

(Whereupon, at the hour of 4:40 p. m., the committee recessed until Friday, May 8, 1936, at 9:30 a. m.)

REVENUE ACT, 1936

FRIDAY, MAY 8, 1936

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

The committee met, pursuant to adjournment, at 9:30 a. m., in the Finance Committee room, Senate Office Building, Senator Pat Harrison presiding.

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

The CHAIRMAN. The committee will be in order. Mr. Banser.

STATEMENT OF JOHN C. BANSER, NEW YORK CITY, REPRESENTING THE AMSTERDAM STOCK EXCHANGE, AMSTERDAM, HOLLAND

The CHAIRMAN. Mr. Banser, you represent the Amsterdam Stock Exchange, of Amsterdam, Holland; is that right?

Mr. BANSER. That is right, Mr. Chairman.

The CHAIRMAN. How much time do you want?

Mr. BANSER. I have a statement that I would like to read uninterruptedly and I figure it will take me 25 minutes.

The CHAIRMAN. Why cannot you put that in the record and just explain to us your situation?

Senator WALSH. What phases of the law do you cover?

Mr. BANSER. Section 211, that applies to nonresident alien individuals.

The CHAIRMAN. If you will just discuss that with us. We have got our experts around us. Put that in the record so they can read the whole thing. Just give us the high points on it.

Mr. BANSER. We direct our protest to section 211 of the proposed law which applies a 10-percent flat rate on foreigners.

The CHAIRMAN. That is nonresidential individuals?

Mr. BANSER. Yes, sir.

Senator WALSH. What is the present tax?

Mr. BANSER. The present tax is the same as on citizens. That is a normal tax of 4 percent and a graduated rate or surtax, if any.

Senator WALSH. Yes.

Mr. BANSER. In the memorandum that I handed up to the committee there are figures set forth showing that if you were to change the present rate to 10 percent you would be assessing about 95 percent of the foreign recipients of income from here that do not now pay any tax, because their income does not fall within the tax brackets. A person with a $4,000 income from the United States now pays $120 in taxes. Under the proposed act, including dividend, a 3-percent

flat tax would produce exactly $120 also. Ten percent would produce $400. That is about 233 percent more than a United States citizen would pay. That is a gross discrimination against the foreigner.

In going down the schedule on pages 3 and 4, running from $1,000 to $21,000 income from the United States, it is the last figure alone that will produce the same tax at the present rate as a 10-percent flat tax would. In other words, you have got to run down to less than 1 percent of the foreign investors in this country, as shown on pages 6 and 7, before you reach the group which, paying a 10-percent flat rate, could pay what they are paying now, or what the United States citizen would pay under the proposed bill. That is a very grave discrimination.

I also point out that if you apply a 4-percent rate you would have to reach an income of $6,000 before he paid the same amount as the United States citizen.

Now the inquiry of course then is: What proportion of these foreigners are you discriminating against? I think we might discriminate to a certain extent. We believe that the foreigners would be greatly satisfied with a flat rate of tax so that they will not be compelled to make a return, but the 10-percent rate is so exorbitant, so discriminatory that it is wholly unfair.

The 3-percent flat rate will produce for you, as you see on pages 8 and 9 of the statement, almost the same amount of income as you are getting from the present rates.

The CHAIRMAN. How much does Amsterdam withhold? How much does France withhold?

Mr. BANSER. I do not know what France withholds. I really cannot go into the question of what other foreign countries withhold, for all of my data is only from the Netherlands.

The CHAIRMAN. How much does the Netherlands withhold?

Mr. BANSER. It does not withhold anything from the taxpayer. It compels the corporation, after it pays a dividend of, say, 5 percent, to pay something between 9 and 9.5 percent of that amount over to the Government. It is something like our tax a couple of years ago, an excise tax on a corporation, not from the stockholders, although it could deduct it, but over there it is paid directly by the corporation, so the stockholder gets all of his dividends without any deduction.

The only thing I am trying to bring home to this committee, and to Congress, is that we are grossly discriminating in respect of the same amount of income to the United States citizen and the foreigners.

Now I do not believe that Congress has ever had the policy, certainly not in the tax laws, of discriminating against foreigners, irrespective of what they may do in some other countries. For the first time we are trying to adopt a policy of discriminating to a tremendous extent; 280 percent more tax in one case, 233 in another, 150 in another, and 95 percent more in other cases. I do not think our State Department should be hampered in their effort right now to bring more comity between this Nation and others, but this will cause a great resentment among the foreigners when it goes up to 10 percent. That is our complaint.

Senator WALSH. Has your representative in this country complained to the State Department?

Mr. BANSER. No; not officially.

Senator WALSH. Of course the State Department will be consulted before this law is passed.

Mr. BANSER. You mean by this committee?

Senator WALSH. Yes.

Mr. BANSER. I do not know whether the foreign government can or would officially take it up.

The CHAIRMAN. Do you know Mr. Beenhouwer?

Mr. BANSER. Yes; I know Mr. Beenhouwer.

The CHAIRMAN. Did not he appear before the House Ways and Means Committee and ask for 10 percent?

Mr. BANSER. He did not ask for 10 percent. He said a moderate rate not exceeding 10 percent. Dr. Beenhouwer did not appear on behalf of the Amsterdam Stock Exchange, he did not appear on behalf of any representative body, but on behalf of himself, as he said in that hearing, that he represents an American investment house over there and he is a member of the stock exchange. So was Mr. Boissevain, but he is no longer a member of the stock exchange. He is now residing in this country, that is, for the present. Dr. Beenhouwer did not represent anybody.

We have been asked by the Amsterdam Stock Exchange to protest not against the proposition of a flat rate, you understand, but against the high rate.

My figures here justify a scientific assessment of 3-percent flat tax. You can justify that by figures. Anything above that you are just going to pull out of the air. There is absolutely no scientific basis for 10 percent. You appreciate that. It was just picked out of the air. There is no scientific basis for a 10-percent rate on the figures produced here on the income that is derived in this country by foreigners. I show here that if you were to assess the 10 percent a man would pay $100 on $1,000 income, where the American citizen is not paying a cent.

The CHAIRMAN. I am advised that France is assessing 18 percent. Do you understand that to be true?

Mr. BANSER. I do not know. There may be a lot of other countries where they are not assessing anything.

Senator WALSH. Your brief is very complete, your presentation is very complete in the brief.

Mr. BANSER. Yes, Senator.

Senator WALSH. I do not think it is necessary to prolong the hearing.

Mr. BANSER. I brought Mr. Boissevain along.

The CHAIRMAN. I do think that the record ought to show this, that before the House Committee on Ways and Means Mr. Vinson, a member of the committee, asked [reading]:

> Mr. VINSON. Your withholding rate on dividends paid in Holland is 9.2 or 9.6 percent?
>
> Dr. BEENHOUWER. I think it is nearer 9 percent than 10 percent.
>
> Mr. VINSON. Would that rate have anything to do with arriving at the conclusion that the rate should be 10 percent?
>
> Dr. BEENHOUWER. No, sir. I am trying to be very fair about it, and I am thinking of the percentage that would produce the biggest revenue.

Mr. BANSER. Yes; I have those minutes with me. That tax is not withheld. In Holland they do not withhold the tax from the dividend; the corporation pays it in addition to the dividend.

Mr. BOISSEVAIN. Yes; the corporation pays it. The dividend is paid out at the net amount. That is a tax on corporations, not on dividends.

The CHAIRMAN. We will go into this matter thoroughly when we go into executive session. We are glad to have your brief and your views.

Mr. BANSER. May I have the record show that Mr. Adolphe Boissevain appeared with me?

The CHAIRMAN. Yes.

(The brief referred to is as follows:)

BRIEF OF JOHN C. BANSER

I believe that I am correct in stating that the proposed revenue bill, if enacted into law, will be the first Federal income tax law to impose upon nonresident alien individuals a rate of tax different from the rate applicable to citizens of the United States on identical amounts and character of income. In the previous and the existing tax laws, the only discrimination against foreigners was that they could not take deductions for dependents.

Although this statement is made on behalf of Dutch recipients of income from investments in American securities, and the data herein set forth is applicable only to Dutch recipients of such income, nevertheless, it is reasonable to assume that such data and the conclusions herein reached are, in substance, applicable to all foreigners receiving similar incomes from sources in the United States.

It is common knowledge that foreign investments helped, to a large extent, to finance the inception and development of our industries, particularly the construction of our main arteries of railroads, and this at the time when our own capital was not sufficient to meet the requirements of our rapidly expanding industrial and railroad developments. Among such foreign investors, the Dutch people had, and continue to have, a leading part. Therefore, it is reasonable to assume that any tax law which affects the income of the Dutch investors will likewise affect the large majority of other foreign investors.

Since such foreign investments have been beneficial, and continue to be beneficial, to business in the United States, it is highly to our advantage that no tax law be adopted which may have a detrimental effect on such foreign investments in American securities. It is not my purpose to propose anything on behalf of foreign recipients of such taxable income which does not, at the same time, have, or will tend to have, reciprocal benefit to the United States. Any law which encourages foreigners to make investments in American securities must, necessarily, be beneficial to the United States. On the contrary, any law which would discourage foreigners to make such investments would have the opposite effect.

I might also mention that such foreign investments in the United States help, to some degree, the export business of the United States because the income therefrom furnishes the means of exchange with which such exports are, at least partly, financed.

The proposed rate of a flat tax of 10 percent on the gross income of foreigners will, in all probability, have a most detrimental effect upon foreign investments in the United States. Such rate has no scientific base and is grossly discriminatory when compared with the tax to be paid by a United States citizen upon a corresponding amount of income. Such discrimination must, necessarily, create a resentment on the part of the foreigner which we should avoid. Certain schools of political economy justify taxation upon the ground that the Government affords protection to the property of the taxpayer and thus make it possible for him to derive income therefrom. No one could offer any cogent argument against this reason for taxing income. But the protection afforded to the income-producing property of a foreigner is no greater than that afforded to the similar property of a citizen, and, therefore, no justifiable ground exists for imposing a greater tax on the foreigner than on the citizen in respect of the same amount of income.

While a flat rate of tax on gross income, especially in the case of foreigners, is probably preferable to the graduated rates, as a flat rate of tax will, in all likelihood, be easier to administer and will eliminate the task of foreigners to make returns, yet the proposed rate of 10 percent is so far too high that it may drive foreign investors away and thus produce less tax than if a flat rate was fixed, approximately what he would pay if he were a citizen.

In order that we may readily visualize the great discrimination against foreigners, if the proposed rate of 10 percent is adopted. I have prepared a comparative table showing the tax a foreigner would pay (1) under the same rates as are applicable to citizens, (2) the tax he will pay if the 10-percent rate is adopted, and (3) the tax he would pay if some other flat rate was fixed. This comparative table is as follows:

(a) If same rate as United States citizen, with $1,000 personal exemption, including normal and surtax;
(b) If proposed rate of 10 percent on gross income with no personal exemption;
(c) If rate of 5 percent on gross income with no personal exemption;
(d) If rate of 4 percent on gross income with no personal exemption; and
(e) If rate of 3 percent on gross income with no personal exemption:

Gross income	Under (a)	Under (b) 10 percent	Under (c) 5 percent	Under (d) 4 percent	Under (e) 3 percent
$1,000	$0	$100	$50	$40	$30
2,000	40	200	100	80	60
3,000	80	300	150	120	90
4,000	120	400	200	160	120
5,000	160	500	250	200	150
6,000	240	600	300	240	180
7,000	320	700	350	280	210
8,000	410	800	400	320	240
9,000	500	900	450	360	270
10,000	600	1,000	500	400	300
11,000	700	1,100	550	440	330
12,000	810	1,200	600	480	360
13,000	920	1,300	650	520	390
14,000	1,040	1,400	700	560	420
15,000	1,160	1,500	750	600	450
16,000	1,280	1,600	800	640	480
17,000	1,420	1,700	850	680	510
18,000	1,570	1,800	900	720	540
19,000	1,720	1,900	950	760	570
20,000	1,890	2,000	1,000	800	600
21,000	2,060	2,100	1,050	840	630

The foregoing table shows the following significant facts on the point of discrimination between citizens and foreigners, to wit:

(1) A 3 percent flat tax on a $4,000 gross income of a foreigner, from sources in the United States, will produce the same amount of tax ($120) as would be produced if he paid the same rate as a citizen. Therefore, any rate higher than 3 percent will be discriminatory against such foreigner. Under the proposed flat rate of 10 percent, the foreigner will pay 233⅓ percent more tax than if he paid the same rate as a citizen. Is not this discrepancy extremely discriminatory against the foreigner?

(2) A 4 percent flat tax on a $6,000 gross income of a foreigner will produce the same amount of tax ($240) as would be produced if he paid the same rate as a citizen. Therefore, any rate higher than 4 percent will be discriminatory against such foreigner. Under the proposed flat rate of 10 percent, the foreigner will pay 150 percent more tax than if he paid the same rate as a citizen. Is not this discrepancy extremely discriminatory against the foreigner?

(3) A 5 percent flat tax on a $8,000 gross income of a foreigner will produce a tax of $400 as against a tax of $410 which he would pay if he paid the same rate as a citizen. Therefore, any rate higher than 5 percent will be discriminatory against such foreigner. Under the proposed rate of 10 percent, the foreigner will pay approximately 95 percent more tax than if he paid the same rate as a citizen. Is not this discrepancy extremely discriminatory against the foreigner?

(4) It is only when the gross income of a foreigner exceeds $21,000 will the proposed rate of 10 percent approximate what he would pay under the same rates which are applied to citizens.

The next logical inquiry is: What proportion of foreign individuals, receiving taxable income from sources in the United States, are likely to be thus discriminated against?

While we have no exact available data to furnish the answer to this question, we do have some authentic information in respect of the number of Dutch people whose taxable income can be placed within the above-mentioned categories.
(See p. 4.)

The following data is taken from the Netherland Treasury Department official publication (1934 edition), showing in detail the taxable gross income, from all sources, of the Dutch taxpayers, reduced into dollars. Although the said publication contains tables for many years, no good purpose will be served by burdening the committee with more data than is necessary for the purpose in hand, and I have, therefore, made a compilation only for the fiscal year 1933-34, being the latest one available, as follows:

Income group	Taxpayers		Total income	Percentage of total taxable income
	Number	Percentage		
$533 to $833	655,183	44.13	$464,080,000	22.06
$833 to $1,333	404,977	27.28	444,490,000	21.12
$1,333 to $2,000	231,347	15.58	364,174,000	17.31
$2,000 to $3,333	119,458	8.05	295,208,000	14.03
$3,333 to $6,666	52,256	3.53	232,696,000	11.06
$6,666 to $13,333	15,121	1.02	135,195,000	6.42
$13,333 to $20,000	3,374	.23	53,997,000	2.57
$20,000 to $66,666	2,608	.17	80,794,000	3.84
$66,666 and above	703	.05	33,666,000	1.61
Total	1,484,616	100.00	2,104,505,000	100.00

As already stated, the above amounts of income represent the gross taxable income of each group of taxpayers from all sources, including income from Holland, the United States, and elsewhere. While no data are available which would show what part of such income was received from sources in the United States, I am reliably informed that considerably more than 50 percent of the said incomes were received from sources in Holland. Assuming, therefore, that not more than 50 percent, at the most, of such incomes were received from sources outside of Holland, the next inquiry is: What part of said 50 percent was received from sources in the United States? While no data are available to furnish an answer to this question, I am reliably informed that if we allocate one-half of such 50 percent to sources within the United States, such portion will, in all probability, represent a greater amount than is actually received from sources in the United States. In other words, not more than 25 percent of the total income of $2,104,506,000 can reasonably be said to have been derived from sources in the United States.

On said basis, we must now revise the foregoing groups of income showing the probable amounts, for each group, from sources in the United States, as follows:

Income group	Number of taxpayers	Total income
$133 to $283	655,183	$114,020,000
$283 to $333	404,977	111,122,000
$333 to $500	231,347	91,043,000
$500 to $833	119,458	73,802,000
$833 to $1,666	52,256	58,174,000
$1,666 to $3,333	15,121	33,798,000
$3,333 to $5,000	3,374	13,499,000
$5,000 to $16,664	2,608	20,198,000
$16,664 and above	703	8,433,000
Total	1,484,616	526,125,000

It appears from the foregoing figures that of the 1,484,616 persons having taxable income in Holland, 1,410,964, or 95.04 percent, are not now subject to any tax on their income from sources in the United States, because their personal exemption of $1,000 exceeds their said income.

Under the proposed revenue bill, United States citizens will not be subject to any tax on similar amounts of income. But if said foreigners are taxed at the flat rate of 10 percent on their gross income from sources in the United States, they will pay a total tax of $39,189,700, as against nothing by an equal number of citizens on the same amount of income. It cannot be gainsaid that this would be a gross discrimination against foreigners. And it has never been the policy

of the United States to discriminate against foreigner b in the matter of taxation, and no justifiable argument can be advanced in favor of such gross discrimination and in fact in favor of any discrimination at all.

Taking now the remaining groups, totaling 73,652, taxpayers in Holland, and averaging their income, we find the following results, if the same rates were applied to them as are proposed to be applied to citizens:

52,256 each would pay 4 percent normal tax on $113	$236,197
15,121 each would pay 4 percent normal tax on $1,235	746,977
3,374 each would pay 4 percent normal tax on $3,000	404,880
2,608 each would pay 4 percent normal tax on $7,000	730,240
And each would pay 4 percent surtax on $3,000	312,960
293 each would pay 4 percent normal tax on $28,000	328,160
And each would pay a surtax of $2,620	767,660
Total	3,527,074

Whereas, at the proposed rate of 10 percent on the assumed income of $134,138,000 (the total of the last five groups on p. 7) these same foreigners would be required to pay $13,413,800, or $9,856,726 (approximately 280 percent) more than United States citizens will be required to pay on the same amount of income. This is not only discriminatory but grossly discriminatory against foreigners, in support of which no justifiable argument can be advanced.

CONCLUSIONS

1. A flat rate of tax on the gross income of nonresident alien individuals, from sources in the United States, is preferable to the present normal tax and graduated rates of surtax. Such flat rate will make for an easier and more satisfactory administration and collection of the tax for it will be withheld and paid to the Government by the resident payors of the income. The nonresident alien individual will, no doubt, prefer to pay a flat rate, provided that such flat rate is not grossly discriminatory, rather than be subjected to the necessity of making out a return and claim a refund, if entitled to such refund.

2. The 10 percent flat rate proposed, however, is far too high and grossly discriminatory when compared with United States citizens with equal amount of income. Such rate is not supported by any data and is wholly arbitrary.

3. A flat rate of not more than 3 percent on the gross income of nonresident alien individuals is supported by the foregoing statement and the data therein contained. This rate would produce, on the said assumed income of $526,125,000 herein allocated to sources in the United States, a gross tax of $15,783,750. Even this is $12,256,676 more than citizens would pay on the same income. A 4-percent rate would produce $21,045,000 as against $3,527,074 from citizens, and a 5-percent tax would produce $26,306,250 tax as against $3,527,074 from United States citizens. Whereas, the proposed 10 percent tax would penalize foreigners to the extent of $49,075,426.

4. Even those groups of the aforesaid foreigners whose incomes are high enough to subject them to the tax, if put on the same footing as citizens, would pay, at the flat rate of 3 percent a total tax of $4,024,140 as against $3,527,074, were the same rate applied to them as citizens.

It is, therefore, respectfully submitted to the committee and to the Congress of the United States that a flat rate of 3 percent tax on the gross income of nonresident alien individuals should be adopted, because that rate can be justified and would, no doubt, be satisfactory to foreign taxpayers, and should be acceptable to the Government. Any rate higher than 3 percent must necessarily be arbitrary and highly discriminatory; and this should, by all means, be avoided.

The CHAIRMAN. Mr. Max Gordon.

STATEMENT OF MAX GORDON, NEW YORK CITY

The CHAIRMAN. Mr. Gordon, you are from New York City?

Mr. GORDON. Yes, sir.

The CHAIRMAN. All right, you may proceed.

Mr. GORDON. I just wanted to say this, in as few words as possible, that the show business is a very hazardous business. If a man were putting on a big show—and you can only employ a great many people

by producing big shows—if you were to put $200,000 in a big musical production—my production of The Great Waltz cost $246,000, and another one that I was interested in this year, The Golden Jubilee, cost $182,000—in other words, if a fellow produces a show for $200,000 and it made $200,000, which is very unusual in these times and I do not think anybody has done it, but if they did, after you take away these taxes you would not be left enough money to produce another one. Now two musical shows are appearing on Broadway, one the Follies and the other one a show called On Your Toes. It is impossible for these fellows that produce shows to keep on gambling, and that is the kind of money necessary to put on big shows.

If you take too much away from him that he would not have enough left to produce another one it will result in this: All the fellows that have been in business for themselves are now making contracts with picture companies to back them, and with other companies to back them, because they cannot afford to take the personal gamble, and it results in a kind of monopoly, because all of these individuals are just wiped out, the individual producers, because they all realize that they cannot afford this gamble. If you take so much away from their profits on a big hit they cannot afford to gamble on the next one, because they haven't got enough left over to do it. It would be impossible.

The CHAIRMAN. Do you incorporate when you produce some of these plays?

Mr. GORDON. I sometimes do and sometimes I do not. In the case of The Great Waltz we did, because that required over $200,000, and five or six people were in on it.

The CHAIRMAN. All right. Have you anything else that you want to say?

Mr. GORDON. Yes. The only other thing I wanted to say is this, that I have been out to Hollywood and I know that the big stars, the people that play to big business, they find it more profitable to do less pictures, because when they get up there in the higher brackets, they would actually lose money. They say, "Why should I make a fourth or fifth picture, because there is practically nothing left to me when I get up into those very high brackets?"

So by making less pictures you reduce the receipts in the theaters, and it reduces the receipts right down the line; the theaters make less money and you get less taxes from people that are in the theater business, you get less employment in the theaters.

By encouraging musical productions you employ not only the people that you see on the stage—I have had, I think, 150 people on the stage that the audience would see—but behind that you employ people that made the costumes, you employ the musicians, you employ stagehands—in the case of the Great Waltz we employed 75 stagehands—you employ painters, you employ scenery makers. You ought to encourage the making of big productions, because they put people to work.

Senator WALSH. Suppose the production cost $200,000, how much in taxes would you have to pay under the present law?

Mr. GORDON. I do not know. I know it was so exorbitant under the old bill that an individual could not gamble on it.

Senator WALSH. Can you give us any illustration as to the difference that this bill will make, as compared to the present law?

Mr. GORDON. I do not know anything about the new bill. I just wanted the old bill revised. I understand if a man made $200,000 from a show and if that were the only show he did, he would have to pay $130,000 to the Government.

The CHAIRMAN. Thank you for your views, Mr. Gordon.

Mr. Clapp.

STATEMENT OF A. W. CLAPP, ST. PAUL, MINN., REPRESENTING SHEVLIN, CARPENTER & CLARK CO.

The CHAIRMAN. Your name is A. W. Clapp?

Mr. CLAPP. Yes.

The CHAIRMAN. You may proceed.

Mr. CLAPP. I. Proposed amendments to section 16: Section 16 of the proposed revenue act is unduly restrictive in its definition of "debt"—paragraph (a).

1. The definition should be enlarged to include any indebtedness evidenced by written contract. Often purchase contracts are not evidenced or accompanied by notes, but the promise to pay is evidenced by the contract only. The proposed definition seems intended to cover primarily only indebtedness represented by negotiable instruments issued by corporations. It is submitted that assuming a bona-fide indebtedness existing March 3, 1936, the form in which it is evidenced is immaterial, and it should be recognized as indebtedness to the extent defined in clauses (1), (2), and (3) of section 16 (a). Assuming that it is wise to confine the definition to contractual obligations, why, after enumerating bonds, notes, debentures, and so forth—all of them contracts—should any other contractual obligation be omitted from the definition?

Illustration: A corporation in February 1933 contracts in writing to buy a plant or to buy land or standing timber, paying a substantial amount down and agreeing to pay the balance in eight annual installments. The obligation to pay is evidenced by an appropriate form of written sale and purchase agreement, or by bond for deed, unaccompanied by any notes. The seller retains title until payments are completed. This is a usual form of transaction. The obligation to pay is a firm contract. In what respect does this indebtedness differ from that evidenced by purchase money mortgage and notes? In the illustrated transaction the seller's relation is—according to the decisions of most States—that of an equitable mortgagee.

The above is but one illustration. There should be no exclusion from the definition of "debt" of any indebtedness evidenced by any written contract made before March 3, 1936, subject to the same qualifications as to extent—clauses (1), (2), and (3), section 16 (a)—which are made with respect to notes, bonds, or other forms of written contract.

It is suggested that section 16 (a) be amended by striking out the word "or" in line 23 of page 25 of the House bill and inserting after the word "trust" in the same line the words "or other written contract to pay money, made or."

The CHAIRMAN. Do you think it is advisable to extend the provisions where negotiations would start before March 3, and which have been concluded before the enactment of this legislation, that those things ought to be taken into consideration, or do you think the date of March 3 ought to mean the line?

Mr. CLAPP. Of course I do not quite appreciate why the date March 3, 1936, was adopted.

The CHAIRMAN. It was because on that date the President proclaimed the message.

Mr. CLAPP. I know. Nevertheless the details of section 16 were not covered by the President's message, nor was there any mention made of credit for your corporation for being indebted. I really believe that if, in good faith, negotiations have reached the point where the details of a contract have been arrived at the fact that it was not put into writing until after March 3, 1936, should not govern. However, this suggestion of mine does follow the proposed section 16 and uses the same date, March 3, 1936.

2. The purpose of section 16 seems to be to protect those corporations which have debts which they must pay in excess of their accumulated earnings or profits at the beginning of the first taxable year. I will speak later on that accumulated earnings and profits. This purpose should not be unduly limited or obscured by technical and restrictive provisions. There are many corporations which will not be protected by the provisions in the House bill, although the same reason for protecting them exists which actuated the inclusion of section 16 in the law.

I have in mind the case of two corporations, each of which prior to March 3, 1933, assumed by written contract certain contractual liabilities of an individual, which liabilities were represented on March 3, 1936, by notes of the individuals, having a maturity of 3 years or more.

Senator WALSH. You do not think the words "certificate of indebtedness" covers the point?

Mr. CLAPP. I do not believe so. I think the words "certificate of indebtedness" are entirely too narrow to cover a simple contract.

The contracts of the corporation were not of guaranty or endorsement, but of outright assumption of the indebtedness, so that the notes are as directly the indebtedness of the corporations as though they had themselves made and issued them. Neither corporation had any accumulated earnings or profits on December 31, 1935. It does not seem that in such cases the fact that the notes which the corporations are primarily obligated to pay are not notes "issued" by the corporation itself should deprive the corporations of the protection of section 16.

It is suggested that section 16 (a) be amended by inserting after the word "by" in the twenty-third line of page 25 of the House bill, the words "or the payment of which had been in writing assumed by the corporation prior to March 3, 1936."

3. Under section 16 (b) the amount which a corporation may retain for payments of debts with a maximum tax of 22.5 percent is determined by amortizing only the excess of all of the corporation's debts over and above the "accumulated earnings and profits" of the corporation as of the beginning of the first taxable year. This limitation on the amount which may be so amortized is bound to deprive many corporations of all of the benefits which I am sure section 16 was intended to secure. The limitation seems to assume that the words "accumulated earnings and profits" mean the same as "cash reserves". The drafters of this section seem to have had in mind large corporations whose policy it has been to keep on hand so far as

possible large cash reserves, which are available for the payment of debts or of dividends. The "accumulated earnings and profits" of most corporations are, however, of an entirely different kind. The phrase means nothing more than earned surplus. In many, probably in most instances, accumulated surplus is actually as effectually invested in and necessary to the conduct of business as the original capital. With earnings and profits of prior years thousands of corporations have expanded their business by acquisition of new plants, the expansion of their plants, and the acquisition of capital assets, such as timber, necessary to the conduct of their business. Assets of this kind are not cash, and are not convertible into cash, without crippling the business. Surpluses so invested are as much, and in many cases as permanently, capital, as the original capital paid in.

The corporation whose accumulated earnings and profits are so invested and used in the business, is no more capable of taking care of its debts from sources other than earnings than a corporation whose investments in capital assets and necessary working capital are represented by capital stock. Let us assume two corporations, A and B. Each were organized ten years ago, with a capital of $1,000,000. Each has had accumulated earnings and profits of $1,000,000, and each has invested all of these accumulated earnings and profits in plant and other capital assets, including necessary working capital. However, corporation A last year converted its surplus into stock by a stock dividend, and it no longer has any "accumulated earnings and profits". Each corporation has indebtedness at the beginning of 1936 of $500,000. Corporation A can amortize the $500,000 and retain from its earnings in each of five subsequent years $100,000, by paying a maximum tax of 22.5 percent. Corporation B, which is in exactly the same financial position, must pay its indebtedness as required, and if circumstances make it necessary for it to retain all of its earnings in order to take care of its indebtedness, it would have to pay a tax of 42.5 percent.

The fact that a corporation has accumulated earnings in surplus is not of any significance, even to borrow money. The true test of course is the net value, that is the excess of the value of your assets over your liabilities. Now whether that excess is represented by surplus or by capital makes no difference. You should not penalize the corporation which has actually capitalized its surplus by putting it into its business by saying, "You shall not have any credit for your indebtedness."

The whole difficulty with the section as drawn is that "accumulated earnings and profits" are treated as though they were cash reserves, available either for the payment of indebtedness or of dividends. There may be corporations that have such cash reserves, but the chances are that there are now, at the end of the depression, very few of such corporations, and they the largest and strongest. Thousands of corporations which have not changed their capital structure in the manner in which corporation A did, in the illustration given above, will be corporations most in need of the benefits of section 16, but the ones which will be denied those benefits. We believe that section 16 (b) should be amended by striking out all provisions relating to excess of the debts over the accumulated earnings and profits, and permitting the amortization of all indebtedness before deduction of the accumulated earnings and profits. If it is desired to place any

limitation upon the amount of indebtedness which may be considered, it should be based upon the possession by the corporation of cash reserves not invested in or reasonably necessary for the conduct of the corporation's business.

II. Avoidance of double taxation: The new plan of taxation of corporations is more "equitable" than the present plan only because it is based on the theory that the individual stockholders should be the unit of taxation. Failure of corporations to distribute their earnings under the present system works to the disadvantage of the stockholder with small total net income, and to the advantage of the larger stockholder. It favors the stockholders whose tax rate, if distribution of the corporate earnings were made, would be in the middle of the higher brackets, as against individuals and partners who have to pay those rates. Whether in practice the proposed system will substantially remove these discriminations, or whether there are disadvantages in the proposed system which outweigh its apparent advantages, we shall not discuss. But we do wish to point out that there are certain features of the plan which perpetuate and emphasize discriminations against the smaller corporations and stockholders.

The philosophy of the plan is that the earnings of a corporation are pro rata the earnings of its stockholders, and that if complete distribution were made of every corporation all present discriminations would be removed. If a corporation, to make good an existing deficit (sec. 14), or to comply with an existing contract forbidding dividends (sec. 15), or to pay its debts (sec. 16), is required to retain from distribution a part of its earnings, the tax that is imposed on it for the right to retain should not be regarded or treated as a penalty, but as an advance payment of the tax which would have been payable by its stockholders if complete distribution had been made.

The imposition of a tax of 22.5 percent or even 15 percent on undistributed earnings is of course an initial penalty on most stockholders. This probably cannot be avoided; but if the corporation finds itself able in future years to completely distribute the earnings withheld, the government should be satisfied with the collection of the normal and surtax which would have been imposed if they had been distributed currently, and the advance payment made by the corporation at the time of retention should be returned to the corporation for the pro rata benefit of its stockholders.

The bill as at present drawn would impose not only a tax on the corporation for retention, but imposes on the stockholders the full normal and surtax on the distribution of the retained amount if and when distributed. There is not only absolutely nothing to indicate that in computing the revenue from the proposed bill, this double tax was taken into account; on the other hand, it is plain that in prophesying the revenue for 1936 it could not have taken into account. Possibly it is the theory that amounts retained will never be distributed. The imposition of double taxes will of course be a deterrent to subsequent distribution—you will actually be freezing these retained earnings in the corporations—and it is natural that this deterrent will apply particularly to corporations in the control of wealthy stockholders who will not be overly blamed if they forget the interests of the much greater number of comparatively small stockholders.

Now, of course, amounts retained from distribution should not be tax free when ultimately distributed. But on the other hand, the full normal and surtax on all corporation earnings should be the only tax collected, and to the extent that collection of this entire tax is only deferred by retention of the corporation's earnings, the payment of tax by the corporation should be considered and treated as an advance payment.

The following specific suggestion is made: Amounts of adjusted net income retained and carried to surplus in any year should be separately tagged on the corporation's books. If in any subsequent year or years the corporation, in addition to distributing its entire current adjusted net income shall have distributed all of the retained amount, then in the next taxable year there shall be refunded to the corporation, without interest, the tax paid by the corporation for the year of retention. The amount so refunded shall be added to the adjusted net income of the corporation in the year in which refund is received, and of course made subject to distribution just as the remainder of its adjusted net income.

Thus each stockholder will have paid the full normal and surtax on his pro rata share of all the adjusted net income of the corporation in the year in which retention was made. His rate may be higher because the distribution of the retained earnings must be in addition to complete distribution of current earnings. The corporation will have lost the interest on the tax originally paid by it on account of the retention.

Furthermore, such a plan removes largely the deterrent to future distribution of retained earnings. It would be an especial boon to the smaller corporations with comparatively small stockholders, and tend to entirely remove a discrimination which is only emphasized by the proposed double tax—a discrimination not only against the comparatively small stockholder, when compared with the wealthy one, but when compared with the individual or partner of comparative means.

In other words, I believe that in trying to work out the philosophy or the theory of the President, that the individual stockholder should be the unit of taxation, that unless you do away with this threat of the double tax you will actually be emphasizing and enhancing discrimination.

(Suggested amendments are as follows:)

SUGGESTED AMENDMENT TO SECTION 16 (B) AND 16 (B) (1)

(b) *Computation of tax.*—If the corporation, in its return for its first taxable year under this title, specifies the number of consecutive taxable years (not less than five) over which the sum of all debts, computed under subsection (a) of this section, shall be amortized for the purposes of this subsection, then for such number of consecutive taxable years, beginning with the first taxable year of the corporation under this title (or if no such specification is made, then for the first ten taxable years) the tax imposed by section 13, in lieu of being computed under said section, shall be computed by adding:

(1) A tax of 22½ per centum of the amount of the adjusted net income equal to the amount of such debts divided by the number of years so specified (or, if no specification, then by ten); and * * *.

The CHAIRMAN. Thank you very much, Mr. Clapp.

Mr. Toner.

STATEMENT OF JAMES V. TONER, ATTLEBORO, MASS., REPRESENTING THE NEW ENGLAND MANUFACTURING JEWELRY & SILVERSMITHS ASSOCIATION

The CHAIRMAN. Mr. Toner, you represent the Saart Manufacturing Co?

Mr. TONER. I am representing the New England Manufacturing Jewelry & Silversmiths Association. I might add to that, Mr. Chairman, that I am professor of accounting at Boston University; I am a certified public accountant and a tax practitioner and consultant.

The membership of the New England Manufacturing Jewelry & Silversmiths Association is concerned over the proposed tax bill for 1936 and desires to present to your committee their viewpoint with reference to the same. This presentation is not to be construed as opposition to any projected program nor as unwillingness on the part of the membership of this association to cooperate in an equitable manner in meeting the costs of government. It is the intention of our association to present to your committee the viewpoint of relatively small businesses which should be given careful consideration in connection with this proposed bill.

The primary function of any tax law is to raise revenue in as equitable a manner as possible. The tax income should be possible of fairly accurate determination; the amount of the tax payable by each taxpayer should be definite; the law should not only be comprehendible by the taxpayer but the amount of the tax should also be computable by the taxpayer.

The primary purpose of the proposed tax on corporations in this new bill does not seem to be the raising of revenue, but seems rather to be a regulatory or punitive measure. It is the substitution of a known, tried, and adjudicated law for an unknown, untried, and exceedingly complicated law.

Whether or not this proposed law will produce additional income or not is a disputed question upon which even those who apparently have access to all the facts are unable to agree.

It is a great deal easier for me to see under this proposed levy less tax income rather than more. Under the present law corporations, without any exemptions, are required to pay a flat rate of tax reaching a maximum of 15 percent. They also are required to pay an excess-profits tax. The dividends paid to stockholders are subject to surtax only, not being subject to normal tax. Under the proposed law, the tax on net income, if distributed entirely, would be eliminated as a corporation tax. The entire tax levy will fall on the stockholders and be subject to both normal and surtax. Without question, a substantial portion of the dividends paid would be received by single persons whose net incomes are less than $1,000 and by married persons or heads of families whose net incomes are less than $2,500. In such cases, the income received, as well as the income earned by the corporation, would not be subject to tax.

Up to date no convincing proof has been presented that the rates proposed under this new law on undistributed earnings would be adequate to compensate for the loss of the taxes now paid under our present tax structure, not to mention the production of additional tax income. In addition, the cost of collection of the taxes under this

proposed change and the administration of this law will increase substantially, because of the larger number of persons affected. This, obviously, will tend to decrease the net yield.

The law seems to attempt to regulate businesses by the imposition of punitive rates upon undistributed net income. It attempts to impose a uniform order on all business requiring the distribution of their earnings, or to be subject to a tax on the undistributed portion, at rates which, if charged as interest, would be considered usurious.

One would infer from the published discussion of the proposed law that certain corporations in the past withheld earnings from their stockholders solely for tax reasons. It is perfectly natural that the administrative officers of the tax bureau should examine every corporate action from the viewpoint of possible effect on taxes. Unfortunately, however, corporations are compelled to withhold earnings from their stockholders for other very urgent reasons.

The desirability of withholding earnings to provide for the proverbial rainy day has been touched on very frequently in the discussion of this law. Amounts so withheld during the past few years have acted as private employment funds and have been dissipated in this period by concerns who have attempted to keep their employees off of the relief rolls.

I am going to submit, in this particular connection, a statement of a concern which started in business in 1896 with a net capital of $26,000. By allowing the earnings to accumulate in this business the net worth on March 31, 1930, amounted to $1,342,079. The net worth of this corporation on March 31, 1936, was $330,900, a shrinkage of a little more than $1,000,000 in 6 years. That $1,000,000 has been dissipated, has been distributed to the employees of this organization.

In this particular case the proportion of each sales dollar that was paid for labor increased from 38 cents in 1930 to 90 cents in 1935.

Senator KING. Did the concern survive this great loss in capital and earnings, whatever it was?

Mr. TONER. It is still operating. All of this shrinkage, gentlemen, you will readily understand, came out of working capital. How long it will survive is a matter of where they can get the replenishment of this working capital. It is a relatively small business and is comparatively closely held.

Also, many concerns, particularly in the novelty field, are required to withhold in the business sufficient capital to finance a new product when the old one has had its run. There are many illustrations in the industrial field which would today be out of business if they had not withheld funds for the development of new products.

Too frequently earnings and cash are erroneously considered as synonymous. Earnings are finally reflected sometimes in cash, but more frequently in increased inventories, receivables, fixed assets, or in decreases of liabilities. Often, after the various governmental bodies have obtained their cut out of the net profits—which are always payable net cash, starting on the 15th day of the third month after the close of the taxable year—there is not much left in cash to pay out to the stockholders. Most concerns would find that their stockholders would not appreciate dividends paid in merchandise, or in receivables, or in machinery. Particularly in a period of advancing prices less and less of the net profits are finally reflected in the cash

account. Increased prices mean increased inventories and increased accounts receivable.

Our industry, located practically all in New England, is primarily a novelty business. We will have a run on an item and just as soon as that item has had its run they will have to start then and build an entirely new product. Now unless, in that type of business, earnings are salvaged from the first run that means we are out of business in financing the new one.

Senator KING. You say you have to repeatedly make capital investments to accommodate the changing modes of the people?

Mr. TONER. Exactly. A small item in this particular industry is a little tie chain. That has been a very profitable item, but it will probably have its run this year because of price effects, but just as soon as that is gone that business has got to get another item.

Senator GERRY. Most of your people are very skilled workmen, are they not?

Mr. TONER. The workmen are very skilled; yes. Of course there are various units in which the degree of skill would change. Now in the Saart Manufacturing Co., the workmen there are particularly highly skilled because of the type of product they handle. In some of the lower-priced lines where press operators constitute a bulk of the employees they are not so highly skilled.

Senator GERRY. Your industry varies very much in different years, does it not?

Mr. TONER. Yes; very much so. With a given line you may have in 1935 an exceptional year, and then for some reason that you cannot control, in 1936 it may go the other way. That is just exactly the condition that exists today in many industries. I do not think that this jewelry and silverware industry has ever been in poorer shape than it is today, due to a variety of causes.

Senator GERRY. In other words, if you have to take losses in certain years you will have to make them up in other years?

Mr. TONER. Yes, sir; that is correct. You have to provide, in the years when you get a little cream, to mix it later with your skimmed milk.

In the jewelry and silverware industry, starting in 1930, nearly all of our units have lost money. Many during this period attempted to maintain their organizations in order to give their employees some income. The volume of business decreased and in some cases the decrease amounted to as much as 80 percent for the former volume. Naturally the losses under such conditions were tremendous and all of these losses came out of working capital. When business started to pick up in 1933 many concerns found themselves short of working capital. This condition was aggravated by the increase in the price of gold from $20.67 an ounce to $35. One concern with which I am familiar was compelled, because of this increase in the price of gold, to increase its inventory more than $35,000.

Senator GERRY. Is it not rather difficult in that industry to sell stock unless you have had good years for a number of years?

Mr. TONER. I would say my experience has been largely with that particular problem. It is almost impossible to sell stock in any corporation in that industry unless it is actuated by some reasons other than investments. You take in the city of Attleboro, or the city of Providence, we have had occasions when we have been able to sell

stock, but in every case they have been actuated more by a desire to do something for the industry than it has been with the hope of making any profit on their investment.

I am also treasurer of the James E. Blake Co. This James E. Blake Co. was reorganized in 1932, and about $150,000 of new cash was put into the business by a group of men who put it in solely to retain the industry for Attleboro. If you liquidated today it would not be worth $15,000 at the top.

Senator KING. When you use the word "dissipate" you mean "distribute"?

Mr. TONER. It is dissipated from the viewpoint of working capital. From the viewpoint of business it has been scattered; yes. It has not been dissipated in the sense that it has been squandered.

In 1933 we did get a pick-up in business for a while, but many concerns found themselves immediately short of working capital. This condition was aggravated by the increased price of gold. When gold was increased from $20.67 up to about $35 that naturally meant to buy stock you had to have more money, you had to carry a bigger inventory, and you had to carry a bigger account receivable. Of course all that was reflected in the selling price. As selling prices advance, as you know, the requirements for working capital increase. One concern that I am very familiar with had to increase their inventory investment alone because of the increased unit price of gold about $35,000.

There are very few units in our industry today that are not short of working capital. Where are they to obtain this working capital? Banks are not interested in capital loans, relatively small businesses cannot sell securities to the public, stockholders and friends are not interested under present conditions in investing funds in small units which are at the present time suffering from lack of working capital. These controversies are bound to continue.

That would bring up the matter of a possible deficiency. Assuming a corporation had an adjusted net income of $60,000 and paid dividends of $24,000, the tax in this case would amount, according to my calculation, to $13,500. Now let us assume an alleged deficiency of $12,000; this will increase the adjusted net income to $72,000.

The only hope for the restoration of this depleted working capital is the ploughing back of any future profits. This, in fact, is the way practically every present unit in our industry has been developed and this same thing is true of almost every other industry.

In my opinion, the proposed tax law will stunt the growth of our small industries and will possibly cause many concerns, which are now struggling along, to go out of business. Certainly the Federal Government does not wish to use its power to tax as a power to destroy.

The amount of tax payable under the proposed law would be almost impossible of determination in the average small business which uses ordinary accounting methods, until some time after the close of the year. A business during the year may be continuously harassed by a shortage of funds and at the end of the year, nevertheless, find that it has made a sizeable net income. This, unless distributions were made during the year, carries with it a sizeable tax liability under the new law.

The uncertainty of the amount of this tax is one of its inherent weaknesses. It was recognized by Adam Smith and it is true today "that a considerable amount of inequity in a tax base is preferable to even a small amount of uncertainty." At the present time, many controversies arise between taxpayers and the Department of Internal Revenue, regarding items of income, deductions, and credits. These controversies are bound to continue under the proposed new law and the ultimate decision regarding the same simply adds to the uncertainties of the tax.

Under this proposed law an alleged deficiency would be quite a serious matter. It would increase the adjusted net income and also the undistributed net income. It would result in an increased tax rate which would be applied to the new adjusted net income. To illustrate: Adjusted net income, $60,000; dividends paid, $24,000. In this case the original tax would be $13,500. Now let us assume an alleged deficiency of $12,000. This will increase the adjusted net income to $72,000. The dividend of $24,000 remains the same. The total tax, at the rate of 25.8334 percent on the new adjusted net income amounts to $18,600.05. The alleged deficiency which must be paid, would increase the tax $5,100, which amounts to 42.5 percent of the deficiency, which must be paid as an increased tax. This is without considering any possible interest charge.

Those of us who were in tax practice in the years 1917 to 1920 remember well the nightmares of the excess profits tax during those years. This levy was eliminated from our later tax laws because of the almost endless complications and controversies regarding this levy. A consideration of this new tax law would lead one to believe that from the viewpoint of complexity this new law is to the old excess profits levy what the theory of relativity is to the table of twos.

This law, if passed, will not only require small businesses to secure expert assistance in the preparation of the returns, but will necessitate almost continuous consultation with tax experts and financial advisers during the year.

From my personal observation there are many taxpayers who are capable of earning fairly large incomes who would not only be able to understand this tax law, but who also might have considerable difficulty in even reading it. These taxpayers are the best customers that this Government has; they pay the bills and should not be treated with as little consideration as is usually given to the poor relatives of a divorced wife. Their interests should be considered and everything done to help them, rather than to continuously burden them with new problems.

Economic and financial conditions are still in a disturbed state. Certain changes, corrections, and improvements are possibly desirable in our scheme of taxation. But business cannot afford at this time to have its best brains focalized on a radically different tax bill which is so complicated that very few, if any, can realize fully its ramifications. Labor today needs the capital resulting from earnings to be ploughed back into industry; it also needs the undivided attention of management on the problems of production and distribution, in order to relieve unemployment.

Theorizing and experimenting with tax laws are not expensive for the theorists who can usually correct their mistakes with the eraser end of a pencil, but business pays for these mistakes in cold hard cash taken from their own pocketbooks.

The business units represented by the New England Manufacturing Jewelry and Silversmiths Association are now struggling like most other luxury businesses for their very existence and cannot afford now to have any additional financial problems imposed upon them and desires some assurance that they will be allowed in the future, as in the past, to determine their own financial policies.

As representative of the New England Jewelry and Silversmiths Association, I respectfully request your committee, in considering the proposed tax bill, to give careful attention to the problems that this proposed bill will present, not only to the units of our industry, but to all the small businesses throughout this country.

Senator KING. With how many companies are you personally familiar from conference with their directing agencies, or the inspection of their books, reports, and so forth?

Mr. TONER. Prior to assuming for the banks the responsibility of management of these two businesses my firm did considerable accounting work that bears on the jewelry industry, so that it is safe to say in our records we have possibly 30 or 40, that is the records of 30 or 40 of those industries, and at the present time I am familiar with about the same number.

Senator KING. Are they all in the same condition as you indicated by these examples?

Mr. TONER. I would say, looking over Attleboro at this moment, consisting of possibly 30 or 40 units, I would say that out of that 30 or 40 units of some size that there possibly are 2 or 3 making a profit and the others are losing money.

Senator KING. How long have they been losing money?

Mr. TONER. We have been losing money since 1930, the last year that any of us have made any money. Some have made a little in 1934; 1935 was not a good year for the jewelry business.

Senator KING. Were those two concerns that you represent through the bank forced into liquidation because of bad conditions?

Mr. TONER. I think that is a good example. The larger company, the Saart Bros. Co., got into financial difficulty because they started with nothing and they built up a rather sizable volume of business, running approximately, at one time, pretty close to one-half million dollars, and the owners withdrew the profits. As a result the banks became considerably involved in furnishing fixed working capital, and they put in a management. In other words, that cites exactly what will happen to growing businesses if profits are compelled by law to be distributed.

Senator KING. So that those two plants are run by the banks, or the creditors?

Mr. TONER. We would not like to advertise that to the trade.

Senator KING. I beg your pardon. Thank you very much.

Mr. TONER. I believe that this law, looking at it from a tax practitioner's point of view, I believe that the objectives might well be accomplished in other ways. I believe it would be a mistake at the present time to sacrifice a known source of income for an unknown source. I believe that practically everything that is attempted through this law here can be accomplished through your present corporate law, plus your capital stock tax law. There is no particular reason at all why you cannot leave your corporate tax rates where they are. You have in your capital stock tax law a stated capital.

Now there is no particular reason why increases on that stated capital could not be subjected to some tax, some raise of tax.

Senator KING. A higher flat rate?

Mr. TONER. A higher flat rate. It might be a percentage rate.

What this law intends, as far as revenue is concerned, is to tax income to the ultimate distributees. Now if you are going to get practically—I think it is 4 percent—you will get that on the normal tax. Now whether the individual distributees, the individual stockholders pay that 4 percent, or whether that is paid by a corporation would not seem to make much difference. The surtax rates are not going to be affected very much by this proposed change.

Senator KING. What would you say as to an alternative, if you were forced to increase the taxes, or forced to accept an alternative something along this line: That this bill, or a measure of some kind, that increases your flat rate tax on corporations, we will say, 17 or 18 percent, striking out the graduation, then increasing the surtax on your normal tax from 4 to 6 percent?

Mr. TONER. I am a businessman enough to know that the Government has got to get an income. I would like to say, but I cannot say it, that the best thing to do is cut down expenses. These expenses have still got to go, to a certain extent. I believe that there will be less economic disturbance, less financial disturbance, if the present tax bases are adhered to with whatever adjustments are necessary on these bases.

I thank you.

STATEMENT OF ALBERT HUBSCHMAN, NEW YORK CITY

Senator KING. Mr. Hubschman, whom do you represent?

Mr. HUBSCHMAN. I am here, Mr. Chairman, as an individual representing no one in particular, but speaking in behalf of the average individual taxpayer.

Senator KING. Where do you reside?

Mr. HUBSCHMAN. New York City.

This committee has before it a tax bill embodying a complete revision of the existing theory of taxation affecting the earnings of corporate business. It represents an attempt to effectuate the recommendation of the President to levy a tax on the earnings of corporate business, comparable to the taxes levied on the earnings of the individual, after providing credit for dividends paid. It is based upon a desire to eliminate the preferential rate of tax enjoyed by corporate business since 1922.

Considering the necessity for additional revenue, the recommendation is timely, courageous and capable of simple application. It is the expression of a desire to provide needed additional revenue, not by creating inequalities in the burden of taxation, but by removing them. The inequalities sought to be eliminated are not differences in tax rates between incorporated and unincorporated business, because ever since the corporation has been the beneficiary of a preferential rate, unincorporated business of any substantial volume has slowly but surely ceased to exist. The inequality that remained, forming the basis of the President's recommendation, is the preferential rate enjoyed by corporate business as against the rate levied upon the earnings of the individual.

This is readily apparent when one considers that from 1922 to 1933, the corporate income reported to the Bureau of Internal Revenue was approximately 87 billion 900 millions of dollars. The dividends paid during that period, less the dividends paid to corporations, was but 38 billion 600 millions of dollars. After reducing the remaining 49 billion 300 millions of accumulation by the tax of 9-billion-some-odd, there remained 40 billions of dollars within the corporate structure, that had been subjected to a rate of not more than 15 percent, and as low as 11 percent, when during that same period the income of the individual was bearing rates ranging as high as 63 percent.

The substance of the objections to this principle of taxation may be briefly summarized as consisting of two basic arguments, namely, the so-called "rainy-day" reserve argument and the argument that it would sterilize industrial initiative.

With respect to the first argument, it is obvious to anyone having experience in industry, that methods of manufacture have under gone a radical change in the past 20 years; 20 years ago industry manufactured for inventory in periods of depression. Cheap labor, cheap material was availed of and goods were manufactured and stored. As late as 1920, we had an inventory depression. Today, the mass-production principle is universal, and inventories consist primarily of work in process of manufacture. This method of manufacturing was employed during the depression from which we are just emerging, and is one of the reasons for its severity. The mass production method of manufacture is based upon the rule that once a process starts, movement through the plan is essential to lower costs. In fact, raw material is ordered so closely that it arrives just before it is needed, and the plant does not function if orders for its product are not immediately ahead.

In short, production follows, rather than precedes sales and the most efficient plant markets simultaneously with manufacture instead of behind manufacture. This being so, what good did the "rainy day" reserve or the surplus account do for labor or raw material the basic factor in heavy industry? Was labor employed or material purchased to manufacture articles for inventory during the depression? Is this not the very reason that it was so difficult for the administration to "prime the pump"? The fact is that upon analysis it will be found that the cash receipts of industry during the depression were equal to or in excess of the cash costs of labor and raw material. The losses sustained on operation consisted of an attempt to recoup through depreciation charges and obsolescence, the inflated costs of plants, equipment, and machinery, erected or installed during the boom years, together with the cost of advertising the corporate name and executive overhead. Industry was and still is reluctant to mark down to current replacement value, the inflated costs of its over-enthusiastic expansion programs. The depletion in the cash reserves, in the instances where such reserves were depleted, can be directly traced, to executive overhead, advertising the corporate name, and the payment of dividends, but not to the employment of labor or the purchase of raw material.

Thus with this understanding of the use of the so-called "rainy day" reserve, the depletion of corporate surpluses in the instances where it was depleted by the payment of dividends during this past depression represented nothing more than an annuity, to the stock-

holders of the corporation whose stock was widely or publicly held. In the privately owned company the so-called "rainy day" reserve was utilized as the medium through which the current earnings of the corporate business enjoyed a preferential rate of taxation, and dividends were postponed by the individuals in control to a year when the receipt thereof would subject them to the least tax liability.

The second argument, namely that the principle involved would sterilize industrial initiative, may be dismissed with the observation that, like its counterpart the threadbare philosophy of unrestricted rugged individualism, it begs the question, because every sincere complaint, although directed against the principle, was founded upon the rate. The rate proposed for the corporation and the existing rates against the earnings of the individual is and should be the basic subject of your consideration. The tax rates in both groups are too high.

Corporate business cannot answer this problem by continuing to shift its fair share of the b..den upon the shoulders of the individual. This it has successfully accomplished to the point where the existing rate on the income of the individual is still considerably higher than the proposed rate on the corporation. If the rate of tax proposed against the earnings of the corporation is so excessive that it will destroy industrial initiative, what effect should the existing higher rate of tax have had upon the initiative of the individual. Obviously the rate should have curtailed his business activity. Instead, the affluent individual transferred his business activity into the corporate form with the incident benefit of the preferential rate, leaving the salaried and professional group to bear the burden of the excessive rate on the income of the individual, and in the main this represents the lower income class. It was accomplished by a segregation of earning power. Accumulated wealth was incorporated; and thus the personal holding company became popular and the subject of congressional attention. The earning power of mental or physical labor was likewise incorporated wherever possible, and what was left, together with the income of the excepted individuals, was the only income subjected to the existing high rates of tax.

The extent to which this trend has affected the available earnings to be subjected to the income tax can best be gleaned from a consideration of the fact that the national income is estimated to be approximately 45 to 50 billions of dollars. Of this sum, 7 or 8 billion represent corporate earning power, and the remainder, salaries, wages, interest dividends and profit on the sale of property. The estimated aggregate of income-tax collections, with rates of tax ranging as high as 78 percent, is but six-hundred-some-odd millions on the earnings of the individual. Even if the existing exemption were reduced to $800 for a single person, the income tax collected would not be over 2 percent of the total.

Our country is one of the wealthiest nations in the world, possessing the greatest middle class, more individual wealth, and the highest standards of living and yet is either a nation of indigent citizens or the tax on net income as defined by the existing revenue laws falls too heavily on some and is avoided by most of our higher income group, thus creating the necessity for an unreasonably high rate of tax to yield but 2 percent of the national individual income.

Something is radically wrong. The solution lies in a simplification and classification of our entire tax structure, and a reduction in rates would be the inevitable result. Since this involves the compilation of statistics not now in existence it follows that this Congress has not before it sufficient data upon which it could predicate such a complete revision of our existing tax structure.

The proposal to levy a tax on the earning of corporate business, comparable to the taxes levied on the earnings of the individual after providing credit for dividends paid, if properly applied, however, can be simple in application, increase the aggregate of tax receipts, and result in a reduction in rates on the income of individuals. This brings us then to the application of this principle as expressed in the bill now pending before your committee.

First. The bill does not apply this principle, because it is based upon the theory that the undistributed earnings of the corporation are to be taxed at a rate that would yield a revenue comparable with the revenue to be realized, if the earnings were distributed.

Therefore the rate schedule embodied in the pending tax bill should be based upon an estimate of the probable revenue yield under existing statutes if the corporate earnings were distributed in their entirety. This estimate in turn must be based upon statistics reflecting the undistributed earnings of the privately owned corporation, because it is this class of corporation that was and is used for the purpose of postponing the payment of dividends to suit the convenience of its owners. These statistics are not available, and consequently the rates of tax embodied in the pending bill represent nothing more or less than an increase in the corporate rate without any consistent relation to the principle involved.

The true application of the principle would require the recognition of the distinction between a publicly owned and a privately owned corporation, and a separate rate schedule for each.

Second. The rate schedules are confusing and unnecessarily complex.

If the Congress insists upon varying the rate in direct proportion to the percentage of undistributed net income, then the rate schedule can be simplified by imposing a tax on the undistributed net income without adjustment for taxes to be paid, rather than by the complex method provided in the bill. And this in turn presents the following problem:

The bill may be unconstitutional because of the manner in which the tax is levied. The bill provides for a variable rate of tax dependent upon the percentage of earnings that the corporation elects to retain. That rate of tax varies from nothing to 42½ percent of the retained income. Notwithstanding the fact that the rate of tax when determined is applied against the net income, it still may be considered to be an excise tax on the privilege of retaining the corporate earnings rather than an income tax on the corporate earnings. The rate is dependent upon an election to be exercised by the taxpayer, rather than on the receipt of income. The fact that the receipt of income is a condition precedent to the power of the taxpayer to make its election does not change the effect of the exaction. An excise on the privilege of retaining the possession of one's own property is an invalid excise.

This defect can be cured by making dividends paid a statutory deduction, and imposing a tax graduated on the amount of the statutory net income and thus eliminating any constitutional objection, and simplifying the computation of the tax.

The statistics necessary for a complete revision and simplification of our existing tax structure are not now available but can be assembled.

Considering the necessity for immediate additional revenue to balance the ordinary budget, I earnestly make the following recommendations which I believe will produce the necessary revenue and truly accomplish the application of the principle contained in the President's recommendation, through the medium of removing existing inequalities by a reduction in the rates of tax on the earnings of the individual.

I may state this, gentlemen, in connection with the recommendations that follow, that they can be expressed in the form of an amendment that should not cover over two pages of wording, with approximately a duplication of the existing rate schedule on individual incomes. In other words, with about three pages of printed matter we can accomplish every result sought here to be accomplished, raise the revenue necessary to balance the Budget and reduce the tax rates on individuals.

That corporations be divided into two classes, namely, holding companies and privately owned companies in one class and all other corporations in the other class.

A holding company and a privately owned company be defined to mean:

(*a*) Any corporation whose stock in all its classes is not listed on any public securities exchange and 45 percent or more of any class of its voting stock is held by less than 15 individuals, for a period exceeding 30 days during the taxable year, or,

(*b*) Any corporation whose stock in all its classes is listed on a public securities exchange, but is not actively bought and sold and 45 percent or more of any class of its voting stock is held by less than 15 individuals, for a period exceeding 30 days during the taxable year.

I would like to direct your attention to an error at the top here. This 50 percent of the net income, as I have defined it, would be 50 percent of the undistributed income in excess of $80,000. That would mean that the privately owned company, if it distributes its profits to the stockholders, would not pay any tax. If it retained any part of it, to the extent it retained it it would pay taxes comparable to the rates for individuals, up to $80,000, and 50 percent thereafter. In effect that, in most instances, would be a lower rate than that included in the existing bill, for this reason, that in this existing bill the rate is on the total net income, and under this recommendation it would fall on the undistributed net income. In other words, on 10 percent retained it is approximately thirty-some-odd percent on the undistributed net income.

Dividends received by any holding company and privately owned company shall be included in gross income.

Dividends paid by any holding company and privately owned company shall be a statutory deduction from gross income.

The tax rate on the net income of holding companies and privately owned companies shall be the same as the tax rate on individuals in the brackets up to $80,000, and 50 percent of the net income in excess of $80,000.

The tax rate on all other corporations shall be 22.5 percent of the net income.

Dividends received by any individual from a holding company or privately owned company shall be subjected to both normal and surtax rates.

There is likewise another omission. The tax rate on the publicly owned company, or any other company, I recommend be set at 22.5 percent of the net income. That is without adjustment for dividend distribution. They are not permitted to deduct dividends paid. In other words, you leave our tax structure exactly as it is now, with respect to that class of companies.

I recommend the creation of a tax commission which shall determine the probable revenue yield in excess of the sum necessary to balance the ordinary budget resulting from the adoption of these recommendations and arrived at through a compilation of statistics obtained from the corporate tax returns for 1935, with directions to report its findings to the President.

The President upon receipt of said report shall by proclamation reduce surtax rates uniformly on the income of individuals not to exceed 30 percent of the existing rates of surtax. Precedent for this recommendation can be found in the power vested in the President to reduce tariff rates.

The tax commission be directed to continue its studies with a view toward submitting recommendations to the Congress for the simplification and equalization of the tax laws and the uniform reduction of rates in all classes of taxpayers.

At this point, gentlemen, may I explain this? It may sound ridiculous to you gentlemen to state that you can reduce rates by application of this principle. I wish to make a rapid mental or oral calculation.

The Treasury has estimated that the corporate income to be earned during 1936 will be approximately 7½ billion dollars. Of this sum they say that 3½ billion will be paid out in dividends in the ordinary course of business affairs, leaving approximately 4 billion dollars within the corporate structure. That would be accumulated.

Now the problem that I think you gentlemen should consider is what kind of companies retain that 4 billion dollars. Is it General Motors? Is it the American Telephone & Telegraph? Is it Henry Ford? Is it the privately owned company or public held company that retains that 4 billion dollars?

Every compilation of statistics by Standard Statistics, by the Brookings Institution, even by the Treasury itself, to the extent that they have got the figures, indicates that 70 percent on the average over a period of years is distributed in dividends to stockholders.

Now, I ask you, with the rate of tax ranging as high as 63 percent—that is, the rate up to 1933 on the income of an individual—do you think that any sane business man owning a corporation through which he is operating, that that businessman would distribute to

himself the income of that corporation in order to subject himself to a rate of tax as high was 63 percent, or leave it in the corporation? I will confidently state to you that of the 4 billion dollars that will have to be retained, at least the 1½ billion dollars. One-half billion dollars represents the accumulated earnings of the closely held company, and I can prove that by simple arithmetic. I will do that in whatever way you want, in just about 2 minutes. Four billion dollars is the retained income and the 3½ billion dollars is the dividend paid. Now, if you assume that the 3½ billion of dividends paid is some figure less than 100 percent, or is made up of less than 100 percent of the dividends of the publicly owned company, you immediately increase the amount of dividends that have been withheld by the privately owned company, by taking this example:

Let us assume the 3½ billions is divided 10 percent privately owned and 90 percent publicly owned. That means that 3½ billion dollars, 10 percent of that is $350,000,000; therefore, $3,150,000,000 represents 60 percent of the earnings of the publicly owned company. Consequently 100 percent would be some figure less than $5,800,000,000, leaving a greater amount than $1,700,000,000 as the earnings of the privately held company that have been withheld from distribution and will be distributed in dividends or a tax, if it suits the convenience of the owner of that company to do so.

The things I am for is not to tax them out of existence, but I say if that exists, and it certainly must exist otherwise, we will raise more revenue in the 78 percent bracket, the forty-some-odd billion dollars of national income; if it does exist, then I say a reasonable increase in the rates of tax on that class of a corporation, coupled with a reduction in rates on the individual so as to provide an inducement on the part of the owners of that class of corporations to pay out their earnings rather than retain them, I say we ought not to penalize them, we ought not to be punitive if for no other reason than a sense of knowing that it is better business to pay it out than to retain it, and leave the existing structure in connection with the widely owned company as it is, because in any event that type of company pays its earnings out in dividends, its stock is widely distributed and the United States, as a whole, benefits.

The CHAIRMAN. Thank you, Mr. Hubschman.

The CHAIRMAN. The next witness is Mr. Alex Glass, Wheeling, W. Va.

(No response.)

The CHAIRMAN. Mr. Glass, chairman, Wheeling Steel Corporation.

(No. response.)

The CHAIRMAN. Mr. F. E. Ringham.

Mr. RINGHAM. Yes, sir.

The CHAIRMAN. You represent the Illinois Agricultural Auditing Association?

STATEMENT OF F. E. RINGHAM, CHICAGO, ILL., REPRESENTING THE ILLINOIS AGRICULTURAL AUDITING ASSOCIATION

Mr. RINGHAM. If I might just say a word in explanation regarding my connections. I am a public accountant in Illinois located at Chicago. For the past 12 years I have been serving in the capacity of chief auditor for a large group of cooperative associations, agricultural

organizations. We have audited during this time about 325 to 350 companies each year, or a total of about 3,600 audits, and we have done all of their income-tax work, prepared their tax returns and prepared exemptions for those cooperatives that are entitled to exemption.

The service that I represent is affiliated with the Illinois Agricultural Association, which is a State farm bureau set up in Illinois, and is the largest State unit in the American Farm Bureau Federation.

My purpose in appearing before the committee this morning is not to protest the method of the tax employed in the new revenue act. It is rather to point out some disparities that will exist as between the several types of cooperatives, and as between a corporative association and a general business corporation.

I will read my statement, which is rather brief, and I would ask the privilege possibly of inserting an explanatory comment at some places.

Cooperative associations organized and operated for the purpose of marketing the products of members or other producers, or for the purpose of purchasing supplies and equipment for members and for others are exempt from Federal income tax under the provisions of section 101, subsection (12), of the Revenue Act of 1935 and similar sections of prior acts. This exemption is continued in the porposed Revenue Act of 1936. Under these provisions a cooperative association is permitted to be organized with capital stock if dividends are limited to 8 percent, and if the stock is held substantially by producers of agricultural products. Business may be done with nonmembers to an extent not in excess of the business transacted with members and reasonable reserves or surplus accruals are permitted for necessary purposes. After providing for dividends on the outstanding capital stock and after setting up reserves the balance of the net earnings or savings must be distributed on a patronage basis to all patrons—members and nonmembers alike. Cooperative associations meeting the above requirements are not affected, adversely or otherwise, by the new Federal revenue act.

Many cooperative associations, however, are unable to obtain the benefits of exemption for the reason that nonmember patrons do not participate in the savings or net earnings of the association. The laws of some States, providing for the organization of cooperative associations, require that patronage refunds or dividends shall be paid only to members or stockholders of the association, e. g., the Agricultural Cooperative Act of the State of Illinois. Likewise, a cooperative livestock commission association must conform to the regulations imposed by the Federal Packers and Stockyards Act, which prohibits the payment of patronage refunds to nonmember patrons. Such nonexempt cooperative associations, by the nature of their set-up, requiring the distribution of all earnings in excess of reasonable reserves for necessary purposes, have accomplished one of the objectives which the 1936 Revenue Act aims to accomplish, namely, the distribution of all corporate earnings not needed in the business. Yet this type of a cooperative association will be required to pay a larger income tax under the Revenue Act of 1930 than will a general business corporation having the same amount of net income and distributing the same amount of its earnings.

Under existing tax regulations, cooperative associations are permitted to deduct from net income the amount of patronage refunds paid, up to the proportionate amount earned on business done with

members, to arrive at taxable net income. It is presumed that this deduction will be permitted also under the 1936 act, since section 27 of this act, pertaining to preferential dividends, would bar the inclusion of patronage refunds in the dividend credit. Therefore, a cooperative association of this type can only use the dividend paid on stock as a dividend credit, whereas a general business corporation may include dividends on both preferred and common stock in its dividend credit. Since the rate of tax increases progressively as the dividend credit decreases, it is apparent that the cooperative will be required to compute its income tax at a much higher rate than other corporations with the result that the amount of income tax will be greater, even though the rate is applied against a lesser basic figure of adjusted net income, representing net income less deductible patronage refunds.

In order to illustrate the paradoxical-sounding statement above, two hypothetical cases are cited—one a general business corporation and the other a nonexempt agricultural cooperative association. Both organizations have 7 percent cumulative preferred stock, outstanding in the amount of $25,000, upon which the annual dividend requirement is $1,750. Both have 2,750 shares of nopar common stock, upon which dividends are declared at the discretion of the board of directors. With respect to the cooperative association, two shares of the common stock are held by each producer-patron as evidence of his right to vote and to participate in earnings on a patronage basis. Dividends on common stock in the case of the general business corporations are paid, of course, on a par share basis. Sales and net income are assumed to be the same in both companies and both declare the same amount of dividends on preferred and common stock.

In the hypothetical illustrations cited, I have shown the corporation tax computed under the 1934 Revenue Act and under the 1936 Revenue Act, both for general business corporation and for the agricultural cooperative association.

General Business Corporation

Basis of 1934 Revenue Act:		
Adjusted net income (before tax)		$10,000.00
(a) 7-percent dividend on preferred stock	$1,750.00	
$1 per share dividend on common stock	2,750.00	
Total distribution	4,500.00	
(b) Income tax: 13¾ of $10,000	1,375.00	
Total distribution and tax		5,875.00
Undistributed net income, to surplus		4,125.00
Basis of 1936 Revenue Act:		
Adjusted net income (before tax)		10,000.00
(a) 7-percent dividend on preferred stock	$1,750.00	
$1 per share dividend on common stock	2,750.00	
Total dividend credit (45 percent of net income)	4,500.00	
(b) Income tax: 13.7097 percent of $10,000	1,370.97	
Total distribution and tax		5,870.97
Undistributed net income, to surplus		4,129.03

Agricultural Cooperative Association (nonexempt)

Basis of 1934 Revenue Act:		
Adjusted net income (before tax)		$10,000.00
Less patronage refund to common-stock holders (2½ percent on $110,000 sales to members)		2,750.00
Taxable net income		7,250.00
Income tax (13¾ percent of $7,250)	$996.88	
7-percent dividend on preferred stock	1,750.00	
Total preferred dividend and tax		2,746.88
Undistributed net income, to surplus reserves		4,503.12
Basis of 1936 Revenue Act:		
Net income		10,000.00
Less patronage refund (as above)		2,750.00
Adjusted net income (before tax)		7,250.00
(a) 7-percent dividend on preferred stock (dividend credit 24 percent of adjusted net income)	$1,750.00	
(b) Income tax (21.1613 percent of $7,250	1,534.19	
Total preferred dividend and tax		3,284.19
Undistributed net income, to surplus reserves		3,965.81

In each of the foregoing computations a distribution of $4,500, or 45 percent of the net income, was made, yet the income tax on the general business corporation was $4.03 less under the 1936 act than under the 1934 act, while the income tax imposed on the cooperative association by the 1936 Revenue Act increased $537.31, or approximately 54 percent over the tax figured on the 1934 basis. Furthermore, the cooperative association will be required to pay about 12 percent more income tax under the 1936 act than a general business corporation having the same net income and making the same distribution.

I might digress there for a moment to cite two illustrations of actual cooperative associations in the State of Illinois and to show the effect of the tax upon these companies, because I think they are significant.

There is a cooperative association at Bloomington, Ill., which paid a net income tax under the 1934 act for their fiscal year ending November 30, 1935, of $1,941.34. If the 1936 act is applied to the same net income, with the same distribution, their tax will increase to a total of $4,053.59, an increase of 109 percent over the tax of the 1934 rate.

In the case of another cooperative association at Grayville, Ill., they paid an income tax in 1935 of $1,051.33. Their tax would be increased $768.42, or an increase of 73 percent.

In both of these illustrations, I want to point out that 80 percent of the entire net income was distributed either in dividends or preferred stock, or in the form of patronage refunds to the holders of common stock; and yet, in spite of the fact that they distribute 80 percent of their net income, their tax will be increased from 73 percent to 109 percent over the 1934 rates.

In order to correct such disparities in the tax and to give the nonexempt cooperative the same benefits on business transacted with members as is now granted to exempt cooperatives, the following amendment to the Revenue Act of 1936, as passed by the House, is proposed:

In section 13, "Tax on corporations", insert a new paragraph as follows:

(d) NONEXEMPT COOPERATIVE ASSOCIATIONS.—Farmers, fruitgrowers, or like associations, organized and operated on a cooperative basis for the purposes set forth in section 101, but which are denied exemption from tax under this title for the reason that nonmember patrons do not participate in the savings of the organization, shall be subject to taxation under this title only on that portion of the adjusted net income realized from business carried on with nonmembers of the organization: *Provided*, That the books and records of the cooperative shall afford a means for allocating the earnings on such nonmember business. The dividend credit as defined in section 27 in the case of such nonexempt cooperative associations shall be a percentage of the total dividends paid (whether on capital stock or on a patronage basis or both) equal to the percentage which the business transacted with nonmembers is of the total business transacted during the taxable year.

Also change the enumeration of the present paragraphs (d) (e), and (f) to (e), (f), and (g) respectively. It may also be necessary to make some revision in section 27, paragraph (h) to except patronage dividends from the classification of "Preferential dividends".

The effect of the amendment to section 13 as proposed will be to exempt from income tax all income earned on business transacted with members, whether such earnings are distributed to the member-patrons or are retained in reserves in reasonable amounts and for necessary purposes, and to tax the earnings on business done with nonmembers on exactly the same basis as in the case of other business corporations; that is, by taxing the undistributed income on such nonmember business.

I cited an illustration of the result using the same hypothetical cases in the result of the 1936 tax. I want to point out with reference to this illustration that the result accomplished here could be accomplished by the method of dividing these cooperative associations into two corporations, one a cooperative and one a general business corporation. All of the business which was done with the members would be allocated to the cooperative associations. All of the business done with the nonmembers would be transacted by the general business corporation. If that situation were obtained, the cooperative part of this enterprise would be granted exemption under existing laws from income tax, and the business corporation part—that is, the part on which profits were earned—to wit, would be taxable the same as any other business corporation. We do not believe that it should be necessary to set up a dummy corporation alongside of a cooperative in order to effect equality as between the tax burden, and we believe that this amendment will accomplish that very thing.

The following example, using the same hypothetical case as in the preceding computations, will illustrate the procedure:

	Business with all patrons	Business with members	Business with nonmembers
Classification of sales.....percent..	100	55	45
Net income.....	$10,000.00	$5,500.00	$4,500.00
(a) Dividends on preferred stock.....	1,750.00	962.50	787.50
Patronage dividends (paid to members only but charged proportionately against income of member and nonmember business).....	2,750.00	1,512.50	1,237.50
Total distribution.....	4,500.00	2,475.00	2,025.00
Dividend credit on nonmember business is 45 percent of adjusted net income on nonmember business.			
(b) Income tax (13.7097 percent of $4,500).....	616.94	None	616.94
Total distribution and tax.....	5,116.94	2,475.00	2,641.94
Undistributed net income, to surplus reserves....	4,883.06	3,025.00	1,858.06

We believe the method outlined to be fair and equitable as between the exempt and the nonexempt types of cooperatives and also with respect to general business corporations.

Senator CAPPER. You are giving some very interesting statements there of the effect of this proposed 1936 tax. To what extent will cooperatives generally be affected? Will your hypothetical cases apply to a large number of cooperatives?

Mr. RINGHAM. Yes, sir; I think it will, Senator Capper, because these illustrations apply to cooperatives that distribute 80 percent of their profits, and it is usual with cooperatives that they make a large distribution. They are set up for that purpose, to effect savings for their members, so they do accomplish the distribution of earnings, and yet with that large distribution, 80 or 90 percent—we have some companies that distribute 90 or 95 percent of their net earnings, and yet their tax will be increased all the way from 30 percent to over 100 percent.

LANSING, MICH., *May 9, 1936.*

CHESTER H. GRAY,
Washington representative, American Farm Bureau Federation,
Washington, D. C.

Michigan State Farm Bureau Board in session yesterday sees danger to cooperative association in Revenue Act of 1936 which has effect of withdrawing protection afforded by previous measures. Board by resolution heartily endorses comment on same contained in brief by Fred R. Ringham, manager, Illinois Agricultural Auditing Association, and urges adoption of amendment he proposes or language of similar effect.

C. L. BRODY.

The CHAIRMAN. Thank you very much.

The next witness is Mr. John Sherman Myers.

STATEMENT OF JOHN SHERMAN MYERS, NEW YORK CITY

The CHAIRMAN. Have you a brief, Mr. Myers?

Mr. MYERS. Yes, sir; I have a statement that I would like permission to file.

The CHAIRMAN. Put that in the record.

(The same will be found at the conclusion of Mr. Myers' statement.)

Mr. MYERS. I represent a group of organizations primarily located in New York that are distinctly concerned over the classification for tax purposes of property aggregating well over $100,000,000, directly owned by at least 75,000 individuals scattered throughout the entire land. In addition to the organizations which I directly represent, there are undoubtedly a great many others, and I estimate that the property held by them will aggregate another two or three hundred million dollars additional.

These organizations are not corporations, they are entirely different from corporations, and I do not propose to argue for or against any particular bill which is before you gentlemen for tax purposes. I am concerned, however, in the treatment of these organizations which are not corporations and yet which if the bill such as we have under the discussion is enacted, or I may say any other bill, would be subjected to taxes which will place them at a most unfair disadvantage as compared with the corporations.

These organizations make available to the small investors primarily small investors, although large investors are interested in them, an opportunity of obtaining an interest in a widely diversified group of securities. These are purchased and are deposited with the trustee. The trustee is normally an important bank or trust company. The beneficiaries of these trusts are either credited directly with their proportionate share of that property, or else the trustee issues to them certificates of participating interest which they hold and which represent their undivided share of the trust property.

Senator COUZENS. Are they comparable to the Massachusetts plan?

Mr. MYERS. Insofar as the Massachusetts plan can be directed toward the investment of securities, which, of course, can be, they are comparable but by no means the same. An interesting feature and a very significant one comparing this type of organization with the investment corporation is that the beneficiary is given the right by carefully drawn trust agreement to withdraw from the trust at any time his share of the property or its equivalent in cash. The trust agreements are elaborate, they go into minute detail, the respective rights of the trustee and the beneficiaries in and to the property are set forth fully, and, of course, they are very difficult, if not impossible, in many instances to amend.

Senator COUZENS. How does the present law apply to them?

Mr. MYERS. May I go back before that and say this, that at the time of the first conception of this type of organization, which was at least 1923 and perhaps before, the sponsors of these organizations, and indeed the Bureau of Internal Revenue, took the idea that they are taxable as strict trusts under section 161 of the current laws, and in some instances the Bureau specifically ruled that these organizations were trusts and not taxable as associations, and therefore subject to tax at corporation rates.

Senator COUZENS. At what rate were they taxed? That is the point I am trying to get.

Mr. MYERS. The individual beneficiary himself paid the tax on the income which the trust received.

Senator COUZENS. So the trust paid no tax at all?

Mr. MYERS. The trust itself paid no tax at all, because the income was all distributed to the beneficiaries.

During the last few months, there has been a distinct tendency on the part of the Bureau and others to look upon these organizations as corporations under the definition of corporations which is contained in past acts and which is carried through in the present act, namely, associations which are subject to the same tax rate as the corporations are.

Indeed, in one or two instances, I believe the Bureau has specifically ruled that these organizations come within that definition.

Under a bill such as is presently before the committee, these organizations if they are to be taxed as a corporation will be subjected to certain rather serious disadvantages. Most of them require in those trust agreements, which I say are very difficult and in some cases impossible of amendment, that the income and profits received by the trustee on the underlying property be distributed twice a year. That distribution cannot be made in its entirety within the calendar year. They make a distribution on January 15 which will cover the income received during the last 6 months' period in the preceding calendar year. It is a physical impossibility for them to make that distribution of all of that income in that year. They have got to have a certain period of time in which to get their material together and to make ready a very substantial number of payments to the various beneficiaries.

Not to permit a dividend credit to an organization of that character merely because the dividend was not paid in the calendar or taxable year in which it was received by the trustee, represents an obvious inequality and one which cannot readily be cured by any amendment of the trust agreement because of the practical difficulties involved in it.

Another inequality presents itself in connection with section 27 (j) of the proposed bill which provides, you will remember, that if any corporation stockholder of 50 percent of the securities of the given corporation receives dividends from that corporation, the dividends so received are not allowed as a dividend credit.

I know of one instance in organizations of this character where one company has made an investment in a trust of this nature which is in excess of 50 percent of the total value of it. The shares of stock that that company holds, the trust shares that it holds, carry no vote, there is no possibility whatsoever of any control, directly or indirectly, by the ownership of that amount in trust property, the administration being set up by a trust agreement, and consequently if this trust is not permitted its deduction for the dividends that are paid to that large holder of its shares, the tax that it will have to pay will be a terrific burden on the innocent minority of the stockholders who have to bear their share of it, and, in my considered opinion, will result in that stock being liquidated through the shareholders themselves taking advantage of their right to withdraw from the trust at any time.

There are a number of administrative difficulties and inequalities that I think I won't take your time with—I have covered them here, but I won't take your time to discuss orally. I want, however, to make a certain recommendation in regard to the taxation of organizations of this character which I believe will meet all of their difficulties, which will follow along the tax theory which the House bill has adopted, and which I believe is in line with the declared recommendations of the administration.

If these organizations are specifically taxed as trusts under section 161, you will find that the theory of the House bill, namely that the ultimate individually received income be taxed at individual rates, will be carried out.

It has always been the tax theory that if the income which is received by the trust is distributed out to the various beneficiaries, the trust itself as an entity pays no tax that compares with the corporation that has distributed all of its earnings, and the individual beneficiaries to whom the income has been distributed, are themselves taxed at individual rates, including the surtax, and in the event that any of the income of the trust is not distributed, then the trust as an entity pays individual income tax including the normal tax rates, and the surtax is on that income which is not distributed. This is not a new theory, this is the theory of taxation of trusts which the previous revenue acts have adopted and which is carried forward in sections 161 and 162 of the House bill which is before you, and if this House bill were so amended to make it clear that the organizations such as I have described—and I do not mean to include any other organizations that might be looked upon as holding companies or otherwise—I am including true trusts in unincorporated form of course, wherein the trustee is a bank or trust company, which operates under a declaration of trust or trust agreements, which permits the beneficiary at any time to withdraw the interest in the trust in kind or its equivalent value in cash, and which affords to him a reasonable diversification of the many securities placed into the trust.

Those are the trusts, gentlemen, that I want treated not as corporations, which they are not, but as trusts which in fact they are. And I think the position that I take on behalf of all of these organizations is not inconsistent with the attitude of those who have sponsored this bill, and I call your attention to the fact that the President, in June 1935, when he sent a message to the Congress recommending an intercorporate dividend tax said this:

> Bona-fide investments that submit to public regulation and perform the function of permitting small investors to obtain the benefit of diversification or risk may well be exempted from this tax.

Senator COUZENS. Are these trusts under any Government regulation?

Mr. MYERS. Those that have been distributed prior to the Securities Act of 1933 have been distributed pursuant to the local blue sky laws of the various States, and since the Securities Act of 1933 they have been distributed under that act. Furthermore, the trustee in every instance has been a substantial bank or trust company which itself is under the regulation of the appropriate public office.

Senator COUZENS. But the portfolio is never examined, or your accounts, are they?

Mr. MYERS. Other than the fact that they are completely revealed as part of the set-up, and that investors at all times may know exactly what securities his money is invested in.

The CHAIRMAN. You can file your brief and it will be given consideration.

Mr. MYERS. I have sought an opportunity to appear before this committee on behalf of a group of organizations who are directly interested in the future classification for tax purposes of property aggregating well over $100,000,000 directly owned by at least 75,000

individuals. In addition to the organizations which I directly represent, there are a great number of others scattered in all parts of the country with property which I estimate aggregates approximately between two and three hundred millions more.

These organizations which I represent are not corporations. They are fundamentally and essentially different from corporations. They make available to investors, particularly to small investors, a means of obtaining an interest in a diversified group of securities. These securities are held by a trustee; usually an important bank or trust company. The beneficiaries are appropriately credited with their pro-rata shares of the securities held or, as in many instances, certificates of participating interests, representing undivided interests in such securities, are issued to the beneficiaries. The beneficiary is entitled by the terms of the trust agreement to at any time surrender his interest and obtain his share of the underlying property or its equivalent in cash. An elaborately drawn trust agreement specifically sets forth all of the details of the administration of the property by the trustee and the respective rights of the trustee and the numerous beneficiaries.

What I have just described covers the fundamental aspects of all of these organizations, although of course there are refinements and variations in individual cases, but in every instance the fundamental characteristics that I have just outlined are present.

I propose to set before you certain facts which will clearly show why these trusts should be treated like any other trusts for tax purposes.

This type of organization has been formed and has been in existence since as early as 1923 or before. Both the sponsor and trustees, as well as the Commissioner of Internal Revenue, treated such organizations as true trusts for tax purposes. Recently, however, some doubt has been cast upon this manner of treatment and it has been suggested, and in some instances ruled by the Commission of Internal Revenue, that such organizations be treated for tax purposes as corporations. I know of no court decision upon the subject. If under a tax bill such as has been passed by the House they are to be treated as corporations, a great injustice will be done to these organizations since, as compared with corporations, they will be under a most serious disadvantage.

Under the trust agreements of most of these trusts the trustee is required to make a distribution of income twice each year; one in July, covering the income received for the 6 months' period ending June 30, and the other in January, covering the income received for the 6 months' period ending December 31. It is a physical impossibility for the trustee to distribute within a given taxable year all of the income it receives in that year and consequently any distribution of such income made after the year end will not constitute a dividend credit under section 27 of the bill as now drawn and the trust will suffer accordingly.

Another obvious inequality presents itself in connection with section 27 (j) which provides that if more than 50 percent of the stock is held by one corporate stockholder, the dividend paid to that stockholder is not included among the dividend creditors. Furthermore, in at least one instance, where it is known that one of these organizations owns more than half of the trust shares issued by another, that

ownership is made for investment purposes only, the shares held carry no vote, and consequently there is no element whatsoever of control or other influence directed toward the trust or the management of its property and to deny the trust, under such circumstances, the benefit of a credit for the dividends paid for this holder of its shares is obviously unjust and the size of the tax that would have to be paid by virtue of this circumstance alone would utterly destroy both the trust, whose securities were held, and the organization which held them.

Having pointed out to you a number of the more outstanding injustices that the proposed tax bill would place upon these trusts, I wish to make to you certain recommendations which I believe, if adopted, would solve the difficultiea; would be in keeping with the purpose of the tax bill as it now stands; and would be consistent with the declared policies of the administration.

It is suggested that these organizations be classified for tax purposes, as strict trusts under section 161 of the bill. If I correctly understand the objectives of the proposed legislation, one of them is to induce the organizations to distribute to its shareholders all or a substantial portion of its earnings. The bill as drawn exempts from taxation organizations which completely distribute within the taxable year all of the earnings of that year.

This underlying principle has, in connection with trusts, been in existence for a great many years in the various tax bills and is continued in sections 161 and 162 of the new bill where all of the income of a trust is currently distributable by a trustee to the beneficiaries, the trust pays no tax but the entire tax is paid by the beneficiaries and in the event that the income is not all currently distributed, the trust, as an entity, pays taxes based upon the individual tax rates, including the surtax. Thus to classify trusts of the character that I have described to you as strict trusts under section 161 carries into full force all of the avowed intentions of the proposed tax bill as applied to corporations.

In this connection I have found it very significant that investment trusts, such as I represent, have been recognized as perhaps being worthy of special treatment for tax purposes in 1935. At that time the Congress had under consideration the advisability of including the dividends received from other corporations in the taxable income of a corporation. In his message to Congress on June 19, 1935, in which this tax of intercorporation dividends was recommended, the President said as follows:

> Bona-fide investment trusts that submit to public regulation and perform the function of permitting small investors to obtain the benefit of diversification or risk may well be exempted from this tax.

For your convenience I would like to file a memorandum embodying the remarks I have just made, together with a proposed amendment embodying the suggestions here urged. I would also like to file memoranda separately prepared by representatives of organizations which I represent. These supplemental memoranda have been prepared with a view of describing the particular organizations on whose behalf they have been prepared. I understand that attached to these supplemental memoranda are proposed amendments which will cover the problems of those particular organizations. I may add that the proposed amendment annexed to my memorandum is sufficiently

broad to cover these particular problems, as well as the problems of other organizations which I represent.

(The memorandum referred to follows:)

PROPOSED AMENDMENT TO HOUSE BILL NO. 12395 IN ORDER TO TAX UNINCORPORATED INVESTMENT TRUSTS AS STRICT TRUSTS

1. Amend section 161 (a) of House bill 12395 by striking out the word "and" at the end of subdivision (3) thereof and by striking out the period at end of subdivision (4) thereof and substituting a semicolon and adding the word "and", and by adding a new subdivision numbered (5) reading as follows:

"(5) Income received by trusts created by trust agreements or declarations of trust, by the terms of which the trustee is a bank or trust company, subject to the supervision or regulation of the Government of the United States or of any State or territory thereof or of the District of Columbia, and by the terms of which any beneficiary may at any time withdraw his share in the trust property, or its equivalent in cash, and by the terms of which there is provided a method for diversification of the investments."

2. Amend section 701 (a) (2) of House bill No. 12395 by changing the period at the end of the said section to a comma and adding the following: "but shall not include the trusts described in section 161 (a) (5)."

MEMORANDUM ON BEHALF OF THE PENNSYLVANIA CO. FOR INSURANCE ON LIVES AND GRANTING ANNUITIES OF PHILADELPHIA, PA.

(Trustee under deeds of trust for: (1) Capital Savings Plan, Inc.; (2) Financial Independence Founders, Inc.; (3) Bank & Insurance Shares, Inc.; (4) Trusteed Income Estates; (5) Income Foundation, Inc.; (6) Future Requirements Plan; (7) National Trustee Fund, Inc.; (8) Wellington Foundation, Inc.; (9) Ben Franklin Foundation, Inc.)

UNINCORPORATED INVESTMENT TRUSTS AND HOUSE BILL NO. 12395

The Pennsylvania Co. for Insurance on Lives and Granting Annuities is trustee under nine so-called periodic-payment savings-plan trusts with a present net worth of approximately $5,000,000. The funds held in trust under these plans represent investments by more than 15,000 individual investors. The plans under which the company is trustee have been in existence only for the last 4 or 5 years so that the amount presently held in trust and the number of investors so investing give no indication of the amounts and persons which will ultimately be involved. The trust plans now outstanding represent a value of approximately $25,000,000 upon completion of the periodic payment.

The form of trust in which the company is interested is merely one of several forms of trusts devised in recent years as a means whereby small investors can secure diversification of securities. It is the purpose of this memorandum to present to the committee the technical set-up of one particular form of trust so that the committee may understand the nature and purpose of the trusts which the company feels distinguishes them from associations and justifies the contention that such trusts should be classified for income-tax purposes as true trusts by an appropriate amendment to section 161 (a) of the present revenue bill.

THE FORM OF THE TRUST AGREEMENTS AND CERTIFICATES ISSUED THEREUNDER

In each of these trusts there is a trust agreement executed by the company which sells the certificates and the trust company as trustee. The holders from time to time of the certificates issued thereunder become parties by accepting and holding their certificates. The trust agreements provide for the issuance of the certificates and either (a) provide rather fully for the rights and privileges of the holders, or (b) provide the general outline of the plan and leave to the certificate itself the detailed statement of the rights and privileges of the holder.

The so-called certificates take the form of a contract between the selling company and the holder, whereunder the holder either agrees to make to the trustee either periodical payments or one lump-sum payment. In the case of periodical payment certificates the trustee is authorized to deduct from each payment (a) an amount for the service fee of the selling company during the first year of the certificate, (b) a trustee's fee at the rate of 25 cents per unit per month, and

(c) In the case of certificates carrying life-insurance benefits, an amount sufficient to pay the holder's proportion of the premium payable upon a reducing group life-insurance policy under which his life is insured to the extent of the payments which from time to time remain due. Trustee is directed to purchase certain designated trust shares with the residue of the payments, and is also directed to invest the income in the same trust shares. Prior to the time when all payments have been made, the certificate holder has the right to terminate his certificate and receive either the trust shares then held for him, or the proceeds thereof (except in one instance where he receives only proceeds). When he has made all the payments and his certificate has matured, he has the right either to terminate his certificate and receive trust shares or proceeds; or to direct the trustee to hold his trust shares and continue to reinvest the income; or to direct the trustee to hold his trust shares and pay the income for him. After maturity the trustee deducts 25 cents per unit per quarter from the income as its trustee's fee. The above are the most important options.

Under all these trusts, the trustee's fees are deducted from the income, and the certificate holder has the right (a) to withdraw his trust shares or the proceeds thereof at any time; (b) to direct the trustee to reinvest the income, or (c) to direct the trustee to pay the net income to the holder.

THE PURPOSE OF THE PLANS

The purpose of these so-called saving plans is to afford a means by which the certificate holders may build up a future estate. By far the greater number of certificates sold are those providing for installment payments which are especially attractive to persons of small means. There was no purpose or desire to set up these plans to create a means of avoiding the payment of surtaxes, and as trustee of these plans, the Pennsylvania Co. for Insurance on Lives and Granting Annuities does not desire that they be availed of for that purpose.

METHOD OF ADMINISTRATION

The trustee receives from day to day the payments made by various holders and comingles the cash in one account. After making authorized deductions from all of the money received during a particular day, the trustee places an order for the number of trust shares which can be purchased with the total net amount at the price designated in the certificate or in the trust agreement, which is usually the market bid price. Upon delivery of the trust shares to the trustee it pays for them, and receives trust share certificates registered in the name of its nominee.

The trustee makes no attempt to physically set aside any particular trust shares for any particular certificate holder. It does, however, keep a separate card account for each certificate holder upon which is shown the number of payments made; the deductions therefrom; the balance for investment; the number of trust shares purchased each time; and the number of trust shares carried to the third decimal place, which it holds from time to time for the certificate holder.

When the trustee receives the dividends upon the trust shares held by it, it pays out to the holders who have elected to receive their dividends, their net pro-rata share. In the great majority of cases, however, the holders elect to have their dividends reinvested, and the trustee in those cases, after making authorized deductions, if any, invests the remaining net amount in additional trust shares in the manner above provided. Here, again, when the trust share certificates are received there is no attempt to physically set aside any particular trust shares for any particular holder. The trustee, however, keeps a separate income card account for each holder upon which is shown his pro-rata share of the dividends in cash and the number of trust shares carried to the third decimal place purchased with said cash; and also enters upon the separate card account above referred to, the amount of the trust shares purchased with the dividends.

When the investor makes a complete withdrawal or a partial withdrawal, or when his account is terminated on account of delinquency, the trustee debits his account with the number of trust shares sold or withdrawn, and, except in the case of partial withdrawal, his separate account is closed.

POWERS OF THE TRUSTEE AND THE SELLING COMPANY

The principal powers of the trustee are strictly administrative. It receives the payments and makes certain deductions authorized by the holder. Pursuant to the terms of the certificate it invests in one specified investment, to wit: the

trust shares of a certain fixed investment trust. The trust shares which from time to time are held for the benefit of each certificate holder, are at all times subject to withdrawal, and in the case of withdrawal the trustee follows the instructions of the holder by either selling and remitting proceeds or by delivery of trust shares. The trustee cannot be removed as to certificates already issued, and has agreed to administer them until termination. There is no managing company or investment counsel.

The company and the trustee have retained certain powers which are comparatively unimportant. For instance, the right to close out delinquent installment accounts, which has in practice been exercised only in cases where only a few payments have been made and the holder has lost interest in his plan. The trustee's right to compel the holder to terminate his certificate after it has matured or after the extended period has elapsed is designed to permit the trustee to close out long standing accounts if it becomes necessary. In the case of certain of the trusts (but not in all), there is also a right of substitution of trust shares in certain events; the selling company having the right to make substitution after giving notice to certificate holders if they do not dissent, and the trustee having the right to substitute with the written assent. The purpose of these provisions is to permit a change in the medium of investment if it becomes necessary for the protection of the certificate holder; for instance, in case the trust shares are no longer available on the market. The purpose is not to provide a means whereby the trust shares may be dealt in to take advantage of changing market conditions.

THE FEDERAL TAX PROBLEM

It is our contention that these trusts should be classed as trusts and not as associations for income-tax purposes. We point out, that neither the trustee nor the selling company has any material control over the trust shares. The medium of investment is fixed by the certificate which the holder purchases and the trustee must purchase the trust shares of a certain designated trust with his money after the authorized deductions have been made. The certificate holder has at all times a right to direct that the trust shares held for his account be sold and that the proceeds thereof be remitted to him. One certificate holder has at all times a right to direct that the trust shares held for his account be sold and that the proceeds thereof be remitted to him. One certificate holder is in no way concerned with what any other certificate holder may direct the trustee to do with his trust shares. The certificate holders do not have beneficial interests in an undivided pot of varied securities. A definite number of trust shares of one investment trust are held for each certificate holder by the trustee. The trustee's functions are, in fact, so limited that it is more a custodian or agent than a trustee in the ordinary sense.

The trusts have none of the elements of management or of being an investment business which have led to the rulings of the Department of Internal Revenue that these trusts are to be classed as associations for tax purposes. The trustee is not engaged in buying and selling securities under the directions of a management company or of investment counsel. It can invest only in the trust shares of one investment trust unless the medium of investment is changed with the consent of the holders. The purpose of the trust is to afford a medium of saving and not a medium of speculation.

Since each certificate holder may at any time terminate his certificate and revest in himself the trust shares held for his account or the proceeds thereof, these trusts are completely revocable by all the persons beneficially interested therein. All of the taxable income of these trusts whether distributed or reinvested at the direction of the certificate holder, is therefore taxable to the individual certificate holders under sections 166 and 167 of the revenue act.

We submit: (1) That these trusts are to be classified as trusts for income-tax purposes, and (2) that all the taxable income therefrom is taxable to the individual certificate holders.

The City Bank Farmers Trust Co. of New York, has also submitted a memorandum setting forth the nature of the trusts in which it acts as trustee which memorandum sets forth many, if not most, of the problems which result if the trusts for which the Pennsylvania Co. for Insurance on Lives and Granting Annuities is trustee, as outlined above, are classified as associations. It seems therefore unnecessary to duplicate here the statements contained in the material furnished by the City Bank Farmers Trust Co. of New York, as to the tax

problems. To that extent, therefore, your committee is respectfully referred to the City Bank Farmers Trust Co.'s memorandum.

Attached hereto is a suggested form of amendment to the revenue bill which it is believed will provide relief for the trusts in which the Pennsylvania Co. for Insurance on Lives and Granting Annuities is interested, if your committee feels that such trusts are entitled to such relief.

PROPOSED AMENDMENTS TO THE NEW TAX BILL IN ORDER TO TAX UNINCORPORATED INVESTMENT TRUSTS AS STRICT TRUSTS

1. Amend section 161 (a) of the tax bill by striking out the word "and" at the end of subdivision (3) thereof, and by striking out the period at the end of subdivision (4) thereof and substituting a semicolon and adding the word "and", and by adding a new subdivision numbered (5), reading as follows:

(5) Income received by unincorporated investment trusts created by trust agreements or declarations of trust where the trustees are substantially limited to holding the trust property, collecting and either distributing or crediting the income to the beneficiary, and liquidating and distributing the principal, any power of sale pending final liquidation being limited to the conservation of the trust property and not being for the purpose of realizing a profit, and there being no power to purchase securities or other property by the trustee or trustees except incidentally or by way of original investment of cash funds.

2. Amend section 701 (a) (2) of the revenue bill by changing the period at the end of the said section to a comma, and adding the following: "but shall not include the unincorporated investment trusts described in section 161 (a) (5)."

MEMORANDUM SUBMITTED ON BEHALF OF CITY BANK FARMERS TRUST CO.

(As trustee for (1) cumulative trust shares, (2) North American trust shares (1955), (3) North American trust shares (1956), (4) North American trust shares (1958), (5) North American bond trusts, (6) miscellaneous trusts)

UNINCORPORATED INVESTMENT TRUSTS AND THE NEW REVENUE BILL (H. R. 12395)

This memorandum is submitted on behalf of City Bank Farmers Trust Co., as trustee for the following trusts, the approximate present market value of the trust shares of each trust being set opposite the name of each trust:

	Approximate market value
(1) Cumulative trust shares	$7,000,000
(2) North American trust shares (1955)	20,500,000
(3) North American trust shares (1956)	21,500,000
(4) North American trust shares (1958)	325,000
(5) North American bond trusts	7,000,000
(6) Miscellaneous trusts	450,000
Total	56,775,000

City Bank Farmers Trust Co., as such, is not individually interested in the application of the new tax bill, but is interested therein only as trustee of the foregoing trusts.

While there are certain minor differences in the provisions of each of the trust agreements creating the above-mentioned trusts, there are certain attributes that are common to all. Summarizing these attributes it may be said that each trust affords to the small investor (a) diversification of investment, (b) investment counsel service, and (c) economy in the collection and distribution of dividends. In each case, not less than 25 securities of as many leading American corporations, are placed in trust with this trust company, and this trust company issues certificates of undivided interest therein, in proportion to the investment of each beneficiary. Certificates representing these participations are generally and hereinafter referred to as "investment-trust shares."

In addition to the purposes already mentioned, the other primary purposes of the creation of these trusts for the investors or beneficiaries is the immediate realization of income, and the long-term realization of appreciation in value of the underlying securities.

In these trusts, no substitution of underlying securities is permitted. The trustee's duties and functions are extremely limited. If it appears that a particular security contained in the trust reserves, from a long-term investment stand-

point, is likely to depreciate in value, it is eliminated and the proceeds, along with all other current earnings and profits, are distributed to the beneficiaries at the next fixed distribution date. The periodical distributions, usually semiannual, are fixed to the extent that all earnings and profits must be included therein. Therefore in general, no securities can be bought; the trustee cannot buy and sell securities for profit, and the trustee cannot trade in securities.

Contrary to the ordinary functions of a board of directors of a corporation, the trustee has no discretion in the matter of handling the cash, or other property, at any time contained in the corpus of the trusts.

At any time, and from time to time, a trust shareholder or beneficiary may surrender to the trustee his certificate or certificates for trust shares and receive in exchange therefor, his proportionate share of the trust res., either in kind, in cash, or partly in both.

The average investment in the foregoing trusts for each beneficiary is approximately $825.

(1) The tax bill should specifically classify investment trusts of this character: When most of these trusts were created, specific rulings were obtained from the Treasury Department that they were strict trusts for taxation purposes and not associations. Due to the change in Treasury Department Regulations in 1935 and certain rulings (but without any pertinent change in the revenue laws) considerable doubt has arisen as to whether these trusts are taxable as strict trusts or as associations. Either under the present tax law or the proposed tax bill, a vast amount of litigation will undoubtedly arise over the question whether different trusts are subject to tax as associations or subject to tax as strict trusts. A large part of this litigation could doubtless be avoided by a specific classification of trusts of this character in the new bill.

(2) Whether classified as strict trusts or as associations, the trusts should not be subject to tax where all of the income thereof is currently distributable to the beneficiaries. The unincorporated investment trust under discussion, if not the only medium, is certain the most convenient medium for investment by the small investor in a diversified group of securities, without at the same time the investor losing practically all direct control over his share of the said securities. In other words, the "insulation" between a trust shareholder and his share of the trust res is more apparent than real, since at any time, he can present his trust shares and receive from the trustee in cash or in property, his proportionate part of the trust res. If any substantial additional taxes have to be paid on the steps intermediate between the payment of dividends by corporations whose securities comprise the trust res and the ultimate receipt by the trust shareholder of his share of these dividends, the advantages afforded by the intermediate trust will be wholly lost.

In most cases the duties and functions of the trustee are irrevocably fixed by the trust agreement as are also the rights and interests of the beneficiaries or trust shareholders. As compared to investment corporations, therefore, many of the unincorporated investment trusts will be penalized and discriminated against under the new tax bill. In other words, if these trusts are brought within the provisions of the new bill relating to corporations, the result will be that in many instances they will pay taxes which, if they were incorporated, they could, and presumably, under the very terms of the bill, would be expected to, legitimately avoid.

(3) Assuming that these trusts are to be classified as associations and taxable as corporations under the new tax bill, the following are some inequities or ambiguities which will arise.

(a) Unincorporated investment trusts are usually required by the trust agreements to make two semiannual distributions of the income of the trust, one in July for the first 6 months of the calendar and the other in the following January for the last 6 months of the calendar year. Manifestly, it is impossible for the trustee to make a year-end distribution on the 31st of December, which distribution is to include all income up to the close of business on December 31. This explains why the earnings for the last half of the year are not actually received by the beneficiaries until on or about January 15. Any such distribution would not constitute a "dividend credit" under section 27 of the bill as now drawn.

It cannot be said that this inequity will in every case be offset by the fact that the distribution made January 15 of the taxable year (covering the earnings for the last 6 months of the previous year) would be allowable as a part of a dividend credit. Suppose, for instance, that a trust should realize a large capital gain in the first year and none in the second. A tremendous net tax, considering the 2 years together, would result.

Also, if it be assumed that one of these trusts, from year to year, substantially varies in size and income, the tax result will be purely speculative, even when the "dividend carryover" provisions of the bill are considered. (See sec. 27 (c)).

In most cases the trust agreements cannot be amended so as to provide for the physical paying out, during any calendar year, of every cent of income received during the said year, that is, without consent of 100 percent of the trust shareholders and of the trustee, which, of course, is obviously impossible to obtain.

(5) Where a trust shareholder presents his certificate to the trustee in exchange for cash and/or properly out of th trust res, it is doubtful under the new bill whether (the trust being considered an association) any part of such payment made out of earnings would constitute a dividend credit to the trust. These doubts arise from the provisions of sections 27 (g) and (i) and from section 115 (a), (b), and (c).

(c) In the case of some of the trusts, more than 50 percent of their trust shares are held by trustees under other trusts. In such cases both trusts would probably be utterly ruined because of the fact that the first trust would have to pay 42½ percent of its total income in taxes. This situation arises on account of section 27 (j) of the bill.

(4) The President has recognized that special consideration should be given to trusts of this character. In his message to Congress of June 19, 1935, recommending a tax upon intercorporate dividends, the President had this to say:

"Bona-fide investment trusts that submit to public regulation and perform the function of permitting small investors to obtain the benefit of diversification of risk may well be exempted from this tax."

As already indicated, it is estimated that the average investment in these trusts is less than $825. In most, if not all cases, the trustee is a bank or trust company subject to regulation by State or Federal authorities. In the majority of cases also the trust shares have been registered with and are subject to regulation by the Securities Exchange Commission.

(5) To tax unincorporated investment trusts as strict trusts would be in keeping with what appears to be one of the main objects underlying the new revenue bill. If the purpose and objects of the new bill are correctly understood, one of them is to prevent any trust or other organization from withholding from distribution to the shareholders a portion or all of the earnings of the trust or other organization, in order to avoid tax on the shareholders. As at present drawn, the bill puiports to exempt from tax all organizations which completely distribute within the taxable year all of the earnings of that taxable year. The same underlying principle has been existent for many years in sections 161 and 162 and corresponding sections of the tax laws. Thus, where all of the income of a trust is "currently distributable" by the trustee to the beneficiaries, the trustee pays no tax as a separate entity but the tax is required to be paid by the beneficiaries. In the trusts under discussion, all of the income must be distributed to the trust shareholders during the taxable year or within a brief period following the close of the year which will afford enough time merely for the trustee to compute the amount of the distribution and make physical payment. Thus, after deducting the expenses of the administration of the trust, all income paid out by the corporations whose securities are held by the trustee, is promptly passed on by the trustee to the beneficiaries who, in turn, are required to pay the tax. This is exactly what appears to be desired under the new bill in the case where a corporation distributes all of its earnings to its shareholders.

(6) Proposed amendment to the new tax bill to classify unincorporated investment trusts as strict trusts. There is attached hereto a memorandum setting forth proposed amendments to the new bill which will tax unincorporated investment trusts as strict trusts. As already pointed out, pending or proposed litigation may determine that most if not all of these trusts are already taxable as strict trusts. It would seem to be advisable from every point of view, therefore, to resolve these doubts by legislation.

PROPOSED AMENDMENT TO THE NEW TAX BILL IN ORDER TO TAX UNINCORPORATED INVESTMENT TRUSTS AS STRICT TRUSTS

1. Amend section 161 (a) of the tax bill by striking out the word "and" at the end of subdivision (3) thereof and by striking out the period at the end of subdivision (4) thereof and substituting a semicolon and adding the word "and", and by adding a new subdivision numbered (5) reading as follows:

"(5) Income received by unincorporated investment trusts created by trust agreements or declarations of trust where the trustees are substantially limited

to holding the trust property, collecting and either distributing or crediting the income to the beneficiaries, and liquidating and distributing the principal, any power of sale pending final liquidation being limited to the conservation of the trust property and not being for the purpose of realizing a profit, and there being no power to purchase securities or other property by the trustee or trustees except incidentally or by way of original investment of cash funds."

2. Change the semicolon at the end of subdivision (b) of section 162 to a period and add the following sentence: "In the case of the unincorporated investment trusts mentioned in subdivision (5) of paragraph (a) of section 161 hereof, where the fiduciary is required to distribute, or credit, the income or any part thereof of a particular taxable year within a reasonable time after the close of such taxable year, such amount shall, for the purposes of this subdivision (b), be deemed to have been 'distributed currently', within the taxable year in which the fiduciary received such income and the sums so distributed or credited after the close of the taxable year shall be deemed to be income of the distributees for the said taxable year."

3. Amend section 701 (a) (2) of the new bill by changing the period at the end of the said section to a comma and adding the following: "but shall not include the unincorporated investment trusts described in section 161 (a) (5)."

MEMORANDUM ON BEHALF OF EMPIRE TRUST CO., AS TRUSTEE AND INDEPENDENCE FUND OF NORTH AMERICA, INC.

This memorandum is submitted on behalf of Independence Fund of North America, Inc., and Empire Trust Co. in conjunction with the remarks of John S. Myers before the Senate Finance Committee in connection with House bill no. 12395.

It is believed that if we have been successful in demonstrating the seriousness of our problem and the inequality which must exist unless the position of these organizations be adjusted so that they stand on equal footing with the incorporated type of organization and the unincorporated type which has a flexibility of administration, the amendment suggested by Mr. Myers should be adopted. The form of that proposed amendment describes a class which is sufficient in its scope to include all organizations which will be confronted with the peculiar problems outlined. If that proposed amendment be adopted the beneficiaries of all such organizations will be treated in like manner. The effect will be to equalize the burden of the tax load.

The primary purpose of this memorandum is to describe in greater detail the hardship which will be wrought by section 27 (j), to one of the trusts sponsored by the Independence Fund of North America, Inc.

This trust is of the periodic investment type. A person, who in the trust agreement is designated a beneficiary, makes, pursuant to an agreement, regular, equal, periodic payments to the Empire Trust Co., as trustee. The Empire Trust Co. upon the receipt of each payment purchases as many cumulative trust shares as can be purchased with such payment at the market price on the day following the receipt of such payment. The trust shares so purchased are credited to the beneficiary on a "beneficiary account" kept by the trustee and are held by the trustee together with cumulative trust shares purchased for other beneficiaries. This trust has been operating since the summer of 1931. The liquidating value of the cumulative trust shares now held by the Empire Trust Co. as such trustee is approximately $4,700,000. We find that the total liquidating value of all cumulative trust shares which are outstanding is approximately $7,000,000 which means the Empire Trust Co. holds over 50 percent of the total issued and outstanding cumulative trust shares. Cumulative trust shares are shares of a fixed investment trust of which the City Bank Farmers Trust Co. is trustee. These trust shares had from time to time been issued in large quantities prior to the creation of the Independence Fund Trust. They were selected as a medium for investment because they afforded a means of acquiring an interest in a diversified group of securities at a price which, although fluctuating with the market prices of the underlying securities, was uniform and because of the fact that there would always be a cash liquidating value for such shares by reason of the fact that the City Bank Farmers Trust Co., as trustee was obligated to pay, upon certain of the trust shares the pro-rata share of the market value of the underlying securities.

The beneficiaries of the Independence Fund Trust as well as the holders of cumulative-trust shares other than the Empire Trust Co., as trustee, will thus find

themselves deprived of a considerable portion of the income of the cumulative-trust shares by reason only of a circumstance, over which they have no control.

The unfairness of this situation is patent—further discussion is unnecessary for the purpose of demonstrating such unfairness.

This individual case, when compared with the magnitude of the entire tax problem confronting the committee, is relatively small and for that reason it is appreciated that it cannot be urged as a valid reason for the abolition of section 27 (j) in its entirety. The individual hardship, however, can be entirely eliminated by placing the cumulative-trust shares in the category of a trust for tax purposes.

The CHAIRMAN. Mr. L. F. Orbe. Have you a brief you wish to file?

STATEMENT OF L. F. ORBE, CLIFTON, N. J., PRESIDENT, NEW JERSEY FLOUR MILLS CO.

Mr. ORBE. No; I have not.

I represent a small concern, a flour mill which has been in business for a great many years and always made a fair return upon its investment. Since the N. R. A. was declared unconstitutional, we thought perhaps that the A. A. A. would be in the same position, and we sold considerable flour at that time ex-tax, feeling that if the law was declared unconstitutional, we would take a chance.

The CHAIRMAN. You sold it free of tax?

Mr. ORBE. We sold it a low price without the tax.

The CHAIRMAN. In other words, you did not include the tax in your sales?

Mr. ORBE. Since the unconstitutionality of the A. A. A., the milling industry is refunding the tax generally to the buyers, and we have to follow suit. Naturally, we did not include it, and now we must return it, and felt that could be deducted from the windfall, which would be satisfactory. If the windfall would be charged retroactively last year where we made a profit and this year we are making an enormous loss for the size of our business, we would simply be thrown out of business. So that I would pray the committee in my case to make an exception to either allow that windfall to be added to the 1936 income so that it could reflect our true position and our true picture of the circumstances, instead of retroactively to 1935.

The CHAIRMAN. You made money in 1935?

Mr. ORBE. Yes; we did. We have always made money since we have been in business, since 1900.

The CHAIRMAN. Was there something else you desired to say?

Mr. ORBE. That is the only consideration I would like to ask.

The CHAIRMAN. Thank you for your suggestion. We will consider it.

The next witness is Mr. Gilbert L. Stevenson, Wilmington, Del.

STATEMENT OF GILBERT T. STEVENSON, WILMINGTON, DEL., REPRESENTING THE TRUST DIVISION, AMERICAN BANKERS ASSOCIATION

The CHAIRMAN. The American Bankers Association have presented a memorandum and a brief to us.

Mr. STEVENSON. It however did not include this angle of it. It did not include the trust angle.

Mr. Chairman and gentlemen, there are about 3,000 banks and trust companies in the United States that have trust departments, and for them I am asking that an amendment be made to the present revenue bill that will permit the more general use of common trust funds in connection with small trust accounts. I do not believe that this amendment will have any effect one way or the other on the amount of revenue realized from this bill. I do not believe that it will provoke any controversy or opposition by anybody. I do anticipate, as I think you gentlemen will see in a moment, that it will serve a very highly desirable humanitarian purpose, and this amendment is unanimously endorsed by the executive committee of the trust division of the American Bankers Association and by the executive council of the American Bankers Association itself.

The substance of this amendment is that in the case of small trust accounts, the funds of those small accounts be combined for investment purposes, and that this combined fund, which I shall call and which is usually called a common trust fund, shall not be taxed as an association, but that the small participating trusts themselves will be taxed, as all other trusts are taxed.

I do not care now to go into the technical features of this short amendment, because I have already gone into it carefully with the technical advisers of your committee. What I do want to do is briefly to call your attention to some of the social and economic angles of this amendment.

In the first place, gentlemen, we who are in the trust companies of this country are to be called upon more and more to accept and to administer small trusts. I know that a small trust is a relative term, that what would be a small trust in one community would not be a small trust in another community. I think, however, we can all agree that a trust of $25,000 or less would be a small trust even in New York City, and I think that we could agree that a trust of $10,000 or less would be a small trust anywhere.

The thing that will surprise you gentlemen, and it surprised me when I began to look into it, is how small the average trust in this country is. Based on figures of the Controller of the Currency, the average trust in this country is only $22,000, and in the national banks that are capitalized at $200,000 or less, it is only $10,500; and in towns and cities of 10,000 and less, it is only $8,500.

Another thing that you gentlemen will be interested in is the fact that trusts are diminishing in size. That is due to two reasons. In the first place, the estates themselves are diminishing, and in the second place, people of small means more and more are coming to banks and trust companies for trust service. I am connected with one of the larger and older trust companies in a city of 100,000, Wilmington, Del., and you would think that the trust accounts of that company would be mostly large accounts, and yet, yesterday morning before I came down here, I had an account made of the last 100 accounts that had been put on our books, and I was surprised to find that although the average of those accounts is $34,190, in that 100 there were 52 accounts of $10,000, and less, and in the 52 accounts there were 13 of $1,000 and less. In other words, gentlemen, we are today in a time of the small trust.

The small trust offers two very serious problems. The first of those is the problem of diversification. Not long ago I asked 29

representative trust investment officers from every section of our country, every section, what was the smallest amount that they thought that they could invest with proper diversification if they had the full investment power, and those answers ranged all the way from $10,000 to $100,000, and averaged $35,000.

But it does not take a trust investment officer, gentlemen, to tell you or me that a trust of $10,000 or less cannot be properly diversified. You put into that trust two $5,000 mortgages, and you let one of those mortgages default in interest, and half of your income is gone. You let one of those mortgages have to be foreclosed, and your principal is jeopardized, and it may be that in the process of foreclosure, a good part of it may be lost.

The second problem is the problem of keeping the money at work. It is the custom now to accept mortgages on an amortizing basis, and you take a $10,000 mortgage that is amortized over a period of 20 years, and that means that a percentage of the principal is paid in every year. It is utterly impossible, gentlemen, to find investments for $500 and $250, and $100 payments on these amortized mortgages.

Senator COUZENS. May I ask you in that connection how you regulate your fees on those small trusts?

Mr. STEVENSON. My own company has never made any distinction between the fee on a trust that size and a trust of $100,000. Some companies have tried to put on a higher fee. Personally I do not think that the small man ought to be penalized by being charged a higher fee for the same service.

Senator COUZENS. What is the usual charge? About 5 percent?

Mr. STEVENSON. About 5 percent of the income, and a termination fee of 2 percent.

Senator COUZENS. What do you mean by a termination fee?

Mr. STEVENSON. When the trust is finally terminated and distributed among the beneficiaries, maybe 40 or 50 years from now at the death of the children, if it is a family trust.

For the last 3 years we have had a special committee on the trust division of the American Bankers Association, headed by Mr. Karl Seninger, of Philadelphia, who is here in the room now, studying what we could do toward the economical handling of these small trusts, and that committee has come definitely to the conclusion that the only way that it can find for the proper caring of these small trusts is by some means of combining the funds of a lot of little trusts into one large fund for investment purposes.

And that, gentlemen, has been the experience of other countries as well as ours. We found at least six countries in which they have solved the problem that way. I mean both civil law and common law countries, and for the last 6 years in this country, a few pioneering trust companies like the City Bank Farmers Trust Co. of New York, the Brooklyn Trust Co. of Brooklyn, the First Trust Co. of St. Paul, Minn., and the Equitable Trust Co. of Wilmington, with which I have been associated, have been handling these common trust funds in a way that has proved to be satisfactory to these small accounts—but here is what we are up against right now.

The circuit court of the United States recently in a two and one decision, has held that under the revenue act as it is now worded, these common trust funds are taxable as corporations or associations.

In plain English that means that unless an amendment like this one that we are suggesting is adopted, that these little trusts are first going to have to pay their proportionate part of the corporation tax, and then in addition to that are going to have to pay their regular income tax, as any other trust pays it on income, and after they have received it. The upshot of that is going to be, of course, that we cannot let these little trusts participate in common trust funds, because that is double taxation, pure and simple, plus the fact that the taxpayer simply is not able to pay it.

What we are asking, and all that we are aksing is first, that these common trust funds created for the benefit of these little trusts shall not be subject to the association tax. We are expecting that they will pay the regular income tax, just like any other trust pays it; and another thing that we are suggesting is that this exemption shall apply only to common trust funds that are operated under rules and regulations that are prescribed by the Federal and the State banking authorities, so as not to take any risk, gentlemen, that these common trust funds will come into the hands of inexperienced trustees and become over-commercialized and being used for speculative purposes.

The CHAIRMAN. Did you put in an amendment?

Mr. STEVENSON. It is included in my brief.

If you gentlemen had to live a few days the life that I have to live as an active trust man, you would appreciate all the more the need of this amendment that I am talking about.

Let me give you an illustration that came in my work a month or two ago. A railroad employee was killed in the course of his duty. He left a wife 26 years old and 7 children, ranging in age from 2 to 9 years. The railroad company paid that widow and those 7 little children $15,000 net after lawyers' fees and expenses were taken out. That left $15,000 standing between that widow and those 7 little children, and the poorhouse. One of her friends came to us and asked us to take over and handle this $15,000 fund. We accepted it. We created a living trust of $5,000 for the widow. We accepted the guardianship of the property of the 7 little children and their funds were $1,300 apiece.

The common trust funds which we have been operating for 5 years we are able to handle those seven little trusts, $1,300 apiece, just as economically and just as advantageously to the beneficiary as if they had been $100,000 accounts, yet, gentlemen, without those common trust funds, we could not have accepted those guardianships at all, and knowing the family—I did know the family—if some bank or trust company had not taken over the management of those seven little funds, that money would have been gone in 12 months' time like butter before the sun, and that family would have become a charge on the public.

Senator COUZENS. Just how are they treated under the existing law?

Mr. STEVENSON. Under the existing law, under this circuit court of appeals decision, they are taxed as corporations, with the corporation tax taken out first and then the regular income tax coming second.

Senator COUZENS. So that your difficulties do not arise from this new bill?

Mr. STEVENSON. We are asking for a remedy under the new bill.

Senator COUZENS. But you also need a remedy under the old bill?

Mr. STEVENSON. Yes; that is right.

The CHAIRMAN. That is a recent opinion, as I understand?

Mr. STEVENSON. A month or two ago. It is in the second circuit court of appeals.

The CHAIRMAN. You are trying to get some relief from that decision?

Mr. STEVENSON. That is right. And, Mr. Chairman and gentlemen, all that we are asking by this amendment is simply this, that you enable us by this amendment—I mean by us, the trust companies of this country—to handle these little trusts as advantageously to beneficiaries as we can now handle the big trusts.

It is not a revenue-producing amendment that I am talking about at all. It is an amendment that will enable us to meet what I regard as our social obligation to these widows and children of our country who have the small trusts, that need our services.

Senator GEORGE. How about the big trusts?

Mr. STEVENSON. They can be invested individually, you see. Trusts of $25,000 or over, you can get the proper diversification through individual investment. We have no trouble there, no problem. It is those little trusts.

Senator GEORGE. Where you must combine them in order to effectively handle them?

Mr. STEVENSON. We cannot do it otherwise.

The CHAIRMAN. Thank you.

(The memorandum submitted by Mr. Stevenson is as follows:)

H. R. 12395, TAXATION OF COMMON TRUST FUNDS

More and more people in moderate circumstances are asking trust companies to undertake the management of their estates. Hardly a day passes that trust companies are not asked to accept trusts, both voluntary and testamentary, in which the corpus does nto exceed $10,000 in value.

Manifestly, the same diversification of investment and assurance of income cannot be maintained in a $5,000 trust as can be in one where $100,000 or more is available for investment.

On the other hand, these people of small means are more greatly in need of the advantages of trust-company management of their estates than are those whose fortunes are larger, and the trust companies are loath to deny them this service.

Due, however, to the complexity of making investments, the bookkeeping and accounting involved in the determination of capital gains and losses on security transactions, and other factors involved, the cost of operation on small trusts individually and separately is prohibitive and the banks and trust companies are in some cases compelled to reject this work unless they can turn to the common trust fund, that is, handling several or many small trust funds as a single unit. This practice not only effects savings to the trust but makes it possible for the small trust to obtain the same character of diversification and liquidity as large ones.

A common trust fund makes it possible to invest a fund of $1,000 as economically and satisfactorily as a fund of $100,000. In other words, a common trust fund is merely a means of grouping the funds of many small trusts for investment purposes.

At the present time there is no general rule as to the taxation of common trusts and the general uncertainty has been heightened by the recent Brooklyn Trust Co. decision (80 Fed. (2d) 865), where the composite fund of the Brooklyn Trust Co. was held to be taxable as an association.

Since all of the ordinary income of the common trust fund must, under the rules, be distributed, it follows that if the common trust fund be taxed as an association, small trusts—the very ones that are least able to bear the burden of taxation—are subject to an extra tax burden, the income being first taxed at the full corporate rate upon the common fund as an association, and then taxed again to the estate or trust itself as though the income were corporate distribution.

Furthermore, under the new tax proposed in the pending bill (H. R. 12395), any increment in the corpus of the common fund (which under the various State laws relating to trusts cannot be distributed as income) would be treated as undistributed and subjected to the heavy tax provided for such income. The trustee thus would be caught in an insoluble dilemma, the State law preventing distribution and the Federal law penalizing failure to distribute.

Moreover, the sound social philosophy in respect to these small trusts is that the corpus thereof should be maintained intact for the protection of the beneficiaries, and not distributed wherever increment is realized. That they should bear their just proportion of tax is not disputed, of course. The question here presented is whether they should be penalized for failure to disintegrate corpus. In the face of such additional taxation, common trust funds simply cannot be used by banks and trust companies.

It is therefore proposed that common trust funds be not taxed as associations, but be taxed as trusts.

Whether the common trust fund should be relieved of this tax burden depends upon the purpose to be served by such a fund. The common trust fund furnishes the only satisfactory medium yet devised through which the funds of small trusts and estates may be invested with proper liquidity and diversification. The actual cost of administering small trusts without the availability of a common trust fund is proportionately so great that banks and trust companies cannot afford to accept small trusts and estates. If banks and trust companies do not accept small trusts and estates they fail to meet the social obligation they owe to all people who need trust service whether their estates are large or small.

The proposed amendment is as follows:

"A common trust fund shall not be subject to taxation under this title, but each trust participating therein shall include in computing its net income its share of each item of the income, deductions, and credits of such fund, computed, classified and subject to the same provisions as in the case of an individual. Subject to the approval of the commissioner, the share of each trust in each such item shall be determined in accordance with the principles of accounting adopted in connection with the operation of such fund. The computation of the gain or loss realized, if any, and the basis of assets received, by a withdrawing trust, upon the withdrawal of a trust from such fund, shall be governed by the rules applicable in the case of the withdrawal of a partner from a partnership. No gain or loss shall be realized by a common trust fund by reason of admission of new participants. The term 'common trust fund' means any fund maintained by a bank or trust company, incorporated under the laws of the United States or of any State or Territory or of the District of Columbia and subject to the supervision of Federal or State banking authority or both, solely for the purpose of managing, investing and reinvesting, as a unit, funds contributed thereto from trusts, estates or other funds as to which such bank or trust company is a fiduciary (referred to in this section as trusts), provided that such fund is one which is maintained pursuant to rules and regulations of the Board of Governors of the Federal Reserve System prevailing from time to time (or could be so maintained if the bank or trust company maintaining the same were a member of the Federal Reserve System)."

The proposed section would simplify the bookkeeping and accounting for the determination of capital gains and losses arising from withdrawals of member trusts or new participations. The experience of all accountants familiar with common trust funds is that the accounting load now imposed becomes increasingly so heavy as to make the cost of operation of the fund prohibitive. Under the proposed section, however, gain or loss will be taxed to the participating trusts on sales of securities from the funds and gain or loss arising from withdrawal will be taxed to a withdrawing trust.

Should there be any apprehension that common trust funds may be commercialized or used for speculative purposes, it would be allayed by the provision in the proposed section that common trust funds may be established and operated only under rules and regulations prescribed by the board of governors of the Federal Reserve System. In the case of nonmember banks, common trust funds would have to be operated under the same rules if they would come under this tax classification.

In the final analysis, this section is designed to make it possible for banks and trust companies to give people with small estates all the advantages of the common trust fund without imposing upon these estates the burden of double taxation.

The CHAIRMAN. The next witness is Mr. Charles H. Frye.

STATEMENT OF CHARLES H. FRYE, FRYE & CO., SEATTLE, WASH.

Mr. FRYE. All I have to say is in a brief, which I would like to submit.

The CHAIRMAN. You have the liberty of filing the brief.

Mr. FRYE. Thank you, I will.

The CHAIRMAN. Are you against this windfall tax?

Mr. FRYE. I am not with the big packers, but I am really doing business on the side alone, and I am not with the big people. The American Institute of Meat Packers is no baby of mine.

The CHAIRMAN. You take a little different position?

Mr. FRYE. I am taking the position that I am satisfied will suit you. I think it will. I do not believe there is any question about it. I have been out there fighting those big concerns all the way through for a long time.

The CHAIRMAN. We will give every consideration to what you say in your brief.

(The brief submitted is as follows:)

As one who is heavily interested in farm and livestock lands and who, until last year, was heavily interested in livestock raising, and whose sympathies for that and other reasons are clearly with the producers, the writer desires to enter an emphatic protest against any processing bill affecting meats. The cost of distribution is already too high, and with a tax added the consumer magnifies the size of the tax and the retailer blames the wholesaler for it. This materially reduces consumption and militates against the producer.

If the bill providing for windfall taxes becomes a law along the lines contemplated to make up for the processing taxes which the Supreme Court ruled invalid, it will handicap the small Pacific coast Federal-inspected establishments far more than it will affect the "big four" packers, and Hormel, Decker, Rath, Morrell and others next in size, because the Pacific coast businesses are scattered over a large territory and the big packers can better afford to pay processing taxes than can the smaller concerns. There is more business within 30 miles of the vicinity of Chicago than we have west of the Rockies, Alaska, the Sandwich Islands, and Manila, combined. The big packers have practically no outside competition in large consumption centers and they get good prices there; while they may quarrel among themselves, they always stand as one against the field, and alternately make the Pacific coast their dumping grounds.

The processing tax, if enacted, will open a very fertile and profitable field for the bootlegger of meats whom it automatically subsidizes. By bootlegger of meats, I mean a "scalper" buying livestock in small lots, slaughtering them under the most deplorably unsanitary conditions at no particular place, and without regard for condition of the premises and discrimination as to the cattle he buys. He prefers to do his killing in an old slaughterhouse where there is an inspector present at certain hours during the day, but whose stamp is always available, and where there is absolutely no supervision whatever as to disposition of condemned carcasses or the visceras that are condemned. He aims to feed the viscera and blood in a raw state to chickens and hogs, which are highly susceptible to disease, then trucks the carcasses, diseased or otherwise, to the marketing centers from the four corners of the country. The unsuspecting consumer buys it believing, of course, that all meats are Federal-inspected. The bootlegger pays no taxes, processing or otherwise. It is claimed that he is responsible for the big increase in losses to the producer from theft. This condition was mentioned by Carl H. Goeken in his address at the meeting of the United States Livestock Association held in Omaha, February 27, 1936.

Then, there are the slaughterers that have a regular place of business, and pay their taxes. These people prefer to operate under either State or city inspection as a pretense of having inspection. While they know that Federal inspection is the only true inspection and the best in the world, they do not accept it on account of the heavy added expense it would involve to bring their buildings and equipment within the Federal requirements, because losses by condemnations are strictly against their ideas and further because of the drastic regulations in turning over their premises to the Government inspectors and the extra burden of expense to keep the premises in a sanitary condition.

It is estimated that 35 percent of the cattle west of the Rockies is slaughtered under these conditions and carry many more times the amount of disease found in 65 percent of the cattle, being the amount slaughtered in Federally inspected houses. Competition with these nonfederally inspected meats is far more serious on the west coast than in the East and Middle West. This is so because the population is less dense and the business here is not dominated by local Federally inspected plants as the business there is controlled by the large packers.

Thus here, we are faced with competition not only from the large packers but from the bootleggers and non federally inspected meats, which will mean bankruptcy for 95 percent of the Pacific coast federally inspected establishments if the proposed tax bill is enacted. These small federally inspected plants on the Pacific coast did not make a profit from the processing taxes declared invalid. The financial statement of any one of them will disclose that they did not receive a windfall but, on the contrary, operated at a loss during the entire time processing taxes were being collected. The money retained by the packers as a result of injunctions was not a profit but simply served to minimize existing losses. Our own certified operating statement for the entire period involved conclusively demonstrates as per figures shown below that, with all the care and thrift we could muster, we were unable to operate at a profit.

Our so-called windfall, as a matter of fact, was turned over as part payment upon existing indebtedness. Our loss for 2 years ended October 26, 1936, was $271,263.47. This we think speaks pretty eloquently and refutes the premise upon which the Government tax advisers are proceeding, namely that packers like ourselves have benefited directly or indirectly from processing taxes or that the processing taxes unpaid as the result of the Supreme Court decision constituted a "windfall."

While I am for the foregoing reasons strongly against the levy of any processing tax on meats, I have the following suggestion as to the manner of collecting a tax: All livestock should be slaughtered under Federal inspection as a health measure and graded as to quality and sold as such to protect the housewife. That will stop all substitution of meats and materially increase meat consumption. The burden of proving title to livestock would be placed on the producer's shoulders. That would absolutely protect the farmer, and the dairyman against losses by theft and the expense they are put to in constantly having their stock watched, and would stop the Federal Government from being "gypped" annually out of thousands of dollars in connection with Bang's disease and tubercular cows if they were all sold in public stockyards by licensed commission men. The Federal Government can contract at a reasonable price with the small Federally-inspected establishments to slaughter all additional livestock offered besides their own. That would give the Government a dead cinch on collecting a tax on all livestock slaughtered in the United States as it would have a check on all livestock killed, with no extra expense, exempting therefrom only the "honest-to-God" farm livestock from Federal inspection.

The CHAIRMAN. Mr. John C. White is the next witness.

STATEMENT OF JOHN C. WHITE, WASHINGTON, D. C., REPRESENTING THE STANDARD RICE CO., OF HOUSTON, TEX.

Mr. WHITE. I appear as attorney for the Standard Rice Co., of Houston, Tex. That company is engaged in the processing of rice at Houston and at various other rice-producing points in the South.

On January 6, they had outstanding claims for refunds against exportations of rice of some $7,000. It is my understanding that checks covering these refunds had actually been issued, but were held up after the decision of the Supreme Court on the A. A. A. case. Under section 601 (b) of this bill, any refund to a processor is forbidden, including refunds on exportation. While it is my understanding that it is intended to draft an amendment which will permit processors to claim these refunds under section 21 (d) of the Agricultural Adjustment Act, it is our position that this does not meet either the moral or the legal obligation of the Government in connection with refunds on exportations.

From the very beginning it was not the intention of Congress to tax the processing of farm products intended for exportation. This is shown by the report of the House Committee on Agriculture, in which it says [reading]:

Provision is made for refund of processing taxes with respect to exports, thereby continuing the present competitive situation of our products in foreign markets.

It is very plain in the case of rice that in the absence of some provision for refund of the processing tax on exports there could not have been any exports. At first, rice was not included in the processing-tax section. Instead there was a marketing agreement which provided for the payment to farmers of approximately 1 cent above the existing price level, and the result was that no rice was exported and that surplus rice was piling up in this country. To cure that situation, the A. A. A. was amended to provide for a processing tax and for the refund or crediting of the processing tax upon exports. Provision was also made in section 17 (b) for processing under Government bond, so that if this company or other companies had obtained the necessary bonds and done their processing in that way no question of refunding would ever have arisen.

The original provision of section 17 (a) was that the exporter shall be entitled at the time of the exportation to a refund of the amount of such tax.

Senator GEORGE. Did you pay the tax?

Mr. WHITE. We paid the tax. The Standard Rice Co. were the processors, and section 601 (b) would forbid the return to them of the amounts paid.

Just before some of that rice was exported, our opinion was asked, if the A. A. A. was declared unconstitutional, whether they could still count upon these refunds, because obviously to get this rice into export they had to meet the lower world price level, and we replied to them that plainly they could; that if it were unconstitutional, they would be entitled to the refund, and that under the plain provisions of the law they were given a flat and unqualified right to export refunds. We felt sure that they could count upon obtaining the refunds and they could proceed in making these sales. This was done, and the claims for refund were filed, and, as I say, have been held up solely as the result of the declaration of the Supreme Court that the A. A. A. was unconstitutional.

That concludes my statement, Mr. Chairman.

The CHAIRMAN. The next witness is Mr. Ivan Bowen.

STATEMENT OF IVAN BOWEN, MINNEAPOLIS, MINN., CHAIRMAN OF LEGISLATIVE COMMITTEE, NATIONAL ASSOCIATION OF MOTOR BUS OPERATORS

Mr. BOWEN. I appear for the legislative committee of the National Association of Motor Bus Operators and I also appear for the Greyhound Lines. I am counsel for them.

I merely wish to present for consideration of the committee two amendments that we feel will remove some of the inequities of this law as it applies to interstate motor bus operation laws, and both of these proposed amendments come out of the same situation with which we are confronted, and that is the requirement of a large number of

States that in our operations in those States, that we are domestic corporations, and we therefore are required to tie a system of interstate motor bus operators together with a holding company in order to meet these requirements of the States for domestic corporations to operate in those States.

The 1934 act provided for consolidated returns for railroads. The House put in the amendment in which they also included interurban electric railroads. The first amendment which I am asking on behalf of the Motor Bus Association is that the common carriers by motor bus and the affiliated corporations that are now under regulation of the Motor Carrier Act of 1935, which is part of the Interstate Commerce Commission Act, be dealt with in the same manner as the railroads and the interurban electric and the street railroads, which are also under the Interstate Commerce Act.

The second amendment, the language which we feel should be inserted in section 141 (d) (3) will correct this situation and put us in the same situation as our competitive carriers in the electric railroad business.

The other amendment which I am offering on behalf of the Greyhound Lines, which I also represent, arises by reason of their corporate structure, which again is affected by this requirement of the State laws of the necessity of domestic corporations in order to operate within those States. There had been put into the act of 1934 a provision whereby it permitted the consolidation upward of corporations without penalty tax upon the distribution of assets. That does not meet our situation, due to the fact that in order to simplify our corporate structure, we would have to consolidate downward into one of these corporations that State laws require us to keep in order to eliminate one step in our corporate structure, and the amendment that I propose here and am suggesting to the committee and which I will leave with the committee, is that we be permitted under the law to consolidate into the affiliated group rather than merely being required to consolidate upward. As it is now, if we consolidate our holding company into one of our operating companies, we are stuck with the tax upon the distribution of assets, and we cannot consolidate upward due to the fact that we have to keep these domestic corporations.

(The proposed amendments submitted by the witness are as follows [new matter in italics, omit part in black brackets]:)

Section 141 (d) (3) of the revenue bill of 1936 is amended to read as follows:

"(3) 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 or (C) a common carrier by motor vehicle or a corporation as defined in and subject to section 214 of the Motor Carrier Act of 1935. For the purpose of determining whether the principal business of a corporation is that of a common carrier by railroad, if a common carrier by railroad has leased its railroad properties and such properties are operated as such by another common carrier by railroad, the business of receiving rents for such railroad properties shall be considered as the business of a common carrier by railroad. As used in this paragraph, the term 'railroad' includes a street, suburban, or interurban electric railway."

Section 112 (b) (6) of the revenue bill of 1936 is amended to read as follows:

"(6) EXCHANGE IN LIQUIDATION.—No gain or loss shall be recognized upon the receipt by a [corporation] either or both of the following persons of property (other than money) distributed in complete liquidation of [another] a corporation, [if the corporation receiving such property on such exchange was on August

30, 1935, and has continued to be at all times until the exchange, in control of such other corporation].

"A. A corporation, if it was on August 30, 1935, and has continued to be at all times until the exchange, in control of the transferor;

"B. A shareholder, if the property received is stock or securities of a corporation controlled by the transferor on August 30, 1935, and at all times thereafter until the exchange.

"As used in this paragraph 'complete liquidation' includes any one of a series of distributions by a corporation in complete cancelation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding 5 years from the close of the taxable year during which is made the first of the series of distributions under the plan. If such transfer of property is not completed within the taxable year the Commissioner may require of the taxpayer, as a condition to the nonrecognition of gain under this paragraph, such bond, or waiver of the statute of limitations on assessment and collection of the tax if the transfer of the property is not completed in accordance with the plan. This paragraph shall not apply to any liquidation if any distribution in pursuance thereof has been made before August 30, 1935."

Section 113 of the Revenue bill of 1936 is amended as follows:

(a) Section 113 (a) (6) of the Revenue bill of 1936 is amended to read as follows:

"(6) TAX-FREE EXCHANGES GENERALLY.—If the property was acquired after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property changed, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112 (b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it—or to property acquired by a corporation in connection with a transaction described in section 112 (b) (6)."

(b) Section 113 (a) of the Revenue Act of 1934 is amended by adding after paragraph (8) a new paragraph to read as follows:

"(8½) PROPERTY ACQUIRED IN AN EXCHANGE IN LIQUIDATION.—If the property was acquired after December 31, 1935, by a corporation in connection with a transaction described in section 112 (b) (6), then the basis shall be the same as it would be in the hands of the transferor."

Senator WALSH. I would like to have copied into the record, several communications that I have received from constituents.

The first is a communication from the Massachusetts Investors Trust and the State Street Investment Corporation containing suggestions regarding the treatment of mutual investment trust corporations under the revenue bill of 1936.

(The statement is as follows:)

INTRODUCTION

The two Boston mutual investment trusts signing this document merely constitute a conduit through which 40,000 persons residing in practically every state in the Union have made investments in stocks of about 130 different corporations. Over a period from 1924 to date these 40,000 people have invested about $120,000,000 in these funds, the average investment being about $3,000 apiece. This $120,000,000 as of March 31 was worth approximately $140,000,000. Most of the shareholders are persons of moderate means, either not in the surtax brackets or else in the lower tier of such brackets, who do not have equal facilities with the wealthy to obtain expert supervision and diversity in their investments. It is in order to obtain these benefits that they have availed themselves of these funds which guarantee to redeem all or any part of their shares at any time at a price approximately equal to the liquidating value per share, which price of course varies from day to day with changing market conditions.

We, the managers of these funds, are anxious that any new tax bill shall not create any injustice to our shareholders and that so far as is possible it remedy existing inequities.

If investment corporations and investment trusts (which for taxation purposes are classed as corporations) provided they distribute their entire taxable income, are taxed under the new bill in effect the same as partnerships, the result on the shareholders will be fairer than under the present law. The present law is particularly unfair to shareholders of moderate means, who are not subject to surtax. Under existing law these people are today forced through their corporations to pay in taxes at the rate of at least 15 percent on gains, although if they had made the same gains directly as individuals, they only pay 4 percent. In the words of the Secretary of the Treasury, Mr. Morgenthau, on April 30 before the Senate committee "it will be well to bear in mind at all times that this is purely and simply a proposal to put all taxes on business profits essentially on the same equitable basis; to give no advantages and to impose no penalties upon corporation stockholders that are not given to and imposed upon the individual taxpayer."

If the partnership theory is adopted exactly (and to do this section 117 of the proposed bill must be slightly amended as hereinafter set forth) although the Government will receive increasing revenues from the shareholders of investment trusts, individual shareholders cannot complain as they will be equitably treated—whether subject or not to surtaxes. If, on the other hand, instead of adopting the partnership theory the flat rate on investment trusts, now 15 percent is substantially increased and/or the present allowance for deduction of dividends, which is now 90 percent, is decreased, the existing inequities will be even further accentuated. Therefore, regardless of the merits or the demerits of the proposed bill in its effect in the general economy and on ordinary business corporations, we urge that in any event the provisions of the new bill substantially as proposed be retained for mutual investment trusts subject only to modifying section 117.

SECTION 117

Section 117 provides that in the case of a taxpayer other than a corporation, only the following percentages of gain or loss recognized upon the sale or exchange of capital assets can be taken into account for computing net income: 100 percent of the capital which has been held for not more than 1 year, 80 percent if for more than 1 year but less than 2 years; 60 percent if for more than 2 years but not more than 5 years; 40 percent if for more than 5 years but not more than 10 years; 30 percent if for more than 10 years.

Investment trusts, probably more than any other kind of corporation, are vitally concerned with the method of taxing gains as frequent changes in their portfolios are made which in all cases result in either capital gains or losses. In the case of ordinary business corporations, not considering for the moment investment trusts, insurance companies and possibly banks, it is reasonable to assume that almost the entire taxable income is derived from ordinary taxable income distinct from capital gains. Therefore, if the words "other than a corporation" are stricken from this section there will be little loss in revenue so far as ordinary business corporations are concerned. Banks and insurance companies are not so much concerned with section 117 as under the proposed bill they are taxed in a special manner different from ordinary business corporations. This leaves investment trusts as the primary class of corporate taxpayer who are concerned with section 117. Under the proposed bill the high tax rates will force investment trusts to distribute at the end of each year all or substantially all of the taxable profits realized on the sale of capital assets. If the shareholders of investment trusts are to be treated as if they were partners who are merely banded together for the purpose of obtaining diversity and expert supervision and use the investment trust merely as a conduit for such a purpose, then in all fairness these shareholders who for the most part are of limited means, should have accorded to them the same relief relative to capital gains as is now provided wealthy individual taxpayers and partnerships. This would be in accordance with the spirit of Mr. Morgenthau's remarks quoted above, and can be accomplished by amending section 117 by striking out the words "other than a corporation." This we advocate. This will diminish the unfair advantage possessed by the wealthy who are able to set up individual trusts managed by private trustees or by banks and which perform the same function that investment corporations perform for persons of limited means.

OBJECTIONS ANSWERED

It has been pointed out that investment trusts will under the terms of the new bill be forced to distribute to their shareholders all or substantially all of their net taxable income including taxable profits realized on the sale of capital assets and that this procedure is economically unsound for two principal reasons. First, that such distribution in times of prosperity will leave an insufficient amount in the treasury of the trust with which to meet the inevitable losses of periods of depression and, second, that it will give to shareholders, particularly those who are of moderate means and less well informed as to financial matters, an erroneous impression as to the probable recurrence of large dividends, and therefore lead to the dissipation of these dividends rather than the saving of them for expenses during the periods of depression.

We feel so far as investment trusts are concerned that although this is a valid objection it can largely if not entirely be met by taking advantage of section 115. Section 115 provides that whenever a distribution is at the election of any of the shareholders whether exercised before or after the declaration thereof, payable in stock of the corporation or in money, the distribution shall constitute a taxable dividend in the hands of the shareholders regardless of the medium in which paid.

This points the way for investment trusts at the close of each taxable year to declare special dividends out of capital gains which as a matter of policy we presume properly operated investment trusts will clearly designate as declared from such gains rather than from regular income and give the shareholders the right to accept in payment of such special dividends additional shares of the investment trust itself. In our case, at any rate, if this procedure were followed, no loan or commission would be charged incidental with the reinvestment of such capital gains. Indeed, it might be advisable to offer these shares at a discount well below liquidating value. In view of the fact that the shares of such trusts as ours are redeemable at approximately liquidating value at any time we anticipate that our shareholders generally would exercise their election in favor of taking additional shares instead of cash, and that therefore the uneconomic circumstances above referred to would be dispelled.

To emphasize our suggestions, we therefore urge—

1. That section 117 be amended by striking out the words "other than a corporation."

2. That regardless of whether the partnership theory is adopted for ordinary business corporations generally that in any case it be adopted for mutual investment trusts such as the type of trust represented by the undersigned.

STATE STREET INVESTMENT CORPORATION,
PAUL C. CABOT, *President*.
MASSACHUSETTS INVESTORS TRUST,
MERRILL GRISWOLD,
Chairman of the Board.

Senator WALSH. Also, communication from Mr. H. I. Harriman, former president of the United States Chamber of Commerce, with reference to section (i) of section 27.

MAY 5, 1936.

Hon. DAVID I. WALSH,
Washington, D. C.

DEAR SENATOR WALSH: Section (i) of section 27 provides that if an intermediate holding company receives more than 80 percent of its income from dividends, and pays out dividends to another holding company, which owns more than 50 percent of its stock, such payments shall be subject to a tax of 42 percent, which is practically confiscation. The act further provides that any payments made after March 15 of the present year should be affected by this clause. In other words, it is in part retroactive.

I am not, in this note, discussing the wisdom of the basic principles of the new tax law, but simply the effects of subsection (i). The reason given for the inclusion of this section is that without it the payment of taxes might be avoided. I do not see how that is possible, but if there is any such danger it could be corrected readily by providing that dividends received by an intermediary holding company will be subject to some form of penalty unless they are paid out to stockholders during the same calendar year in which they are received. This will mean that the subholding company would receive its dividends from its underlying companies and pay them out to the ultimate stockholder, and thus be subject to personal income taxes.

In any event, a clause, such as subsection (i), should not be enforced within a year of enactment so that corporations shall have a fair opportunity to simplify their structure and eliminate subholding companies wherever possible. I know that many systems are trying to do this as rapidly as possible.

Very truly yours,

H. I. HARRIMAN.

Senator WALSH. Also a communication from ex-Governor Channing H. Cox, ex-Governor of Massachusetts, now president of the Old Colony Trust Co., suggesting changes in section 104 (a).

MAY 6, 1936.

Hon. DAVID I. WALSH,
United States Senate, Washington, D. C.

DEAR SENATOR: I dislike to add to your burdens at this time when you are considering the new revenue act. There is, however, a very important matter in that connection which affects this bank directly, and which I should like to call to your attention.

It was evidently the intent of the framers of the act, as appears under section 104 (a), to exempt from the general operation of the act all banks and trust companies in the United States. As section 104 (a) now reads it excludes banks "a substantial part of whose business is the receipt of deposits and making of loans and discounts."

Some years ago the Old Colony Trust Co. withdrew almost entirely from commercial banking and confines its activities principally to the administration of estates and trusts and general registration and transfer work. In other words, our business is principally that of a corporate fiduciary. The policy in so doing was to protect trust customers as far as possible from the risks attendant on commercial banking, and we had understood that this separation of duties, where possible, was generally favored by the Treasury Department. We hope that such banks as ours will be given the same treatment as commercial banks, and therefore hope that the phraseology of paragraph (a), section 104, will be amended either by eliminating the lines 8 and 9 on page 81, or by adding to the paragraph as it now stands the following words: "or which does a general trust business."

This matter is of real concern to us, and we feel that banks of our general character should be in the same classification as banks "a substantial part of whose business is the receipt of deposits and the making of loans and discounts." It is possible that the draftsmen of the bill had no intention to make such a distinction. In any event, we shall greatly appreciate your consideration of this matter and your endeavor to have this section corrected. Earlier today I tried to convey these ideas in a telegram to you.

With kind regards,

Sincerely yours,

CHANNING H. COX.

Senator WALSH. I should also like to have inserted into the record memorandum on behalf of the Employers' Liability Assurance Corporation, which desires the retention by the Senate of section 119 (a) (2) (B) of the 1936 Revenue Act as enacted by the House [reading]:

The Employers' Liability Assurance Corporation, a British corporation organized in 1880—

First liability insurance company to do business in the United States.

In June of 1936 will have been writing liability insurance in the United States for 50 years.

The department of the corporation doing business in the United States derive approximately 82 percent of their gross income from United States business.

The corporation has over 6,000 shareholders, most of whom are nonresident aliens and have small holdings. In fact only 113 shareholders receive dividends in excess of $1,000 annually.

The corporation gives employment to thousands of United States citizens and pays large sums in city, State and Federal taxes.

The 1934 and 1935 Revenue Acts apply only to foreign companies doing 50 percent or more of their business in United States; 4 percent on dividends paid individuals; 13¾ percent on dividends paid corporations before December 31, 1935; 15 percent on dividends paid corporations after December 31, 1935.

Not intended by Ways and Means Committee (rept., p. 14), the 1936 Revenue Act as passed by the House applies to dividends paid by domestic companies and applies only to those dividends paid by foreign companies doing 85 percent or more of their business in United States and then only to that proportion of the dividend which gross income derived from United States business bears to world gross income from all sources; 10 percent on dividends paid individuals; 15 percent on dividends paid corporations.

The act in this respect is satisfactory to us.

While no injury will be done to our company if the percentage provided in section 119 (a) (2) (B) of the 1936 Revenue Act be permitted by the Senate to remain as enacted by the House, if it be proposed to alter the provision so as to lower the required percentage these cogent arguments against the imposition of any withholding tax on dividends paid to nonresident alien shareholders by foreign corporations are suggested:

United States has no power or jurisdiction to tax such dividends paid by foreign corporations when such dividends are declared abroad.

Jurisdiction based on (1) Citizenship or residence; (2) ownership of property; (3) the carrying on of activities within or under the protection of the United States (*Burnett* v. *Brooks*, 288 U. S. 378).

The imposition of such a tax on dividends paid by foreign corporations is contrary to the practice and custom of Great Britain or any other foreign country.

A British corporation having declared a dividend would be obliged to pay such a dividend and cannot withhold any part thereof even though required so to do by a United States Revenue Act.

The provisions in the 1934 and 1935 Revenue Acts that withholding shall apply only to those foreign corporations doing 50 percent or more of their business in the United States are arbitrary, unsound, and contrary to fact.

(*a*) Forty-nine percent company exempt;

(*b*) Gross income from United States may result in loss;

(*c*) Money when received abroad loses its identity as United States money;

(*d*) If domestic corporation derives less than 20 percent of its gross income from United States business, its entire income is deemed to come from foreign sources;

(*e*) If such a tax is legal, a nonresident alien shareholder of a foreign corporation doing less than 50 percent of its business in the United States may receive more of the fund from which the dividend is taken, and which might originally have come from the United States and yet such shareholder would not be taxed;

(*f*) Special hardship on small shareholders.

Under the 1934 and 1935 Revenue Acts such tax works a great hardship on the Employers' Liability Assurance Corporation.

(*a*) Probably our insurance company, with one possible exception, is only company thus effected;

(*b*) Cannot withhold under English law.

In thus paying tax itself, this corporation is discriminated against as respects both domestic and other foreign corporations.

(*c*) Even if could withhold, cannot get thousands of small shareholders to fill out complicated Federal income tax returns and file claims for refunds.

(*d*) Therefore, corporation must pay a tax large in proportion to its net income, much of which it would be entitled to receive back from the United States if the returns and claims could be obtained and filed but none of which, as a practical matter, can be obtained.

Thus the Government takes property from the corporation in payment of the shareholders' tax.

It does not follow that because there is to be a withholding tax on dividends paid to nonresident alien shareholders by domestic corporations that there should be a similar tax on dividends paid by foreign corporations.

(*a*) This is a tax on the shareholder, not on the corporation, so no question as to similar treatment to domestic and foreign corporations arises;

(*b*) The indemnity provisions of section 143 (b) protect a domestic company from suit by shareholder in a United States Court but cannot protect a foreign company from similar suit in a foreign court.

Thus the domestic company does not have to pay and absorb the shareholders' tax as a foreign company must.

A withholding tax on dividends paid to nonresident alien shareholders by foreign corporations serves no justifiable purpose because—

(*a*) It burdens business with accounting complication and expense and produces no appreciable amount of revenue;

(b) It can have no effection the proposed tax on undistributed earnings, since foreign corporations pay a flat-rate tax;

(c) It does not prevent the formation of foreign corporations by United States citizens;

If this were done, the foreign corporation would pay a 22½-percent income tax and the withholding tax does not apply to United States shareholders.

Upon the other hand, a withholding tax on dividends paid by domestic corporations to foreign corporate shareholders would tend to prevent the formation of foreign corporations by United States citizens.

(d) It is difficult to see what the purpose is but it could easily be provided that such withholding apply not to bona-fide foreign corporations.

Therefore,

1. There should be no tax on dividends paid by foreign corporations to nonresident alien shareholders.

2. No withholding of such tax should be required.

3. Since no appreciable revenue would be produced, there being no apparent purpose for such tax, and since there is no intent to tax only our company, if it is desired that there should be a withholding tax provision applicable to dividends paid by foreign corporations, retained in the 1936 Revenue Act as a matter of taxing policy, it would appear that justice to our company requires that the percentage be permitted to remain as fixed by the House in section 119 (a) (2) (B).

Senator WALSH. I should like to have inserted into the record some suggestions in regard to section 104½, and section 102, relating to tax on real-estate corporations, submitted by some corporation owners of real estate in Massachusetts.

According to the Statistical Abstract of the United States for 1935, prepared by the Department of Commerce, the total assessed valuation of real property subject to the general property tax was $124,706,000,000 in 1932, and the States, counties and minor civil divisions levied in real estate taxes in that year $5,026,763,000, which amounted to $40.37 per capita. Of the total receipts of local tax bodies, including school districts, townships and other civil divisions, $4,361,307,000 was derived from real estate taxes, or 92.48 percent of the total receipts. The counties received in real estate taxes $877,142,000, or 85.92 percent of the total receipts, and the cities, towns, villages, and boroughs received $2,007,495,000 in real-estate taxes, or 91.89 percent of the total received from general property taxes. These statistics bear out the assertion which is frequently made, that about 80 percent of the cost of running our local Governments comes from real-estate taxes. In Pittsburgh, I am told, real estate pays 90 percent of all the taxes, and doubtless this is true in many other large cities. Everyone will admit that real estate is still bearing the greatest part of the load of local taxation.

REVENUE BILL OF 1936

Amend section 102 (b) (1), definition of "personal holding company" by adding the following proviso at the end of the definition on line 12, page 78, of the bill H. R. 12395, as passed the House:

"*Provided*, That no real-estate corporation owning, leasing, or managing office, loft, or apartment buildings shall be included in this definition."

REVENUE BILL OF 1936—H. R. 12395

On page 81, line 16, of the bill as passed by the House, insert the following new section:

SEC. 104½. TAX ON REAL ESTATE CORPORATIONS.

(a) DEFINITIONS.—As used in this section the term "real estate corporation" means a company incorporated under the laws of the United States or of any State or Territory, at least 80 per centum of whose gross income for the taxable year is derived from the ownership or leasing of real estate.

(b) RATE OF TAX.—There shall be levied, collected, and paid for each taxable year, in lieu of the tax imposed by section 13, upon the net income of every real-estate corporation a tax of 15 percent of the amount of the net income in excess of the credit provided in section 26 (relating to interest on certain obligations of the United States and Government corporations).

STATEMENT OF RICHARD B. BARKER, WASHINGTON, D. C.

The CHAIRMAN. Have you a brief, Mr. Barker?

Mr. BARKER. Yes. I am merely going to put into the record with your permission a brief suggestion to the committee how it can strengthen the constitutional provision so that your windfall tax will be more constitutional than it now stands.

Senator CONNALLY. But will it be constitutional?

Mr. BARKER. I have grave doubts on that.

Senator CONNALLY. Are you a lawyer?

Mr. BARKER. Yes, sir; a tax attorney. Especially following Mr. Evans' speech here last Tuesday, but I think with a little expert draftsmanship, we can have a better chance of having it sustained than it now stands.

The brief submitted by the witness is as follows:

My appearance before this committee is for the purpose of suggesting two changes in the provisions relating to the "windfall tax." The suggested changes relate to section 501 (e) (2) and (3) and more specifically relate to:

(1) Changing the definition of the term "cost" from the cost to the taxpayer of the materials entering into the article to the manufacturing cost of the article, and

(a) Changing the definition of the term "selling price" from the selling price minus amounts repaid or contracted to be repaid prior to March 3, 1936, to the selling price minus amounts repaid or contracted to be repaid up to 30 days after the final enactment of the act.

These two changes are suggested because not only are the present provisions unjust and unfair but also, without such changes being made, the grave doubts as to the constitutionality of the windfall tax become exceedingly forceful and clear. This Congress has experienced the chaos that results from enacting an unconstitutional tax and should do everything in its power to strengthen the constitutional position of the windfall tax if it is going to pass it.

First, then, as to the definition of the term "cost" being restricted to the cost to the taxpayer of the cost of materials. The term "cost" becomes important under the statute because it enters into the computation of "margin" and "average margin" and to the extent that a taxpayer's margin during the period he has been reimbursed for A. A. A. taxes exceeds his average margin, he is presumed to be unjustly enriched.

Thus, the presumption of unjust enrichment is to a large extent based on the difference in cost of materials during the year of reimbursement and during the preceding 5-year period. But presumptions in the law of evidence are based upon the proposition that given a certain set of facts the conclusion to be drawn therefrom will be almost invariable. It has been defined as follows:

"A presumption is an inference of the existence or nonexistence of some fact which courts or juries are required or permitted to draw from the proof of other facts, an inference which common sense enlightened by human knowledge and experience draws from the connection, relation, and coincidence of facts and circumstances with each other." Under such circumstances are established the presumptions that an official will act according to law; that a dying man will speak the truth; that a mailed letter will be delivered to the addressee. When statutes, however, create presumptions that have no justifiable relationship to the facts on which they are founded, the statute will be ruled unconstitutional as being arbitrary and capricious.

It takes no profound economics to demonstrate that a presumption of unjust enrichment should not be based upon the difference in spread between two sets of selling prices on the one hand, and two sets of costs of materials on the other hand.

Let us illustrate: The President's report on the cotton-textile industry (S. Doc. 126, 74th Cong., 1st sess.) shows that in March 1933 (before the adoption of the A. A. A.) cotton was selling for 7.98 cents per pound. In March 1934 the same report shows that cotton was selling for 13.33 cents per pound. Suppose that in March 1933 the manufacturer sold an article containing a pound of cotton for 25 cents and that he sold the same article for 35 cents in March 1934. In March 1934 the processing tax on that pound of cotton amounted to approximately 4.51 cents. Under the formula contained in the statute, it would be presumed

in the above hypothetical case that the manufacturer had been unjustly enriched by the full amount of the tax. To prove this let us apply the formula.

From the selling price of the article (35 cents) we deduct the sum of the cost of the material in the article (13.33 cents) plus the average margin. If we use the March 1933 figures as representing a 5-year period, we find the average margin to be the difference between the selling price (25 cents) minus the cost of materials (7.98 cents), or a difference of 17.02 cents. This is added to 13.33 cents mentioned above, making a total of 30.35 cents. This figure is deducted from the March 1934 selling price of 35 cents mentioned above and the balance, or 4.65 cents, is presumed to be unjust enrichment to the extent it does not exceed the tax of 4.51 cents. The unjust enrichment therefore is 4.51 cents.

However, the same report of the President shows that whereas the cost of labor and manufacturing expense for the above article was 9.15 cents in March 1933, the same costs amounted to 14.96 cents in March 1934, a difference of 5.81 cents. March 1934, it will be remembered, was while N. R. A. was in effect and after the September 1933 textile strike, both of which caused higher labor costs.

Thus, while under the statutory formula now proposed the manufacturer was unjustly enriched to the extent of 4.65 cents (or 4.51 cents), it is a known fact that his other manufacturing costs had increased during the same period by 5.81 cents, so that instead of being unjustly enriched he was in fact poorer to the extent of 1.16 cents.

In short, I submit that this committee should propose an amendment to the bill so that the presumption of unjust enrichment takes into consideration not only cost of materials but all the other manufacturing costs which greatly increased since the adoption of the A. A. A. Only by taking such factors into consideration can you establish not only a fair presumption but also a constitutional presumption.

The fairness of this suggestion and in fact its necessity from a constitutional angle has been recognized. S. 4413 applies the theory of section 501 of this bill to the rights to recover refunds of A. A. A. taxes paid over to the collectors of internal revenue. In section 303 (d) (5) and (6) of that bill it is provided that no refund shall be made unless the claimant establishes that he had not been unjustly enriched. In establishing a formula to determine unjust enrichment, however, that bill takes into consideration all of the manufacturing costs of the processor rather than only the cost of materials.

For the sake of fairness and also to strengthen the doubtful props of the constitutionality of the windfall tax, I urge upon you that section 501 (e) (2) of the present bill be changed to define "cost" as meaning manufacturing cost rather than only the cost of materials.

The second change which I suggest to this committee deals with the so-called March 3, 1936 provision contained in section 501 (e) (3) of the bill. That section provides that in determining the question of unjust enrichment the taxpayer shall be given a credit equal to the amount of any tax moneys repaid to a vendee which have been reimbursed to the vendor. The bill provides, however, that this credit shall be given only if such repayment took place to the vendee prior to March 3, 1936, or if repaid subsequent to that date pursuant to a written contract entered into before March 3, 1936.

Why was the date of March 3, 1936 established by the House in this bill? An examination of the hearings before the House Ways and Means Committee shows that it was to prevent the manufacturer from refunding the tax to his vendee and thus avoiding the windfall tax. Such action on the part of the House may be commendable but we must go further and examine the theory of this tax. If the purpose of this tax is to prevent unjust enrichment, then Congress should have no objection to the manufacturers' passing the tax refund on to his vendee at any time during the taxable year. If, on the other hand, the purpose of Congress is to re-collect a tax which the Supreme Court has held to be unconstitutional, then the March 3, 1936 date becomes important because only by the insertion of such a retroactive date can Congress compel manufacturers to be unjustly enriched and thus collect the tax.

It thus becomes patent that the insertion of the March 3, 1936 date is not for the primary purpose of preventing unjust enrichment, but for the purpose of insuring the recollection of an unconstitutional levy. By using such a retroactive date you will merely emphasize to the Supreme Court that rather than preventing unjust enrichment you are compelling manufacturers to be unjustly enriched in order to recollect an unconstitutional levy. You will thus bring the windfall tax within the scope of Mr. Justice Robert's language in the Butler case, where he said:

"It is an established principle that the attainment of a prohibited end may not be accomplished under the pretext of the exertion of powers which are granted."

It was also stated in the House Hearings that the reason for using the March 3, 1936 date was in order to concentrate the collection of this tax from the manufacturers rather than having the money rediffused among numerous wholesalers and retailers. That reason also is commendable but again it overlooks fundamentals. To illustrate, I need only to cite what has happened quite frequently in the flour industry. In some instances, the millers openly advised the bakers to whom they sold flour that the tax was being passed on to them. I understand that many of the millers have indicated their willingness to refund the amount of the tax reimbursed to them to the bakers but cannot do so because of this March 3, 1936 date. On the other hand, many of the bakers when they sold bread, etc. absorbed the tax themselves—absorbed it even under the formula prescribed in this bill. In other words, the bakers have paid an unconstitutional tax out of their own pockets. As between the Government and such a baker, it is obvious that the baker has the better right to the money that is in the hands of the miller. Only if you are trying to recollect by subterfuge a tax that has been declared unconstitutional can you justify any attempt to deprive such a baker of that money. The use of the March 3, 1936 date emphasizes that such is the purpose of the bill and I feel confident that under such circumstances the Supreme Court would not hesitate to declare the windfall tax arbitrary and capricious.

In summary, therefore, I urge upon you that if you are going to pass a windfall tax you amend sections 501 (e) (2) and (3) of the bill and change the definitions of the words "cost" and "selling price." Only by such procedure can the bill possibly be called fair and just and still more I believe that only by such procedure can you possibly sustain a constitutional attack on the windfall tax.

The CHAIRMAN. Mr. Martin.

(No response.)

The CHAIRMAN. Mr. Chute.

(No response.)

The CHAIRMAN. Mr. Bradley.

Mr. BRADLEY. Yes, sir.

The CHAIRMAN. I understand you want to present a brief for the record.

STATE OF LINN BRADLEY, RESEARCH CORPORATION, NEW YORK CITY

Mr. BRADLEY. I should like to just make a few remarks if you have the time, in general support of the objectives of this bill as in individual citizen and not representing any organization. I am appearing only as an individual citizen.

I have been engaged in adult education in the economic field for some time and have come into association with social workers, educators, economists, bankers, and a good many average citizens, and one thing that has occurred to me in connection with this entire bill is the objective of the bill and the economic indications.

It seems to me that the objective is most praiseworthy, and I consider that objective to be to restore our economy to a good condition in order that the rights of property may be maintained.

As I view the situation, our whole situation is something like this, that the rights of property are distinctly in jeopardy, and it behooves the committee in this taxation measure to look well into the implications of the taxation measure to see to it that the rights of property are sustained. Of course that requires quite a bit of study to see what the implications are, and as I see the basic feature in taxation at the present time as implied in this bill is to see that the velocity of money is made proper in order that individuals may be sure to have

employment in productive enterprise, and I view it that the attempt to levy taxes upon corporations is all to the good, but I see in it that the trouble is not merely the levying of taxes upon undistributed earnings provided those earnings have actually gone into the purchase of labor and material. The great difficulty comes about as it has in every civilization that has ever gone down, and that is the difficulty of maintaining the flow of money when you get a superconcentration of wealth, and I would like to see the committee give due consideration to the possibility of taking the next step, which they are going to find in my humble judgment absolutely essential, and that is to go beyond the corporations—my view, I do not mean to say to neglect the corporations—I am in favor of the move in the direction it is going, but the important thing is to see that money or the things we use for money do not remain stagnant, and I do not see that merely by taxing a corporation's undistributed income and putting it in the hands of the stockholders, that that really and necessarily is going to provide that proper flow of money. Eventually you are going to, I believe, have to face the question of taxing any stagnant money wherever it may be, and it just happens that right now the critical thing before us is the stagnation of money in the accounts of corporations, and that of course we wish to forestall or overcome in a wholesome way; but you still have the problem when the money becomes stagnant in the hands of stockholders, there is nothing being done to see to it that those funds really get into motion.

I should like the privilege, if I may, of submitting a written brief.

The CHAIRMAN. You may submit it and elaborate your views for the record.

BRIEF OF LINN BRADLEY

In commenting upon the proposed legislation for the avowed purpose of raising revenue, I propose to stress the economic aspects of the bill, the significance and the implications involved. I shall make but few comments upon alleged inequities as between various types of corporations and between various individuals, since these have been given earnest and thoughtful treatment by other witnesses appearing before this committee. My chief concern is directed primarily to the growing threats against the institution of private property and against the political and economic freedom of the individuals making up our Nation. For I see a dictator lurking in the shadows. Beyond him sleeps the break-down of society.

With increasing rapidity we are approaching a condition in which taxation bids fair to become a matter of growing and serious concern. History teaches most clearly that revolts against governments and break-downs of civilization are almost invariably preceded by stirring conflict in the arena of taxation. We are now unmistakably headed in that direction. This should give us pause, move us to reflect and to ponder.

How to tax, when to tax, whom to tax, and what to do with the proceeds of taxation have ever been difficult problems for which societies have sought a wholesome solution. Failures in this field have far outnumbered the successes. We ought to do better. Will we? Many of us have been confused in our thought. We have fallen into the inexcusable error of believing that taxes can be paid with money. Real taxes are naught but a portion of the product of men's toil. This being so, it is clear that although one can pay a tax bill by means of money, this does not mean that the real tax has been paid in fact. Another fallacious notion has been accepted, this being the statement that consumers pay all taxes. This is not so. Apparent taxes, payable in money, may be paid by the consumer; but real taxes are always paid solely by producers, by surrendering a portion of the product resulting from their toil. We need to draw a clear distinction between apparent taxes and real taxes. This will aid us in our attempt to comprehend what it is all about.

It is indeed evident that in order to be able to understand our outstanding problems it is necessary for us to have a comprehension of the structure of society, of the role of the political state, and of the role of those whom the political state

seeks to govern and to guide. We ought to understand how society was brought into being, how it evolved, and why it evolved as it did. For unless we gain such a comprehension, our attempts to made adjustments made necessary through the evolution of society are more apt to work harm than to bestow benefit.

A society is a cooperative group of individuals composed of two distinct parts, one of which is a coercive body, and the other of which is a voluntary noncoercive body. These two bodies are quite different in their functions, both are cooperative and both are essential to the continuance as well as to the welfare of society.

The problem of greatest importance in a society is that of achieving and maintaining a wholesome balance between these two distinct parts.

If the coercive body, the political state, in seeking to effectuate this wholesome balance, errs economically over a fairly long period, the result is a top-heavy condition in the coercive body, and a weakened condition in the voluntary noncoercive body. And whenever the number of individuals embraced by the coercive body is unduly enlarged, occasioned through economic errors on the part of those in control of government, the number of individuals embraced by the voluntary noncoercive body—the producers of real wealth—is unduly decreased, even to the extent of thereafter rendering it practically impossible to restore a wholesome balance. Whereupon such a society slowly and then more rapidly disintegrates; and thereafter the society must laboriously reconstitute itself. Usually this reconstitution is brought about only after the lapse of centuries. That is the fate in store for us unless we mend our ways.

And so it is crystal clear that men must ever be on guard against such economic errors as will inevitably lead to an internal break-down.

In our present society we enjoy the blessings of that institution known as private property, an institution that has been largely responsible for whatever progress man has made in bending nature to his will. At all hazards this institution ought to be preserved. Nevertheless, this institution can be misused—it has been misused. It is because of my conviction that this praiseworthy institution is now in real and dire jeopardy that I make so bold as to submit this memorandum for your serious and intelligent consideration.

Civilization, as we know it, cannot exist unless there be a highly developed division of labor erected upon a voluntary base. And without such a division of labor functioning through land and other means of production and distribution, that kind of civilization must perforce cease and come to an inglorious end. Now, this division of labor, an essential for society, cannot continue to exist and develop unless there be an adequate flow of what we use for money—not too great a flow; not too small a flow. And this flow of money must be attuned to prices in such wise that all able and willing persons may be permitted to render worthwhile service to society.

And because society and all its members are unsafe in the absence of such a division of labor, its main concern is directly and inseparably connected with measures that will promote and assure this division of labor, with producing and distributing an abundance, with serving and with enjoyment of services rendered. Moreover, since money and prices are essential tools in the functioning of this division of labor, the conclusion is inescapable that control over the flow of money and over its quality must be sanely and wisely exercised by the coercive body, the political state. At this point it is well to state that our Constitution contains ample warrant for such action, for the reason that Congress has been given the express power to coin money and to regulate its value. But the value of money is not required to be measured in gold. And the real value of money is measured by what it can be exchanged for that is worth while. Here is a power in the hands of Congress that has been used far too little. Were it properly used, there would then be no hue and cry for an amendment designed to grant more power to control commerce in the hope that thereby our problems could be solved.

Whenever the division of labor ceases to function effectively, due to a breakdown in the cooperative activities within the voluntary noncoercive body of a society, no matter what the reason therefor, the coercive body must fill the breach, must take up more burden. However, if the measures adopted by the coercive body—the government—are economically unsound, there is an unfailing force which leads that society—and everyone therein—toward chaos. Patching and patching, in the hopes of finding a solution, are of no avail.

It is incumbent upon us, at this juncture, to inquire concerning the drift of our society, to strive to learn what brought us into the present predicament, to the end that we may properly appraise our situation, understand our problems, and then chart our course, that we may avert retrogression. There are but few who

will gainsay that there is something glaringly wrong in our society today. The great difficulty is to get at the truth and then to bring men into substantial agreement as to causes and as to permissible remedies.

Before this committee have appeared men and women to plead their cause, each representing, by and large, some group or bloc for which favors have been sought, however much they may have essayed to mask their real purpose. As I read their testimony, including their prepared statements, and as I listened to the oral arguments of several of these, it occurred to me that this beating of bloc against bloc, of group upon group, gave rise to sounds closely resembling the fiddling of Nero while Rome was being rapidly returned to dust.

Make no mistake about it; it is high time for us to have done with these childish displays. Why, mere listening to them and reading their separate pleadings but detracts us from needful consideration of the important problems confronting our Nation, crying out aloud for sane and prompt treatment. Neither the country nor its inhabitants can possibly be rendered secure through pitting group against group. There is no salvation in the obvious attempts to let George pay the taxes. That is what each ventures to achieve—pass the burden to the other fellow. We must first strive to provide security for society, lest all hang together for the sins of the few and the many.

In an earlier paragraph the statement was made that the preservation of our civilization and the continuing functioning of the essential division of labor require an adequate flow of money—not too great; and not too small. To be more specific, this rate of flow can, and upon other occasions has, become so high that confidence in the efficacy of money declines to a low point, thus leading to a flight from the dollar—and then chaos. On the other hand, when the rate of flow of money is excessively small, there is widespread unemployment—and untold human misery. We must learn how to control the velocity of money, for the welfare of society, and then have the courage to adopt such measures as will insure this result.

The outstanding task of government is to provide adjustment methods and measures whereby to maintain a wholesome flow of money of such quality as to justify the maintenance of confidence therein, this confidence to be kept to a desired point—not too much confidence; not too little confidence. Now this in no sense requires that the money be convertible into, or backed by, gold, although it may be freely admitted that this noble metal does facilitate the maintenance of confidence in what we use for money; but only if other necessary measures are also provided to the end that all able and willing persons may be permitted continually to render useful service to society and to secure a wholesome portion of the products of society as a whole. We need to adjust matters, while retaining the institution of private property in land and improvements thereto as well as the political freedom of men, so that the effective demand for labor is kept up to such a high level that all who would serve may perforce command, as compensation for their services, a suitable portion of the products produced by society as a whole. And right here let it be pointed out that no one can determine accurately just what portion of those products is produced by any one individual or groups of individuals. Every person in a society takes part in the entire production, whenever there is a widespread division of labor.

Heretofore I have given, in terse form, the substance of some researches into the economic problems with which we are faced. For centuries men have been endeavoring to maintain the institution of private property, by limiting the scope and extent of the right or privilege of individuals to hold title to land and improvements. But property is not a one hundred percent ownership, since it is always subject to the power and the duty of government to limit this scope and extent, from time to time, as circumstances and conditions may dictate. Taxes levied upon land, for example, are an evidence of this restriction imposed by the political state. Corporations engaged in transportation, as common carriers, or in the production and distribution of gas or electricity, known as public utilities, hold title to property that has been restricted by legislation, as is well known.

Several other instances might be cited to show that government has, upon occasion, restricted the scope and extent of property. The members of this committee surely will recall some of these. Yet, during all prior attempts, such as these restrictions, there was a continuing drift toward an ever greater concentration of control over property, a control wielded in one way or another, until eventually this control waxed so great that former societies went to seed—and then they decayed or died. Recall Babylon, Carthage, Alexandria, Greece, Rome, the Byzantine Empire, and France. And now other societies, other nations, are following along that identical groove cut by these earlier societies as they moved forward, and then reversed.

Heretofore, in our modern economy, we have had bankruptcy and foreclosure and debt repudiation, and such like, as the safety valve which enabled us to blow off steam. And yet, even so, the pressure has continued to increase, owing to the growing concentration of control over property. Wherefore, we must seek diligently for a better safety valve, one which will afford us the privilege of retaining the institution of private property and yet prevent such an undue concentration of control thereover as will otherwise surely make it impossible to preserve our society. True it is that we have sought to avoid difficulty by reliance upon inheritance taxes, income taxes, gift taxes, and the like. But we have not succeeded, for the simple reason that we did not understand and realize, as a Nation, just what we ought to do to overcome difficulty in this field. Nor could we have gotten the bulk of those persons who have been most favored by society, to go along with the less favored, for the good of all concerned. Sometimes the most favored, being obstinate in their nature, have been liquidated through the guillotine.

For a long time we have relied entirely too much upon others' promises to pay, and then failed to permit our debtors to pay us with goods or by rendering services. Too long have those in control unwisely relied upon their command over so-called credits. Too long have they lived in a fanciful world, economically illiterate, and refused to face realism. Too long have they believed that they could do, and felt that they ought to do, and that it was safe for them to do, just whatsoever they pleased to do with what they called their land and their credits and their money. They had best wake up.

For the past several years we have tied down the only safety valve we had in our economic system, and the internal pressure has continued to increase until now it threatens to break loose and disrupt our economic boiler, with violence akin to an explosion. Clearly we ought to be astir and do something worth while, instead of patching and patching, quibbling and fiddling. For we have not much time left for needful and constructive thinking, for pondering and reflecting, and for acting wisely and intelligently.

We are able to have what we call prosperity—for some at least—so long as those receiving money incomes in excess of their current spending for goods and services, are both willing and able to loan their surplus money incomes to others for spending to the extent, and at the speed necessary under a given price level, for so increasing the effective demand for labor relative to its available supply as to provide jobs at prices sufficiently high to enable the toilers—whether with brain or with brawn—to command a decent living. Thus it is abundantly clear, that our future, under the orthodox scheme of things, is and has been dependent upon loaning money in ever increasing volume. This is bound to come to an impasse, in time.

We dare not continue to thus depend upon increasing loans and debts in this way and to this extent. What we must do is: Provide some practical and salutary means for maintaining the flow of money in such wise as to assure desired confidence in our money and to retain substantially all able and willing men in socially useful employment, producing those goods for which men crave, and rendering those services for which men yearn. Nothing less can possibly suffice.

Although it has not been made prominent, I suspect that one of the main social motives behind the proposed revenue legislation is to achieve an increase in the velocity of unborrowed dollars to such a point that able and willing workers will have job opportunities opened to them—and to keep these open. In such an eventuality, a most laudable goal, the Government could promptly get out of the sickening and unwholesome business of relief, of doles, of loans to economic cripples, of subsidies to one group of voters—at the expense of another group of voters—and be done with the present drift toward, first, a vile dictatorship, and, second, to some form of socialism, the place where all error leads—and eventually terminates.

Another social motive—quite apart from the avowed purpose of raising revenue—seems to be to minimize the rate at which control over property is becoming concentrated in a small number of places. It appears as though there is a hope that corporations which earn a sizable income will be under a powerful inducement to pass the lion's share of these earnings out to stockholders, and that then the recipients, in case they are already possessed of sufficient property to provide them with an income which places them in an upper bracket, will be compelled to pay over to the Government such a large portion of their income that the rate at which control over property is being concentrated, will have been materially lowered.

With these social motives I find that I am in hearty accord. And I earnestly hope that these motives may be achieved. However, I desire to look at these objectives a bit more closely. For I have grave doubts that the proposed legislation will accomplish them. The weakness of the proposed legislation, judged on the basis of these two social motives—which, to repeat, I heartily approve—lies in the fact that the recipients of money incomes will be allowed to do as they please with whatever money they have left over after paying the taxes levied upon their incomes by the Government. This constitutes the legislation only a half-measure, a mere patch, although the patch is laid in the proper direction. Patches only retard, they do not and cannot possibly do what is necessary to secure society.

Although the proposed legislation, if adopted, may succeed in effectuating a larger distribution of corporate earnings, no one can predict what effect this is going to have upon the velocity of money, either borrowed money or unborrowed money. No one can predict what will happen to price levels—for the simple reason that we do not live in an economic world blessed by pure and unadulterated competition. Competition is thwarted on every hand, a pity indeed. And no one can, with confidence based upon justification, predict what the income of the Nation in goods and services is going to be. We have fought too much over the distribution of a small income, when we should have been devoting our major efforts to increasing the real income of the Nation. And even now, we propose to leave to chance, the amount of this real income, by trusting to individual action upon the part of recipients of money incomes. We must not.

What possible good can be accomplished by a measure which bids us, as a Nation, to jump from the frying pan into the fire? We ought to have the courage to face realities, by seeing to it that members of our society are not permitted to hoard funds in the event that they do not see fit to spend these funds or to loan them promptly to others who will spend them for goods and services whereby to furnish socially useful employment to willing men and women. As sure as night follows the day, the members of this committee, or their successors, are going to be charged with the chore of enacting measures which will in effect restrict the scope of the people's property right in our money. Whatever you do now will but be a step toward the ultimate chore, which is to regulate the velocity of unborrowed funds so that the demand for labor is raised to a socially desirable point, and to maintain it there. As far as I have been able to see the light, the power of taxation must be brought to bear upon funds unduly withheld from circulation, not only by corporations but also by individuals.

The very essence of difficulty in our economic system, which is built upon the right of private property, a money and price system, resides in the fact that it is impossible to determine in advance what money wages ought to be paid by employers as a group. For the reason that no one can determine in advance what money receivers will do with the money they receive. They now have the privilege of either spending it for goods or services, or loaning it to another for such spending, or hoarding it in a box or in a bank account. They cannot have their cake and eat it. Nor can they maintain the right of private property in essential means of production and distribution and simultaneously do as they please with their money receipts. As members of a society they have an inescapable duty to perform. The time is fast approaching when they shall have to choose either to give up the right to property in these essential means, or else to give up their privilege to do as they please with such money as they receive as a member of our society.

The crude methods which we have heretofore utilized for making belated adjustments for our inability to determine in advance what wages and salaries ought to be paid by employers as a whole, have done two vicious things. First, they have resulted in an unwise and unsound concentration of control over essential means of production and distribution. Second, they have produced untold human misery by preventing men from serving society and receiving a reasonable share of the products of society. We must dare to improve.

As a concrete proposal, I suggest that you consider levying a graduated tax upon earnings of corporations, increasing with the size of the earnings; levying a graduated tax upon funds withheld from circulation either by corporations or by individuals, varying with the time the funds are withheld and with the amounts withheld; that you arrange to utilize a suitable portion of the receipts for paying a portion of the wages or salaries of persons engaged in private industry of whatsoever kind you deem socially desirable, to the end that the effective demand for

labor be increased, and the further end of making it possible to overcome rigidity in prices.

Let me remind the members of this committee that the most-favored Greeks as well as the most-favored Romans, of old, saved their precious coins while they awaited the return of what they viewed as good times, when by their very act of excessive saving they rendered it impossible for the good old days to return. And in modern days we find these precious coins amid the ruins of their once famous cities and villages as eloquent witnesses to their economic follies and fallacies. Evidently they feasted upon the same specious principles that our captains of industry and the governors of our savings banks and the directors of our insurance companies now are wont to feed upon, aided and abetted by the sophistries of many of our economists and financiers.

With what I believe to be the real social objectives of the proposed taxation legislation, as expressed in the bill under consideration, I am in hearty sympathy, and I thoroughly approve of its aims. But I would be remiss and lacking in courage did I neglect to point out to you that, even if you succeed in driving funds out from corporate treasuries and into the hands of stockholders, you will not have achieved your goal, if you limit yourselves to merely raising revenue for the purpose of paying men attached to the Government pay rolls and to paying doles and providing relief to people who are compelled, through no fault of their own, to remain idle. Soon or late, either you or your successors will find it necessary—if civilization is to be preserved—to levy graduated taxes upon unborrowed funds withheld from circulation for an undue length of time, and to employ funds, thus collected, for paying a portion of the wages of persons employed in nongovernmental activities. In my humble judgment, there just is no other rational way to preserve our society and its members.

The attached two monographs, entitled "Causes of Man-made Depressions", and "Money, a Natural Monopoly", are respectfully submitted for inclusion with the foregoing statement, and I ask for the privilege of including them with that statement, on the ground that they will further aid in throwing needed light upon the problems with which this committee is confronted.

Respectfully submitted.

LINN BRADLEY.

CAUSES OF MAN-MADE DEPRESSIONS

The following statements are an outcome of an attempt to delve beneath the surface of our bewildering perplexities, to gain a mite of understanding of what it is that keeps the wheels turning, and why it is that at times they revolve so sluggishly. They seem to throw much-needed light upon our present situation, explain much history, and to indicate quite unmistakably whither we are drifting.

One. Man-made depressions are born whenever persons in control of funds do not themselves spend, or lend to others for spending, funds in those amounts and under such circumstances as will enable substantially all able and willing persons to continue to sell goods or their services for an amount of money that is adequate to command possession of goods and services of others to the extent required for a comfortable standard of living.

Two. A voluntary decrease in the rate of spending of "borrowed dollars" brings on a voluntary decrease in the rate of spending of "unborrowed dollars." These voluntary actions almost invariably precede widespread unemployment and defaults. They are the immediate causes of man-made depressions. And they are also the forerunners of revolts against governments and those who design and determine the policies and measures of governments.

Three. Society undermines itself and its members whenever it tolerates an excessive withholding of funds from circulation and simultaneously acts in such a manner as to prevent prices falling far enough and with rapidity sufficient to compensate for the concomitant decrease in velocity of circulation of the money supply. Excessive saving and lending of funds is the undoubted father of an excessive withholding of funds from socially desirable circulation.

CONCENTRATION OF CONTROL

Four. An outstanding and undeniable defect of our economy is: The inevitable, albeit dangerous, concentration of control over essential means of production and distribution. When this concentration becomes lodged in the hands of a rather small minority—no matter how the control is wielded—it leads unvaryingly and unfallingly to great and ever greater ridigity in prices of goods and

services, due in part to contracts calling for fixed payments in the form of interest and otherwise; and to excessive but unwise reliance upon saving and lending of funds, due in part to the unwillingness of receivers of large money incomes to spend a required portion thereof for goods and services, and, eventually, to an excessive decrease in velocity of "unborrowed dollars," brought on as a result of a voluntary decrease in the quantity of money loaned to and spent by borrowers in periods when the debt burden already has mounted to undue heights.

The net result is excessive rigidity in prices and curtailment of supply, in combination with an excessive withholding of funds from circulation. In consequence of this combination we have widespread unemployment, a forced lowering of the standards of living of millions upon millions, both here and abroad, and even a growing threat to civilization itself, readily discernible to those who are courageous enough to look about with wide open eyes.

Five. Rigidity in prices, curtailment of supply, legal claims upon money due at future dates, private property in essential means of production and distribution, and political freedom either to spend or to lend, or to withhold funds from circulation (hoarding in one form or another), are highly incompatible. Eventually this mixture is doomed. One or more of these elements must succumb, bite the dust. History has a habit of repeating.

Six. One vicious defect of our economy is: Too much reliance is placed upon saving and lending funds—thereby creating a credit and an interest-bearing debt, payable only in lawful money; too little reliance is placed upon spending "unborrowed funds" for goods and services—whereby to facilitate real collection of the credit and real payment of the debt. An effective yet safe political measure or measures for maintaining a suitable balance between lending and spending is a vital need.

OTHER DEBTS

Seven. One glaring defect in our economy is: The lack of provision for either inducing or else compelling creditors as a class to permit and enable debtors as a class to pay their debts, although indirectly, by means of goods and services, to the extent required for assuring working opportunities to substantially all able persons, and for assuring to substantially all who serve society real wages ample for sustaining themselves above the poverty level.

Eight. One grave defect in our economy is: The lack of provision for regulating the real value of money through statesmanlike measures for regulating the velocity of "unborrowed money" in such wise as to maintain an economically-sound ratio between the volume of lending and the volume of collecting, in the form of goods and services.

Nine. One baneful defect in our economy, one which threatens not merely our society but also our personal security, is: The lack of provision for increasing the total quantity of "unborrowed dollars" spent for goods and services in a given period, to a sufficient extent to surmount rigidity in prices and to compensate for a shrinkage in the quantity of "borrowed dollars" spent therefor, whereby to maintain useful employment at a high level—and yet avoid bringing forth a flight from the dollar.

Ten. In a society such as ours, that enjoys a highly-developed division of labor, private property in essential means of production and distribution, a money and price system, agreements involving time and lawful money, the porfit motive, competition and individual incentive, the best interests of that society and of its members imperatively require the central governing body to effectuate a wise regulation of the real value of money through a sound regulation of the velocity of "unborrowed funds."

POWER TO LEVY TAXES

This regulation can, apparently, be best achieved through its power to levy and collect taxes upon funds unduly withheld from circulation, and by using funds thus collected for paying a socially-desirable portion of the money-wages and money-salaries of persons engaged in producing and distributing goods and in rendering other services desired by members of that society.

Rigidity in prices can thereby be surmounted, curtailment of supply will be obviated, principal and interest of loans can be collected for the most part, and the demand for services can thereby be maintained at such a level that those who serve society can command suitable compensation in money. And with this in hand, they can provide themselves not only with the actual necessities of life but also with some measure of nonessentials. Thus the wheels will be kept turn-

ing briskly and society will remain secure. For none of the able and willing will then seek in vain for an opportunity to serve their fellowman.

It is high time that we shrink from the mountains of mischievous propaganda rained upon us by those who seek only their own selfish ends, or sprinkled upon us by those who mean well, perhaps, but who nevertheless would regiment us and steal our freedom. The times demand of us that we strive earnestly and unflinchingly to understand that private property in land and in creations of man is a most excellent institution, when it is not misused; that we exert ourselves to the utmost that we may penetrate the fog in which we are immersed, and that we then have the courage and the indomitable will to enact such political measures as will lead us onward and upward.

MONEY, A NATURAL MONOPOLY

The economic or financial strength of members of the savers' group in our society, those receiving as income more dollars than they currently spend, is far from being equal. Those possessed of the best properties, the best incomes, the strongest contracts, and such like, are in position to acquire their money-incomes very much as formerly. The relatively weak members, financially speaking, are reluctant to leave the haven, the group of savers, because they either fear the future or they yearn to ever increase their incomes through acquiring more and better properties or through obliging some others to put forth effort with brain or brawn and pay interest to those on the other end of the obligation.

But in time, these weaker members are forced out of the haven. Meanwhile, they struggle to remain therein. To this end they begin to curtail their expenditures, hoping thus to escape the inevitable. Before long, their incomes equal their expenditures, and a bit later their incomes fall below their necessary disbursements. Now they are without the haven, they are living on their past savings. In strict truth, they have been forced to collect some of their real credits. They have been forced by the relentless pressure of events.

Economic warfare originates within this haven whenever a considerable number of the savers' group refuse to lend the unspent portion of their money-incomes to others who are willing to spend it for goods and services. For the lending to be effective in forestalling this type of warfare, it must be done promptly. Nor does it avoid the issue, to keep the unspent portion on deposit in a bank account, and then throw the blame upon the banker's broad shoulders. In plain truth, the bankers and their depositors must share the guilt together.

ECONOMIC WARFARE

When this economic warfare is being waged between members of the savers' group to determine who shall be permitted to remain within this warm haven and who shall of necessity pass out therefrom and become exposed to the chilling blasts of fear for the future, there is brought about a voluntary decrease in the velocity or turnover of money in circulation, consequent upon a voluntary decrease in the number of dollars loaned to and spent by borrowers.

Rigidity or stickiness of prices, due in part to fixed-interest contracts, in part to fixed rates of payment of one kind or another grounded in custom or tradition, in part to taxes and whatnot, and in part to controllers of property seeking at least that proverbial 6 percent upon their invested capital, this rigidity, when combined with decreased total spending of dollars for goods and services, invariably brings on unemployment. And in its wake come defaults and the usual train of disasters and miseries.

Thus it is clear that when the volume of lending by savers, either directly or indirectly through banks, decreases substantially, thereby inducing an undue shrinkage in the velocity of unborrowed dollars, then the relatively weak members of the savers' group pass through the exit portals of the haven, despite their objections and their struggles. Those removed struggle to re-enter the haven; those yet within cling with all their might. Each strives to improve his position and increase his strength at the expense of the others; each covets his brothers' credits. It is the strong who get them.

LEFT TO CHANCE

If the prices of goods and services should be reduced with ample rapidity and to the extent demanded by the changed rate of turnover or velocity of dollars in circulation, widespread unemployment and defaults would not need to follow.

In practice, however, prices do not fall far enough nor with sufficient rapidity. And so, unemployment grows apace. This in turn brings more fear in its wake, and it further decreases the velocity, the quantity of dollars spent in a given period of time. And the vicious economic warfare takes its toll.

It is incontrovertible that our otherwise praiseworthy economic system is unprovided with sound and wholesome measures for overcoming rigidity of prices, either at the desired speed or to the required extent, when those in the savers' group and in the borrowers' group alter their courses as to lending and borrowing, respectively. It is most unfortunate that all this is left to chance.

We have but few choices. Some shriek ad nauseum for a brisk and broad expansion of credit (an enlargement of debt), unmindful of or else oblivious to the patent fact that debt laid us low. Others plead for a regimentation of one kind or another. Some urge us to curtail hours of labor and the output of goods per man-hour of effort, surely a most foolish policy. Some demand that we artificially raise prices, so as to benefit some particular section at the expense of those in other section of our society. Others insist upon forcing a reduction in prices. And, last but by no means least, there are those who start oiling the printing presses.

BREACH OF TRUST

Far too few understand the need for holding that money is, in its very nature, a "natural monopoly" like water and such; and the further need for demanding that those coming into possession of sums of money, regardless of the kind or amount, shall pass it along to others in exchange for goods or services, either by themselves spending it promptly or else loaning it to others who will so spend it. Society's safety requires it to so coerce creditors, through law.

Vast improvement will be made when the velocity of unborrowed dollars is scientifically regulated by the central governing body. Verily, money is the circulating life-blood of a civilized society. On this account, no one should be suffered to withdraw it from the veins of industry and of agriculture, and from the arteries of commerce—to impound it behind dams of fear and then withhold it too long from others who are under compulsion to acquire a portion thereof.

Whosoever unduly withholds money from circulation is as guilty of a grave breach of trust as is he who withholds a potable water supply from human beings dependent thereon. In other words, those who hoard funds in banks (or boxes) are guilty of withholding an essential from other members of society. And bankers share in this guilt when they clutch too tightly the reins of credit placed in their hands.

The interests of society, forsooth the best interests of all its members, imperatively command a lawful withdrawal of the right of a receiver of money, to impound and withhold the same from circulation for an undue length of time. For the reason that when he does this he directly interferes with the rights of others to serve society and to exchange their products for products of others. There is, in strict truth, abundant justification for a sound and salutary regulation of the velocity of unborrowed dollars. In its absence, the right of property will ever remain in dire jeopardy.

The CHAIRMAN. At the request of Senator Hale, of Maine, I wish to have placed in the record a telegram from Mr. Thomas A. Cooper, bank commissioner, Augusta, Maine.

AUGUSTA, MAINE, *May 7, 1936.*

Senator FREDERICK HALE:

Referring to section 104, new tax bill. May I strongly urge you to use your influence in opposing the elimination of the section exempting undistributed income of incorporated banks and trust companies. Imperative that reserves should be built up.

THOMAS A. COOPER, *Bank Commissioner.*

The CHAIRMAN. Also, I have received a letter from Congressman James P. B. Duffy, of New York, enclosing communication received by him from local union no. 104, American Flint Glass Workers' Union, Rochester, N. Y., both of which letters will be placed in the record.

(Letters referred to are as follows:)

HOUSE OF REPRESENTATIVES,
Washington D. C., May 4, 1936.

Hon. PAT HARRISON,
Chairman Committee on Finance,
United States Senate, Washington, D. C.

MY DEAR SENATOR HARRISON: I am enclosing herein letter from local union no. 104, American Flint Glass Workers' Union of North America, suggesting an amendment to the revenue bill of 1936, which I will appreciate your having filed with the record for consideration by your committee.

Very sincerely,

JAMES P. B. DUFFY.

AMERICAN FLINT GLASS WORKERS' UNION OF NORTH AMERICA,
LOCAL UNION NO. 104,
Rochester, N. Y., April 30, 1936.

Hon. JAMES B. B. DUFFY,
Washington, D. C.

DEAR SIR: I am writing you asking you to do all in your power to incorporate the following paragraph in the tax bill dealing with imported goods, articles, and commodities:

"The Secretary of the Treasury is hereby authorized and directed to collect an excise tax on the entry into the United States of all goods or commodities which were made dutiable under the Tariff Act of 1930 or carry an excise tax by action of the Excise Act taxes of 1932. The tax herein assessed and levied shall represent the difference, less 8 per centum allowed for profits and bonding charges between foreign costs and the American wholesale selling price, or costs of production, whichever is higher, of similar or comparable goods or commodities, the products of American workers or farmers. Such tax shall be assessed and collected notwithstanding any other provision of law."

Very truly yours,

R. J. PETERSON, *Corresponding Secretary.*

The next witness is Miss Cathrine Curtis.

STATEMENT OF MISS CATHRINE CURTIS, NATIONAL DIRECTOR, WOMEN INVESTORS IN AMERICA, INC., NEW YORK CITY, N. Y.

Miss CURTIS. Mr. Chairman and members of the committee. In recent months, Women Investors in America, Inc., has been making a statistical survey of the relative number of men and women stockholders of large, representative, publicly owned corporations in this country which discloses the fact that, of the first 40 corporations whose records have been supplied, there are a total of 2,026,795 men and 1,874,090 women stockholders, women in numbers being 48 percent of the total. Of these 40 corporations, figures indicate that men own 140,333,828 shares, and women 75,210,284 shares, or 35 percent of the common stock. This survey does not include the joint stock ownership of husband and wife.

Nineteen of these corporations have outstanding preferred stocks and the figures show that of these 19 corporations, there are 207,910 men and 247,273 women stockholders, the latter owning 5,550,176 shares out of a total of 12,471,104 shares.

To illustrate with the figures of representative individual companies: General Electric Co. has 89,172 men common-stock holders owning 9,675,147 shares as against 75,884 women stockholders owning 8,283,932 shares. Union Oil of California has 11,512 men common-stock holders owning 11,625,881 shares, as against 8,349 women stockholders owning 11,230,669 shares. Atchison, Topeka & Santa

Fe Railroad has 15,890 men common-stock holders owning 559,171 shares as against 16,224 women owning 517,392 shares.

In the utilities even a large percentage in number of stockholders are women. United Gas Improvement has 46,482 men and 52,578 women owning, respectively, 6,554,517 and 5,272,016 shares. American Telegraph & Telephone has 233,695 men and 378,866 women stockholders owning respectively 6,671,345 shares and 7,455,868 shares.

Fourteen of the 19 companies having preferred stock outstanding have more women than men stockholders. Atchison, Topeka & Santa Fe Railroad, for example, has 4,629 men owning the preferred stock as against 9,153 women owning respectively 210,744 and 349,150 shares.

Therefore it will be seen that a larger number of women than men have a stake in the preferred stocks of our large corporations. To my mind, this large investment in stocks, particularly preferred stocks, is vitally important in considering the basic principles embodied in the present tax legislation and their effect on the security heretofore enjoyed by this type of investment, namely, preferred stock.

The above-mentioned survey offers conclusive evidence that women own a tremendous stake in the equities of American industry, even though for many the unit of ownership is less than 10 shares. Big Business, the "Bogey" which self-seeking politicians, demagogues, and radicals shoot at and aim to destroy is in effect nothing more or less than the life savings of our people invested in private enterprise—savings which have been made possible through courage, self-denial, and thrift of women with their men for the purpose of protection during periods of depression and in old age as well as a heritage for their families.

Suffice it to say that our women have in many ways a bigger stake in the Nation's wealth and prosperity than have the men, and are determined to use every means in their power to protect and preserve their investments in America, not only in its wealth but in its citizenship and its system of government. Women's voice must be heard and heeded in connection with this vicious, unsound, and revolutionary tax bill which not only strikes at the heart of American industry but at the principle of thrift and conservation without which no family, no corporation, and no government can survive and prosper.

Women are becoming more and more amazed and terrified at the continued apparent failure of our legislators to recognize and accept the words of counsel and warning of many eminent tax experts and of our practical, experienced businessmen, many of whom have appeared before you and to whom we owe the building of our industries and our Nation, rather than to theorists and individuals whose experience is confined to politics rather than business.

Accordingly, our organization wishes to present its views on both the social and the economic aspects of the revolutionary change contained in the proposed tax bill. I wish to endorse the objection to this bill made to this committee on Wednesday by Mr. George O. May, and to repeat that we believe the graduated tax on undistributed profits or corporations is unsound in principle.

It is apparent the bill is designed to compel corporations to distribute each year the entire net income during that year. Thus, corporations will, in the future, have no opportunity to build up any

reserves for the rainy day. Let us assume that this bill had been in effect since 1920 and then when the depression of 1931 came corporations had available no surpluses, or at least no cash reserves with which to continue the payment of dividends on their preferred stocks. Many corporations continued to pay dividends on their preferred stocks and some continued to pay dividends on their common stocks during the years of depression, years when such corporations were not earning their dividends, but it is obvious that there would have been a very much greater cessation of dividend payments during that period when investors most needed such income.

Women, as I have stated, are the largest holders both in numbers and amounts of preferred stocks. Dividends on preferred stocks of most corporations may only be paid out of earned surplus. If the opportunity of building up surpluses without paying an exorbitant tax therefor is taken away, the security of an investment in preferred stocks, and even in bonds, is greatly diminished, and from an economic standpoint, this condition would only tend to increase the distress occasioned during the depression, without any corresponding benefit.

I would like to read to this committee a portion of an editorial appearing in the New York Times of April 25, which is as follows [reading]:

ANOTHER "DEATH PENALTY"

It is increasingly clear that, in the eyes of many of its advocates, the proposed tax on undistributed corporation profits is more important as a "reform" than as a revenue measure. The Treasury, indeed, has not even attempted to estimate what revenue it will bring in as at present drawn. A trustworthy estimate would be almost impossible, for it is not yet known how many corporations are subject to the special treatment in the list of exemptions, and it cannot be known in advance what the future dividend policies of corporations will be.

The bill, as it has emerged from the committee, moreover, is now seen to contain a reform within a reform. This is nothing less than a new and quicker "death penalty" for holding companies, not only in the public-utility field but in every field. There was no suspicion of this in the proposed measure on which hearings were held. There is no suspicion of it in the official explanation that the Democratic members of the Ways and Means Committee give of the bill. There is no suspicion of it even in the statement of the Republican members of the committee denouncing the bill, because the Republican members were excluded when the bill was drafted. Unless the effects that this provision would have were unrecognized and unintended, it must be set down as a deliberate joker.

I wish at this point to call attention to the great injustice inflicted upon the minority stockholders of an intermediate holding company occasioned by the imposition of the penalty tax of 42½ percent imposed by section 27 (i). It must be conceded that a minority stockholder in such a corporation can have no control over whether or not a majority of the stock is held by a single corporation and has no possible way of protecting herself from the penalty proposed to be imposed. Such minority stockholder becomes an innocent victim of an unjust punitive tax. This is but one of many other instances of serious injustices which would occur from the enactment of this tax bill.

Although all tax laws necessarily involve some injustice, the aim should be to minimize injustice to the greatest extent possible, and some attempt to do this has been made in providing for certain exceptions. We do not think a sound tax bill which attempts to include reform measures should be enacted without exhaustive study and under no circumstances until it is established that the required revenue will be produced.

Is the objective of this bill to raise taxes or is it to so cripple business that the form of regimentation that is proposed next time may find corporations so weakened that they will be without substantial cash surplus to fight regimentation? Is taxation the real purpose of the bill, or is its real purpose an attempt to break down corporation strength?

The jobs, salaries, profits, and dividends of industry supply the taxes which support government—but are not these taxes paid to government for protection and general welfare whether they be paid by corporations or by individuals? If this be true a 42½ percent tax imposed upon a corporation is clearly not a protection either to industry or the taxpayer, but is a confiscatory measure.

I find many women in all walks of life and in many States protesting Government squandering of taxpayers' money and credit.

Probably not one-tenth of 1 percent of the people of the United States understand much about this pending tax bill, but if it is passed and its effect should be what has been claimed by impartial authorities who have heretofore appeared before you, to the end that small businesses are destroyed, recovery is retarded, investments are impaired, then everyone in the United States will know what this bill has done and will hold you responsible. And if this bill should fail to result in the provision of an amount of tax revenue which has been officially stated would be $1,100,000,000 under the present tax law, it will be your problem to explain the reasons for such a radical change being made in our tax structure in such a short time with obviously little study and an apparent objective of incorporating contentious social reforms.

We urgently recommend the abandonment of this proposed legislation and the immediate appointment of a special committee of Congress which would include independent tax experts and experienced business executives for the purpose of studying and formulating a tax program which would be understandable, equitable, and in which the interests of those who produce and pay taxes may be considered and protected.

Women Investors in America, Inc., the only national women's organization founded upon the subject of finance, earnestly requests representation on such a committee that women investors and taxpayers may no longer be subject to taxation without representation, recognition, or consideration.

I thank you, Senator Harrison.

The CHAIRMAN. The next witness will be Mr. F. C. Leslie, representing the Goodyear Tire & Rubber Co.

Mr. LESLIE. I am representing a group of tire companies, including the Goodyear Tire & Rubber Co.

STATEMENT OF F. C. LESLIE, B. F. GOODRICH RUBBER CO., AKRON, OHIO

Mr. LESLIE. I merely wish to point out what we think is an error in the drafting of section 501, or rather, an omission. That does not provide for a credit against the tax upon which the "windfall" tax is to be assessed, of the additional excise tax required to be paid by the tire manufacturers when the processing tax was held invalid.

The Revenue Act of 1932, as you will recall, levied an excise tax on tires of 2¼ cents a pound. Section 9 of the Agricultural Adjustment Act provided for a credit of—as far as tires were concerned—of the amount of processing tax which was levied on the cotton content, so as to avoid double taxation. When it became necesary to obtain injunctions against the collection of the processing tax, the full excise tax was not paid. Only a net excise tax was paid, the other being accrued on the books of the tire manufacturers. When a refund of the moneys in escrow was made to the tire manufacturers, they promptly paid this additional excise tax, which amounts to about 50 percent of the amount that was saved or refunded to the tire manufacturers under the processing tax.

Section 501, as we read it, does not make a provision for a credit of that payment going against the base upon which the "windfall" tax is to be paid. We think it should, because that falls in the same category as moneys refunded to customers. It did not go into the pocket of the taxpayer or the tire manufacturer.

This particular problem concerns only the tire manufacturers, because they are the only persons who had an exemption under section 9 of the Agricultural Administration Act.

The CHAIRMAN. The committee will give consideration to that suggestion. I have talked to our experts, and I understand you have talked to them.

Mr. LESLIE. That is right. Mr. Chairman, I should like the privilege of filing a memorandum in that connection.

The CHAIRMAN. You may.

Mr. LESLIE. Thank you.

(The following letters were subsequently submitted:)

MAY 8, 1936.

Hon. PAT HARRISON,
Chairman, Senate Committee.

DEAR SENATOR: Section 501 of House bill 12395 imposes an unfair penalty upon tire manufacturers. This penalty arises because the base upon which the 80-percent tax is levied is not reduced by the amount of additional excise tax which the tire manufacturers were required to pay when the processing tax was held to be invalid.

The Revenue Act of 1932 levied an excise tax of 2¼ cents per pound upon the manufacture and sale of tires. Section 9a of the Agricultural Adjustment Act provided for a credit against the above-mentioned excise tax in an amount equivalent to the excise tax on the cotton content of such tires. During the period that collectors of internal revenue were restrained from collecting processing taxes from the processors, the tire manufacturers paid only such portion of the excise tax which remained after applying the credit provided for in the Agricultural Adjustment Act. When the processing tax was finally held to be invalid, the tire manufacturers paid to the Federal Government the additional excise taxes due, together with interest.

The payment of additional excise tax above mentioned falls in the same category as refunds made by the tire manufacturers to their customers under contract by reason of processing tax being held to be invalid, and it should be treated in the same manner as payment to customers, namely, it should be credited against the base upon which the unjust enrichment tax of 80 percent is levied.

To levy a tax on tire manufacturers on the amount of money obtained as a result of the processing tax being held invalid without giving them the credit above mentioned would not be a levy upon unjust enrichment but a tax upon something which the tire companies did not receive for their own benefit and would result in penalising them.

No other industry is confronted with this same problem since the credit provided in section 9a of the Agricultural Adjustment Act applied only to tires.

The penalty resulting to tire manufacturers from the present wording of section 501 of the above act applies to tire manufacturers who purchase their fabrics from

someone else as well as to tire manufacturers who produce their own fabrics, when the tire manufacturer receives a refund from the outside vendors as the result of the processing tax being held to be invalid.

This problem has been discussed with the technical advisors of this committee and with those representatives of the Treasury Department who are directly interested in this problem, to whom your committee is referred.

We respectfully request that section 501 of the proposed Revenue Act of 1936 be appropriately amended so as to provide for a credit against the base upon which the unjust enrichment tax is levied of the amount of the additional excise tax which tire manufacturers were required to pay because the processing tax was held to be invalid.

Yours very truly,

R. H. MINER,
F. C. LESLIE,
T. F. DOYLE,
Representing a Group of Tire Manufacturers.

MAY 8, 1936.

Hon. PAT HARRISON,
Chairman, Senate Committee.

DEAR SENATOR: Section 501 of House bill 12395, the tax law now being considered by your committee, is unfair to persons upon which the unjust enrichment tax is levied who were engaged in exporting products processed wholly or in chief value from a commodity upon which processing tax was levied under the Agricultural Adjustment Act, for the reason that it does not provide for a credit against the base upon which the unjust enrichment tax is levied for articles processed or manufactured for and sold in export.

The Agricultural Adjustment Act provided that no processing tax should be levied upon a commodity which was exported. Hence any moneys obtained by a taxpayer, whether actually paid or merely accrued against articles going into export, would not be unjust enrichment as defined by the President's message upon taxation or within the policy of the proponents of the above-mentioned bill.

We respectfully request that section 501 be amended so as to provide for a credit against the base, upon which the unjust enrichment tax is levied, of an amount equivalent to the tax on the articles which were exported.

Yours very truly,

R. H. MINER,
F. C. LESLIE,
T. F. DOYLE,
Representing a Group of Tire Manufacturers.

The CHAIRMAN. Before the committee concludes the hearings I desire to have placed in the record for the consideration of the committee various letters, briefs, and statements which have been received.

STATEMENT OF CHARLES L. CHUTE, EXECUTIVE DIRECTOR OF THE NATIONAL PROBATION ASSOCIATION, INC., NEW YORK CITY

Representing the above association and speaking unofficially for several other national welfare organizations with whose representatives I have conferred recently, I respectfully urge the Finance Committee to consider the injurious and unintended effect upon these and other social welfare organizations of the following clause. This clause was inserted in the Revenue Act for the first time in 1934 and has been carried over in the pending revenue bill (H. R. 12395). It is found three times in the bill and reads as follows: "and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation" (sec. 23 (O), p. 39; sec. 23 (Q), p. 42; sec. 101 (6), p. 72).

We believe that this provision if narrowly construed would affect practically all social welfare or other organizations whose work is strictly charitable or educational and who previous to 1934 have had special rulings by the Commissioners of Internal Revenue that their work conforms entirely to the requirements which entitle them to the limited exemption of income tax on contributions and corporation tax.

Some rulings of the Commissioners of Internal Revenue have already been made to the effect and we fear that more will follow. The language above quoted is so broad and sweeping that any welfare organization which interests itself in improved social legislation, and most such organizations do so, might be ruled against. It depends entirely on the interpretation given to the words "substantial", "propaganda", and "influence."

We are assured that Congress never intended to deprive bona-fide social welfare organizations, who are interested in assisting Congress and the legislatives of the several States in securing data at their command and framing desirable social legislation, of the advantage which they have had for years of exemption of contributions. The removal of this exemption will seriously handicap or destroy some of these creditable organizations and will discourage or divert contributions from the public.

We have been told that this sweeping clause was inserted in 1934 to reach one or more specific organizations who were masquerading as "charitable or educational corporations." In so doing a great many more worthy welfare organizations were affected. We believe that the need for this provision has now passed. The Commissioner of Internal Revenue has been increasingly strict in his interpretation of these clauses, barring from exemption all but genuine charitable and educational organizations.

We respectfully request that this clause be eliminated in each of the three sections where it occurs.

If your committee decides that it is impossible to eliminate this clause it is not impossible to amend the sections after each occurrence so as to safeguard organizations which are not and never were aimed at. To this end I suggest that the following clause be inserted after each of the three occurrences above cited: "except legislation directed specifically to the care or protection of individuals or families who are dependent, delinquent or otherwise in need of assistance, or legislation directed to the improvement of social or industrial conditions."

SUBMITTED BY MR. CHARLES F. PAUL, JR., WHEELING, W. VA., MEMORANDUM IN RE AMENDMENTS TO REVENUE ACT REGARDING BASIS OF PROPERTIES EXCHANGED IN LIQUIDATION UNDER SECTION 112 (B) (6)

By section 110 (a) of the Revenue Act of 1935 a new provision was added to section 112 (b) of the Revenue Act of 1934. This new provision, cited as section 112 (b) (6), apparently was enacted for the purpose of facilitating and encouraging the simplification of the corporate structures of taxpaying corporations by the liquidation of subsidiary corporations in furtherance of the legislative policy evidenced by the intercorporate dividend tax and the abolition of consolidated returns. The new provision attempted to make the transaction in which the assets of a controlled subsidiary corporation are transferred to the controlling company in complete liquidation of the subsidiary, tax-free.

Unfortunately for the purposes of the new provision, no corresponding changes were made in the applicable basis provisions of the act. As the act now stands, upon the transfer of the assets of the subsidiary to the parent, those assets lose the tax basis of cost, adjusted, which they bore in the hands of the subsidiary and acquire the basis of the parent company's investment in the subsidiary, distributed in proportion to the market values of the assets at the time of transfer. The practical effect of this situation is that the transfer in liquidation is not a tax-free transaction, but simply one in which the realization of the tax liability is deferred. No corporation can take advantage of 112 (b) (6) without incurring a new tax liability in the transaction except one which has an investment in its subsidiary equal to the total value of the subsidiary's assets, and a corporation in that situation has no need of 112 (b) (6). The section, therefore, wholly fails in its purpose.

It is submitted that in a tax-free exchange upon liquidation of a subsidiary corporation under section 112 (b) (6) of the Revenue Act of 1935, the properties in the hands of the parent company should bear the same basis that the same properties had in the hands of the transferor rather than the basis, distributed, of the parent company's investment in the subsidiary.

The transaction in which a parent company dissolves a subsidiary and takes over its assets in liquidation is more nearly analogous to a reorganization than it is to any other type of exchange. In other words, the change effected is simply a change in the corporate structure rather than any substantial change in the ownership of property. In this situation it would seem that the basis provisions of section 113 (a) (7) should apply to the property transferred rather than the provisions of 113 (a) (6).

The basis provisions of section 113 (a) (6) are difficult, if not impossible, of application to a liquidation under 112 (b) (6) where that liquidation is accomplished, piecemeal, over a period of years. The law and the regulations as presently constituted would seem to require a revaluation of the liquidating company's remaining assets as of the time of each transfer in liquidation, and an allocation of basis to each item of property upon constantly shifting proportions. The difficulties and complexities in the administration of these provisions are readily apparent. In sharp contrast is the comparative simplicity of applying the basis provisions of 113 (b) (7) to this situation.

The present provisions seem to apply with peculiar hardship and injustice to a parent corporation which has subsidiaries which have built up their asset value out of earnings. In these instances, the income tax on the earnings has been paid (and while consolidated returns were made, by the parent corporation itself) and to deny to the parent corporation the adjusted basis of the subsidiary upon transfer of these assets is, in effect, to tax this same income twice. The practical effect of this situation is to prevent the parent corporation from complying with the apparent policy of Congress looking toward the simplification of corporate structures unless it is in position to go through a reorganization proceedings, thus accomplishing indirectly what the present law seems to prohibit if done directly. If the parent company follows this latter course, it may effect a tax saving but it incurs additional, and it would seem wholly unnecessary, expense in lawyers' and accountants' fees, State franchise taxes, and the like.

The proposed new revenue act now being considered by the committee intensifies the dilemma in which business corporations having wholly owned subsidiaries find themselves. Under the proposed act a parent company having one or more subsidiaries which experience operating deficits not only cannot deduct the loss in determining its own net income, but will have to retain sufficient of its own net income to make good the deficit of its subsidiary, paying the tax thereon as undistributed income and adding nothing to its own surplus by so doing. By certain provisions of the act it is proposed that business corporations should be forced materially to shorten the corporate cloak, while other sections of the same act render the taxpayer subject to arrest for indecent exposure upon compliance. If the real purpose of the proposed act is to render subject to tax the individual shareholder's proportionate interest in the real income of a business carried on in the corporate form, then the Congress, in all fairness, should permit the business of the country to adjust itself to the policy of the act by simplifying corporate structures so that the real net income of the business as a whole can be determined accurately without penalizing the acts necessary to that end. It is reasonable to assume that Treasury estimates of the tax yield of the proposed act are based upon the anticipated income from ordinary business operations and not upon any "windfall" tax yield from forced capital transactions. If this be true, the suggested amendments to the basic provisions affecting transfers in liquidation under 112 (b) (6) will not affect the Treasury Department estimates.

HOTEL HARRINGTON,
Washington, D. C., May 9, 1936.

Hon. PAT HARRISON,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR HARRISON: At the suggestion of Senator Bulow, I am submitting the following statement on the proposed changes in the corporation tax structure. I did not receive word that you would hear me Friday until the public hearing had been closed but I understand this statement will go into the record.

When the first laws were enacted under the income tax amendment to the Federal Constitution, it was recognized that a tax on corporation earnings was not a true income tax. Later on the tax on corporation income was added because it was along the line of least political resistance. Nevertheless it has never been a true income tax because it applied a given rate to each stockholder's share of the earnings, regardless of the amount of his holdings in the corporation and of his own income. Thus, share owners of moderate means who would not otherwise be subject to an income tax nevertheless suffered the reduction of the rate of the corporation income tax on their share of the corporation's earnings.

In recent years many corporations have protested loudly against taxes levied upon them. When the President a few weeks ago proposed to do away with all Federal income taxes on distributed corporation earnings, it was to be expected that corporation interest would acclaim a measure to relieve them from absolutely

all direct Federal taxation providing only that their net returns are paid out to stockholders. Instead of that, one corporation spokesman after another has protested against being allowed complete exemption from corporation income taxes. The spectacle would be highly amusing if it were not for its significance. Corporations, being inanimate, cannot testify. Only humans do that. And it is obvious that the individuals (not corporations) represented in the protests against the pending tax bill could be expressing only one interest—that of avoiding the higher income taxes they must pay on distributed earnings. Only those already enjoying incomes of at least $25,000 would be so affected. It is to their selfish advantage that the corporation continues to pay 15 perent because their own rate is higher. The stockholders with smaller incomes would gain by the proposed act, because they would pay a lower rate on the additional distribution of earnings than the present corporation rate. Therefore it is a case of the large-income few endeavoring to prevent an act that would advantage the small-income many, and the corporations as well.

Not only is the corporation tax plan proposed by the President a return to the basic principle of a true income tax, but it can reasonably be expected to result in more wholesome corporation practices. The distinction between undivided profits and capital stock is only a matter of bookkeeping, as evidenced by the frequent conversion of the former into the latter through the device of stock dividends. Any sound business enterprise can obtain or maintain sufficient capital (including a reasonable reserve) by the issuance of the required amount of stock. That would be facilitated by establishment of the practice of distributing all earnings, to which the stockholders are morally entitled. Substitution of adequate capital stock for the practice of building up capital out of earnings should develop a more forthright and dependable relationship with both stockholders and creditors. That the huge surplus has not been conceived primarily as sound financial policy is rather definitely proved by the present objections on behalf of rich stockholders against exemption of distributed earnings from taxation, for the reason that they are obviously motivated by purely personal interests as distinguished from those of the corporation.

Even in the case of corporations owing for part of the capital investment, it is in the public's interest that they provide this additional capital by the usual method of stock issues. If they are not sound enough business enterprises to secure the needed capital in this way, they should not be given encouragement to withhold earnings from stockholders as a means of prolonging their existence.

I represent a so-called small corporation (capitalized for $100,000), but I cannot see that the principle upon which a corporation structure is properly formed depends upon the size of the concern. Indeed, the larger corporation, because of its more impersonal character and because most of its stockholders do not participate in any way in its management, should be especially discouraged from treatment of any of its earnings as capital investment. The effect of the President's proposal cannot but result in greater confidence in corporations by their stockholders and thus should prosper them.

Yours truly,

W. R. RONALD,
President, the Mitchell Publishing Co., Mitchell, S. Dak.

BRIEF SUBMITTED BY NATHAN AGAR, CERTIFIED PUBLIC ACCOUNTANT, NEW YORK CITY, ON PROPOSED 1936 INCOME TAX LAW

A number of objections of more or less merit have been raised to the proposed 1936 income tax law. A few of these objections follow:

(1) It abandons a tried method of raising revenue entirely in favor of a new and untried method.

(2) Under its provisions the tax yield for 1936 may be lower than anticipated due to the withholding of corporate dividends on 1936 income until 1937.

(3) It is very complicated in form.

(4) The effect of the proposed law in its present form would be to handicap business extension, to weaken corporate structures so as to increase bankruptcies, thereby tending to create depressions, and in the event of depressions the situation would be catastrophic as businesses would be caught without adequate reserves.

The writer generally favors the thought behind the proposed new tax law but feels that the haste with which it has been put together has resulted in a form which could be greatly improved upon. The writer therefore suggests the following idea for the law believing that it will remove the above objections and

present the law in a form very simple and easily understandable and acceptable to business, a tax law which actually equalizes taxation on business profits and which will secure the objectives outlined by the President.

SUGGESTED INCOME TAX LAW

(1) Place all business on equal footing regardless whether organized as corporation, partnership, or individual ownership.

(2) Apply income rates on net business income (allowing partnerships and individual owners to charge fair salary). Following rates are tentative and submitted mainly for purpose of explaining theory:

On net income up to $2,000	10
On net income up to $2,000 to $5,000	12½
On net income up to $5,000 to $15,000	15
On net income up to $15,000 to $40,000	17½
On net income above $40,000	20

(Or if the desired revenue could be secured from the rates in the 1935 law these could be continued, or whatever rates the Treasury Department figured necessary.)

(3) All businesses requiring retention of part of income to be permitted to retain without additional tax 25 percent of income after above tax. Figuring above tax to average 20 percent the amount permitted to be retained would be approximately 20 percent of the original income. (Corporations and other businesses not requiring to retain part of income would continue to be covered by section 102 which would remain in the law and be amplified to cover all forms of business.)

(4) An additional tax of 40 percent to be levied against the net amount of income remaining after deducting the income tax plus the 25 percent of income permitted to be retained (if required). This rate of 40 percent to be reduced, however, by the same percentage as the percentage of this remainder income paid out as dividends and the adjusted rate to be applied against the amount of the income subject to the additional tax which is not paid as dividends. (The 40 percent rate is tentative and the Treasury Department could figure what rate necessary in connection with (2).)

Under this arrangement businesses (other than personal service and profession) conducted by partnerships and individuals would be treated exactly like corporations. The individuals would pay the same tax as the corporation and would be permitted to retain 25 percent of the remaining income in their business tax-free. They would then have the right to declare how much of the remaining income they wished to retain in the business and pay the additional tax on as such or they could pay on this income as individuals as if they declared it to themselves similar to dividends. If they choose the latter course and still left the income in the business it would be considered thereafter as additional capital. Corporations under this basis conducting a personal service business where capital is not a material-producing factor would have the election for the first year of being taxfree if all their stockholders reported their proportionate share of their profits; the basis of tax on these corporations in subsequent years to be the same as their original election.

(5) Make minimum number of changes in 1934 law—only supplement to embody above ideas. Also temporarily retain the capital stock tax and excess profits tax law and apply it to all forms of business (corporation, partnership, and individual).

Illustration of application of proposed plan

Business earns					$100,000
Business tax:					
10 percent of	$2,000	5		$200	
12½ percent of	3,000			375	
15 percent of	10,000	15	40	1,500	
17½ percent of	25,000			4,375	
20 percent of	60,000			12,000	
	100,000				18,450
					81,550
Free of additional tax (if needed in business) 25 percent					20,388
Balance subject to 40 percent unless distributed as dividends					61,162

If pay all $61,162 as dividends total tax is $18,450. Business could retain $20,388 and stockholders or owners receive $61,162 up to $81,550.

If all retained, 40 percent of $61,162	$24,465
Business tax above	18,450
Total tax paid equals 42.9 percent	42,915
Retained by business	57,085
	100,000
If retained, 50 percent of $61,162 would pay 20 percent of $30,581	6,116
Total tax would be $6,116 plus $18,450	24,566
Business would retain $20,388 plus $30,581 minus $6,116	44,853
Stockholders or owners would receive	30,581
	100,000
If retained, 25 percent of $61,162 would pay 10 percent of $15,291	1,529
Total tax would be $1,529 plus $18,450	19,979
Business would retain $20,388 plus $15,291 minus $1,529	34,150
Stockholders or owners would receive	45,871
	100,000
If retained, 75 percent of $61,162 would pay 30 percent of $45,871	13,761
Total tax would be $13,761 plus $18,450	32,211
Business would retain $20,388 plus $45,871 minus $13,761	52,498
Stockholders or owners would receive	15,291
	100,000

If the plan proposed above should be adopted businesses earning income not needed to be retained would pay dividends as at present. (Covered also by sec. 102). Businesses requiring to retain a fair amount of their income could do so at a reasonably low increase in tax. The businesses that have been retaining income unnecessarily where it was difficult or impossible for the Treasury Department definitely to prove this condition would either have to pay an additional tax or to pay out income in dividends. It is not intended that the rates would be applied equally to all conditions and some concessions or adjustments would be necessary but possibly less so than in the present draft of the law.

The writer also wishes to make a few minor suggestions with respect to some of the sections of the proposed law, as follows:

(1) Reword section 27(J) to read "Where part of the income of a corporation is derived from dividends received from another corporation, then, to that extent, the dividend credit shall be limited to dividend distributions made by the recipient corporation during the taxable year in which the aforesaid intercorporate dividends are received."

(2) In the event of a deficiency in income for any taxable year determined by the Treasury Department in a subsequent year the additional income, in the absence of bad faith on the part of the taxpayer, for the purpose of the undistributed income tax, shall be added to the income of the taxpayer for the year in which it was determined by the Treasury Department.

(3) Dividends paid in subsequent years out of income on which the business has paid an undistributed income tax should be tax-free to the recipient.

(4) Operating losses should be permitted to be carried over for 2 years for purposes of undistributed profits tax.

(5) Capital Losses on operating businesses restricted to assets actually used in the regular business of the corporation (not investments and the like) should be permitted to be applied in full against operating profits.

(6) No change should be made in the present law with respect to assets owned at March 1, 1913.

THE PEOPLE'S LOBBY, INC.,
Washington, D. C., May 8, 1936.

Senator PAT HARRISON,
Chairman, Senate Finance Committee,
Washington, D. C.

MY DEAR SENATOR HARRISON: At the hearing before your committee Wednesday, Senator Barkley questioned Mr. Otto Cullman, of Chicago, with reference to the constitutionality of his proposal that new buildings be exempted from taxation

as a condition of granting Federal credit, or grants for relief, to State or to local governments. Mr. Cullman replied that such exemption of buildings from taxation was not constitutional. Will you permit me to correct this for the record?

New York State exempted new buildings constructed for a period of 5 to 10 years, and at one time approximately $832,000,000 of such buildings were exempted from taxation. Cities of second class in Pennsylvania can transfer all taxes from buildings to land values, and the city of Pittsburgh has so transferred most taxes by gradual changes over a period of several years. North Dakota first through legislation and then through a constitutional amendment held that buildings are not real estate but personal property, and therefore are not subject to real estate taxes, and taxes on buildings have been entirely abolished. Through assessing buildings at practically nothing and land at full value, practically every State in the Union can effectively transfer taxes on buildings to land values, so that the principle which Mr. Cullman recommended is constitutional throughout the United States. This does not mean that every State and local government would be wise to make this change at once, but they could reduce the assessment of buildings to half or one-third of that of the assessed value, while retaining the assessed value of land at 100 percent of selling price, and thus achieve the object of encouraging the construction of more buildings, reducing the taxes upon small homes and adequate improvements, and ending speculation in city land. Such procedure if State-wide would of course relieve small farmers as well, of part of the taxes which they pay today.

I would much appreciate it if you would permit this letter to be incorporated in the record.

Yours sincerely,

BENJAMIN C. MARSH,
Executive Secretary.

THE CRYSTAL TISSUE CO.,
Middletown, Ohio, May 7, 1936.

POSSIBLE EFFECT UPON THE INTERESTS OF THE CRYSTAL TISSUE CO. SHOULD (H. R. 12395) REVENUE BILL 1936, AS INTRODUCED APRIL 21, 1936, BECOME LAW

The properties of this company are located approximately 2½ miles south of Middletown, Ohio, in a village composed practically of all employees of the mill.

The Crystal Tissue Co. commenced operation of the properties in the middle of the year 1920 with a capital of $375,000. Since that time the book net worth of the company has increased to $1,100,000, which increase for the most part represents accumulated profits left in the business or contributions of capital after distribution to shareholders.

Any tax law which penalizes the corporation for gradually increasing its investment in the business is economically unsound. If such a tax law had been in existence from the date of organization of this company, the company undoubtedly would not have a book net worth today of $1,100,000, neither would its number of employees have risen from 125 in 1920 to 270 at this time.

To build up this business as it has been built up over a period of 15 years, not only keeping pace with improvements in equipment of the industry, but increasing the number of employees has at various times required that money be borrowed from the banks. The paper manufacturing industry as a whole requires a large investment in plant and property, and from time to time it is necessary to make extensive alterations and improvements A tax law which penalizes the corporation for making these necessary alterations and improvements can only be detrimental to the industry, to this corporation, its stockholders, andits employees.

It necessarily will be more difficult to borrow money from the banks when it is necessary to finance improvements and alterations to the property. It is obvious that any tax measure which creates such a condition is objectionable.

Any proposal to tax undistributed earnings should give consideration to what occurs in a period of rising prices which would increase the dollar investment in inventories, thus causing a considerable nonspendible profit for the company. Such a condition would necessarily under the proposed revenue bill of 1936 cause larger taxes to be due but would not supply the cash with which to pay the tax.

Under the present system of taxation, our accounting department is required to spend a large percentage of its time in connection with determination of amounts of tax due the various taxing bodies. The proposed revenue act will

only add to this work and must necessarily add work on the Bureau of Internal Revenue. The computation of the tax alone under the bill requires many complicated adjustments which are beyond ordinary business people and will only make additional work for tax experts, accountants, and lawyers.

Respectfully,

Z. W. RANCK, *President.*

OFFICE OF THE PRESIDENT,
THE ESTATE STOVE CO.,
Hamilton, Ohio, May 7, 1936.

Senator PAT HARRISON,
Chairman, Senate Finance Committee,
United States Senate Office Building, Washington, D. C.

DEAR SIR: This company made formal application for a hearing before the Senate Finance Committee in connection with the pending corporation undistributed tax bill but has been advised that owing to the great number of applications for hearing that it will be impossible to accord our company an opportunity for hearing concerning their particular situation. We have been invited to submit a brief covering the situation which will be considered by the committee. Knowing that the committee will receive a great many such briefs, in voicing our opposition to the pending tax bill we are only touching the high points as we know that there will be a great many submitted for the committee's consideration.

This company, which has been in continuous existence in the same line of business for a period of 104 years, has found it necessary in order to operate successfully to build up a surplus commensurate with the requirements of the company ascertained from the experience of a great many years. At the end of the year 1929 the company had a surplus of $1,470,839.60; and as was the case with many industrial concerns in this country, we have experienced 5 extremely bad years, having accumulated losses to such an extent as to reduce our surplus at the end of our 1935 fiscal year to $345,028.13, which reserve is entirely inadequate to furnish the necessary amount of cash working capital, and is further evidenced by the fact that it is necessary for the company to be a heavy borrower from the banks. During the present year it will be necessary to borrow approximately a million and a quarter dollars from our banks who have shown great confidence in the stability and future of this company. Should this company experience another year or two of business in which heavy losses should occur as they did in the last 5 years, the company's credit with the banks should be destroyed to such an extent that it would not be able to continue operations; therefore, a further building up of the company surplus is essential. It should be stated that the nature of the business in which this company is engaged is such that a very high percentage of the assets are of a fixed character and not liquid or current.

Please consider the large amount of borrowings necessary to operate this business in connection with the capital of the company which amounts to $1,250,000, showing that the surplus existing at the end of the year 1929, which was greater than its capital, is absolutely essential to the safe and successful management of this business.

It may be interesting at this point to state that at the present time this company is furnishing employment to approximately 1,800 persons. Had it not been for the surplus existing at the end of 1929, this company could not have maintained its schedule of operations during the depression and would have therefore added to the serious unemployment situation which existed in this community. Thus a sufficient surplus reserve at that time made possible the employment of nearly 1,000 persons throughout the period of the depression.

Further consider that during the last 5 years owing to the financial condition of the company, replacements and maintenance of factory equipment was reduced to the minimum and now with improved business it is absolutely essential that a considerable amount of money be expended to bring the factory equipment up to a normal and efficient working condition. Should our company be successful in showing reasonable profits during the year 1936 and the years to follow, it is absolutely imperative that a great part of such earnings be plowed back into the business and only a reasonable amount thereof paid out either in the form of dividends or taxes. In our present situation it is imperative that a considerable amount of additional facilities in the form of buildings and equipment be provided. If the tax bill as passed by the House should become law, it would be impossible for us to restore the present equipment and add additional needed machinery and buildings, which additions are necessary to enable us to maintain and increase employment.

In our judgment the new corporation tax bill should be so set up so that companies in a situation like our own be permitted to set aside a substantial portion of their expected earnings for plant maintenance and improvement and to provide a reasonable amount of needed working capital. I do not want to undertake to lay down specifically the exact terms of a bill that would cover this situation, as I am quite certain that this situation has been called to your committee's attention by many others, and that it will simmer down to purely a matter of setting up the principle involved and that the details can be safely left in the hands of your committee. In our judgment the amount of undistributed profits should be based on a schedule of the relation of working capital to the sales dollars of the company, as it is quite evident that the sales dollars control the amount of capital required to safely operate a business.

We hold ourselves in readiness to furnish additional and detailed information in our own situation and if it is desired I shall be very glad to appear in person before your committee to discuss this matter further.

Respectfully submitted.

DAVID F. HAHN, *President.*

THE AMERICAN ROLLING MILL CO.,
Middletown, Ohio, May 7, 1936.

The SENATE FINANCE COMMITTEE,
United States Senate, Washington, D. C.

HONORABLE SIRS: We wired you on May 1, 1936, asking for a hearing before your committee to present our protest to the new proposed Federal tax bill, H. R. 12395. The wire in reply from your committee informed us that it was your intention to close the hearings on this bill on Thursday, May 7, and in that the schedule of hearings before your committee was complete, our request could not be granted unless it was decided to continue the hearings to some later date. We were advised by one of our Senators from Ohio, Hon. Robert J. Bulkley, in regard to this hearing, that it would be well for us to prepare our testimony in writing so that it could be presented for your consideration in case the hearings are not extended and we are not given an opportunity to appear for a personal hearing.

We oppose the passage of this tax bill, H. R. 12395, for the reason that it will destroy most of the industrial corporations, both large and small, of our country within a very few years.

Most of these companies have suffered tremendous losses during the depression years, and what profits they have made during the past year or two have not, except in a few cases, been sufficient to restore these companies to a reasonably sound financial condition. Their surplus and their cash was depleted during the depression; and their earnings in the most recent years, if they have had any, have not restored their surplus and cash to a position where they will be able to pay out, in cash, the dividends to their stockholders and the Federal taxes demanded by this bill.

Their machinery and equipment that has become worn out during these past 7 years or has become obsolete must be replaced if they are to continue to do a profitable business. With expanding business, their inventories must be increased, and it will be necessary in connection therewith to expand the total amount of the notes and accounts receivable owed them by their customers.

Under this proposed tax law, the corporate taxpayer would be forced to distribute such a large part of his cash acquired through earnings as dividends and Federal taxes, without considering the cash to be paid out for local taxes, State taxes, franchise taxes, sales taxes, and numerous other kinds of taxes, that it would not be possible to retain sufficient cash to take care of the replacement of machinery and other facilities, inventories, and other consumable assets. Dividends and taxes are not paid in the form of surplus; they are paid in cash.

Under this tax bill, dividends and taxes are the first demand on the cash of a company, so it will be necessary for the management of companies to retain their cash for this purpose. They would, therefore, have to permit their manufacturing facilities to deteriorate and maintain the operation of their business at a low rate, since the restriction on the use of any reasonable part of their cash for purposes other than to pay taxes and dividends would not permit them to increase inventories and expand the amount of receivables due from customers. Such action, without question, would force the majority of the industrial companies of this country into bankruptcy within a few years.

If a corporation should be in need of extra cash for a short period, it is very doubtful if banks or other financing organizations would loan them this cash. In that the first and major demand on the cash of the company would be for taxes and dividends and the balance of cash remaining after such payments would be very limited, there could be no assurance to the bank that such a loan could be repaid in a reasonable time, in fact, no assurance it would ever be repaid. It is our opinion, then, that most companies, after a few years of weakening their financial condition under such a tax law, would have to look to our Federal Government, if a Federal agency should be set up for this purpose, for the borrowing of cash required to maintain their business. This would result in the bureaucratic control of industry, which is undoubtedly what the persons who drafted this bill had in mind.

Many of the larger corporations in this country and a few of the smaller corporations have come through the depression and the subsequent year or two of improved business without any material reduction in the amount of their surplus and with ample cash. Generally, these corporations are the ones whose business is relatively steady and does not show the violent fluctuations between good times and bad existing in the majority of industries. In most cases their earning power is fairly well maintained, and they have not had to absorb, against their previously acquired surplus, the tremendous losses taken by most corporations during depression years.

Under this proposed tax law, these corporations who have been able to maintain a strong surplus account and ample cash will be in a cash position in 1936 and subsequent years to pay out in dividends 100 percent of their earnings, or as close to 100 percent earnings as they are able to guess, thus relieving themselves entirely of any payment of Federal tax. In our opinion, this is not only unfair to those large and small corporations who do not find themselves at this time in a strong financial position but is using the taxing power of our Federal Government to destroy these corporations.

Many corporations have been fortunate enough to have their debts, prior to March 4, 1936, evidenced by a form that would permit an adjusted allowance under section 16 of this tax bill. While this section supposedly gives relief to such corporations having their debts evidenced by certain types of securities, in effect, as we apply the provisions of this section to many actual cases, we find that it does not give relief at all, and the taxpayer will be forced to pay taxes under schedules 1 and 2 or alternate schedules as provided for in section 13. We find that section 16 gives relief only in special cases and then only partial relief, which, in our opinion, would not be sufficient to permit the corporation to go ahead and pay off its debts under the sinking-fund and refunding provisions of the security which it has issued.

In the case of other corporations whose debts are not evidenced by the certain types of security recognized in section 16, such corporations, after paying the required dividends and taxes, or taxes, if no dividends are paid, would not, in a majority of cases, be able to take care of the payment of such debts under terms specified at time they were contracted. In this case the creditors would have no alternative but to force the company into bankruptcy in order to collect, through liquidation of the company, as much of the indebtedness to them as possible. If the creditor corporation did not collect it in this manner, so long as the Federal Government were forcing the debtor corporation to pay out either as dividends or taxes the bulk of the cash earned, the creditor corporation would not be able to secure any payment of their account with such corporation. The other more pressing corporate needs would absorb all of the limited remaining cash earned by the debtor corporation.

In the case of a company which is now trying to reorganize, if this law or a similar law is put into effect such companies would not be able to reorganize and would, consequently, be forced into bankruptcy. In practically all cases of reorganization it is necessary for the creditors of these corporations to accept bonds, notes, stock, or other types of securities in exchange for their accounts due from such corporation. Except in rare cases, the creditors of these corporations requiring reorganization would not find it safe to accept the securities of the reorganized corporation in substitution for their debts. It would be financial suicide for a creditor corporation to freeze any substantial amounts of their cash in investment in numerous other companies who happen to be debtors required to undergo reorganization. While it has been a very common practice during these past 5 or 6 years for one company to help another company get back on its feet by scaling down its debts and accepting securities of the other company in lieu of their current account, this practice would practically go out of existence if this proposed tax law were to be enacted.

As we see it, it would not be possible in most cases for banks to make short-term commercial loans to companies to take care of additional requirements in working capital during the heavier business seasons. It has been previously pointed out that these companies would not be in position to take advantage of the larger volume of business in these seasons that they could otherwise enjoy, in that they would not have sufficient cash to carry such business. Certainly, under this law, their suppliers could not extend to them any unusual terms on goods purchased if such suppliers were not to place themselves in a very precarious position. At the same time, all banks being practically cut off from the commercial-loan business would not be able to secure sufficient business with which to keep going, and for this reason many of them would have to go out of business. Consequently, we believe that if this proposed tax law were to pass within a short time many banks in our country would be forced out of business. The only possible outlet they could have for surplus funds now used for commercial credit would be in purchasing additional issues of Government securities.

In the bankrupting of a company that would, under this law, be legislated out of existence it should be pointed out that, undoubtedly, the larger number of these companies would shut down permanently and cease to operate. Under these conditions all the employees of these companies would be thrown out of work. We would predict that the unemployment situation that has existed and still exists in this country is practically negligible to what this situation would be under the conditions that would be brought about by enactment of this tax bill your committee is now considering.

In the case of our own company, the American Rolling Mill Co., the situation concerning which I am perfectly familiar, I am able to give your committee the probable action that would have been taken by our directors and management during the past 19 years that this corporation has been in existence if this proposed law had been in effect. For the first 14 consecutive years this company paid dividends to its stockholders, and during this period more than quadrupled the number of employees earning their living in its employ. More recently the corporation has resumed payment of dividends to its stockholders and has increased the number of persons in its employ more than 25 percent.

Analyzing this tax bill and applying its provisions over these 19 years, it is very clear that in many of these years we would have had to eliminate entirely the payment of dividends to our stockholders and subject ourselves to the penalty tax of 42½ percent on adjusted net income as provided in this law. This would have been necessary so as to have maintained sufficient cash to have taken care of the replacement of our machinery and other facilities and the increase required in our inventories and customers' accounts.

Under these circumstances, it would have been, undoubtedly, the duty of our board of directors to have advised our stockholders as to the reason for the non-payment of dividends in years when the corporation enjoyed substantial earnings—that it was necessary for them to withhold the payment of dividends and subject themselves to a penalty tax of 42½ percent just to retain sufficient cash to maintain the corporation in a sound operating condition. In only a very few years during this 19-year period would the corporation have been able to have paid sufficient dividends to have placed the Federal tax rate of the corporation at or near the present rate of 15 percent. In all other years when dividends could have been paid, they would have been of such a percentage of the adjusted net income that the Federal taxes applied under this proposed statute would have been considerably in excess of the Federal corporation-income tax paid.

For the future, if this tax bill or a similar tax bill were enacted, the management of our company would find it impossible to pursue its present policy in respect to the payment of dividends and to employment and maintenance of wages to employees.

The first consideration must be to maintain the company in a sound financial condition in the interest of its 15,000 employees and 22,000 stockholders and their families and others who are in any way dependent on our company for their income. For this reason they would not consider it advisable to pay dividends to our 22,000 stockholders unless the corporation were fortunate enough, in any one year, to have tremendous earnings and at the same time to be in such a cash and financial condition that such earnings could be dissipated in the form of cash dividends and Federal taxes.

If history repeats itself, in the future our stockholders will undoubtedly be cut off from dividends for many years when the company has substantial earnings. They will, of course, have to be advised in those years that because of confiscatory Federal taxes it is not possible for the corporation to reduce its cash by paying

cash dividends, thereby seriously weakening its financial position. Under a situation of this kind we believe that the majority of our 22,000 stockholders would not be favorable to such a tax measure and would probably question the advisability of continuing to support representatives who voted or supported such a measure.

In conclusion, I would like to offer certain suggestions in relation to the tax bill, if it appears necessary to change our present Federal income-tax law at this time and to make certain comments thereon relating to Federal taxes.

We believe that if the Federal Government will set about in a businesslike manner reducing Federal expenditures and in balancing its Budget through the reduction of expense rather than imposition of ruinous taxes on its citizens and corporations, that the majority of such citizens and corporations would be willing to subject themselves to somewhat higher taxes than those previously in existence until such time as the Government has materially reduced the present tremendous Federal debt. We view the operation of the Federal Government in the same way that we would view the operation of a large corporation. If such a corporation has determined that it cannot reasonably secure added income from its business by increasing its volume of sales or raising the sales price of its products, even though it may enjoy a monopoly in the products it produces, it then becomes necessary for this corporation to reduce its cost of doing business. The first thing such a corporation does is to discontinue those functions that it is carrying that do not add tangible value directly to the product it is producing.

Similarly with the Federal Government, most of whose expenditures do not increase the tangible wealth of our country, all of those functions and expenditures which are not absolutely required to maintain the function of our Federal Government should be discontinued. After setting the Federal Government up on this sound basis, then the income required by the Government in the form of taxes from its citizens and corporations to balance the Budget and to reduce the tremendous Federal debt that has been incurred in recent years will be accepted, generally, by the taxpayers, with the knowledge that the Federal Government is on a sound basis and its past bills must be paid if our country is to be maintained in a good financial condition.

The citizens and corporations of this country, however, will forcibly resist the imposition of taxes by the Federal Government or State government that in any way will confiscate or destroy their income or their business. The imposition of a tax of the character of this H. R. 12395, the purpose of which is clearly to force the control of private industry into the hands of bureaus and departments of our Federal Government, will not be accepted now or at any time in the future.

Respectfully yours,

C. L. KINGSBURY, *Controller.*

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.
(Attention of Senator Pat Harrison, chairman.)

MR. CHAIRMAN: As a committee representing the Textile Export Association of the United States, we hereby wish to draw to your attention and confirm telegram sent you under date of April 24, 1936, reading as follows:

"Section 601 of revenue bill now before Congress apparently provides for refunds only upon proof of payment of processing tax. Exporters and distributors to charitable institutions, etc., had no control over collection of processing taxes and consequently should not be penalized for nonpayment by processors. Respectfully suggest incorporation in this section of a provision similar to paragraph E of section 602. Also suggest limitation for filing claims sections 601 and 602 be changed to read: 'January 1, 1937, or 6 months after publication and issuance of prescribed claim forms by Commissioner, whichever is later.' Thanks."

In further explanation of the above we take the liberty of drawing your attention to the apparent inequality under the new proposed legislation of section 601, dealing with export refunds, as against section 602, dealing with floor-stock refunds. It is our firm belief that this inequality will work untold hardship on exporters who by the Constitution and the law were guaranteed refund of taxes, such as processing taxes, never becoming applicable on exportations of products of the United States.

The claims that have been filed for refunds on exported goods are of considerable volume; and due to the fact that the first processors, for certain reasons of their own, have been unwilling or unable to give correct information as to payment of tax, the exporters have been put in a very unenviable position.

We feel that the provisions made applicable to section 602 should also be made applicable to section 601, and that all legitimate and proven claims for refund on actual exported goods should be allowed and paid by the Government.

We have before us a brief submitted to your committee by the American Cotton Waste Exchange, which we hereby endorse.

We pray that this matter be given your committee's consideration, and that our petition to include the provisions of section 602 into section 601 be approved.

Respectfully submitted.

TEXTILE EXPORT ASSOCIATION OF THE UNITED STATES,
HENRY G. FANTERS,
KARL S. WHITE,
Tax Committee.

UNITED STATES PLYWOOD CO., INC.,
New York, May 7, 1936.

Mr. F. M. JOHNSTON,
Clerk of Committee on Finance, Washington, D. C.

DEAR MR. JOHNSTON: I wish to acknowledge and thank you for your telegram of May 6 advising me that the committee could not hear all who have requested a hearing on the taxation matter.

I am President of the United States Plywood Co., with principal offices in New York City, and also of the Aircraft Plywood Corporation, havings its manufacturing plant in Seattle, Wash. I have a full and complete set of certified accountant figures on the progress of these two concerns which in my opinion proves beyond question that both firms would have been in bankruptcy had a law such as is now proposed been in effect early in our activities.

The United States Plywood Co started with $500 in 1919 and certainly could not have grown to its present proportions if it had not been able to retain the major part of its profits without penalty. The proposed law puts a ball and chain on the feet of the small man and definitely would prevent his ability to grow to reasonable size.

I see no testimony on the important point that profits do not accrue to a corporation in the form of cash but distribute a large part of themselves to equipment, trucks, inventory and other assets of that nature, while the taxes must be paid to the Government in cash taking all the life blood out of the business.

We have already effectively passed an undertaking requiring $100,000 for the equipment of heavy machinery and the employment of about 60 additional men. We could only proceed by borrowing the money and we are afraid to do so because we do not know how we can repay our loan if our profits must be distributed.

The Aircraft Plywood Co. and the United States Plywood Co. together employ about 400 people and we pay out in dollars and in other items of our general business overhead from $2,500 to $3,000 a day. This is exclusive of our merchandise purchases. We have maintained our full force of people without discharging a single one during the entire depression.

May I add that we are entirely in sympathy with much of the social legislation which has been enacted both from a humanitarian and economic standpoint but we believe that the administration's attitude toward business on the whole has been too antagonistic, causing a feeling of insecurity which has definitely retarded recovery.

I lay no claims to qualification as an expert on taxation, but I do know that the proposed tax law is going to ruin a great many concerns, is going to place the penalty of uncertainty upon many of the rest of us and is contrary to the experience of every sound businessman who has been taught to conserve his resources against the multitude of contingencies that always arise.

Respectfully submitted.

LAWRENCE OTTINGER, *President.*

TIEDEMANN & HARRIS, INC.,
San Francisco, Calif., May 7, 1936.

Hon. PAT HARRISON,
United States Senate Finance Committee, Washington, D. C.

DEAR SIR: Upon my arrival in Washington I found that your committee had scheduled all representatives of outside businesses that you considered possible to hear.

I, therefore, bespeak the cause of Tiedemann & Harris, Inc., and other independent packers at northern California through this letter.

While citing the firm of Tiedemann & Harris, Inc., whose affairs are familiar to me, I know that the same conditions are applicable to other independents in our community.

Briefly, the following pertinent facts will show the problems we face which naturally cause us some concern as to the future in face of reported taxes, both as to processing and surplus earnings.

Capital	$53,000.00
Surplus as of Jan. 1, 1936	40,482.35
Deficit as of Apr. 1, 1936	2,719.11

Actual capital being used in our business, $305,655.72, of which $170,913.40 constitutes property and necessary operating equipment, and $134,742.32 liquid capital—accounts receivable and inventories.

Against this we have a mortgage on our property of $35,539.84, owe $71,366.14 accounts payable, and $30,000 notes payable.

Our business was established in January 1923. Our property was purchased in 1928.

A dividend has never been paid on capital stock since the start of this business.

We employ 60 persons, at an annual salary of $97,500, which equals 60 percent of our total operating costs outside of merchandise.

To be forced to pay suggested taxes on undisbursed surplus would unquestionably prove very embarrassing to us in view of our present indebtedness.

Since the curtailing of hog production we have been forced to accept only 60 percent of our former volume, on the form tonnage.

Consumers resist present high prices and will not purchase the products we feature, namely, hams, bacon, and boiled hams, at present levels in sufficient volume for us to operate profitably. Further advance due to processing taxes or any other cause would be ruinous.

Through shortening of hours our personnel has been held at the same number which formerly was able to handle our business, when a much greater volume was handled.

Your consideration is respectfully requested in our behalf as well as for other independent merchants in the same line of endeavor in northern California.

These proposed taxes unquestionably will be the undoing of many small concerns who like ourselves still have more burdens to carry than is comfortable.

It is my personal opinion that the failure of our business would not result in reemployment of our personne' by others. This business would be distributed among so many others it is very doubtful if the slight increase to each would necessitate additional employment.

Respectfully submitted for your consideration.

Sincerely,

JOHN TIEDEMANN.

MEMORANDUM FILED WITH THE FINANCE COMMITTEE OF THE SENATE BY THE COMMITTEE ON FEDERAL TAXATION OF THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS RE PROPOSED REVENUE ACT OF 1936

MAY 6, 1936.

Mr. JAMES F. HUGHES,
President, New York State Society of Certified Public Accountants.

DEAR SIR: The committee of the New York State Society of Certified Public Accountants appointed by you, as president of the society, to study and comment on Federal revenue legislation, has pleasure in submitting a short review of the proposed Revenue Act of 1936 (H. R. 12395) recently passed by the House of Representatives.

Your committee feels that its comments should be made as constructive as possible and deal with the possible effects of the bill as it may be applied in actual practice rather than concern itself with the underlying political or economic aspects of the proposed measure. Nevertheless, after studying the measure as a whole, your committee feels that the adoption of an entirely new base for taxing corporations at the present time when business is struggling to its feet from a long period of depression is most unwise. We feel that the possible damage to the weaker corporations through passage of the measure in its present form has not been given adequate consideration and the time since the measure was passed

by the House of Representatives has been too short to judge what its final effect on business may be. We submit, however, that obviously what the country requires is a simplification of its tax measures, instead of which the House of Representatives has passed a bill of such a complicated nature that the ordinary taxpayer will be unable to understand it or even to determine what its tax liability may be, and, in addition, the yield to be obtained from the new principle of taxation as applied to corporations is so uncertain that even the credit of the Government itself may be seriously affected if the revenue falls far short of expectations.

TIME FOR FILING RETURNS

Experience of the past has shown that a great many taxpayers find a period of 2½ months after the close of the fiscal year in which to file their returns too short a time. It seems almost unnecessary to point out that, where taxpayers have to deal with a compliacted law in the form now proposed, if the present filing date is adhered to, then any taxpayer should be privileged to file a tentative return which would automatically extend the time for filing a complete return by 60 days and that it should only be necessary to ask the Commissioner for an additional extension of time for filing if the completed return cannot be filed within the 60-day extension covered by the tentative return.

REALIZED INCOME AS COMPARED WITH TAXABLE INCOME

One of the principal shortcomings of the proposed new revenue bill is the feature that taxation is based on an arbitrary and legally defined statutory income rather than on the true income of the corporation which is all that would be legally available for distribution. The following example will illustrate this point; assuming the case of a corporation which has no surplus accumulated from earnings:

	True income	Statutory income
Net taxable income	$200,000	$200,000
Nondeductible losses (e. g., from sale of capital assets, losses from litigation, etc.)	200,000	2,000
Total income	None	198,000

Obviously, this corporation, having no earnings, cannot distribute any dividend and, if it declared a dividend in any form, it would no doubt violate State law. But the proposed law would exact a tax of 15 percent, or $29,700, thereby creating a deficit and making the tax really a levy on capital and not an income tax.

It is admitted that the foregoing example is an extreme one, but it clearly brings out that some corporations will be taxed out of existence under the proposed new law unless the limitation on what is technically called a capital loss suffered by corporations (other than personal holding corporations) is removed.

TAX ON LIQUIDATING DIVIDENDS

The new bill provides in section 115 (c) for the application of the capital gain provisions to distribution in complete liquidation of corporations. There seems to be no good reason why there should not be the same provision with respect to distributions in partial liquidation. The committee report states that the present situation retards liquidation and the Treasury thereby loses taxes. The same comment, although possibly not to the same degree, could be applied to partial liquidations where only a portion of the stock of a corporation is retired.

INTERMEDIATE HOLDING COMPANIES

Section 27 (j) relating to intercorporate dividends puts a teriffe penalty upon a corporation 50 percent or more of whose stock is owned by another corporation. Under this provision a corporation 80 percent or more of whose gross income is derived from dividends will receive no credit if such dividends are in turn paid over to a corporation owning 50 percent or more of its stock. Clearly this is confiscatory and the proposed bill should be amended by striking out this provision.

RELIEF PROVISION FOR DEBTS

The relief provisions imposing a flat rate of tax on corporations which are unable to pay adequate dividends because of contractual obligations outstanding as at

March 3, 1936, should be amended so as to include in the term "debts" any loans whether obtained from banks or other sources even though not represented by a note, bond or other similar instrument.

DIVIDENDS IN OBLIGATIONS OF A CORPORATION

Section 27 (d) provides that consideration has to be given to the fair market value at the time of payment if a dividend is paid in obligations of the corporation. This will undoubtedly prove unworkable in practice, and we suggest that this section be amended to provide that, so far as the corporation is concerned, the amount of the dividend credited shall be the face value of the obligation and that, in so far as the stockholders are concerned, the amount of the dividend in their hands shall be the face value or the amount received through sale or exchange of the obligation if disposed of within the taxable year. If disposed of later the sale or exchange of a dividend received in an obligation of a corporation should be exempt from the limitations of loss contained in section 117.

OPERATING LOSSES

We recommend that the provision permitting operating losses in 1 year to be carried forward against the operating profits of the succeeding 1 or 2 years be reinstated in the law as otherwise the proposed plan of forcing all future income to be declared in the form of dividends or be largely paid over to the Government in the form of taxes will prevent corporations from making any real recovery of financial losses suffered through the period of the drepression.

AFFILIATED CORPORATIONS

Due to the fact that many corporations find it necessary to operate wholly owned subsidiary corporations by reason of State laws applicable to their business in different locations, we recommend that the principle of taxing the entire income of the parent corporation on a consolidated basis be reenacted. Cognizance could well be given to taxing as a separate entity wholly owned subsidiaries which are engaged in a different line of business than the parent corporation, but clearly where the operations of the subsidiary are only a part of the activities of the parent corporation the income of such subsidiaries should be included with that of the parent company and the entire operations be taxed as income arising from a single business.

SUGGESTED CHANGE IN COMPUTATION OF DIVIDEND CREDIT

Section 13 provides that the term "Undistributed net income" means the sum of the dividend credit provided in section 27 plus the tax computed under subsection (b). We recommend that a third clause be added to the above-quoted provisions to the effect that, in addition to the two foregoing items, there should be added the amount of additional tax paid in any year in respect of adjustments of prior years' tax returns.

The need for this is demonstrated by the well-known fact that frequently adjustments of tax returns are made through such matters as change in the basis allowed for depreciation, or because of court decisions affecting the deductibility of items, or the taxability of receipts not capable of final determination at the time the return was filed.

The above suggested addition to section 13 (a) will enable the corporation to correct an overpayment of dividend through an innocent mistake in its determination of the amount of tax payable at the time its return was filed. This would appear to be necessary because of the many complications connected with the calculation of the amount of tax payable in any particular situation.

ALTERNATIVE METHOD OF TAXATION

In the preceding paragraphs your committee has endeavored to make constructive suggestions toward remedying the most glaring defects in the proposed bill. Due to the complexity of the measure, however, it has not been possible to make any exhaustive examination and we are of the opinion that it will be impossible to put the measure on a sound basis in the time available. While your committee feels that the general idea of the bill has much merit, it cannot approve the measure as a whole in its present form as it believes adequate revenue could be obtained through a much simpler measure and, at the same time, make a step toward inducing corporations to pay out in the form of dividends a larger part of the surplus not actually needed in the business.

In this connection the attention of your committee has been drawn to an editorial in the New York Times of Monday, May 4. We understand that this editorial has already been furnished to the Senate committee considering revenue legislation and, as we believe that the suggestions put forth in said editorial are the most constructive suggestions so far made, we desire to record our approval of them. The committee feels it unnecessary to quote extensively from said editorial but, for your convenience and information, the following summary of the general form of an alternative tax plan, as put forward by the Times has been prepared.

It is well known that at the present time only four or five individuals in every hundred pay personal income tax, and thus the most desirable measure that could be passed would be one that spread the personal income tax over a much greater number of individuals. The Times editorial contains the following recommendations with which this committee is in hearty sympathy:

(1) The dropping of the capital-stock tax and the excess-profits tax is approved.

(2) In order to have a more certain yield from the new measure a tax on all corporate income should be imposed at a flat rate of 15 percent. This suggestion would also help simplify the law as it would do away with the graduated rates of tax running from 12½ to 15 percent. Nevertheless, it may be desirable to have some graduation in the tax to apply to corporations whose net income is $20,000 in any 1 year or less.

(3) Approval is given to making all dividends in the hands of individuals subject to the normal tax of 4 percent.

(4) In the case of corporations, all income of any year not distributed to stockholders should be subject to a normal tax of 4 percent in addition to the flat tax on all income of 15 percent, this 4 percent rate to apply on all income retained not in excess of 20 percent (or one-fifth) of the income of the year. If more than 20 percent of the income is retained, then apply a graduated tax, as follows:

	Percent
On the second fifth of retained income	5
On the third fifth of retained income	10
On the fourth fifth of retained income	15
On all retained income over four-fifths of the income of the year apply a tax of	20

(5) Before determining the income subject to the graduated rates as above, a corporation should be allowed to retain subject to an additional tax of only 4 percent (i. e., in addition to the flat rate of 15 percent) all earnings earmarked for purchase of additional plant facilities and new machinery or for creation of tangible facilities with the object of enlarging the production of the plant and increasing employment. This would mean that income, as indicated in this paragraph, should first be deducted from the total income of the year and taxed at 4 percent and then the balance of the income be taxed as suggested in (4) above.

The tax on undistributed income should, of course, be coupled with the relief provisions contained in the bill passed by the House and also to the foregoing, particularly those matters relating to the difference between statutory and actual income.

The adoption of the method of taxing undistributed income suggested above removes the possible lag in revenue due to having a dividend year running from March 16 of one year to March 15 of the next year. As it is often impossible for a corporation to determine its profits for dividend declaration purposes before its accounts are closed after the end of its taxable year, we further recommend that the definition of the dividend year as contained in the proposed bill at the time it was introduced to the House be reinserted in any bill formulated along the lines suggested in the closing paragraphs of this memorandum.

Yours truly,

NORMAN G. CHAMBERS,
Chairman of Committee on Federal Taxation of the New York State Society of Certified Public Accountants.

The CHAIRMAN. The committee recesses until 10 o'clock on Monday morning, at which time we will meet in executive session. The public hearings are closed for the present.

(Whereupon, at 12.15 p.m., recess is taken until Monday, May 11, 1936, at 10 a. m.)

REVENUE ACT, 1936

TUESDAY, MAY 12, 1936

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

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

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

Also present: Herman Oliphant, General Counsel for the Treasury Department; Guy T. Helvering, Commissioner of Internal Revenue; George C. Haas, Director of Research and Statistics, 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; Henry A. Wallace, Secretary of Agriculture; Prew Savoy, special attorney, Department of Agriculture.

The CHAIRMAN. The committee will be in order.

Senator BYRD. Mr. Chairman, I offer this resolution:

The Secretary of the Treasury is hereby requested to furnish a list of all corporations for the tax year of 1935 that had a net income, before Federal taxes, of more than a million dollars, and, based upon the actual distributions of that year, would receive a tax reduction under the pending bill:

(a) The amount of such reduction of such corporations.

(b) The rate of taxation if any that would be paid by such corporations in the event the pending bill was then in effect.

This is practically the same request that I made in a letter to the Secretary.

The CHAIRMAN. Does that include in it the request of Senator Black?

Senator LA FOLLETTE. That ought to be in there.

Senator BYRD. Senator Black will have to get up his own.

The CHAIRMAN. Here is a letter that I wrote to the Secretary of the Treasury yesterday. I had overlooked the fact as to the provision of the law limiting the disclosure of such information except as indicated in the statute.

The letter is as follows:

MAY 11, 1936.

Hon. HENRY MORGENTHAU, Jr.,
Secretary of the Treasury, Washington, D. C.

DEAR MR. SECRETARY: At the executive session meeting of the Finance Committee held today, requests for certain information to be obtained from income-tax returns were made by members of the committee. These requests met with the approval of the committee, and therefore, in behalf of the committee I would ask for the following information:

First, I would request the information as set forth in a letter addressed to you by Senator Harry F. Byrd under date of May 8, 1936, a copy of which is attached hereto.

I would also ask that you furnish the committee a list of our larger individual taxpayers by name who own stock in corporations, showing as far as possible the amount of dividends actually received and the amount of dividends in addition which they would have received if the principal corporations in which they owned stock had distributed all of their net income in dividends. In respect to these individuals, it is requested that the names of these principal corporations be shown and the amount of net income and dividend payments made by such corporations. For the purpose of tax computation, the total income of these larger individual stockholders should also be shown. It is suggested that in connection with these large income taxpayers, you show in one column the amount of tax actually paid by the corporation on the profits which constituted their part of the corporate earnings as compared with the amount of tax that these individuals would have been required to pay on the same profits, if they had been received by them indirectly as dividends distributed.

Mr. Kent, Acting Chief Counsel of the Bureau of Internal Revenue, was present during the discussion this morning, and can undoubtedly give you a more detailed analysis of the information requested. It appears that under section 257 (b) of the Revenue Act of 1926, this information may properly be submitted to the committee in executive session.

Sincerely yours,

(The enclosure referred to is as follows:)

MAY 8, 1936.

Hon. HENRY MORGENTHAU, Jr.,
Secretary of the Treasury, Washington, D. C.

MY DEAR MR. SECRETARY: It has been stated that many of our financially strong corporations, especially those of substantial size, will pay little or no taxes to the Federal Treasury if the pending bill is passed. I am checking the accuracy of these statements, and I am likewise interested in the opportunities that may be afforded such corporations by the bill to avoid the payment of taxes.

We must guard carefully against giving these large corporations a greater advantage and perhaps a stranglehold over their present smaller competitors. Frankly, I am concerned about the application of the proposed tax policies to those corporations which now have large surpluses and a strong cash or credit position.

We must make certain that legislation does not prevent the healthy growth and expansion of our smaller businesses by imposing a penalty upon them if their financial position and their business opportunities do not permit the payment in dividends of substantially all their profits. I want your assistance in appraising the situation.

I have selected from Moody's Manual a few of the largest corporations, with a view to determining the rate of tax which would be imposed upon them if the pending bill should be enacted. The only statistics I have available are for 1934. I should appreciate it very much if you would check the list I give you and let me have a similar list for 1935, if statistics are available to you.

A few of the corporations which would pay no tax, based on 1934 returns (now pay 15 percent)

Company	Net income after tax	Dividends paid out
American Telephone and Telegraph	$121,748,729	$167,960,475
American Tobacco Co	24,084,260	26,590,558
American Smelting & Refining	7,583,302	7,875,000
General Electric Co	19,726,044	19,681,453
Goodyear Tire & Rubber Co	4,287,684	4,506,907
International Harvester	8,943,837	8,264,040
National Biscuit Co	11,307,573	18,999,342
National Dairy Products Co	6,451,930	8,197,573
Ohio Oil Co	5,411,924	5,294,728
R. J. Reynolds Tobacco Co	21,586,894	27,000,000
Texas Co	5,545,906	9,345,820

The above list of financially strong companies that can completely avoid taxation can be greatly expanded.

Corporations which would pay less than 5 percent

Company	Net income after tax	Dividends paid out	Tax under new bill (*percent*)
Air Reduction	$4,145,416	$3,737,142	2.82
Allied Chemical & Dye Corporation	17,645,355	15,703,374	2.00
Corn Products Refining Co	9,792,696	9,294,750	1.30
Curtis Publishing Co	5,906,326	5,400,000	2.45
E. I. du Pont	46,701,465	40,788,914	3.50
Firestone Tire & Rubber	4,154,656	3,572,192	4.00
General Foods	11,143,876	9,452,614	4.40
Great Western Sugar	5,781,727	5,370,000	1.55
Imperial Oil Co	14,101,661	13,415,189	1.40
Liggett & Myers Tobacco Co	20,086,691	17,200,227	4.16
Parke, Davis & Co	8,719,368	8,232,450	1.50
Pennsylvania Railroad Co	13,977,839	13,214,946	.80
United States Smelting & Refining	6,062,908	6,000,129	.25

Corporations which would pay less than 10 percent

Company	Net income after tax	Dividends paid out	Tax under new bill (*percent*)
American Can Co	19,522,945	15,756,321	6.63
Armour and Co. (Delaware)	8,235,835	5,599,830	8.84
Eastman Kodak Co	14,503,247	10,499,066	8.54
General Motors	94,709,131	73,621,710	6.78
Great Atlantic & Pacific Tea Co	20,478,190	16,430,796	8.72
International Shoe Co	8,967,024	6,671,742	7.78
J. C. Penney Co	18,147,318	11,307,108	9.37
Phillips Petroleum Co	8,737,200	4,153,038	8.30
Procter & Gamble	14,870,027	10,512,906	8.30
Socony-Vacuum Oil Co	24,131,397	18,652,561	6.90
Standard Oil Co.:			
California	18,347,807	13,069,479	8.95
Indiana	18,949,680	15,371,229	8.63
New Jersey	67,882,371	54,304,193	8.06
Texas Gulf Sulphur Co	8,966,478	8,730,000	8.22
United Fruit Co	12,049,800	8,717,963	8.60
F. W. Woolworth Co	32,142,363	23,285,676	8.64

I also ask that you furnish me with the names of all corporations which, for the last year for which the statistics are available, had a net income, before Federal taxes, of more than $1,000,000, and, based upon the actual distributions for the year, will receive a tax reduction of 50 percent or more under the pending bill.

You will appreciate that the fundamental purpose of my inquiry involves not only competitive advantages to the strong corporations, but the restraints of heavy taxes upon small- and medium-sized enterprises upon which we must depend so largely for reemployment of labor, and for healthy business growth.

It is unnecessary for me to add that the data must be available promptly if it is to serve a useful purpose. I shall appreciate very much your assistance and cooperation.

Cordially yours,

HARRY F. BYRD.

Senator BYRD. This makes some slight change in the request that I made. I want the amount of reduction of each corporation, which my letter did not specifically ask for.

Senator LA FOLLETTE. It would seem to me, Mr. Chairman, in view of your letter, which seems to me to cover Senator Black's request, that we could pass Senator Byrd's resolution which asks for a little additional information than that requested in your letter to the Secretary.

The CHAIRMAN. Without objection, this resolution will be adopted, and the clerk will transmit it immediately just as it is adopted to the Secretary of the Treasury, requesting him to comply with it.

Senator BARKLEY. Is there any question that the letter carries with it the effects of the resolution? Whatever we do ought to be in the one resolution, and not parts of piecemeal resolutions.

The CHAIRMAN. Yesterday there was no resolution passed. I took it as the action of the committee. The law says it can be furnished when the committee requests it.

Senator BARKLEY. Was it not your intention that your letter should cover both these informations sought by Senator Byrd and Senator Black?

The CHAIRMAN. Yes. This letter went yesterday to the Secretary of the Treasury. This is some additional information that Senator Byrd desires, so we will send another letter.

Senator BARKLEY. I do not object to it, but I think if we are going to pass a formal resolution asking for information, it ought to ask for all of the information that we want.

Senator LA FOLLETTE. Would it not satisfy the situation to propose that the committee authorize and endorse the letter which the Senator transmitted to the Secretary, as expressing the action of the committee?

Senator BYRD. A separate motion?

The CHAIRMAN. Yes.

Senator LA FOLLETTE. I move then that the committee express its approval of the letter which the chairman has written to the Secretary of the Treasury as embodying and expressing the action taken by the committee on yesterday.

Senator CLARK. I second the motion.

The CHAIRMAN. Without objection, the motion will be adopted.

Senator BYRD. Then the motion that I made is adopted too?

The CHAIRMAN. That is adopted, and a letter will be sent immediately for that information.

The Secretary of Agriculture is here, and I request you, Mr. Secretary, to come forward and make such statement as you desire.

STATEMENT OF HON. HENRY A. WALLACE, SECRETARY OF AGRICULTURE

Mr. WALLACE. As you are aware, I have sent you a memorandum in the form of a letter which I think you have before you, and I believe all of the members of the committee have mimeograph copies of this letter. I suspect that the most orderly method of procedure would be for me to read this letter:

"MAY 7, 1936.

"Hon. PAT HARRISON,
"*United States Senate.*

"MY DEAR SENATOR: I wish to thank you and the members of your committee for this opportunity to express my views and the views of the Department of Agriculture with respect to such portions of the pending tax bill (H. R. 12395), and such further related matters as are of direct interest to this department.

"I refer, first, to the provisions for a tax of 90 percent on income which constitutes an unjust enrichment of processors resulting from the nonpayment of processing taxes growing out of the decisions of the Supreme Court in the *Hoosac Mills* and *Rice Millers cases;* second,

to provisions which I shall suggest intended to insure the retention of the $963,229,981.67, collected as processing and related taxes under the Agricultural Adjustment Act in all cases where the taxpayer did not bear the burden of the tax; and, third, to the levying of excise taxes at moderate rates on the processing of certain agricultural commodities.

"I wish to endorse strongly the inclusion of the bill of provisions looking to these ends: The first, on the ground that with rare exceptions the processors did not absorb the processing taxes, but passed them on to consumers or back to producers, and that hence the approximately 320 million dollars of impounded and otherwise uncollected taxes, lost by the Government as a result of the Supreme Court's decisions, represent an unjust enrichment or outright gift which should be recovered by the Treasury; the second, on the ground that, where the taxpayer did not sustain the economic burden of the tax, he should not recover the taxes paid, for the same reasons which justify a tax on the net income resulting from nonpayment of such tax; and the third, on the ground that agriculture has a profound interest in the maintenance of the Federal Government's revenues and in the production of a part of such revenues from sources having some relationship to agriculture."

I discuss now the tax on unjust enrichment:

"The decision of the United States Supreme Court in the *Rice Millers' case* returning impounded processing taxes to processors resulted in a loss to the Federal Government of approximately 320 million dollars in impounded or otherwise uncollected taxes.

"Processors' margin, during the period the processing taxes were in effect, were widened in practically all cases to include the tax. This means that the tax was passed on to the consumers or back to the producers and was reflected in market prices up to January 6. The processors therefore are absolutely not entitled to keep for themselves tax revenues which have already been paid to them by consumers and producers. To allow the processors to retain this revenue would be in the nature of a sheer gift which, for example, for the cotton, wheat, and hog processing industries would amount to several times their annual net profits of prosperity years.

"I am aware that the large meat packers have recently been agitating against the 'windfall' tax provisions on the ground that these provisions for a tax of 80 percent on unjust enrichment from this source would be unfair to small packers.

"I wish to point out that the lion's share of the tax gift will go, not to the small packers, but to the big packers, if they should succeed in defeating the 'windfall' tax provisions. Ten large packers alone were enriched by about 50 million dollars of unpaid taxes, or half the total unpaid hog taxes. This sum is probably four times these packers' 1935 earnings from hog operations. The processors' margin on hogs was widened to include the tax by large and small processors alike. This is much different than saying that there were no small packers who lost money. Some of them did. Small packers were bound to have difficulty following the sharp reduction in hog supplies caused by drought. They are always hard pressed by larger competitors in periods of falling hog supplies and rising hog prices. The fact of size, however, would not seem to justify the application of a different principle in the matter of unjust enrichment.

"That the real interest of the few big packers in their opposition to the 'windfall' tax is not the small packer but the enormous unearned enrichment to themselves is further revealed by the volume of hogs slaughtered by them and by the small packers. During the fiscal year 1935, there were 16,627 hog processors. Four large packers slaughtered 40 percent of all hogs, 10 additional packers slaughtered 24 percent of the total, and 32 additional packers slaughtered 17 percent of the total. These 46 packers slaughtered 81 percent of all the taxable hogs slaughtered in 1934–35."

Senator CLARK. How many packers are there in the United States, Mr. Secretary?

Mr. WALLACE. There are 16,627 hog processors. Of course, there are other packers that deal in cattle.

Senator CLARK. And 46 packers slaughtered 81 percent of all of the hogs?

Mr. WALLACE. Yes.

Senator CONNALLY. Mr. Secretary, does that include small butchers or is that real packing plants, the 16,000?

Mr. WALLACE. I think this includes all hog processors, however small. That is all that would be reached by the Bureau of Internal Revenue.

Senator BARKLEY. How many of what you call packers are in the packing business in the whole country? Do you know and can you give the figure?

Mr. WALLACE. That is a matter of definition, and it would be impossible for me to give you a definite answer.

Senator BARKLEY. Forty-six would be a small proportion of the total number engaged in the hog-packing business, would it not?

Mr. WALLACE. Yes; although the 46 did 81 percent of the business.

Senator BARKLEY. That would be a small percentage?

Mr. WALLACE. Yes; that would be a small percentage.

Senator COUZENS. Mr. Secretary, I would like to ask how you arrive at this conclusion: "Small packers were bound to have difficulty following the sharp reduction in the hog supplies caused by the drought." Do I understand that you mean the committee to understand that was the only cause for the hog supplies to be short?

Mr. WALLACE. It is always a matter of past history as you study packing earnings, that whenever hog prices go up and hog supplies go down, the big packers, gain, because of the inventory carried over from the preceding period of low hog prices; the small packers not being in a position of carrying such large inventories, find themselves in a difficult competitive position.

Senator COUZENS. I understand that, but you say impliedly that the only cause was the drought. Was there not another cause?

Mr. WALLACE. You are referring to the Agricultural Adjustment operations?

Senator COUZENS. No. You say "Small packers were bound to have difficulty following the sharp reduction in hog supplies caused by the drought." Was there another cause for the small supply?

Mr. WALLACE. I say, you are referring to the Agricultural Adjustment operations, are you not?

Senator COUZENS. That is what you are talking about, is it not?

Mr. WALLACE. The dominating factor in the great scarcity of hogs was the extraordinary drought. If there had been no Agricultural

Adjustment operations whatever, there would have been, I suspect, the way things turned, almost as great a reduction as there was.

There were three causes for the very pronounced condition. One was the extraordinary short corn crop of 1934; second, the extraordinarily low hog prices of 1933 and early 1934 to which there is always something of a reaction; and, third, the fact that we had definitely endeavored under the Agricultural Adjustment program, to bring about a sufficient reduction in hogs so that there would no longer be a large supply to place on the market.

Senator COUZENS. What percentage of the shortage was attributable to that last classification?

Mr. WALLACE. I am unable to state definitely at this time, although we have made a definite estimate of that and can give you the figure.

Senator COUZENS. If these small packers processing some 19 percent of the whole, lost money, how are they going to return or pay to the Government this unjust enrichment money if they did not get it?

Mr. WALLACE. They got the money, all right.

Senator COUZENS. If the lost money and have no money to pay this unjust enrichment which you allege, how are they going to pay this unjust enrichment money? In other words, there is plenty of evidence before the committee to indicate that among this 19 percent of the hog processors who made no money, they have no money to pay this unjust enrichment tax. How are they going to do it?

Senator KING. Go into bankruptcy, if they are not already there?

Senator COUZENS. This is a serious situation.

Mr. WALLACE. That kind of a situation has happened in the Bureau of Internal Revenue again and again.

Senator COUZENS. What do you mean? That they pay a tax on money that they did not earn?

Mr. WALLACE. I mean to say that there have been many small concerns that have found themselves in a position unable to pay the taxes which were owing to the Government.

Senator COUZENS. What taxes?

Mr. WALLACE. Income taxes.

Senator COUZENS. They do not have to pay any if they do not make any, so they cannot have any experience along that line.

Mr. WALLACE. Oh, yes, they can.

Senator COUZENS. How?

Mr. WALLACE. They can find the experience in the succeeding years so difficult that they are unable to pay, although they expected to be able to pay as the result of the preceding year's operations.

Senator BARKLEY. If after collecting these processing taxes and not turning them into the Treasury, they are in a big fix, how much worse fix would they be in if they had not collected the taxes?

Mr. WALLACE. The point I would make, answering your question somewhat indirectly, is that if there had been no processing tax whatever, if there had been no Agricultural Adjustment program whatever, these men would, so far as their operations are concerned, have been in a position of loss just the same.

Senator COUZENS. You say no, just the same. That is the point I am trying to make. If it is just the same, then why the return of the enrichment money that they did not collect or did not get, be-

cause their business showed a loss? You say it would be just the same if we had the Adjustment Act or not.

Mr. WALLACE. This is the point I would make Senator; that the small packer as well as the large packer, widened the margin between the paying prices to the farmers and the selling prices to the consumers.

Senator KING. That is, they paid more for their products, you mean?

Mr. WALLACE. No. Small packers to some extent, we will say, paid less for their hogs and charged the consumer more for the product.

Senator KING. The evidence before us shows, by these small packers, that they were compelled to pay advancing prices largely because of the limited production because of your policy of killing the pigs and restricting production, and they were compelled to pay higher prices than they otherwise would, and the evidence before us shows an enormous advance in prices which they had to pay for the hogs.

Mr. WALLACE. Senator, the point I was making was dealing with the incidence of the processing tax itself, with the margin. I am not dealing with the absolute price of hogs, but the margin between what the packers paid to the farmer and what they sell the product for to the consumer. The point I was making was the fact that the small packers like the large packers widened that margin, in part by paying a lower price than these farmers——

Senator BARKLEY (interposing). As the price went up due to whatever cause brought it about, whether it was from drought or from the Agricultural Adjustment, or for any other reason, as the price of hogs went up, the margin of difference between the price paid the producer and the price charged the consumer, maintained its status? It did not vary because the price went up, so that that width was maintained, the higher the price went, would it not?

Mr. WALLACE. In general that is correct, although there is a tendency, just going back over the years before the Agricultural Adjustment, there is a tendency, I believe, in times of rising prices, because of the superior competitive position of the large packers, to reduce that margin a little bit when hog prices are going up, because they have that inventory to enable them to out-compete the smaller packers. There is a tendency to reduce the margin in times of rising prices.

Senator BARKLEY. They carry over stocks for which they had paid a lower price, and that enables them to reduce the margin a little bit?

Mr. WALLACE. Yes.

Senator CONNALLY. As I understood you a little while ago, if there had been no processing tax on, the demand for pork products would have been higher to the producer than they would have been probably if otherwise with the tax on; in other words, the added expense of the tax had a depressing effect on the price to the producers. When that tax was added, the processors wherever they could, did pass that on and thereby created the spread that you speak of?

Mr. WALLACE. Yes; he passed it on. There were only two ways that he could pass it on; one was charging more to the consumer, and the other was paying less to the farmer.

Senator CONNALLY. And the fact that it was on, would give him an advantage in paying a little less to the farmer, because all prices have a certain reaction to demand, and the natural demand for hogs adjusted by the price with the tax on, might have justified, like that same price if there had been no tax on to the producer, competition with other meats and other food products.

The CHAIRMAN. All right, Mr. Secretary, will you proceed?

Mr. WALLACE. "The total tax liability on hogs slaughtered in that year was $174,000,000. Of this amount, the 4 largest packers owed the Treasury $69,000,000; the next 10 largest packers, $36,000,000; and the next 32 largest packers, $30,000,000. These 46 large firms incurred a tax liability of $135,000,000 out of a total of $174,000,000, or an average of $3,000,000 per taxpayer. The balance of less than $40,000,000 covers the slaughter operations of over 16,500 hog processors, or an average of $2,400 per taxpayer. The four largest packers collected in processing taxes in the 1935 fiscal year about four times the annual net profits of the entire meat-packing industry in prosperity years.

"Representatives of the meat packers are publicly on record, including statements made in testifying before committees of Congress, to the effect that they pass the processing taxes back to the farmers. Such statements are to be found, among other places, in the hearings relating to the Agricultural Adjustment program before the Committee on Agriculture of the House of Representatives, Seventy-second Congress, second session, pages 232 and 268, hearing on H. R. 5585, before that committee, during the Seventy-fourth Congress, first session, page 253, and in the hearings on S. 1807, before the Senate Committee on Agriculture and Forestry, Seventy-fourth Congress, first session, pages 183–188. Their present assertions that they now have a just claim to this money are indeed inconsistent with their prior statements and with the true facts.

"The Hoosac Mills and Rice Millers' decisions destroyed the self-liquidating nature of the Agricultural programs.

"The losses of revenue which these decisions caused the Government, totaling, as I have said, in excess of $320,000,000 in unpaid taxes, have made new tax legislation essential.

"Farmers who as producers and consumers contributed a share of all processing taxes are, I believe, overwhelmingly in favor of enactment of the 'windfall' tax provisions. I feel also that the principle of the Revenue Act of 1919, following the World War, that the Federal Government might properly tax at high rates (graduated up to 85 percent) the usual income derived from war contracts with the Government, sustained in *Hoe & Co.* v. *Commissioner* (30 Fed. (2d) 630), is equally applicable to the facts presented by the type of 'windfall' income which is the subject of the 'windfall' tax and should be sustained in court now."

The next subject for discussion is the limitation on refunds of processing taxes collected, which has to do with the proposed modification of section 21 (d).

Senator COUZENS. You mean section 21 (d) of the A. A. A.?

Mr. WALLACE. Of the Agricultural Adjustment Act, as amended.

The three departments, Agriculture, Justice, and Treasury, have been in conference on this. They are not in quite complete accord as to certain methods of procedure, although all are agreed that the provision should be rewritten.

The CHAIRMAN. Do you recommend a provision being placed in here modifying that law or changing that law?

Mr. WALLACE. Yes; that was the modification of that section. That was the view of Agriculture. I believe Justice has somewhat the same view. I believe Mr. Oliphant is here and will present a somewhat different view with regard to it.

The CHAIRMAN. But you all are not in accord on that proposition?

Mr. WALLACE. I think that Justice and Agriculture are in substantial accord. I think that the Treasury has a different procedure in mind. I have talked with the Secretary about it, and we have agreed that we would each submit our views to this committee.

Senator BARKLEY. Is there a difference in policy or principle or in the procedure?

Mr. WALLACE. It is a difference in procedure, I would say.

Senator KING. Are you relating to the past, or to the future?

Mr. WALLACE. Relating to the future.

Senator KING. For a continuation of this processing tax?

Mr. WALLACE. No. This is dealing with another matter. I am bringing up another matter having to do with a modification of section 21(d) concerning which modification in principle, all three departments are in accord. This provides that section 21(d) must be rewritten to make it more specific, but as to the exact method of procedure, there is something of a difference as to the best way to go about it. A very amicable difference.

Senator CLARK. Is that section 21(d) of the A. A. A. amendments?

Mr. WALLACE. Yes, sir. Now, I will discuss that particular point.

"In addition to the question of the 'windfall' taxes to prevent the unjust enrichment of the processors, referred to, an even larger problem is the question of establishing adequate procedure for handling claims for the refund of the processing taxes actually paid into the Federal treasury. Processing taxes alone, paid during the time the tax was in effect, totaled $852,382,985. When the other invalidated taxes imposed under the Agricultural Adjustment Act are added, the total sum involved is increased to $963,229,981.67. Obviously, if these sums, or any large proportion of them were refunded, there would be a very heavy additional burden on the Public Treasury. The problem of equitable procedure with reference to claims for refund in connection with these taxes is therefore an exceedingly serious one.

"In the amendments to the Agricultural Adjustment Act approved last fall (Public 320, sec. 21 (d)), an attempt was made to cover this problem. This provision adopted prior to the Hoosac Mills decision, is believed to be inadequate to deal with the problem. To the present date over 8,500 claims for refund have been filed with the Commissioner of Internal Revenue, and over 200 suits have been filed in courts to recover such taxes from the collectors. One district court has held the provisions of section 21 (d) to be invalid.

"Attention is called to the fact that the provisions of 21 (d) are being attacked in the courts on the following grounds:

"1. Although it states the conditions under which the Commissioner of Internal Revenue may deny the refund of the taxes paid, it does not establish positive conditions compliance with which shall entitle the claimant to the refund of the taxes. It is argued from this assertion that the provisions are so vague and general as not to give an adequate remedy. The district court in the case mentioned

adopted this view. It may be added that this was one of the main arguments advanced in the Rice Millers case.

"2. The existing language provides no specific period of time within which the Commissioner must act on claims filed with him. Therefore, the claimants allege that the Commissioner could defer action until after the statute of limitations has run and they would then have no recourse to the courts. In some cases the time for the bringing of suit will soon expire. They contend that this denies them due process of law. Undoubtedly, this fact would be sufficient for the courts to take jurisdiction, and the requirements of section 21 (d) would become meaningless.

"3. Under the existing language, the procedure is not carefully worked out as to the precise way in which the claims are to be handled. For example, if a lower court should find that the Commissioner was in error, it does not show clearly what the subsequent steps would be, that is, whether the case would be returned for further findings or whether the court would render a final decision.

"It is suggested that it is rather cumbersome to require hearings on each claim, even in cases where the Commissioner decides that the claimant is entitled to the refund. Such hearings are now required.

"These difficulties with the existing provisions, if the courts adopt the view of the claimants, are so serious as to indicate that, if the language is not revised, the Government may be forced to refund the major part of the taxes collected under the Agricultural Adjustment Act (as already indicated, nearly 1 billion dollars in total) regardless of the equities involved. Accordingly, we believe it essential that the existing language of 21 (d) be so revised as to meet the difficulties enumerated, particularly in the matter of giving to processors a clear and positive indication of what they need to show in order to be entitled to a refund of the taxes.

"The suggested amendment is based on the fundamental principle that the processors should be entitled to a refund of the taxes illegally collected only in those cases and to the extent that they themselves actually bore the burden of the tax. Where the burden of the tax was actually passed on to ultimate consumers or back to producers, there is no method by which the tax could be refunded to the person who ultimately bore the burden of the tax, and to provide in such cases for refunds to the persons who paid the tax in the first instance would simply result in unjust enrichment on a scale even larger than that involved to date in the return of the impounded funds."

Senator CONNALLY. Mr. Secretary, may I interrupt you there for a moment? Where the tax is passed on to the consumer, it is an easier problem than where it is passed back to the producer. How are you going to determine whether it was passed back to the producer or not? Is that not largely a matter of speculation?

Secretary WALLACE. Of course, the method which we are proposing here would not involve distributing money either to the consumer or to the producer.

Senator CONNALLY. I understand that, but you say here just a moment ago where the burden of the tax was actually passed on to the ultimate consumer or back to producers.

Mr. WALLACE. Yes.

Senator CONNALLY. I am for your principle that you are standing for, but it is a difficult thing to provide a method of arriving at whether they passed it back to the producer.

Secretary WALLACE. But that does not enter into the procedure we are advocating. The procedure we are advocating is that the Treasury be protected from returning any of this vast sum of money, amounting nearly to a billion dollars to processors. If the money is not returned to the processors, then it does not become a matter of practical concern as to whether the money belongs to the producers on the one hand or to the consumers on the other. There is no need for precise measurement.

Senator CLARK. Is it your contention, Mr. Secretary, that what you are advocating here is that if a processor could show that he had not passed on the tax, that he should not be liable for the tax?

Mr. WALLACE. We are still standing for a principle in this procedure that if such a showing can be made, then the processor might recover.

Senator COUZENS. There is one point raised by Senator Connally that I do not think you have answered completely. That is how, in arriving at a refund, you can determine that a certain amount of it went back to the producer? I do not see how you can arrive at that.

Mr. WALLACE. Well, it is just being stated here in passing. If you want me to discuss that—I think it is off the main channel of thought, but if you want me to discuss that——

Senator COUZENS (interposing). I thought that two factors went into it; one, that it was paid by the processor, and the other that it was passed on to the consumer.

Mr. WALLACE. What enters into the computation of the refund is the total margin between what was paid to the producer and what was charged to the consumer. It is not necessary for the purpose of the principle which I am advocating here to see how much of that increased margin came out of the reduced price to the producer and how much came out of the increased price to the consumer. That is not necessary for the principle which I am working with here. It is a matter on which work has been done, but it is not a matter of practical consideration.

Senator BARKLEY. In other words, it is immaterial which way it passed, but he must show that it did not pass in either direction in order to recover?

Mr. WALLACE. That is right.

Senator GEORGE. Suppose he did not pass back to the producer but a fraction, it would become material.

Mr. WALLACE. If you will allow me to complete the reading of this part, I think you will discover that that particular part is covered. If this increased margin above the normal margin represented only a small portion of the processing tax, then it will be possible under the procedure set up here for the processor to obtain the refund.

Senator GEORGE. I did not know that you had dealt with it.

Senator KING. Was the price paid for the hogs the same in every part of the United States?

Mr. WALLACE. Certainly not. The price paid for hogs varies greatly according to the freight rates and the nearness to the market.

Senator KING. Then how could you determine—I am intrigued with that suggestion of a possible passing of part of it back to the producer. How could you do that? How could you determine whether

the processor had passed any of it back to the producer or whether it had all gone to the consumer?

Mr. WALLACE. That is an immaterial point for the purpose of the discussion. I am merely saying that we can determine—here is the increased margin. It went either back to the producer or it went on to the consumer, or it went a little of each; but for practical purposes, we are not concerned which way it did, but we can say that here is the total amount.

"The suggested amendment is based on the fundamental principle that the processors should be entitled to a refund of the taxes illegally collected only in those cases and to the extent that they themselves actually bore the burden of the tax. Where the burden of the tax was actually passed on to ultimate consumers or back to producers, there is no method by which the tax could be refunded to the person who ultimately bore the burden of the tax, and to provide in such cases for refunds to the persons who paid the tax in the first instance would simply result in unjust enrichment on a scale even larger than that involved to date in the return of the impounded funds. This principle that refunds should be made only to the extent to which the burden of the tax was actually borne by the person claiming the refund is that which was enunciated by Congress in adopting section 21 (d) last fall. The suggested language would make it much more specific and lays down a definite rule for the showing that processors must make in order to indicate their right to the refund under this general theory. The suggestions of this Department are contained in the proposed amendment numbered '(3)', Appendix I."

I think you have it, Senator Harrison.

Senator KING. The appendix apparently is eliminated.

Senator COUZENS. We can take up that, can we not?

Mr. WALLACE. It is described in rather simple fashion in the part which I will now read.

The CHAIRMAN. Suppose I put that in the record in this connection.

(The matter referred to is as follows:)

APPENDIX 1

(1) Page 230, line 2, strike out the period following the figures "1936" and insert in lieu thereof a semicolon and the following: "*Provided, however*, That in the case of articles other than direct-consumption sugar processed wholly or partly from sugar with respect to which a processing tax was paid, which are exported or delivered for charitable distribution or use, the exportation or the delivery for charitable distribution or use may take place at any time prior to September 1, 1936."

(2) Page 230, line 5, strike out the period following the word "based" and insert in lieu thereof a comma and the following: "and no such refund shall be allowed to any person unless he shall establish that the amount claimed has not been, and will not be, repaid to him by the processor or other vendor, under the terms of any existing agreement. No claim under this section (except a claim under the proviso contained in subsection (a)) shall be disallowed on the ground that the tax, with respect to the article or the commodity from which processed, has not been paid."

(3) Page 233, immediately following line 25, insert the following new sections:

SEC. 603. The Agricultural Adjustment Act, as amended, is amended by striking out section 21 (d) and inserting in lieu thereof the following:

"(d) (1) As used in this subsection 21 (d):

"(A) 'Commodity' means any commodity, prior to processing, of a type with respect to which a processing tax was imposed under the provisions of this title, or would have been imposed had it been processed in the United States (as defined in section 10 (*f*) of this title) during the period in which the tax was in effect.

"(B) 'Article' means the product which is obtained by processing the commodity, and includes the goods obtained by any further manufacture or by combination with other materials, whether the manufacture or combination be done by the processor or another.

"(C) 'Claimant' means any taxpayer who has filed with the Commissioner a claim for refund of processing, floor stocks, or import compensating taxes paid under this title.

"(D) 'Affiliate' means a corporation a majority of the voting or unlimited dividend stock of which is owned or controlled by the claimant, or which owns or controls a majority of such stock of the claimant, or a majority of the voting or unlimited dividend stock of which is owned or controlled by the same interests which own or control a majority of such stock of the claimant. As used in this subdivision, 'corporation' includes an association, trust and any other business organization, and 'stock' includes certificates and any other evidence of beneficial interest.

"(E) 'Commissioner' means the Commissioner of Internal Revenue.

"(F) 'Processing tax' means the tax imposed by this title upon the processing of a commodity which at the time of processing was owned by the processor or an affiliate.

"(G) 'Custom-processing tax' means the tax imposed by this title upon the processing of a commodity which at the time of processing was not owned by the processor or an affiliate, but was processed for a customer.

"(2) No suit, action, motion, or proceeding of any nature, whether brought before or after the date of enactment of this amendment, shall be entertained by, or maintained in, any court for the recovery, recoupment, set-off, refund, or credit of, or counterclaim for, or review of a customs protest against, any amount of any tax, penalty or interest, which was imposed or accrued under this title, unless subsequent to the date of the adoption of this amendment and prior to January 1, 1937, a claim for refund of such tax, penalty or interest has been filed with the Commissioner; and after filing such claim suit may be brought only as provided in subdivisions (7) and (9) of this subsection (d).

"(3) No claim shall be considered by the Commissioner for, and no recovery, recoupment, set-off, refund, credit, or counterclaim shall be made or allowed to any claimant of, the amount of any such tax which has been heretofore refunded or credited by the Commissioner to such claimant under the provisions of subsection (a) or (c) of section 15, section 16, or section 17 of this title, or otherwise refunded or credited to such person.

"(4) (A) No claimant shall file more than one claim relating, respectively, to processing taxes, custom-processing taxes, or floor-stocks taxes, paid with respect to a single commodity. Claims relating to import compensating taxes shall be in such number as the Commissioner may prescribe.

"(B) Such claim and any amendment thereof shall be under oath and shall contain such information and be in such form as the Commissioner, with the approval of the Secretary of the Treasury, shall prescribe by regulation. The Commissioner is authorized to require, at any time in the course of the proceedings before him, such additional information under oath as he shall deem material or relevant to consideration of the claim. The Commissioner is authorized to disallow any claim because of failure by the claimant to supply any information required by regulation or special notice to the claimant.

"(C) In the absence of fraud or of mistake in mathematical calculation, the findings of fact and the decision of the Commissioner upon the merits of any claim presented under this subsection 21 (d) shall not be subject to review by any other administrative or accounting officer, employee, or agent of the United States.

"(5) The Commissioner shall allow the claim only to the extent that it be established to his satisfaction, and he shall find, that the claimant bore some or all of the burden of the tax himself, and did not shift it to others by selling the article or performing the services for a price which included the tax or by purchasing the commodity at a price reduced to compensate the claimant for the tax, or in any other manner.

"(6) (A) Where the refund claimed is for a processing tax (but not for a custom-processing tax) paid, it shall be prima-facie evidence that the burden of the tax was borne by the claimant to the extent (not to exceed the amount of the tax) indicated by the circumstance that the average margin per unit of the commodity processed, was lower during the tax period than it was during the period before and after the tax. If the average margin is not lower, it shall be prima-facie evidence that none of the burden of the tax was borne by the claimant but that it was shifted to others.

"(B) Such average margin for any period shall be determined by computing the average amount obtained from the sale of the articles derived from each unit of the commodity, and deducting therefrom the sum of (1) the average amount paid by the claimant for each such unit of the delivered commodity and (2) the amount of any processing tax paid with respect thereto. The amount paid for the commodity shall be either the current market price at the time of processing of the commodity, or the actual cost of the commodity processed, according to the usual accounting procedure of the claimant. The amount obtained from sale of the articles shall be either the current market price at the time of processing of the commodity, or the actual receipts from the articles sold, according to the usual accounting procedure of the claimant. If the accounting procedure of the claimant is based upon actual costs of the commodity or actual receipts from the articles, and specific lots thereof cannot be traced, then he may be considered to have processed each unit of the commodity in the order in which it was acquired, and to have sold each article in the order in which it was processed.

"(C) (1) The tax period shall mean the period with respect to which the claimant actually paid such processing tax or taxes to a collector of internal revenue; and (2) the period before and after the tax shall mean the twenty-four months (except that in the case of tobacco it shall be the twelve months) immediately preceding the effective date of the processing tax, plus the six months February to July, 1936, inclusive. Information relating to these last six months may be filed by amendment if the claimant so desires. If, during any part of such period, the claimant was not in business, or if his records for any part of such period are so inadequate as not to provide satisfactory data, the average margin of the taxpayer for such part of such period shall, when necessary for a fair comparison, be deemed to be the average margin, as determined by the Commissioner, of representative concerns engaged in a similar business and similarly circumstanced.

"(D) If the claimant bought the commodity from an affiliate, the cost may be considered by the Commissioner to be the amount paid for such commodity by the affiliate which bought from a nonaffiliated seller. If the claimant sold the article to an affiliate, the selling price may be considered by the Commissioner to be the amount received on the sale of such article by the affiliate which sold to a nonaffiliated buyer.

"(E) Notwithstanding that the average margin was or was not lower during the tax period than it was during the period before and after the tax, either the Commissioner or the claimant may show that the change or lack of change in the average margin was due to changes in factors other than the processing tax. Such factors shall include (but shall not be limited to) any clearly shown change (A) in the type or grade of article or commodity, or (B) in costs of production. Where a claimant asserts that the burden of the tax was borne by him and that the burden of any other increased cost was shifted to others, the Commissioner shall determine, from the respective effective dates of the tax and of the other increase in cost as compared with the date of the change in margin, and from the general experience of the industry, whether the tax or the increase in cost was shifted to others. Where the Commissioner determines that the change in margin was due in part to the tax and in part to the increase in other cost, he shall apportion the change in margin between them. If a claimant processed an agricultural or other product in addition to the commodity with respect to which he claims a refund, and if the Commissioner determines that the burden of the tax was shifted in whole or in part by means of the transactions relating to such product, the average margin with respect to such product shall also be considered in the manner and with the effect provided in this subdivision (6).

"(F) If the claimant modified contracts of sale, or adopted a new contract of sale, to reflect the initiation, termination or change in amount of the tax, or at any such time changed the sale price of the article (including the effect of a change in size, package, discount terms, or any other merchandising practice) by substantially the amount of the tax or change therein, or at any time billed the tax as a separate item to any vendee or indicated by any writing that the sale price included the amount of the tax, or contracted to refund any part of the purchase price in the event of recovery of the tax or decision of its invalidity, it shall be prima facie evidence that he did not bear the burden of the tax; but the claimant may establish that such acts were caused by factors other than the processing tax, or that they do not represent his practice at other times during the tax period.

"(7) Where the refund claimed is for floor stocks, import compensating or custom-processing taxes paid and the Commissioner has disallowed such claim in whole or in part, or where the Commissioner has failed to allow or disallow any

claim (including one for processing taxes) within eighteen months after it was filed, unless such time has been extended by written consent of the claimant, or where he has failed to serve a copy of his findings of fact and conclusions of law within ninety days after conclusion of the hearing provided in subdivision (8) of this subsection (d), the claimant may bring suit in the manner, and subject to the conditions and limitations, otherwise provided by law.

"(8) (A) Within ninety days after the date of the mailing of a notice that a claim for the refund of processing taxes paid has been disallowed, in whole or in part, the claimant may file a petition with the Commissioner requesting a hearing on the merits of his claim, and a reconsideration of the Commissioner's determination and finding.

"(B) Within ninety days after the filing of such petition, the Commissioner shall set a date and designate a place for such hearing and shall notify the claimant thereof by registered mail. Such hearing shall be set for a day certain not more than one year after the date of the filing of the petition and may be continued from day to day, during a period not to exceed two years from the date of the filing of the petition and for a longer period upon the written consent of the claimant.

"(C) The hearings authorized by this subdivision (8) shall be conducted by the Commissioner, or such officials of the Treasury Department as he may designate to act as presiding officers, and shall be open to the public. The Commissioner is authorized, with the approval of the Secretary of the Treasury, to prescribe rules of procedure and evidence, conforming as nearly as may be practicable to those of the Board of Tax Appeals. The claimant shall be entitled to be represented by counsel, to have witnesses subpenaed, and to examine and cross-examine witnesses. The presiding officer shall have authority to administer oaths, examine witnesses, rule on questions of procedure and the admissibility of evidence, and require, by subpena in the Commissioner's name, the attendance and testimony of witnesses, and the production of all necessary returns, books, papers, records, correspondence, memoranda, and other evidence, from any place in the United States at any designated place of hearing, and the taking of a deposition by any designated individual competent to administer oaths. The Commissioner shall serve a copy of his findings of fact and conclusions of law by registered mail on the claimant after conclusion of the hearing.

"(D) The Commissioner is authorized to draw up a table of costs and fees, relating to such hearings, not to exceed with respect to any item those charged in the Supreme Court of the United States. The costs shall be assessed and collected (in the manner provided by section 19 (b) for the collection of taxes imposed under this title) against a claimant when the hearing provided by this subsection results in no modification of the determination made under subdivision (5) of this subsection (d).

"(9) (A) If the Commissioner, after the hearing prescribed in subdivision (8) of this subsection (d) disallows, in whole or in part, a claim for refund of processing taxes paid, the claimant may file a petition for review within six months after a copy of the Commissioner's findings of fact and conclusions of law have been served on him. The Commissioner shall certify and deliver to the claimant a transcript of the proceedings before him, within three months after request by the claimant and after payment of a fee, to be prescribed by the Commissioner in an amount substantially equivalent to the actual cost of preparing and certifying such transcript.

"(B) The United States Circuit Court of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the determination of the Commissioner, except as provided in Section 239 of the Judicial Code, as amended, and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 240 of the Judicial Code, as amended.

"(C) Such findings and conclusions may be reviewed by the United States Circuit Court of Appeals for the circuit in which is located the collector's office to which was made the return of the tax for which a refund is claimed, or, if no return was made, then by the United States Court of Appeals for the District of Columbia; or any of such courts may review such determination if designated by the Commissioner and the claimant by stipulation in writing.

"(D) Such courts are authorized to adopt rules for the filing of the petition for review, the preparation of the record for review, and the conduct of proceedings on review.

"(E) Upon such review, such courts shall have power to affirm, or, if the determination is not in accordance with law, to modify or to reverse it, with or without remanding the cause for a rehearing, as justice may require.

"(F) If the determination of the Commissioner is affirmed, costs shall be awarded against the claimant. If such determination is reversed, the judgment shall provide for a refund of any costs and fees paid by the claimant pursuant to subdivisions (8) (D) and (9) (A) of this subsection (d). If such determination is modified, costs shall be awarded or refused as justice may require.

"(10) (A) The decision of the Commissioner made after the hearing provided in subdivision (8) of this subsection (d) shall become final (1) upon the expiration of the time in which to file a petition of review in an appellate court, if no such petition has been duly filed, (2) upon issuance of a mandate of affirmance by an appellate court, or (3) upon his entry of a final order made in conformity with a mandate of modification or reversal issued by an appellate court. If an appellate court remands a case to the Commissioner for a rehearing, his subsequent decision shall become final in the same manner as though he had rendered no prior decision.

"(B) As used in this subsection (10), the term 'appellate court' means the Supreme Court of the United States, a United States Circuit Court of Appeals, or the United States Court of Appeals for the District of Columbia.

"(11) No interest shall be allowed in connection with the recovery, recoupment, set-off, refund, or credit of, or counterclaim for, or customs protest against, any amount paid as tax, penalty, or interest under this title.

"(12) The Commissioner may appoint such officers, attorneys, economists, and other experts, without regard to the Classification Act of 1923, and Acts amendatory thereof, and without regard to the civil-service laws or regulations, as are necessary to execute the functions vested in the Commissioner by this subsection (d). No salary in excess of $8,500 per annum shall be paid to any such appointee.

"(13) (A) There is hereby authorized to be appropriated, out of any money in the Treasury not otherwise appropriated, the sum of $——— to be available to the Commissioner for administrative expenses and refunds under this title. Such sum shall remain available until expended.

"(B) The administrative expenses provided for under this subdivision shall include, among others, expenditures for personal services and rent in the District of Columbia and elsewhere, for law books, books of reference, press releases, trade journals, periodicals, and newspapers, for contracting reporting services, printing and paper in addition to allotment under the existing law, travel expenses, for mileage and per diem in lieu of subsistence of witnesses, payment of which may be made in advance upon certification of such officer as the Commissioner may designate and such certification shall be conclusive. In addition to the foregoing, the administrative expenses provided for under this subdivision shall include such miscellaneous expenses as may be authorized or approved by the Commissioner for carrying out the provisions of this title, including witness fee and mileage for experts, notarial fees or like services, and stenographic work for taking depositions.

"(14) Subsections (a), (b), (c), and (g) of this section 21 are hereby repealed

"(15) If the application of any provision of this subsection (d) to any person or circumstance is held invalid, the remainder of the subsection, and the application of such provision to other persons and circumstances, shall not be affected thereby."

SEC. 604. The provisions of sections 8 (2), 8 (6), 8 (7), 8 (8), 8 (9), 9 (a), 9 (b), 9 (d) (1), 9 (d) (2), 9 (d) (3), 9 (d) (7), 9 (d) (8), 9 (e), 9 (f), 9 (g), 12 (b), 15 (b), 15 (b-1), 15 (b-2), 15 (b-3), 15 (d), 15 (e), 16 (a), 16 (b), 16 (c), 16 (d), 16 (e) (2), 16 (e) (4), 16 (e) (5), 16 (f), 17 (b), 18, and 19 of the Agricultural Adjustment Act, as amended, are repealed, as of January 5, 1936. No tax, civil penalty, or interest which accrued under any provision of law repealed by this title, and which is uncollected on the date of the enactment of this title, shall be collected; and all liens for taxes, civil penalties, or interest arising out of taxes under such provisions of law are canceled and released.

SEC. 605. (a) Section 2 (1) of the Agricultural Adjustment Act, as amended, is amended by striking out the words "balance between the production and consumption of agricultural commodities, and such marketing conditions therefor, as will reestablish", and by inserting in lieu thereof the following: "conditions with respect to the handling of agricultural commodities or the products thereof in the current of interstate or foreign commerce (including the regulation of those conditions which burden, obstruct, or affect interstate or foreign commerce in

such commodities or products thereof) as will promote the general welfare by reestablishing and maintaining".

(b) Section 9 (c) of the Agricultural Adjustment Act, as amended, is amended by striking out the last sentence of said section.

(c) Section 10 (c) of the Agricultural Adjustment Act, as amended, is amended by striking out the comma following the word "title" and inserting in lieu thereof a period and by striking out the words "including regulations establishing conversion factors for any commodity and article processed therefrom to determine the amount of tax imposed or refunds to be made with respect thereto."

(d) Section 12 (c) of the Agricultural Adjustment Act, as amended, is amended by striking out the words "and refunds made" in the second sentence of said section.

(e) Section 15 (f) of the Agricultural Adjustment Act, as amended, is amended to read as follows:

"(f) The President, in his discretion, is authorized by proclamation to decree that all or part of the taxes heretofore or hereafter collected in the Territory of Hawaii, the possession of Puerto Rico, and the Virgin Islands with respect to any processing, manufacture, or sale of sugar beets, sugarcane, or sugar in those areas or upon the processing, manufacture, or sale in the continental United States of sugar beets, sugarcane, or sugar produced in or coming from those areas, shall not be covered into the general fund of the Treasury of the United States but shall be held as a separate fund, in the name of the respective area to which related, to be used and expended in whole or in part for the benefit of agriculture, including research and scientific experiments, investigations, and surveys with respect to diversification of agriculture and land use in those areas, or for the purposes of the Soil Conservation and Domestic Allotment Act or the Sugar Act of 1936, as the Secretary of Agriculture, with the approval of the President, shall direct. The funds authorized to be held as a separate fund as herein provided are hereby appropriated to be available to the Secretary of Agriculture for the purposes for which said funds are established, together with administrative expenses in connection therewith, and said sum shall remain available for such purposes until expended."

SEC. 606. The provisions of section 13 of the Agricultural Adjustment Act, as amended, are hereby continued in force but only for the purpose of carrying out the provisions of sections 1, 2 (as amended by section 605 (a) of this title), 3 to 5, inclusive, 7, 8 (1), 8 (3), 8 (4), 8 (5), 8a, 8b, 8c, 8d, 8e, 8f, 9 (c) (as amended by section 605 (b) of this title), 9 (d) (6), 10 (a), 10 (b), 10 (c) (as amended by section 605 (c) of this title), 10 [illegible], 10 (f), 10 (g), 10 (h), 10 (i), 11, 12 (a), 12 (c) (as amended by section 60[illegible]d) of this title), 14, 15 (f) (as amended by section 605 (e) of this title), 20, 21 (e), and 22 of said act, as amended, which said sections are hereby reenacted: *Provided, however*, That no repeal, reenactment, or amendment made by this title shall be construed to import illegality to any act, determination, proclamation, certificate, regulation, ruling, order, agreement, or license of the Secretary or of the President done or made under the provisions of the Agricultural Adjustment Act, as amended, which are reenacted by this section prior to the date of the enactment of this title, all of which are hereby legalized, ratified, and confirmed.

Mr. WALLACE. I think you will get the sense a little easier from the explanation which I will now read.

Senator KING. All right.

Mr. WALLACE. It sets forth the procedure as to the making of claims for the refund of processing taxes.

"The claim under the suggested amendment would be filed just as any ordinary claim for a refund. In view of the large number of taxpayers who might file claims, and so as to give the Bureau of Internal Revenue an adequate period of time within which to consider the claims, a longer period of limitations is given than under the present laws within which the Commissioner may consider and reject or allow the claim. If the claim is allowed no hearing would be held. If the claim is disallowed, the claimant may petition for a hearing within 90 days after the disallowance. The taxpayer may subpena witnesses and be represented by counsel. The Commissioner is empowered to name a person to preside over such hearings who

may place witnesses under oath; the witness may be examined and cross-examined. If the claim is allowed as a result of this hearing, nothing further is required to be done. If the claim is disallowed, the claimant may petition for a review of any error of law by a United States Circuit Court of Appeals. If the findings of the Commissioner are in accordance with law, they are not reviewable."

Senator WALSH. Are the persons whom the Commissioner can name to hear the evidence and determine the facts, officials of the Internal Revenue Department or outsiders?

Mr. WALLACE. I suppose they will be employees of the Bureau of Internal Revenue.

The CHAIRMAN. The Secretary was not reading from the amendment.

Senator HASTINGS. Does your amendment provide that the representative of the Internal Revenue shall have the definite and final conclusion?

Secretary WALLACE. Not with respect to questions of law.

Senator HASTINGS. But with respect to questions of fact? All of these things are questions of fact. Whether he passed it on or did not pass it on is purely a question of fact. Does your amendment propose that the Commissioner shall decide?

Secretary WALLACE. The commissioner would be final with respect to questions of fact.

Senator HASTINGS. So if he wanted to, he could throw them all out and nobody would have any redress.

Secretary WALLACE. There are certain matters governing questions of fact which are set forth later, which I think should be heard before there is further discussion on that particular point.

"If the court finds that the commissioner erred as a matter of law, the case may be reserved or remanded for further hearing by the commissioner. The power of the courts to reverse such findings would be in all respects similar to and no greater than the power to reverse a decision of the United States Board of Tax Appeals (See *Helvering* v. *Ranking*, 295 U.S. 123). If, however, the Supreme Court should decide that a claimant is constitutionally entitled to the independent judgment of the court on the facts (see *St. Joseph Stockyards Co.* v. *United States*, No. 497, decided Apr. 27, 1936), the courts would have power to examine the evidence before the commissioner as a question of law. Except as to the statutory period of limitations, the procedure outlined is that which was contemplated in section 21 (d) as it now reads. Of course if deemed desirable, a quasi-judicial administrative board could be substituted for the commissioner."

In that, the Treasury has in mind a different procedure.

Senator KING. I see no impropriety in making some official of the Treasury the final arbiter on the question of fact. Of course, if the facts are so obscure or so indefinite as to become a question of law, and we have that in our chancery proceedings, then as a matter of law, the higher court can review it. It seems to me you are following a very sound judicial procedure there.

Secretary WALLACE. A little later we will discuss the method of measurement which would enter into the determination of the question of fact. But first, there is a question of procedure in the case of floor stock taxes, which are slightly different than the procedure with regard to processing taxes.

"The procedure just outlined is suggested for application only to claims for refunds of processing taxes, which constituted 88 percent of all taxes paid under the Agricultural Adjustment Act. There were only 73,000 payers of processing taxes, of whom but 1,400 paid about 95 percent of the processing taxes collected.

"The procedure in the case of floor stock taxes paid:

"Since there are about 1,193,000 floor stocks taxpayers, who paid only about 10 percent of the total amount of taxes involved, and since the questions presented are far simpler, the hearings provided for in the case of processing taxes have not been recommended for this class of claimants but the taxpayer, upon rejection of his claim, is allowed to proceed in the same manner as claimants for refunds generally under the revenue laws."

Senator KING. Pardon me for interrupting. Out of that 1,400 were there processors who were millers and who had to deal with cereals and so on?

Secretary WALLACE. Oh, yes. This is quite different from those involved with the packers. This would deal with cotton spinners, cigarette manufacturers, wheat millers, and so on.

Senator COUZENS. May I ask at this point: There have been suggestions made before the committee that to simplify this refunding of floor tax, it might be desirable to refund the taxes that they paid at the beginning of the act rather than to attempt to fix inventory on January 6, 1936. Have you have any views about that?

Mr. WALLACE. We have some definite views on that, but it is a highly technical problem, exceedingly technical.

Senator COUZENS. I am not asking you to go into it.

Mr. WALLACE. I have not been into the precise details of that particular question for 6 weeks, and if I discussed it at this time, I might create confusion, and I am sure that what you are after is light and justice with respect to this particular point, and I would prefer not to answer it. It might be that one of our men here would be sufficiently posted on it now who might be able to answer your question now if you care to ask it of him.

Senator COUZENS. I won't ask it now, but I would like at some time to go into that question, because it seems to me it would simplify the procedure if you took it as of the payment of the tax rather than as of inventory on January 6, 1936.

The CHAIRMAN. And if you could give us any figures how much the loss would be in revenue.

Mr. WALLACE. Shall I have one of our men get in touch with Senator Couzens and then write you a letter with regard to this particular point?

Senator COUZENS. I prefer that the whole committee get it whenever you are ready. I am not pushing it now; I just want the information at some time.

The CHAIRMAN. Just furnish it to us, and also about the revenue involved in the two plans.

Senator WALSH. The point was made here that it would be simpler to take it as of the time that they paid the tax.

Senator CLARK. You note here that 1,400 out of the 73,000 processing taxpayers paid 95 percent of the taxes collected, and then this provision—of course the other 71,000 would be subjected to the same drastic procedure as the 1,400, would they not?

Mr. WALLACE. They would be subjected to the same procedure.

Senator CLARK. Do you not think it is a very drastic procedure to have an officer of the Agricultural Department passing upon the matter finally, as a matter of fact, with no review by any court whatsoever?

Mr. WALLACE. It does not happen to be an officer of the Agricultural Department.

Senator CLARK. An officer of any department.

Mr. WALLACE. It happens to be the Commissioner of Internal Revenue.

Senator CLARK. An officer of any department, passing finally as a matter of fact, and not subject to judicial review.

Mr. WALLACE. The method of ascertaining the facts being set forth by the Congress.

Senator CLARK. A mere ministerial officer acting as a final arbiter, not subject to any judicial procedure whatsoever. Don't you think that is drastic procedure?

Mr. WALLACE. I would think, Senator, that it might be well if you would delay asking the question until I read a little further here.

The CHAIRMAN. All right, Mr. Secretary.

Mr. WALLACE. As to the justification for the rules suggested:

"In proposing specific rules to guide the Commissioner in determining whether or not the processor has actually paid the tax, the proposed amendment places main reliance on a comparison of processors' margins before, during, and after the tax was in effect."

That is a very significant sentence there. That is the heart of the procedure here suggested, that the main reliance be placed on a comparison of processors' margins before, during, and after the tax was in effect.

"It is a well-known fact that, in the case of most of the commodities affected by the processing taxes, the amount of the tax was quite large compared to the normal margins retained by processors between the price at which they buy the raw material and the price at which they sell the finished products. Accordingly, if the processor shifted the burden of the tax, either by increasing his selling price down, or by reducing his buying price below, what it otherwise would have been, this would be evidenced by an increase in his gross operating margin retained during the tax period. On the other hand, if he actually absorbed the tax himself, that would be shown by the fact that his gross margin during the period the tax was in effect would be no larger than when there was no tax. The tendency to increase margins during the time that the tax was in effect is illustrated in figures 1, 2, and 3, appendix II, prepared by the Bureau of Agricultural Economics from data obtained from trade sources."

Because of the fact that the other Senators had not these appendixes, I am going to ask Mr. Savoy to supply them with them.

The CHAIRMAN. I think we had better put them in the record now.

Secretary WALLACE. You will notice in the upper figure [referring to chart] the buying price is indicated in the lower line with respect to wheat, and the selling price of the wheat products is indicated in the upper line. The upper chart seems somewhat confusing, but the essence of it is indicated in the lower chart, which is the subtraction of the lower line from the upper line, and thus gives precisely the amount of the margin, definitely.

Taking the lower chart, therefore, which begins in January of 1932, you will see that the amount of the margin expressed in cents per bushel between what was paid to the farmer for wheat and what was obtained from the product of that bushel, was about 37 cents, roughly, and went along just about that point, 37 cents to, say, 43 cents, just roughly estimating from the chart, up until April of 1933, and then a number of things began to get in the wind. And there was a little bit of an increase.

Senator CAPPER. Where is that on the chart?

Mr. WALLACE. Mr. Savoy is pointing to it with his pencil.

Then in July 1933 when the processing tax went into effect, there was that sudden increase up to a little above 75 cents.

You remember in July, there were a number of uncertainties. We had in the Department of Agriculture, and there had been suspended since October 1933, the requirements of reporting of speculative transactions, and those had not been reinstated, and there was a terrific wheat speculation as the result of a number of things about which nobody in the Government knew anything, definitely. Wheat prices were skyrocketing and nobody knew just what the price of flour ought to be. That thing smashed, as I remember it, on July 17.

I think possibly that situation had something to do with that unusual peak in margins there. Not attributing anything improper on the part of the millers in any sense. Nobody knew what the situation was, I think. It was a vast speculative boom which collapsed in the middle of July 1933. We reinstated our reporting requirements at that time.

Then of course, the N. R. A. came in a little later. It did not have so much effect here as it did with the cotton spinners, however, which caused certain uncertainties as to just what that margin should be. The thing began to settle down, however, a little later. I do not know what the average margin there is as compared with the previous margin.

Do you happen to know, Mr. Savoy, what the average margin for that period was? You can read it roughly off the chart, you see. The chart itself gives what I am after. That lower line subtracts the processing tax from the total margin and gives what the margin would have been if there had been no processing tax, the real extent to which the latter part of the lower line continues the early part of the line previous to July 1933.

This next chart shows the picture in the case of hogs. It is the same kind of a picture. You have the margin from January 1933 until November 1933 and the processing tax was put on gradually; first of 50 cents a hundred, and then stepped up a little later to $1, and finally to $2.25. So beginning with November 1933 the lower line continues what the margin would have been after the processing tax, whatever it was, was subtracted.

You note in a rough way that it continues the preprocessing tax margin, and that after the tax was removed, that the situation of the lines goes back to where it was in the preprocessing tax period.

Senator BLACK. Do you mean that the margins between the price paid for the hogs and the price at which they were sold after processing remained practically the same both before the processing tax was put on and after the processing tax was put on?

Mr. WALLACE. Yes, sir; provided you subtract the processing tax during the period of the processing tax.

Senator BLACK. But if you do not subtract the processing tax, the margin was a great deal more.

Mr. WALLACE. It was greater by the amount of the processing tax.

Senator BLACK. If the processing tax were permitted to be retained on the hogs as far as the general business is concerned, the profits would be increased and the margin would be increased by the exact amount of the processing tax, according to that chart.

Mr. WALLACE. You cannot tell anything exactly from a chart.

Senator BLACK. I say, approximately, from the chart.

Mr. WALLACE. Yes. That is what you would judge.

Senator BLACK. In general, not taking the individual cases of packers, but the profits as a whole of the industry.

Mr. WALLACE. In toto, yes.

Senator GEORGE. The chart merely indicates, I judge from your statement here—you considered only the price paid for the raw material and the price received, and no consideration has been given for any other change in the variable factors involving the costs of production and manufacture.

Mr. WALLACE. You are speaking of labor, particularly?

Senator GEORGE. Yes.

Mr. WALLACE. We might say that we have to some extent as a corrective of that situation, the margin as it exists after the tax was removed.

Senator GEORGE. But I say, your charts are made on that basis?

Mr. WALLACE. They are made on that basis; yes, sir.

Senator GEORGE. Of the purchase price, the cost of the raw product and the selling price?

Mr. WALLACE. That is correct, Mr. Savoy, that the charts are made on that basis of the absolute margin between what is paid for the product and what is obtained for the product, so that if there has been marked increase of labor, that does not appear?

Mr. SAVOY. That is correct.

Mr. WALLACE. This [indicating] is the cotton situation in a similar manner. Neither, may I say, Senator, has been taken into account a saving that might come, we will say, from improvements in technique during the period. You will notice, for instance, in the cotton textile business, that the margin there—you have, starting back in the year 1925, you will find rather an unusual thing. The margin between the price of the product and the selling price of the finished goods is steadily going down all the way there to 1933. It is rather an unusual situation of the impact of technology in the particular business.

Senator BAILEY. Mr. Secretary, the chart shows the margin, but does it relate itself to volume of sales?

Mr. WALLACE. No; not at all. Those things are not taken into account.

Senator BAILEY. But if the loss was due to decreased volume, it would still be a loss? Does it tell us if there was a considerable reduction in the volume of sales of grey goods in the periods shown on the charts?

Mr. WALLACE. Senator, the only light which I could throw on that, which I think would be a dimmer light than you yourself could throw,

is the light which I obtained from listening to the presentation before the cabinet committee by the textile industry a year ago, and if I remember the figures, there was a considerable reduction in the volume of sales of grey goods during that period.

Senator BAILEY. The spindles in place in this country were down about 8,000,000 from the peak.

Mr. WALLACE. I have here, Senator, if you would be interested, a chart which gives in percentage terms the consumption of cotton goods in the United States beginning in 1923. If you will phrase your question with the time element in it, I might be able to give an answer.

Senator BAILEY. The time indicated by the chart.

Mr. WALLACE. I do not have it quite that far back. Taking the years 1923 to 1925 as 100; in the year 1928 it would seem that the consumption was 7 percent above that normal; in 1929, the consumption was apparently about 14 percent above that base; in 1930, it was about 13 percent below that base; in 1931, it was about 13 percent under that base; in 1932, about 19 percent under that base; in 1933, it apparently was about 9 percent over, in the latter part of 1933 there was a terrific upturn until it looks like in the month of August or the late summer it exceeded the 1923–25 base.

Senator BAILEY. That terrific upturn was by way of anticipation of the existence of the processing tax. They were making goods ahead of time.

Mr. WALLACE. That, or in anticipation of N. R. A. wages, or both. In 1934—this is rather interesting—it was somewhat above the 1931–32 level.

Senator BLACK. How much above?

Mr. WALLACE. It looks like it is about 4 or 5 percent above. In 1935 it is below again.

Senator BLACK. About how much?

Mr. WALLACE. 9 percent below 1923–25.

Senator BAILEY. That is the consumption of cotton goods?

Mr. WALLACE. That is the consumption of cotton goods.

Senator BAILEY. Can you compare that now with the consumption of raw cotton?

Mr. WALLACE. I think that could be obtained. There would be some time lag, but the answer would be roughly the same. You mean raw cotton that does not enter into export?

Senator BAILEY. Yes. Our domestic raw cotton.

Mr. WALLACE. I do not think the answer would be greatly different, but there would be a time factor.

Senator HASTINGS. Mr. Secretary, if the processor did only half as much business as he did in former years, after the tax was put on, and the margin of profit was the same, he might very well be making very much less for his concern, might he not?

Mr. WALLACE. I think that would be an axiom, if he did only half as much business and had a small volume, he would be making less than half as much.

Senator HASTINGS. Then if your rules of determining the facts are based solely upon the difference in the margin, is that a correct rule in order to determine whether or not the processor is entitled to a return of his tax?

Mr. WALLACE. I do not think the Government would be responsible for the volume of the business done.

Senator BAILEY. The Government would not be responsible for the volume, but the increased taxes and the prices reduced the volume, and I think that should be a factor that should be taken into account.

Mr. WALLACE. I think you should take it into account.

Senator HASTINGS. Is your amendment drawn so that it can be taken into account?

Mr. WALLACE. I do not think the amendments are drawn to take that particular point into account.

Senator KING. In determining the marginal differences which you have indicated on these charts, have you taken into account the factor, for instance, of imports, increased exports, or the change in the prices of foreign goods?

Mr. WALLACE. I do not see where that would enter into it. That has not been taken into account, Senator.

Senator BAILEY. But bearing in mind all the time that the price of cotton—the tax could not be passed back to the farmer, because of the Bankhead Act lending policy of the Government.

Mr. WALLACE. The nature of supply and demand in cotton is such that there is very little evidence that it would be passed back to the farmer in any case.

Senator BAILEY. You bought 5,000,000 bales of cotton. That prevented cotton from going down, and that is the only thing that did, as far as I know. I think the processing tax would have fallen on the farmer but for the lending policy of the Government.

Mr. WALLACE. The economists seem to think that in the case of wheat and cotton the nature of supply and demand is such that very little of the tax would have been passed back to the public in the case of those two products, but in the case of hogs there is a little different situation.

Senator BAILEY. You did not lend money on hogs?

Mr. WALLACE. It is a different type of demand. I do not fully agree with the economists, you understand, Senator. I dispute with them on the hog situation. I have felt right along that the thing was passed much more largely on to the consumer than most of the economists think.

Senator BAILEY. You will agree to this effect, that as long as the Government was lending 12 cents a pound on cotton, that all the farmer had to do was to put it in the warehouse and he could be assured of 12 cents, and that the Government would hold the bag. That was pegging the price at 12 cents. That was the effect of that loan. Then we reduced it to 10.

Mr. WALLACE. We started out at 10, increased to 12, then reduced again to 10.

Senator BAILEY. That had the effect of pegging the price?

Mr. WALLACE. Yes.

Senator GEORGE. Mr. Secretary, as a matter of fact then, whatever our theories may be about it, as a matter of fact, in the case of hogs, in the early days of the processing tax, it was frequently passed back to the producer. He frequently sold his hogs on the market less the processing tax.

Mr. WALLACE. I do not like to use the word "frequently", because that would suggest that was passed back in the case of one farmer and not in the case of his neighbor. In hogs, there is such a thing as a

national market and the price on a given day tends to be roughly the same less the customary price differentials in all the markets.

Senator GEORGE. While there is a national market, there is quite a difference between prices for hogs in different sections. For instance, a peanut-fed hog suffered all of these years.

Mr. WALLACE. That is one of the customary price differentials that the packers try to enforce.

Senator GEORGE. And nobody can quite figure it except the packer. As a matter of fact I happened to be raising hogs when the processing tax went in, and I sold some hogs from which the processing tax was bodily taken on the basis of any market.

Mr. WALLACE. That was an illegal thing. We had a number of complaints of that sort.

Senator GEORGE. That did not continue very long, as a matter of fact.

Mr. WALLACE. No.

Senator GEORGE. Generally, at least in my section. In other words, after the processing tax had been in effect some time, we began to get the market or substantially the market, and I presume they were not passing it back to the producer.

Mr. WALLACE. I do not think any of the large packers undertook to do a thing of that sort.

Senator GEORGE. I did not say that, of course. They were the intermediate buyers.

Mr. WALLACE. I think some of them may perhaps have tried to do a thing like that.

Senator GEORGE. And the intermediate buyers, they perhaps themselves did not know how they could handle their own problems, so they simply took the tax out of the price paid.

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

Mr. WALLACE. This is rather a detailed discussion here. Shall I take up your time with this? I do not know whether there are any points in the detailed discussion that I have not brought up. I have discussed figure 1, figure 2, and figure 3.

Senator COUZENS. Let us eliminate those that you have already discussed

The CHAIRMAN. Only discuss those things that you have not already taken up.

Senator BARKLEY. Those figures will go into the record.

Mr. WALLACE. We might as well put those in the record, I suppose.

The CHAIRMAN. Yes; the whole thing will be in the record.

Senator BARKLEY. These charts will be in the record too, will they not?

The CHAIRMAN. Yes. All right, you may proceed.

(The omitted portion of the Secretary's statement and the charts referred to follow:)

WHEAT AND MILL PRODUCTS: PRICES AT MINNEAPOLIS AND PRICE MARGIN, 1932 TO DATE

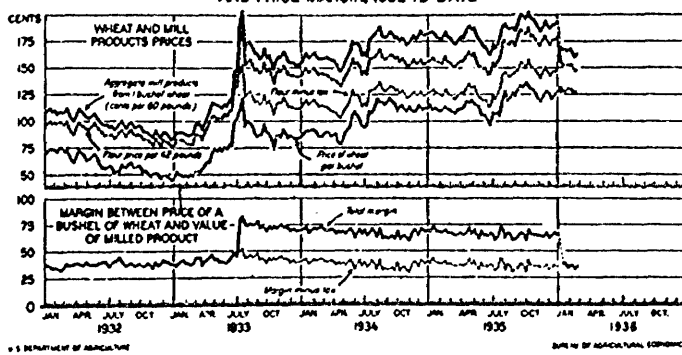
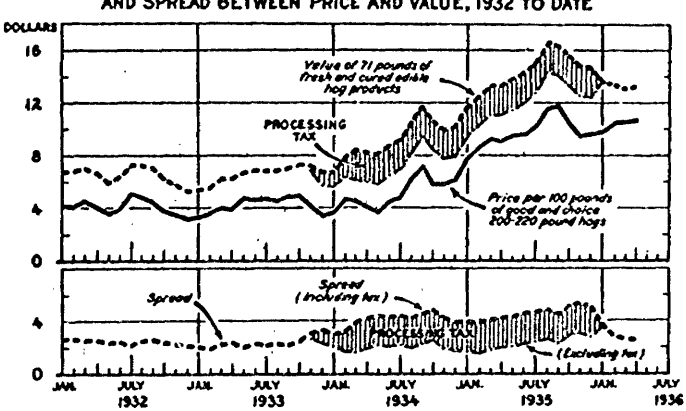


Figure I shows the data for wheat. The upper part of the chart shows the price of wheat per bushel at Minneapolis, the value of the 42 pounds of flour manufactured from a bushel of wheat, and the value at the mill of all products manufactured from a bushel of wheat. It is apparent that the prices of both wheat and milled products fluctuate widely, but move together rather consistently. This means that the milling margin is relatively constant and stable. This margin is shown in the lower part of the chart. The increase in the margin immediately following the first imposition of the tax is clearly apparent. When the tax is deducted from this margin, and the margin minus the tax is shown (as is indicated by the dotted line), it is quite evident that the net margin during the period the tax was in effect was substantially the same as that prior to the imposition of the tax. It is also apparent that the gross margin rose by the full amount of the tax when the tax was first imposed, and that when the tax was terminated, the gross margin fell by almost exactly the amount of the tax removed: If the milling costs of flour millers underwent no changes at the time of the imposition or removal of the processing tax, it would appear that practically the entire tax was recovered in the widened operating margin of the millers. This fact is generally admitted by wheat millers.

PRICE OF HOGS AND WHOLESALE VALUE OF HOG PRODUCTS, CHICAGO, AND SPREAD BETWEEN PRICE AND VALUE, 1932 TO DATE



In figure 2 the same comparison is shown for hogs and hog products, except that here the amount of the processing tax is shown by the shaded area in both the upper and lower portions of the chart. As you will recall, the hog processing tax at the beginning was at a rate of 50 cents per hundred pounds, live weight. This rate was gradually increased. The lower part of the chart illustrates the way in which the gross spread between the buying price and the selling value increased as the rate of tax was increased. Also, the termination of the tax is reflected in a drop in the spread by substantially the rate of the then tax.

Average Price of Raw Cotton and of Estimated Gray Cloth Obtainable Per Pound and Margin, 1925-26 to Date

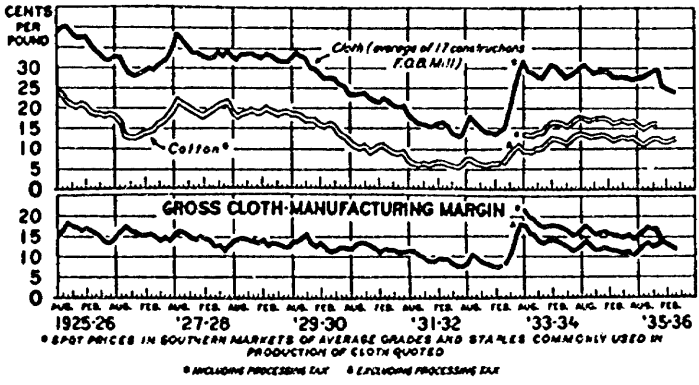


Figure 3 shows similar data in the case of cotton. In this case, the margin rose shortly before the tax was first imposed and rose still more when the tax went on. This was due to the fact that the N. R. A. codes materially increased manufacturing costs just prior to the first imposition of the processing tax. It is evident, however, that when the tax went into effect the margin rose by the amount of the tax above that prior to that date.

Mr. WALLACE. "These exhibits are introduced merely to illustrate that, in the case of three of the major commodities involved, facts as to changes in gross margins are obtainable and do provide a positive basis for manufacturers to show whether or not they did in fact absorb the tax. These charts, of course, are based merely on the average figures obtained from the available market quotations."

In other words, these charts illustrate in a general economic sense the general situation. While they illustrate the principle they are not the precise method which would be used in practice. They illustrate, to my mind, the broad, general justice of the method which would be used in practice. I well realize that in many of these broad, governmental activities, especially where taxes are involved, there are, of necessity, literally hundreds of specific injustices. The question is to discover the rule which will make for the maximum of justice and the minimum of injustice. I do not know of any particular rule that will completely eliminate injustice.

As I say, the charts are based on the general situation. "In claiming refunds, each manufacturer would be expected to use his own records,

indicating exactly what the situation was in terms of his own operations. The suggested provisions indicate clearly the data which manufacturers might need to submit in making such a showing.

"In addition to these general margin provisions for creating a prima-facie presumption whether or to what extent the taxpayer bore the burden of the tax, a number of supplementary provisions are suggested to cover special situations. One of these special situations is in cotton textiles, where other factors, such as N. R. A. codes, were increasing costs as well as the processing taxes. In such cases either the claimant or the Commissioner of Internal Revenue may introduce evidence indicating the extent to which these special circumstances explain the changes shown in the margin, and the Commissioner of Internal Revenue is directed to give such evidence due weight in determining whether the processor bore the burden of the tax and in arriving at the amount of the refund due the claimant."

I do not know whether that covers the point in which you are interested, Senator George, or not.

Senator GEORGE. It does, in a sense; yes, sir. I merely wanted to know, though, what factors were taken into consideration in the preparation of the charts. That is what I was driving at.

Mr. WALLACE. Yes.

Senator GEORGE. Not whether anything else should have been taken into consideration necessarily, but what actually was used as a basis.

Mr. WALLACE. "Provisions are also made for the Commissioner to take into consideration other evidence indicating who bore the burden of the tax, such as, for example, the practice of a concern in including the cost of the tax as a specific item in billing its customers."

In the case of certain processors the tax was included in the bill to the consumer. Senator George has given an illustration where the processor attempted to bill the producer for it. There are other processors who made it a very regular procedure to bill the consumer for the tax.

Senator COUZENS. That is, the billing was separate on the invoice?

Mr. WALLACE. Yes.

Senator COUZENS. So that would be prima-facie evidence of passing it on.

Mr. WALLACE. Yes. "It might be noted that the language proposed as a substitute for the existing language of section 21 (d) is consistent with the language which the House has already adopted for the "windfall" taxes, in that the conditions under which a processor could show that the return to him of impounded taxes was equitable, because he had in fact borne the burden of the tax himself, are the same as those which would constitute prima-facie evidence that he was entitled to the refund of the taxes which he had previously paid. The substitution of the proposed language for section 21 (d), together with the approval on your part of the "windfall" taxes as passed by the House, would, therefore, prevent the unjust enrichment which might otherwise result from the invalidation of the taxes under the Agricultural Adjustment Act, by providing for repayment in full of those taxes the burden of which was borne by the taxpayer, but not those paid by the consumer or the producer, and also by providing for the recapture of a major portion of the "windfall" income in those cases

where the processor had not paid any tax, although he collected its equivalent."

Senator KING. Mr. Secretary, pardon the interruption. If you care to express an opinion I would be glad to have you do so, and if not, then do not hesitate to indicate your lack of desire. Having read, as you doubtless have, the bill as it passed the House dealing with the so-called windfall tax, do you see any imperfection or defects in it which need to be strengthened materially?

Mr. WALLACE. When you speak of imperfections or defects you get into a field where I, as many others, rely on the judgment of men who spend many hours a day looking into the minutia of such things.

Senator KING. Of course, you now refer to the Internal Revenue, not to the Senate or the House?

Mr. WALLACE. I am referring to you gentlemen and your advisers.

Senator BARKLEY. I want no invidious references made there by the intimation that these Members of Congress do not spend hours on matters of this kind.

Mr. WALLACE. There is no use fooling ourselves by pretending to do things that are superhuman.

Senator KING. In your view is it a reasonable measure or does it work injustices?

Mr. WALLACE. It seems to me that, for my own part, the imperfection, I would say, is the amount of recapture. That is only 80 percent. I would think it ought to be a higher percentage, but it may be the most practical point at which to put it after taking everything into account.

Senator CONNALLY. Mr. Secretary, the reason for it is that if the amount were 100 percent there would be a serious question of confiscation.

Mr. WALLACE. I have never suggested 100 percent, Senator.

Senator CONNALLY. You run into very able-bodied competition.

Mr. WALLACE. It may be that those of you who have had prolonged experience in weighing constitutional matters and who are in sympathy with the object of the windfall tax nevertheless feel, after taking everything into account, that is the best way in which to serve justice. I would not quarrel with it. I merely express regret that it could not be 90 percent, because some people think that the gentlemen are entitled to receive out of the Federal Treasury sums of money that will be, in many cases, three, four, and five times as much as their annual profits in prosperous years. There is something in me that rises up in wrath at that kind of situation.

Senator KING. I think that view would be entertained by some of us.

The CHAIRMAN. All right, Mr. Secretary.

Mr. WALLACE. That leaves that particular discussion on section 21 (d). The next discussion has to do with the extension of principle of refund provisions of title IV of H. R. 12395. This has to do with the sugar situation.

The CHAIRMAN. As I understand the sugar proposition, the law that we passed runs out in 1937.

Mr. WALLACE. Yes.

The CHAIRMAN. It is necessary, in order to carry it out, that the processing tax on sugar to the amount of the differential between the

Cuban rates and our taxes under the Cuban Treaty should be continued.

Mr. WALLACE. Yes; that is mentioned, incidentally, here, although it is more in detail that particular matter is mentioned in a separate letter to you.

The CHAIRMAN. Yes.

Mr. WALLACE. "In title IV of H. R. 12395, the Committee on Ways and Means undoubtedly sought to cure the inequities which have resulted from the decision of the Supreme Court invalidating the tax and related provisions of the Agricultural Adjustment Act. Two situations appear to have escaped the attention of the committee.

"One class of cases requiring individual attention, due primarily to the fact that the tax on all sugars marketed prior to December 1, 1935, was paid and to the further fact that the Agricultural Adjustment Act, provided for export refunds in the case of articles manufactured wholly or partly from a taxed commodity, is that of exporters who held on January 6, 1936, articles manufactured wholly or partly from tax-paid sugar, and who have exported and are exporting such articles at a price diminished by an amount representing the processing tax on sugar."

There is a particular situation in sugar, which demands particular handling to avoid doing injustice to particular individuals.

Senator GEORGE. Mr. Secretary, in that connection, I think some of the exporters of textiles and other things who appeared before the committee said they were not being fairly dealt with in that bill.

Mr. WALLACE. Well, it is the kind of situation that could exist there.

Senator GEORGE. The same as sugar?

Mr. WALLACE. Yes. Have you studied that situation, Mr. Savoy?

Mr. SAVOY. That is taken care of in the second class of cases of which you spoke.

The CHAIRMAN. When we get down to the discussion on that particular subject we can have the services of Mr. Savoy up here with us, can we not?

Mr. WALLACE. Certainly, sir. "Under H. R. 12395 holders of such stocks are not entitled to a floor stocks adjustment, nor are they entitled to an export refund. It would seem equitable and in line with the other remedial provisions which have been proposed, to allow a refund, where the tax was paid, to exporters of articles manufactured wholly or partly from sugar, to the extent to which the price was reduced by an amount representing tax. So that it will be possible to have all claims for refunds on file prior to January 1, 1937, it would seem reasonable to allow this refund only as to exportations made prior to September 1, 1936. This Department, therefore, recommends amendment no. 1 contained in appendix I attached.

"During the 6 months preceding January 6, 1936, a very small amount of the taxes due was collected."

Senator KING. You mean on sugar?

Mr. WALLACE. No; this is getting into another field now.

Senator KING. All right.

Mr. WALLACE. "At the same time goods were being exported or delivered to charitable organizations and cotton was being manufactured into large cotton bags. If the provisions of the Agricultural Adjustment Act had been upheld, the persons doing these acts would have been entitled to specific refunds. If the tax was not paid by the processor, it is expected that a substantial portion thereof will be collected under title III of H. R. 12395, by means of the so-called "windfall" tax. If the tax was paid, the bill provides for the refund thereof in such cases. To do equity, this Department recommends that no refund in the class of cases mentioned be disallowed on the grounds that the tax was not paid.

"This principle is recognized in section 602 (c) of title IV of H. R. 12395, relating to floor stocks on hand on January 6, 1936, and there would seem to be no substantial basis for any different treatment being accorded to the class of cases to which I have referred.

"However, it would seem reasonable to require, in case this concession is made, that the person otherwise entitled to the refund establish that he has not received and has no contract to receive any adjustment from the processor or other vendor. This Department, therefore, recommends amendment numbered (2), contained in appendix I, attached.

"Substantial revenue will be required in addition to that derived from the "windfall" net income tax. We are now getting into a discussion of possible processing taxes in the new legislation. Farmers have an interest which is as great as that of any other group in provisions for adequate Federal revenues. This interest prompts a suggestion of excise taxes on certain agricultural commodities as a means of providing such revenues.

EXCISE TAXES ON THE PROCESSING OF VARIOUS COMMODITIES

"With respect to processing taxes, in addition to a processing tax on sugar beets and sugarcane (covered by separate letter), you are advised that upon the invitation of the Committee on Ways and Means of the House of Representatives, this Department, following the recommendation of the President in his message to the Congress of March 3, 1936, suggested to that committee that a possible source of revenue would be found in the imposition of a processing tax on various named commodities greater in number than those contained in the Agricultural Adjustment Act or imposed thereunder at rates far lower than those in effect under that act. Since then, and after consultation with other executive departments, this Department has revised the list of commodities and has made minor alterations in some of the rates. The commodities, the rates of tax suggested as a source of revenue, and the estimated amount of tax to be derived therefrom are set forth in appendix III."

Senator COUZENS. I would like to have appendix III read at this time.

The CHAIRMAN. Will you read Appendix III?
(Appendix III, referred to, is as follows:)

APPENDIX III

Estimated revenues from proposed schedule of tax rates, 1936–37

Commodity	Units	Estimated [1] net units fiscal year 1936–37 (millions)	Previous tax rate (cents)	Proposed schedule	
				Tax rate (cents)	Estimated revenue (1,000 dollars)
Basic commodities previously taxed:					
Wheat	Bushel	443.00	30.00 M	8.00 M	35,440.0
Rye (extract spirits)	Bushel	7.50	30.00 M	6.00 M	450.0
Corn (extract spirits)	Bushel	127.33	5.00 M	6.00 M	7,639.0
Hogs	Hundredweight	90.60	225.00 M	30.00 M	27,180.0
Cotton	Pound	2,698.97	4.20 M	1.50 M	40,453.0
Rice	Pound	1,639.60	1.00 M	.25 M	4,097.0
Peanuts	Pound	435.70	1.50 M	.50 M	2,178.0
Sugar:					
Continental	Pound	3,158.25	.50 M	.50 M	15,791.0
Domestic insular	Pound	5,731.67	.50 M	.50 M	28,658.0
Foreign	Pound	3,932.23	.50 M	.50 M	19,661.0
Sirup [2]	Pound	86.00	.50 M	[3] .50 M	430.0
Total sugar					64,540.0
Tobacco:					
Cigars:					
Small	Number	146.00	[3] 13.70 M	6.00 M	8.8
Large	Number	4,800.00	[3] 90.40 M	40.00 M	1,920.0
Cigarettes:					
Small	Number	142,775.00	[3] 12.30 M	6.00 M	8,566.0
Large	Number	2.30	[3] 16.70 M	9.00 M	0.2
Manufactured tobacco	Pound	296.50	[3] 3.00 M	1.00 M	2,965.0
Snuff	Pound	85.80	[3] 3.00 M	1.00 M	858.0
Total tobacco					14,218.0
Basic commodities not previously taxed:					
Barley (extract spirits)	Bushel	69.33		6.0	4,099.8
Oats	Bushel	35.00		4.5	1,719.9
Cattle and calves	Hundredweight	198.20		8.0	8,656.8
Sheep and lambs	Hundredweight	11.25		4.0	450.0
Competing commodities previously taxed:					
Jute yarn (cotton) [4]	Pound	17.65	2.90	1.0	178.0
Paper (cotton) [4]	Bags	198.80	[3] 267.00 M	[3] 95.0 M	190.0
Open mesh paper (cotton) [4]	Pound	4.05	2.14	.75	30.0
Competing commodities not previously taxed:					
Rayon (cotton) [4]	Pound	198.87		1.8	3,574.8
Silk (cotton) [4]	Pound	65.80		3.8	2,500.0
Spirits (except brandy)	Gallon	100.00		3.0	3,000.0
Grand total					[5] 220,564

[1] Adjusted for exports and imports of manufactured articles.
[2] Sirup expressed in terms of raw value sugar content. Since it is chiefly imported, the entire amount is calculated at compensating rate of ½ cent per pound.
[3] Equivalent rate on product of previous taxes on tobacco used.
[4] Indicates basic commodity with which this commodity competes.
[5] Approximate average rate for bags of all sizes.
[6] Includes revenues from taxes upon commodities originating in Puerto Rico, Hawaii, Virgin Islands, and Philippine Islands as follows: Sugar, $28,658,000; tobacco, $573,000.

Mr. WALLACE. There are not any further revisions, are there, Mr. Savoy?

Mr. SAVOY. No, sir.

Mr. WALLACE. The suggested rate on wheat is 8 cents a bushel.

Senator KING. Who has to pay it, the farmer?

Mr. WALLACE. That is in the same manner as before. The processor collects it.

Senator BYRD. Mr. Secretary, when you read out the suggested rates I would like you to read the old rates.

Mr. WALLACE. All right, sir. The old rate was 30 cents and suggested rate is 8 cents. Rye is next. In this case the old rate was 30 cents and the suggested rate is 6 cents.

Corn, the old rate was 5 cents and the suggested rate is 6 cents.

The CHAIRMAN. What was that?

Mr. WALLACE. The old rate on corn was 5 cents and the suggested rate is 6 cents. In the case of corn there is an increase in the suggested rate.

Senator KING. I suppose it would follow as a necessary corollary that if you impose an excise tax you are going to restrict production, if you put in all those rules and regulations incident to supervision and whatnot.

Mr. WALLACE. The Supreme Court said we cannot do that.

Senator CLARK. That is an economic fact rather than a legal fact, Mr. Secretary. Of course, the cost of production naturally diminishes production, does it not, ordinarily?

Mr. WALLACE. Not necessarily. Agriculture does not follow all the rules that have been taught us by the laissez faire economists that seem to work in the business world.

Senator CLARK. Then as a matter of fact, to increase production would raise the cost of production without any equivalent provision for increasing the price.

Mr. WALLACE. I have not been able to see that that so-called law works in agriculture. I have not been able to see that it works there in the way that it seems to work in industry.

Senator KING. Mr. Secretary, do you contemplate, if Congress should impose an excise tax upon the various agricultural commodities, that there would be, directly or indirectly, openly or in some mysterious and subtle way, an attempt to restrict or control the crop production in those commodities?

Mr. WALLACE. No; I do not see anything of that sort involved.

The CHAIRMAN. You expect to follow the law as written by Congress.

Mr. WALLACE. Yes, sir. As a matter of fact, this matter here is a part of the President's recommendation in his original tax measures. It is a question of raising revenue. You have a desperate need of raising revenue. The question is where to get the money.

Senator KING. Would it not be better to just propose the flat sales tax?

Mr. WALLACE. That is outside of my field. This happens to be a part of the taxation legislation in which agriculture is concerned, and on which I believe agriculture may speak with some propriety, but when you get into the wider field you have gentlemen much better qualified than I

Senator COUZENS. You were about to start with hogs in your appendix III.

Mr. WALLACE. The old tax on hogs was $2.25 and the new tax proposed is 30 cents.

The old tax on cotton was 4.2 cents and the proposed tax is 1.5. The old tax on rice was 1 cent a pound and the new tax proposed is 0.25 of a cent.

On tobacco the tax is broken up into small cigars, large cigars, small cigarettes, large cigarettes, manufactured tobacco and snuff.

Senator COUZENS. You missed sugar.

Mr. WALLACE. The sugar seems to be omitted on my particular copy.

Mr. SAVOY. Here is the revised copy.

Senator GEORGE. There is no change in the sugar.

Mr. WALLACE. The sugar is the same amount.

Tobacco, in the case of small cigars, the old rate per thousand was 13.7 and the new rate is 6 cents per thousand. Large cigars, the old rate was 90.4 and the new rate is 40 cents a thousand. Small cigarettes, the old rate was 12.3 cents a thousand and the new suggested rate is 6 cents. Large cigarettes, the old rate was 16.7 cents a thousand and the new rate is 9 cents. Manufactured tobacco per pound, the old rate was 3 cents and the new rate is 1 cent.

Senator BAILEY. Mr. Secretary, you mean by the "old rate" the previous tax rate proposed under the 1935 amendment or the rates proposed under the original act?

Mr. WALLACE. As I remember it, the 1935 amendment happens to give the rate which had been in existence under the previous acts.

Senator BAILEY. It was graduated down with respect to prices, if I recollect.

Mr. WALLACE. I believe this is the rate that applied under the A. A. A. Act as amended in 1935.

Senator BAILEY. The cigarette tax, under the new act, the 1935 act, was 1.9, as I recall it. Now, is this a comparison with 1.9?

Mr. SAVOY. It was 1.9 per pound of tobacco. This is measured by thousands of cigarettes.

Senator BAILEY. You can figure that very quickly. You have got cigarettes, small, 6 cents a thousand. That is 2 cents a pound. So it is higher than it was under the 1935 act. As I understand it, that is 13.

Mr. WALLACE. It is 12.3 cents and 16.7 per thousand, respectively. That was designed to represent a situation that existed under the old act.

Senator BAILEY. I think your 12.3 related to the original act of 1933.

Mr. SAVOY. No, sir; it is an average of the rates on the various tobaccos in cigarettes during the period the tax was in effect.

Mr. WALLACE. That would be a question of fact into which we will go for your satisfaction, Senator.

The CHAIRMAN. The total that you propose to raise there is about $220,000,000?

Mr. WALLACE. $220,564,000, roughly estimated.

Senator LONERGAN. Mr. Chairman, may I ask a question?

Senator BYRD. The Secretary has not finished, has he?

Mr. WALLACE. Do you want to go down over the items?

Senator BYRD. There is a new lot here, that is entirely new.

Mr. WALLACE. Barley had no rate before and it is now proposed to have a 6-cent rate. In the case of these grains there is an effort to have them proportional amongst themselves.

Senator KING. That would be a very heavy tax against beer, would it not?

Mr. WALLACE. You will note it excludes spirits, by the way.

Senator KING. Well, barley is used in the manufacture of beer.

The CHAIRMAN. What else is there now?

Mr. WALLACE. Oats, 4.5 cents. Cattle and calves, 8 cents. Sheep and lambs, 4 cents. Those are all new rates there.

Senator BYRD. Mr. Secretary, to what extent does that increase the cost to the consumer of meat? I notice you have got cattle and calves 8 cents and you estimate the revenue at $8,656,000. To what extent does that increase the cost to the consumer of meat?

Mr. WALLACE. That goes into that rather difficult economic field again. It must increase the cost to the consumer of meat by as much as, I would guess, less than 1 percent.

Senator BYRD. One percent of what it is now? You mean it should do that?

Mr. WALLACE. If it were all passed on to the consumer I would guess it would increase the cost to the consumer—well, it would be 8 cents and the present price of cattle on the average, I guess, is about $8 so I guess it would be about 1 percent of the live-cattle price, and less than 1 percent, after selling charges were added on.

Senator BYRD. Now, you have got different rates for hogs, cattle, and calves, sheep and lambs. Do they more or less compete?

Mr. WALLACE. Yes; there is a competitive situation there. There was an effort made there to proportion the taxes as between hogs—they have 30 cents, you will note—and the cattle is 8 cents, sheep and lambs 4 cents.

Senator CONNALLY. Are those rates per hundred pounds?

Mr. WALLACE. Those rates are per hundred pounds. That was in an effort to apportionate it to the degree in which they consumed feed grains.

Senator KING. We had a great deal of evidence here tending to show by reason of the tax upon hogs, beef, and so on, the processing tax had strayed a great many of the American people to an enlarged use of fish, because that was competitive, and a larger use of chickens. Are you imposing a tax on fish and chickens?

Mr. WALLACE. No; there is no tax on fish proposed here, and I hope we never attempt to collect the tax on chickens.

The CHAIRMAN. Are there any other items there?

Mr. WALLACE. Jute yarn is 1 cent a pound.

Paper bags, 95 cents a thousand.

By the way, this compares with the old tax on jute yarn of 2.9 cents. The proportion there is roughly proportionate to the production of cotton. In a like manner the paper bags are reduced from $2.67. You have a situation proportionate to the reduction of the cotton bags.

The open-mesh paper was 2.14 cents a pound and it is now reduced to seventy-five hundredths, or three-fourths of a cent a pound.

Rayon, the new tax is 1.8 cents a pound. That is altogether new.

Senator KING. That is in competition with cotton, the same as jute?

Mr. WALLACE. There have been a great many economic studies made on the competition between rayon and cotton. In certain years at certain times you cannot prove it, and in other years you can prove it.

Senator BYRD. What about the rayon that is made from wood pulp? The rayon in my State is made from wood pulp, not from cotton.

Mr. WALLACE. It is on the theory of competition with cotton, and also on the theory that we do cast around in agricultural products, products that are competitive with agriculture, to have the tax roughly proportionate, so that the supply and demand situation as between the commodities does not change.

Senator GERRY. That is from whatever source?

Mr. WALLACE. From whatever source.

Senator BLACK. What has been the expense of collecting the taxes in comparison with income taxes, for instance?

Mr. WALLACE. The Bureau of Internal Revenue calculates that expense monthly, I believe. They are able to inform you.

Senator BLACK. I did not know but what you knew it approximately.

Mr. WALLACE. I do not have it in mind at present. It is a well-known figure. Mr. Helvering, do you have that?

Mr. HELVERING. I can give it to you if I have it right here.

Senator BLACK. Would it be less expensive to have an increase in income taxes, inheritances, and corporation taxes?

Mr. HELVERING. The cost of collecting the processing tax is considerably less than the average cost to the Bureau.

Senator BLACK. I know, but what I had in mind was whether or not there are any figures which would show whether a simple increase in the taxes that are now collected such as income and inheritance taxes, and things of that kind, would cost as much or less than the processing tax.

Mr. HELVERING. No, sir.

Senator BLACK. In other words, the expense would be greatly more in collecting our new processing taxes than it would be if we were simply adding to the income taxes to be collected?

Mr. HELVERING. The collection of income taxes is greatly in excess of the collection of processing taxes.

Senator BLACK. As a whole, but we would collect the income taxes anyhow.

Mr. HELVERING. Yes.

Senator BLACK. I was wondering if, for instance, you raise the percentage of income tax, that does not necessarily mean a great increase in the total cost of collecting the income taxes, does it?

Mr. HELVERING. If you had an increase of 5 or 10 percent that would not make an appreciable difference in the total cost.

Senator BLACK. That is what I mean. Then whatever the amount would be of collecting the processing tax, that would likely be in excess of collecting the increased income tax, would it not?

Mr. HELVERING. That possibly is true; yes.

Senator LA FOLLETTE. It certainly would be true, would it not, Mr. Helvering, if it simply involves the changes in the surtax brackets?

Mr. HELVERING. Yes.

Senator LA FOLLETTE. Because you have those returns to go over anyway.

Mr. HELVERING. Yes.

Senator LA FOLLETTE. You can get $226,000,000 of additional revenue by simply starting the surtax bracket at $3,000 and 4 perce[illegible] and going as we do now, to 75 percent of $5,000,000 and after?

Mr. HELVERING. Yes; and there would practically be no increase in the cost of collection.

The CHAIRMAN. Mr. Secretary, is there something else?

Mr. WALLACE. I might say, Senator, I was very much surprised by the efficient job that the Bureau of Internal Revenue did in collecting the processing tax. When the figures came in it turned out to be very much less than I had supposed. I remember there were certain statements made in the old days as to the high expense of this kind of procedure.

Senator LONERGAN. Mr. Chairman, may I ask a question?

The CHAIRMAN. Yes, Senator Lonergan.

Senator LONERGAN. Mr. Secretary, on what basis are these proposed rates fixed?

Mr. WALLACE. Of course, there is not any one guiding principle. If you will allow me to complete the statement here I think you will find an answer to your question given here.

"As a whole, the processing taxes on agricultural commodities suggested would constitute only a very slight burden on consumers, since the total of these taxes if passed on to consumers would represent a very small percentage of the retail prices at which these products sell. In addition, since the proposed rates are, with the exception mentioned, far below the level of the rates previously in effect under the Agricultural Adjustment Act, it is not believed that collection of these taxes would cause any appreciable hardship or burden.

"Great emphasis should be given to the fact that each one of the great agricultural programs advocated by farmers since 1920 contained a provision for an adequate and a continuous source of revenue.

"This position by spokesmen for agriculture reflected their determination that, so far as possible, their programs should be self-liquidating, and should not, through reliance upon annual appropriations, be subject to political vicissitudes and uncertainties as to Federal farm policy. The continuous source of revenue provided by the McNary-Haugen bill was the equalization fee. The export debenture plan proposed to use tariff revenues. The Agricultural Adjustment Act provided for compensation of the Treasury by processing taxes to cover expenditures required to carry out the production-control programs.

"In making up this schedule, roughly, the commodities fall into the following classes:

"First, sugar, in which the rate recommended is equal to the processing tax rate, in the main covered by a separate letter. You will recall that, when the sugar tax was levied, there was a reduction in the rate of import duty equal to the processing tax rate. Also, in the case of the leading continental processors, even with a one-half cent tax, their profits would probably amount to between 8 and 10 percent on stated capital and surplus. Without the excise tax, profits would average between 12 to 16 percent."

You see one of the guiding motives there, Senator. I would like to say that one of the guiding motives or one of the things to be taken into account in fixing that particular rate was that with the quotas as at present in effect the sugar processors would be receiving on the average a return between 12 and 16 percent as compared with the return during the late twenties. It averaged, as I remember the figures, roughly 4.5 percent. Is that right, Mr. Savoy?

Mr. SAVOY. Yes, sir.

Mr. WALLACE. It was roughly 4.5 percent during the late twenties. Under the quota provision, without the tax, they would be getting a rate of between 12 and 16 percent return, and with the tax they would be getting a return between 8 and 10 percent, which has been the rate they have been getting, roughly, during the past 2 years. So you can see that one of the things to be taken into account in the case of sugar is this situation. It does not happen to be an item which governs in the other cases.

Senator HASTINGS. Mr. Secretary, would you think it unwise to make these rates sufficient to pay all the expenses, all the money that is due to farmers under the recent act?

Mr. WALLACE. Well, that has not been the approach at all. This has been a separate approach. You see that was the approach under the old A. A. A. The old act was set up so that the money that came from processing taxes would pay the cost of the program.

Senator HASTINGS. You think it is unwise to try to get enough out of these processing taxes to liquidate that obligation?

Mr. WALLACE. I question whether it would be wise to go that far.

Senator HASTINGS. This does not raise half enough for it, does it?

Mr. WALLACE. Well, just about half enough.

Senator COUZENS. You are departing then from the theory of the agriculturists themselves, that they wanted their program self-sustaining?

Mr. WALLACE. Yes; to that extent we are departing from that theory, although I think, in practice, the farm organizations, if they came before you in a hearing, would assent to this program at the present time, but it departs to that extent from the historic position.

The CHAIRMAN. Permit an interruption, Mr. Secretary. May I say to the members of the committee that we will meet here at 2 o'clock this afternoon, and I hope very much that all the members will be here. Mr. Oliphant, representing the Treasury Department is to go on, and the newspapermen can be here if they desire.

Before we adjourn this morning I shall read a letter that I received from Chairman Jesse H. Jones of the R. F. C. He was requested to give us any views he desired, either by giving it out personally or by writing a letter, so when the Secretary gets through this morning I will present that to the committee.

Senator BAILEY. Mr. Secretary, what plan have you to prevent the passage back to the farmers of the processing taxes which you propose here?

Mr. WALLACE. There is and can be no plan.

Senator BAILEY. Now, under the old law there was no means except by pegging prices, by way of loans the farmer did get the money back through the benefit payments and rentals, but under this plan there is nothing of that sort, is there?

Mr. WALLACE. Nothing of that sort; no.

Senator BAILEY. Now, he loses, does he not?

Mr. WALLACE. That is absolutely right, although you will remember, Senator, in my earlier conversation with you I held to the position that these taxes in the main are passed on to the consumer. That has been the record right along, in spite of the economists to the contrary notwithstanding.

Senator BAILEY. You realize that the farmer always thinks that the tax is passed back to him.

Mr. WALLACE. Yes, sir.

Senator BAILEY. Is it not true that the maxim of the trade is that the farmer sells in the buyer's market, he is at the mercy of the buyer?

Mr. WALLACE. The farmer always thinks he is at the mercy of the buyer, and the consumer always thinks he is getting the worst of it.

Senator BAILEY. Is it not a fact that the farmer sells in the buyer's market?

Mr. WALLACE. And the middleman always thinks he is between the upper and nether millstones.

Senator BAILEY. What would you say about that?

Mr. WALLACE. I say we are getting into a metaphysical field.

Senator BARKLEY. To what extent does this program synchronize with the soil erosion, the soil allotment act, and so forth?

Mr. WALLACE. That is altogether separate from it.

Senator BARKLEY. I know it is separate, but you are working out a program under the Soil Erosion Act.

Mr. WALLACE. I would say that the farmers feel that they have obtained under the Soil Conservation and Domestic Allotment Act, signed February 29 of his year, a procedure under which they will be getting, say, $440,000,000 to $500,000,000 of money annually.

Senator KING. Who pays for that?

Mr. WALLACE. That is coming out of the Treasury.

Senator BAILEY. He is not going to get it out of these taxes?

Mr. WALLACE. You cannot say whether he is getting it out of income taxes, inheritance taxes, or whatnot. In view of the fact he is getting that benefit I think the majority of the thoughtful leaders of farm organizations would feel that they ought to be, to some extent, as the result of agricultural taxes, contributing. Now, they feel—I do not agree with them—they feel, as you say, that a considerable part of this is passed back to them, that they, in effect, would be paying for the program. I do not agree with them.

Senator CLARK. The farmer would be in a better shape to pay it than he would be without the Soil Erosion Act?

Mr. WALLACE. Yes; I rather think so.

Senator BARKLEY. In other words, it synchronizes to about 50 percent, the payment to the farmers out of the general funds of the Treasury. This money will go into the general fund. If it were earmarked at all it would probably take care of about one-half of the expense.

Mr. WALLACE. Yes; if there was an earmarking provision.

Senator BAILEY. Is that contemplation, that it is going into the general fund for the purpose of sustaining the Soil Erosion Act?

Mr. WALLACE. No; I do not know of any suggestion to that effect.

The CHAIRMAN. The Supreme Court said that that could not be done, that you ought not to try to tie the two together, that you ought to divorce them. This is a separate proposition.

Senator CONNALLY. Mr. Secretary, I notice the rate on hogs is only about one-eighth of the old processing tax. The old tax was 2½ cents and the new one is 30 cents.

Mr. WALLACE. That is $2.25 and the new rate is 30 cents a hundred.

Senator CONNALLY. Is not that entirely out of line with the other percentages? I notice on cotton it is only reduced approximately

one-third, not quite one-third. On hogs it is one-eighth of the former rate. Then you put a tax on cattle and calves, and sheep and lambs, which had no processing tax before.

Mr. WALLACE. If you will just allow me to complete my statement and then we will have a little discussion of the hog tax. I might say the general principle, Senator Connally, in these new processing taxes, is, to some extent, on the one hand, to equalize the competitive situation as between the consumers, and on the other hand to equalize the competitive situation as between the different classes of livestock as they consume feed grains.

Senator CONNALLY. You would outbalance it, because if you reduce the hog tax and put on the tax on sheep and cattle that was not there before, are you not unduly helping the hog people?

Mr. WALLACE. Well, Senator, I do not know that you are asking that question seriously. I am quite sure that you would not.

Senator CONNALLY. I do not mean to reflect on anybody, but is not that inevitably the result, that would give an undue competitive advantage to the hog people?

Mr. WALLACE. I do not think you would urge that position seriously, Senator.

Senator BARKLEY. If that were true the situation would be reversed, if you had $2.25 tax on hogs and nothing on cattle.

Mr. WALLACE. I mean you would come into a little acrimonious controversy between different sections. I feel the suggested rate here is a very fair proportionate rate between the groups. In the Corn Belt you feed the hogs and the hog folks will say, "Why should we pay nearly four times as much as the cattle folks under the new program?"

Senator CONNALLY. You do not reduce the corn.

Mr. WALLACE. We increase the corn a little. There are special things that enter into each one of these rates which would take a long, detailed discussion to go into.

Senator BAILEY. Were the rates arranged, Mr. Secretary, on some special principle, or some definite principle?

Mr. WALLACE. Yes; there is, to some extent, a guiding principle, and to some extent there are special things that enter into each one of them. That is what I am attempting to discuss at the present time. If you will allow me to complete the statement I think some of these things will show forth.

We have just discussed the principle regarding sugar.

"In the next class is cigarettes, in which an excise rate equal to approximately one-half of the old processing-tax rate is suggested. Neither wholesale nor retail prices of the leading brands of cigarettes have been reduced since processing taxes were eliminated, and even with a tax at this rate, the profits of the leading manufacturers of cigarettes would average between 10 and 12 percent of the stated capital and surplus. In the case of cigarettes, the tax at the rate suggested would equal approximately 1 percent of the retail price."

Senator BAILEY. You mean 1 percent of the retail price of cigarettes?

Mr. WALLACE. Cigarettes, yes.

Senator BAILEY. I do not quite get your figures. I am sure they are right. There are 3 pounds of the farmer's tobacco in 1,000 cigarettes. You divide the previous tax rate by 3 and you get 411. You have got a 6-cent rate here on a thousand, that is 6 cents on 3

pounds, that would be 2 cents. Now, the rate under the act of 1935 is a graduated rate based on the price in the prior year. It was 1.9. That would be a small increase. I would like to have those figures checked, just to see how the base was arrived at.

Mr. WALLACE. What is the average retail price of a package of cigarettes in this country?

Senator BAILEY. Fifteen cents, that is the regular cigarettes, the majority of cigarettes; 15 cents a package. The price to the wholesaler is 12 cents and the Government gets 6 cents, and there is 6 cents for the farmer, the manufacturer, and advertiser.

Mr. WALLACE. There would be 50 packages in 1,000 cigarettes and the retail price would be $7.50. $7.50 would be approximately the retail price of 1,000 cigarettes then.

Senator BAILEY. Yes; that is $7.50.

Mr. WALLACE. And the proposed rate on the small package is 6 cents, on the large it is 9 cents, it is just slightly over 1 percent for the large packages.

Senator BAILEY. The price in the trade is $6, but the price retail is $7.50. Sometimes the price drops to $5.25. It ranges from $5.25 to $7.50. We are talking about the manufacturer.

Now, I would like to get this view from you. The cigarette people did not increase the price of cigarettes; they stayed at 15 cents. The price of tobacco went up, as we all know, 16 cents, then 27 cents, and the last year's average was 20 cents. Who paid the processing tax under those conditions?

Mr. WALLACE. I think perhaps the cigarette people might be able to make a showing under the set-up which I have described previously, that they have absorbed a considerable part of the processing tax. I suspect they might be able to make a showing on that point. That is not the point under consideration here.

Senator BAILEY. You think there would be recovery without regard to that?

Mr. WALLACE. If they can make a showing that they had not passed it on to the consumer or to the merchant, it would enable them to make recovery. But that has nothing to do with the principle I am suggesting here, that inasmuch as they made very good profit even under that situation that they could stand the processing tax of 9 cents a thousand on cigarettes and still have a return of 10 to 12 percent, on the average, on their invested capital and surplus.

Senator BAILEY. Now, the taxpayer would not be allowed to recover would he, if he made substantial profits?

Mr. WALLACE. Yes; under the procedure set up he would be able to make recovery even though he made very substantial profits. That does not enter into that case.

Senator BAILEY. You have an amendment in your appendix to that effect?

Mr. WALLACE. Yes. "In the next group are wheat, rye, rice, peanuts, cotton, and tobacco products other than cigarettes. In this group are the commodities on which the taxes are for the most part passed on to the consumer. The rates suggested are from one-third to one-fourth of the old processing-tax rates. Corn has the same economic characteristics as this group but the processing tax previously levied are small (less than 10 percent of the farm price) and, therefore, has

been changed but little. The rate suggested for corn is in line with those suggested for barley and oats.

"In another group are hogs, on which the tax levied in a considerable measure is passed back to farmers. Here the rate suggested is roughly one-eighth of the old processing tax rate. In addition, a tax is suggested for cattle and calves, sheep and lambs, that roughly corresponds to the tax suggested on hogs, on the basis of the grain consumed by the different classes of livestock.

"Additional taxes are suggested for specific products which enter into competition with or are substituted for the products on which processing taxes are levied, such as barley and oats which enter into competition with corn; and silk and rayon which enter into competition with cotton. There is some question as to the amount of competition between silk, rayon, and cotton, but regardless of the extent of the competition it is believed that silk and rayon can bear the small tax suggested.

"Spirits are made from sugar, rice, barley, rye, corn, and other products subject to tax. Because of the costs of collections and unequal burdens on processors of these products if taxed separately when used in making spirits, it is suggested that, when such articles are processed into spirits, they be free from the processing tax on the articles, and that instead a flat tax on the production of spirits (except rice spirits, rum and brandy) be imposed, as shown in the attached table. The rate of this tax is roughly equivalent to that which would be received from the spirits if the tax were levied on the products used in making the spirits.

"Finally, since the Agricultural Adjustment Act is being amended because of the Hoosac Mills decision, it would seem very desirable, and I hope that it may be deemed proper, to amend that act further at this time, so that only the valid provisions of that act and those provisions necessary to work out the remedial provisions recommended shall remain in effect. I suggest repealing the provisions which appear to be invalid under the decision of the Supreme Court, the striking out of language relating to such invalidated provisions, and the affirming and reenacting of those provisions considered not to have been invalidated. The amendments numbered "3" (except for the amendment to sec. 21 (d)), contained in appendix I, are for this purpose. Those same provisions with respect to the Agricultural Adjustment Act and those now contained in title IV of H. R. 12395 are in substance contained in title IV of S. 4413, now pending before your committee."

That is the end of the statement. I do not know whether you want to take the time to go on.

Senator BAILEY. Mr. Secretary, your main concern is to get enough money to carry out the soil-erosion program. If we levy taxes so that you get the money you are satisfied, are you not? That is your interest in this matter?

Mr. WALLACE. Well, it is a double interest. In the first place, because of the invalidation of the agricultural program and the passage of the soldiers' bonus the Treasury was left in a very bad way, and it was therefore proposed in the original message of the President that various methods be adopted.

Senator BAILEY. Notwithstanding that, if the Congress provides the five or six hundred million dollars that is needed for the soil-

erosion program you will not raise any question as to how we raise it, as to how we raise the money that you want, that what you want is the money, is that not true?

Mr. WALLACE. That is a point, of course. What we want is the money, but we somehow have a feeling that if you do raise some money on the processing of agricultural products the Treasury will be able to get a little more money and the Senate and House will feel a little more kindly toward the farmers.

Senator BAILEY. All you are doing in getting it out of the agricultural products is you are making the farmers pay.

If we could get it in some other way, where the farmer would not pay, he would get his money free then, would he not?

Mr. WALLACE. I suspect the farmers would feel that the other interests are not completely charitable, so far as he is concerned. While they might show charity for a year, the charity might run out at the end of the year.

Senator BAILEY. We are not dealing with the charitableness of other interests, we are dealing with our own Congress. It is not what they say, it is what we do.

Mr. WALLACE. Concerning that matter it might be appropriate to talk to the representatives of the farm organizations themselves.

The CHAIRMAN. You do not want to have any doubt about getting this appropriation, no matter what legislation we pass for the farmers?

Mr. WALLACE. You read my mind.

The CHAIRMAN. All right. We will divorce that from this proposition.

Senator BLACK. You also think, do you not, Mr. Secretary, that we should adhere, as far as possible, in spite of any decisions that may have been made, to the just canons of taxation, one of which is to place the taxes in such a way that they will not be unjust to those least able to pay, and that the taxes should, as far as possible, be governed by certainty of collection at the least cost, and the burden be placed on those who are most able to bear the burden?

Mr. WALLACE. That is an excellent theoretical statement.

Senator BLACK. Well, it is an excellent fact if it can be brought about. That is what we should strive for in all our tax laws, is it not?

Mr. WALLACE. I think it is, in the main, practical, and a guiding principle. Also I think, Senator, you will discover there are times when exceptions must of necessity be made.

Senator BLACK. There is no reason why the sales tax is bad, if we should adopt it in principle at one time, if we can get the money in some other way.

Mr. WALLACE. I should hate to follow logic on anything completely. I think you would get wrecked if you do.

Senator BLACK. Justice is better?

Mr. WALLACE. Of course I would defend, under the old A. A. A., the processing tax, which was essentially an exceedingly high sales tax, because under the old A. A. A. there was protection to the consumer, with regard to the ultimate cost to the consumer, that is the consumer was not to pay a higher percentage of his dollar to the farmer, the processing tax included, than was the case before the war. That was involved there. Now, a situation of that sort which tended to bring about a balance as between the groups of our population would be a benefit to the general welfare.

I would say that as large a sales tax as that which existed under the A. A. A. was justified even though it did violate the principles of economists. I think practically all the economists feel that a sales tax is terribly bad, and yet practically every State is using it.

Senator BLACK. There is no excuse for it, however, if it puts the burden on the wrong people, those who are least able to pay it.

Mr. WALLACE. We know that property taxes always bear a higher percentage to the value of the property in the case of the poorer people than in the case of the wealthier people. We find that to be universally true, and yet it is universally done.

Senator BLACK. But there is a movement all over the country to exempt property and therefore you must tax those who are least able to pay.

Mr. WALLACE. That is a very tough thing. Nevertheless, while we are proceeding to the ideal tax procedure you must often find it necessary, for the purposes of State and Federal revenue, to engage in types of taxation which are not completely ideal.

Senator BLACK. That is when you have the majority against you so that you cannot pass the best taxes.

Mr. WALLACE. That may involve a different proposition.

Senator CONNALLY. Mr. Secretary, I have just one question. Is there not a law on the books now authorizing the diversion of a portion of the tariff taxes to foreign relief purposes? Was not that contained in the act?

Mr. WALLACE. In section 32 there is a provision that one-third of an amount equal to the customs receipts should be used for certain purposes.

Senator CONNALLY. Well, if that is true, of course, that fund would supplement any other revenues that would come into the Treasury for use on your soil-erosion program, would it not?

Mr. WALLACE. No; the use of that fund is for certain specific purposes.

Senator BAILEY. Was it not on the export of the manufacturers' raw material rather than relating to the farmers?

Mr. WALLACE. No; it is exports, whether agricultural or manufactured out of agricultural products, and the manufacture is left optional to a considerable extent with the Secretary of Agriculture.

Senator CONNALLY. Is that provision being carried out now?

Mr. WALLACE. Yes; we have done a number of things under that provision. We have subsidized a small quantity of exports intended for the world market, a great deal of them. We have purchased agricultural products that have been unduly depressed in price, and distributed to the people on relief. There has been quite a lot of that. And, as you are aware, we used, oh, perhaps $45,000,000 of it—the amount not yet exactly known—for cotton, in effect to pay the difference between the sales prices of cotton and the loan. That is where most of it has gone, more than half of it has gone to cotton.

Senator CONNALLY. I was somewhat responsible for the adoption of that provision. That was the Jones amendment in the House, was it not?

Mr. WALLACE. That is right.

Senator CONNALLY. I sponsored it in the Senate. I just wanted to know how far the Department was utilizing that as a source of revenue.

Mr. WALLACE. We will be happy, within about a month, to give you quite a complete report on that. We can give you quite a report on it now, in fact.

Senator BAILEY. Mr. Secretary, did I understand you to say that you considered the processing tax as a sales tax?

Mr. WALLACE. I said in principle it was very similar to sales taxes on a restricted line of products.

Senator BAILEY. That is in the sense that they are intended to be paid by the consumer, the ultimate consumer. They are intended to go forward rather than backward. What have we in this act to prevent the tax from being passed back to the farmer?

Mr. WALLACE. I do not know of any way with respect to any sales tax, I do not know of any method of making sure as to where the incidence will be. That applies to any tax. I do not know what tax it will be. I think in the case of the income tax you are more nearly sure than anyone else.

Senator BAILEY. And the inheritance tax?

Mr. WALLACE. Yes, and the inheritance tax. There you can be exactly certain as to where the incidence will be. I do not know what you can do about it.

The CHAIRMAN. Mr. Secretary, that finishes your statement, does it not?

Mr. WALLACE. I merely wanted to mention this, Senator, that I have sent you this letter with regard to the new sugar legislation.

The CHAIRMAN. That will be placed in the record.

(The letter referred to is as follows:)

MAY 7, 1936.

Hon. PAT HARRISON,
United States Senate.

DEAR SENATOR HARRISON: Reference is made to our conference of April 30, 1936, relating to various tax problems, at which time you requested information with respect to a processing tax on sugar as a possible source of revenue.

When H. R. 12395 was under consideration by the Committee on Ways and Means of the House of Representatives, this Department, upon invitation of that committee, recommended that a tax be imposed on the processing of sugarcane and sugar beets, measured by the sugar produced therefrom, at the rate of 0.5 cents per pound of sugar, raw value. It was recalled that a processing tax on sugar at this rate became effective under the Jones-Costigan Act, at the same time as the statutory duty on Cuban sugars was reduced by an equivalent amount. While this tax was in effect, the average price paid by consumers for sugar at retail was less than the average retail price of sugar during the 5 preceding years. This Department recommends this tax to your committee also.

If this tax is levied, the total tax borne by sugar imported from Cuba, the principal foreign source of supply, including the import duty of 0.9 cent per pound of sugar, raw value, would amount to 1.4 cents per pound, as compared with the tariff rate of 2 cents per pound that prevailed for 4 years prior to June 9, 1934, the effective date of the Jones-Costigan Act, and the tax on all other sugar, except the small amount imported from other foreign countries, would be 0.5 cent per pound. The total estimated revenue from the excise and the duty is $102,000,000. Without this excise, the returns to the Treasury would be confined to receipts from import duties, estimated at $36,000,000 for the year 1936, which compares with an average of $76,000,000 in the 3-year period 1931–33.

It will be noted from appendix I, attached, that, at the March and April price level for raw cane sugars and without a processing tax on sugar, unless there is a simultaneous discontinuance of the quota system, the growers' share of the sum of the net return from the sale of beet sugar and Government payments to producers would be reduced from 55.2 percent of the total in 1934 and 54 percent in 1935 to 51.6 percent for the 1936 crop. The processors' share would be increased from 44.8 percent in 1934 and 46 percent in 1935 to about 48 percent for

the 1936 crop. It is then estimated that, without the tax at the rate suggested, the net income of the processors, expressed as a percentage of their stated capital and surplus, would increase from 8.5 percent in 1934 to between 12 and 16 percent in 1936, whereas the estimated return with such a tax in effect would be between 8 and 10 percent.

In summary, if the excise tax on sugar is not put into effect and the quota system is continued, the Government's revenues would be curtailed as indicated above at the same time as the returns of processors would be increased to between 12 and 15 percent of their stated capital and surplus. Such a situation, if continued, in addition to the great improvement in conditions in the sugar industry since adoption of the sugar-quota system and production adjustment, would seem to require consideration of action under section 13 of the Agricultural Adjustment Act, as amended. This section sets forth the conditions under which any of the provisions of the act with respect to any basic commodity may be terminated.

Sincerely yours,

H. A. WALLACE, *Secretary.*

(Appendix I, referred to in the Secretary's letter is as follows:)

APPENDIX I

Returns to U. S. Treasury from sugar taxes and duties under various conditions, with estimated effects on returns to sugar-beet growers and processors

Year (calendar, crop, or fiscal, as indicated)	Average prices of cane sugar at New York		Net returns from sale of beet sugar	Return to sugar-beet growers per ton of beets harvested		
	Cuban 96° raw, duty paid [1] (calendar-year basis)	Refined granulated [2] (calendar-year basis)	(crop-year basis)	Processor payments [4]	Government payments	Total return
1925	$4.83	$5.41	$5.20	$6.39		$6.39
1926	4.84	5.41	5.90	7.61		7.61
1927	4.73	5.30	5.10	7.62		7.62
1928	4.23	4.80	4.20	7.11		7.11
1929	4.77	5.30	4.80	7.08		7.08
1930	3.99	4.44	4.50	7.14		7.14
1931	3.92	4.40	3.83	5.94		5.94
1932	3.48	3.82	3.68	5.26		5.26
1933	3.21	3.70	3.12	5.13		5.13
1934	3.00	3.43	3.10	5.76	$1.75	6.91
Estimated:						
1935	3.23	3.60	3.30	5.88	1.05	6.90
1936 [7]	[10] 3.75	[13] 4.60–4.80	[16] 4.20	[19] 5.38	1.05	7.08
1936 [8]	[10] 3.75	[13] 4.60–4.80	[16] 4.20	[19] 5.23	[21] 1.05	6.78
1936 [9]	[10] 3.75	[13] 4.60–4.80	[16] 5.73	[19] 5.63	[21] 1.60	7.23
1936 [10]	[10] 3.75	[13] 4.60–4.80	[16] 3.75	[19] 5.63	[21] 1.12	[22] 6.75
1936 [11]	[10] 3.75	[13] 4.60–4.80	[16] 5.75	5.63	[21] 1.40	6.03

[1] Sources: For 1925–33 U. S. Tariff Commission Report No. 73. For 1934–36 data compiled by Sugar Section. These data are for the calendar years indicated.

[2] Sources: Same as in footnote 1 above, for average quoted prices which were corrected by Sugar Section to find the average actual sales prices recorded here. The prices for 1934–35 include the tax. These data are for the calendar years indicated.

[3] Sources: For 1925–33 from Sugar Section, data taken from form 88-12; for 1926–28 and 1932–35 estimated by Sugar Section on the basis of the relationship to cane-sugar prices in the period 1929–32. Selling expenses and processing taxes paid are deducted from the gross selling price of beet sugar to find the net return recorded here which is divided between processors and growers in accordance with the terms of the contract. It should be noted that these data are not for calendar years but represent the net return from the sale of beet sugar manufactured from beets grown during the calendar year indicated. The selling period for beet sugars under the processor-grower contract extends from the 1st of October of the year in which the crop is produced to September 30 of the following year.

[4] Sources: For 1926–34 from table 137 Yearbook of Agriculture, 1935

[5] Payment for the 1934 crop and estimated payment for the 1935 crop by the Agricultural Adjustment Administration of obligations under former production adjustment contracts.

[6] Parity price for the 1934 sugar beet crop was $6.79 per ton. A payment of $1.75 was made on the basis of an estimate of $4.04 to be received by growers from processors. Parity price for the 1935 crop was $6.90. It is estimated that under the former production adjustment contract, parity price for the 1936 crop would have been approximately $6.75 per ton.

[7] No tax; 12.5 cents (equal to 40 cents per ton of beets or 20 cents per ton of Louisiana sugarcane) agricultural conservation payment; and 37.5 cents (equal to $1.20 per ton of beets or 60 cents per ton of Louisiana sugarcane) conditional payment, this being the difference between the tax and the agricultural conservation payment.

[8] This estimate is composed of an agricultural conservation payment of 40 cents per ton plus a conditional payment of $1.20 per ton, the sum of which is the equivalent of 50 cents per hundred pounds sugar, raw value.

Footnotes continued on following page.

Returns to U. S. Treasury from sugar taxes and duties under various conditions, with estimated effects on returns to sugar-beet growers and processors—Continued

Year (calendar, crop, or fiscal, as indicated)	Percent of net return from sale of beet sugar, plus payments by Government, received by—		Net income of a group of beet processors which includes 75 percent of the industry (fiscal year beginning Apr. 1) [10]	Net income of same group of beet processors as a percent of capital and surplus (fiscal-year basis) [10]	Receipts of U. S. Treasury from taxes and import duties on sugar [11]
	Growers	Processors			
				Percent	
1925	55.3	44.7			$124
1926	58.4	41.6			140
1927	53.7	46.3	$4,414,505	3.70	124
1928	53.0	47.0	8,530,230	6.85	113
1929	60.0	40.0	5,773,027	4.69	124
1930	70.4	29.6	−6,290,761	−6.08	112
1931	60.6	39.4	−4,670,089	−4.41	94
1932	48.1	51.9	2,070,481	1.89	71
1933	48.0	52.0	10,724,605	10.03	63
1934	55.2	44.8	9,322,251	9.51	69
Estimated:					
1935	54.1	45.9	8,750,000–9,750,000	8.0–9.0	23
1936 [7]	55.6	44.6	13,500,000–18,000,000	12.5–16.5	8
1936 [8]	51.6	48.4	13,500,000–18,000,000	12.5–16.5	36
1936 [12]	56.3	43.7	9,000,000–11,000,000	8.0–10.0	74
1936 [13]	56.6	43.4	9,000,000–11,000,000	8.0–10.0	83
1936 [14]	51.8	48.2	9,000,000–11,000,000	8.0–10.0	102

[8] No tax; no payment other than 12.5 cents per hundred pounds of sugar, raw value (equal to 40 cents per ton of beets or 20 cents per ton of Louisiana sugarcane) under the Soil Conservation and Domestic Allotment Act.

[10] This price equals the average price of duty-paid raw sugar for March and April 1936.

[11] Estimated payment under the Soil Conservation and Domestic Allotment Act for agricultural conservation in connection with sugar-beet production.

[12] 50-cent tax; 12.5 cents (equal to 40 cents per ton of beets or 20 cents per ton of Louisiana sugarcane) agricultural conservation payments; and 37.5 cents (equal to $1.20 per ton of beets or 60 cents per ton of Louisiana sugarcane) conditional payment, this being the difference between the tax and the agricultural conservation payment.

[13] This estimate is based upon the assumption that the price of raw sugar duty-paid would be approximately $3.75, in the absence of a processing tax, and that the refiners' margin would fall within a range of 55 cents to $1.05.

[14] Estimated on the assumption that a net actual selling price of from $4.60 to $4.80 for refined cane sugar will prevail and that a differential between the net return from the refined beet sugar and refined cane sugar will be close to 45 cents per hundred pounds, which corresponds approximately to such average differential for the crop years 1929–33, inclusive.

[15] These estimates are made on the assumption that 300 pounds of refined beet sugar is recovered per ton of sugar beets and that under the processor-grower contract the grower will receive approximately 50 percent of the net return from the sale of the sugar after deducting all selling expenses and any processing or excise tax paid.

[16] 50-cent tax; 12.5 cents (equal to 40 cents per ton of beets or 20 cents per ton of Louisiana sugarcane) agricultural conservation payment; and 24 cents (equal to 72 cents per ton of beets or 36 cents per ton of Louisiana sugarcane) conditional payment, this being the estimated amount required to give growers "parity price" for the 1936 crop.

[17] The estimated payment of 40 cents for agricultural conservation plus an additional payment of 72 cents per ton that would be required to bring the grower's total return up to an amount equal to what is estimated would have been the parity price for the 1936 crop of sugar beets under the former production adjustment contract.

[18] 50-cent tax; no payment other than 12.5 cents per hundred pounds of sugar, raw value (equal to 40 cents per ton of beets or 20 cents per ton of Louisiana sugarcane) under the Soil Conservation and Domestic Allotment Act.

[19] These estimates assume approximate continuation of the prices and processing taxes that existed in 1933.

[10] Sources: Moody's Manual of Industrials and the Manual of Sugar Companies, published by Farr & Co. covering approximately 75 percent of the domestic beet industry. The fiscal year does not coincide with the crop year, but covers the period Apr. 1 to Mar. 30.

[11] Data for the period 1925–33 represent the gross collections as indicated in U. S. Department of Commerce publication Foreign Commerce and Navigation, less payments for drawbacks.

Data for 1934 represent net import duty collections of $37,000,000 and processing and compensating tax receipts of $32,000,000 making a total of $69,000,000 from which no disbursements for benefit payments were made during calendar year 1934; but payments were made in 1935 on the 1934 crop.

Data for 1935 represent an estimate of net collections of import duties on sugar of $35,000,000 plus an estimated revenue from processing and compensating taxes on sugar of $63,600,000, giving a total of $98,600,000 from which it is estimated disbursements of $75,000,000 were made as benefit payments on the 1934 and 1935 crops, which would leave an estimated net revenue from taxes and duties for the year 1935 of $23,000,000.

Data for 1936 include an estimated net revenue from import duties of $36,000,000 and net proceeds from processing and compensating taxes, if enacted at 50 cents per hundred pounds, raw value, of sugar, of $66,000,000. From the estimated revenues for 1936 in the various cases there is deducted an amount equal to the payments indicated for the 1936 crop. Two disbursements to be made in 1936 are not deducted, namely, the payments to be made under the provisions of the Supplemental Appropriation Act, fiscal year 1936, of obligations incurred under former production adjustment contracts, and payments to be made under the Soil Conservation and Domestic Allotment Act. Net Treasury receipts, in those cases involving conditional payments, would be approximately $4,000,000 larger than those shown if the rates suggested in appendix II are adopted.

The CHAIRMAN. I would like to read a letter I have received from Mr. Jones, Chairman of the Reconstruction Finance Corporation. [Reading:]

DEAR SENATOR HARRISON: This Corporation has been requested to give some impression to your committee as to its attitude and opinion with respect to the fairness or advisability of exempting from the tax imposed by H. R. 12395 the adjusted income which bank holding company affiliates may be required to retain in order to comply with the provisions of guaranty agreements which they have entered into with this Corporation in connection with investments made by the Corporation in their subsidiaries.

If it is shown in any case that strict compliance with the provisions of any such agreement will impose an unfair burden upon the holding company, the Corporation will consent to reasonable modifications in the provisions of the agreement. Insofar as any of the rights and investments of this Corporation are concerned there would, therefore, seem to be no reason for suggesting any change in the bill, especially in view of the fact that section 15 of the bill already makes special provision for income which is required to be retained pursuant to agreements entered into prior to March 3, 1936.

I should like to add that the proposed manner of taxing banks seems entirely fair and highly desirable, in that while it requires banks to pay some additional taxes, it permits them to strengthen their capital structure, which is in the public interest.

I have not had time to study the bill carefully, but if substantial concessions could be made that would encourage modernization, new plant construction, and new buildings to replace old ones, new equipment for railroads and industry of all kinds, including allowances for new debts created for these purposes, the employment situation, and business generally would in all probability be greatly helped, and society much better served.

You and your experts will know best the necessary formula. But, to illustrate, if a dollar so used, whether from earnings or borrowed money, could in substantial part be deducted in arriving at the adjusted net taxable income, the taxpayer would be encouraged to improve plant and equipment, thus stimulating the movement of capital goods and the employment of labor.

Sincerely yours,

JESSE H. JONES, *Chairman.*

We will recess until 2 o'clock.

(Whereupon, at the hour of 12:20 p. m., the committee recessed until 2 p. m. of the same day.)

AFTERNOON SESSION

(The hearing was resumed at 2 p. m. pursuant to recess.)

The CHAIRMAN. Mr. Oliphant, you may proceed.

STATEMENT OF HERMAN OLIPHANT, GENERAL COUNSEL FOR THE TREASURY DEPARTMENT

Mr. OLIPHANT. I understand the request of the committee, transmitted through its chairman, was, as he put it, to come down here and answer all of the objections that have been made to this bill by all of the witnesses during the public hearings. That, obviously, is a very large order, because there have been a great many witnesses discussing a great many aspects of the bill, able witnesses, thoughtful witnesses. People who have wanted to be heard have seen to it that they have been well represented—and that is all to the good.

But if I am to reduce the job that you assigned me to manageable proportions, both from the standpoint of the committee's convenience and also from my own, I will have to proceed according to plan.

My thought is that I could save you time if I would just take a few minutes to sketch the principles underlying the bill, and I am address-

ing myself now to the tax on corporate earnings, and then take up in a very brief memorandum the seemingly more important objections, which we have gathered from having some 15 men in the Treasury go over, read, and re-read, and re-read this testimony. And then I shall be prepared, or those with me will be prepared to answer as far as we can, questions that the committee may care to ask.

I should like to say at the outset, so far as the general idea underlying the proposed tax on corporate earnings is concerned, that when I am as old as that idea is, I shall probably be dead. Its principle was embodied in our original income tax law during Civil War times, it was considered by committees of Congress in 1917, it was up for vote in 1921, and substantially this plan was adopted in the Senate in 1924, I think it was.

But to come to the specific tax proposal, and how that proposal was formulated, along with other proposals, and submitted to the President for his consideration in the discharge of his duty to make recommendations for taxes to the Congress, I might say this: that it is the work of a great many minds. There are as you know, in the Bureau, a number of men constituting a staff whose business it is constantly to work on possible tax legislation. A great many suggestions are received there during each year, a great many questions come up in connection with the application of existing taxes, and there is a mechanism there whereby all of those flow to a place where they can be examined and the more promising ones garnered out for possible future use.

This proposal went through that process, and I propose to describe very briefly something of what that process was like.

The problem confronting the Treasury was the disarray into which the Budget picture was thrown by the invalidation of the processing taxes and by the passage of the soldiers' bonus. There has been a lot of talk about balancing the Budget, but the Treasury's immediate responsibility in formulating this tax proposal was the more immediate problem of putting the Budget picture back into the situation it was prior to those two events, because the primary concern of the Treasury is to see that representations made on behalf of the United States Government to prospective purchasers of its securities shall be made good, and under our system of government, the mechanism for making those representations is the President's Budget message.

So the Treasury was confronted with a real problem, and the President's immediate problem was to find the necessary temporary revenues to take the place of the shortage in collections during the current year, and the necessary permanent revenue to provide for the permanent agricultural program and for the liquidation of the soldiers' bonus over a period of 9 years.

Senator HASTINGS. Is it or not correct that approximately 499 millions of dollars was set up in the Budget to take care of these payments to the farmers, and something like 276 millions of dollars, as I recollect it, for the C. C. C. were in what you call the emergency budget of the present year, and that they have been transferred to what you now call the permanent budget for 1937?

Mr. OLIPHANT. I wish I were in a position to answer that question. Obviously the man who can answer it authoritatively would be Mr. Bell, the Acting Director of the Budget, and I am sure he would be glad to attend at your convenience.

Senator HASTINGS. Are you familiar enough with the Budget to know that that is a fact?

Mr. OLIPHANT. I should like to avoid if I could, going into a detailed discussion of the budget, merely because that lies outside the realm of such competence as I have, and I would not want to make statements here without the approval of the Director of the Budget, and other persons responsible for that situation.

That was the immediate problem confronting the Treasury, and it was just as real as maintaining one's good faith ever is, whether that is the good faith of an individual or the good faith of the Government.

So, we in the Bureau of Internal Revenue and in the Treasury Department, looked around to see what the possibilities were of obtaining such a large additional sum of money, realizing that Congress was going to be called upon to exercise a power which I think in its solemnity is exceed by few powers, other than the power to make war and peace, namely, the power to impose taxes.

Our approach to that problem was this: Let us frame the tax measure so that the burden of the tax will fall in that area and upon that portion of the population where it will create the minimum of hardship. That brings you at once to this question. After all, taxes have to be paid by individuals. When all is said, taxes come out of the pockets of individuals.

From what sources can individuals pay taxes? Except for minor items, there are only four. They can get funds with which to pay taxes from business profits; they can get those funds in the form of receipts from rents; they can get them from interest; and they can get them from wages and salaries. There are no other possibilities, if you exclude minor items such as royalties and things of that sort.

The problem then is, from which of these four sources from which people can pay taxes, should the major part of this new money required be taken in order to produce a minimum of hardship upon the population, the people as a whole? What do the figures show?

They show, first, that people's receipts from interest are going down with the falling interest rates in this period of easy money into which we have entered. They show, second, that the taxpayers' receipts from rents are but slightly up; they are up but only slightly. They have just begun to recover.

And they show, third, that people's receipts from salaries—and we can disregard wages largely, because most income tax payments out of wages and salaries come out of salaries rather than out of wages—that such increase as we have had in business profits, to which I shall allude in a moment, has not yet had time to get itself reflected in a corresponding increase in people's salaries. As we emerge from this depression there has been, as on emergence from all previous depressions, a lag between an increase in the business profits and an increase in the salaries paid out of those business profits.

That leaves the fourth item, business profits, and on that it is gratifying to note how substantial the increase in business profits is. This is in no sense an attack on business profits. We welcome it, because increased business profits means increased business activity and that means increased employment; and increase of employment, I dare say, is the problem that lies nearest to the heart of every

man in this room if he adjourns all other considerations except considerations for the public good.

What are the dimensions of the increase in business profits? Reliable figures from impartial sources show that corporate profits during 1935 were 42 percent above those in 1934. They show also, one of the most reliable index reflecting profits of corporations, that during the third quarter of 1935, business profits were 69 percent above business profits during the third quarter of 1934. They show that in the fourth quarter of 1935, the increase over the corresponding period in 1934 was 117 percent. Figures for the first quarter of 1936 are not available. Preliminary estimates indicate a substantial increase, not as great as the last increase that I mentioned.

So that if the additional tax burden is to fall in that area where the increased burden which the Congress is called upon to lay will produce the least hardship, the major part of the increased revenue must come from business profits, in the absence of any corresponding increase in the three other sources from which people can pay their taxes.

So we in the Bureau and in the Treasury, seeing what the dimensions of the increase in business profits, turned to the next problem. Upon what part of that field, i. e., upon what portion of all of the people of the country receiving the increased business profits, should the major portion of the additional burden be placed if we are to produce the minimum of hardship?

Business profits are received by three groups of people; by the owners of individual businesses, by partners, and ultimately by the stockholders of corporations. There are a total, according to the last census figures available, of 450,000 corporations in this country. There are a total of individual businessmen and individual partnerships of 1½ million, to use round figures. The gross sales or production of corporations comprising the whole national figure for this year, 1933, was 142 billion, and the gross sales or production of the individual enterprises and partnerships was 30 billion.

The first thing occurring to us, and to anybody else approaching the problem in the same way, was the fact that those engaged as individual businessmen and as partners are bearing the full tax load of our graduated surtaxes. Are those receiving business income from corporations, doing so? The answer to that question, which surprised the Treasury when they found it, to my mind, makes no other form of taxation at this juncture possible of defense.

On our estimates—and past performance shows their dependability—if corporate profits during the year 1936, all of them, went out to the stockholders and passed through the personal income-tax mill as opposed to part of them being paid in the form of a corporation tax, the total of that is the figure you have had of over $4,000,000,000. That is, if these profits all went to stockholders and we applied our present graduated surtax rates to them, they would produce enough additional revenue to provide for the permanent needs of the Government at this time, over 620 millions of dollars.

So that is where we wound up. We found: Increase in business profits with no corresponding increase in rents, salaries or interest; business profits coming from individual enterprises or partnerships now paying the full income tax load, and enough corporate profits not carrying the full surtax load which if made to do so, would pro-

vide a total of 620 of millions of dollars, stated by the President to be required at this juncture.

Senator HASTINGS. Mr. Oliphant, have you the amount of taxes paid by corporations for 1935?

Mr. OLIPHANT. Yes; we have those figures.

Senator HASTINGS. Was it not about a billion one hundred million? Has it not been stated that the corporate tax was about a billion one hundred million dollars?

Mr. HAAS. We are estimating for the calendar year of 1936, a total corporate tax of 1,132 million dollars.

Senator HASTINGS. And that is an increase over 1935 of how much?

Mr. OLIPHANT. I cannot say offhand, but it was an increase.

Senator HASTINGS. What I was trying to get at, Mr. Oliphant, is this: If there is an increase in the business as you say, I was trying to find out how much would be the increase in taxes under the present rate?

Mr. OLIPHANT. I will have to leave to Mr. Haas a discussion of the details of the estimates. I should say this, however, that all of those estimates, that is, the past performances of the Treasury which the Secretary gave to the committee when he was down here, as well as this estimate, take into account the probable increase in business activity, and reckoning with the probable increase in business activities, this tax will produce according to the Treasury's estimates 623 millions of dollars of additional revenue.

The CHAIRMAN. And the figures of 1 billion 132 million, if you would leave the flat rate, embrace the increase in business also?

Mr. HAAS. That is right.

Senator HASTINGS. If the increase in business is 45 percent, would the increase in taxes be approximately 45 percent?

Mr. OLIPHANT. I do not think I can answer that.

Senator BYRD. Does that include the windfall tax?

Mr. OLIPHANT. The windfall tax is a separate tax.

Senator CLARK. The 623 millions is the corporate surplus tax alone?

Mr. OLIPHANT. That is the corporate surplus tax alone. Put it this way. If you take the total of corporate earnings during 1936—this is purely a hypothetical statement—and distribute them all to the stockholders so that they all pay the same surtaxes—that the stockholders pay the same surtaxes that everybody else has to pay, or if they are unpaid in the corporation and you impose a corporate tax which is the mathematical equivalent, it will produce all of the additional money that is required for permanent purposes.

Senator BYRD. Wait a second. What do you mean by "permanent purposes"?

Mr. OLIPHANT. I am using a shorthand expression. To take care of specifically the payment of the soldier's bonus spread over a period of 9 years, and to finance the permanent agricultural program recently enacted by the Congress. Those two items.

Senator BYRD. Does it not include relief and public works?

Mr. OLIPHANT. No. I was confining myself to the specific request made by the President in his message.

Senator BYRD. Your estimates are general. Have you broken them down to any specific corporations? Take the American Telephone & Telegraph Co. What effect will this tax bill have upon the payment of taxes by that company?

Mr. OLIPHANT. I have not brought data on that with me, because my understanding is that the Secretary will be here tomorrow in response to a double request from the committee, namely the effect of this bill upon the taxes of certain corporations that have been enumerated, and the effect of the bill upon certain corporations that may lie back of those corporations that have not been enumerated.

Senator BLACK. And certain individuals who lie back of those corporations.

Mr. OLIPHANT. I have not read the copy of the request.

Senator BYRD. You prefer not to discuss that today?

Mr. OLIPHANT. I have not the data here. In fact, a very large army of people were working on getting it ready for you in time for tomorrow.

Senator BYRD. I will ask you one question. If a company today is paying out more than its earnings, and under this proposal it naturally follows that they will certainly reduce the dividend payments to what they do earn, because they would not want to diminish their surplus when the possibility is there, or when they are certain that the Government will tax them so that they cannot establish another surplus, or will tax them an excessive rate to replenish any surplus that they may diminish in the form of paying out those dividends.

Mr. OLIPHANT. The purpose of this bill is to bring about this situation, that if the earnings of any corporation are fully distributed, that will include the case you cite, so that if the stockholders are paying the surtaxes that everybody else has to pay, then a corporation would not pay the tax.

Senator BYRD. Yes; but you do not answer my question. The American Telephone & Telegraph Co. in the year 1934 paid out 46 million more than it earned. That 46 million went to the stockholders and was taxed, of course, in the returns of the stockholders. Do you not think that the American Telephone & Telegraph Co. from now on will only pay out those earnings and not pay out any surplus in the form of dividends?

Mr. OLIPHANT. Assuming that figure is correct, that it corresponds to figures in the Bureau, which I suppose will appear tomorrow, I assume that is true.

Senator BYRD. I ask you that with respect to any corporation.

Mr. HAAS. I think, Mr. Senator, it would be somewhat dependent upon the cost of money and also upon the fiscal policy of the corporation. A corporation when it decides to pay dividends and keep them up regularly on its stock has in mind that it will have to go to the stockholders from time to time for new funds and therefore wishes to establish a reputation for its stock as a regular income-producing security. It will still have that in mind under this bill.

Senator BYRD. Let us discuss the American Telephone & Telegraph Co. Do you think that they would be compelled to keep up a certain rate of dividends in order to secure the necessary finances that they may desire?

Mr. OLIPHANT. The bill does provide for a carry-over in case in a particular year they pay an excess of dividends over earnings. They are credited with that in a subsequent year. That is section 27.

Senator CLARK. Do you mean if the corporation depletes its surplus for the purpose of paying dividends over its earnings in a certain year, then they are credited for that amount and permitted to recoup their surplus in that amount in subsequent years?

Mr. OLIPHANT. Yes.

Senator BYRD. It is only when the surplus is depleted to a considerable extent. The surplus of the A. T. & T. is 142 millions. I ask you as a tax expert if you think that the A. T. & T. will continue to pay out more than they earn if this bill passes, as a matter of prudent administration?

Mr. HAAS. I would think so, Mr. Senator. As I said a moment ago, there are certain factors which determine that decision, and I think one of the most important of them is that they have to go to the stockholders for funds. During the 10 years ending in 1930, if I remember the figures correctly, they raised about 950 millions of dollars from stockholders through the issuance of stock rights. If the investing public desire regular dividends that would be a major factor in determining the corporation's policy. The corporation might, during a period of prosperity, sell sufficient stock to have a surplus from which to continue dividend payments during lean years.

Senator BYRD. Do you admit that a substantial strong company can pay dividends, and can sell rights, and thereby establish a surplus, whereas a weaker company cannot?

Mr. OLIPHANT. That is one of the objections raised in the testimony, to which I am coming later on.

Senator BYRD. I want to ask you the specific question and I want to take 1934 and assume that our figures are correct, that the A. T. & T. earned $121,000,000, and paid out $167,000,000. What will that corporation pay if they continue that policy in the form of taxes, under this bill?

Mr. HAAS. Mr. Senator, I view a corporation as a group of stockholders——

Senator BYRD (interposing). I am asking you what the A. T. & T. will pay?

Mr. HAAS. If they pay out all of their earnings, the A. T. & T., according to my way of thinking that a corporation is just a group of stockholders——

Senator BYRD (interposing). I want it by the records that now stand. The A. T. & T. is credited with paying certain taxes now, on the books of the company. I want to know if they will pay if the policy is continued?

Mr. HAAS. I would answer that question by saying that the A. T. & T. as a corporate entity or any other corporation, if it pays out all of its earnings, would not have to pay any tax; but we have to look at it realistically. A corporation is just a group of stockholders. Those stockholders would be paying more revenue to the Government than they are now paying.

Senator BYRD. How will they be paying more if the A. T. & T. is already paying out more than it earns?

Mr. HAAS. If the earnings of the A. T. & T. are going directly to individuals and are being taxed as part of their individual incomes, your statement is absolutely correct, but if the A. T. & T. earnings are going into other corporations, personal holding companies, and so forth, then——

Senator BYRD (interposing). What about a charitable institution? If you do not tax at the source, which you are now doing—eliminate that tax and then the stock is owned, stock of the A. T. & T. is owned

by a school or a church or some charitable institution, what effect will that have?

Mr. HAAS. Insofar as stocks are owned by tax-exempt charitable institutions, the corresponding earnings will escape taxation.

Senator BYRD. Have you figured how much that will be?

Mr. HAAS. We have made allowances for that in the estimate.

Senator BYRD. I would like to have that broken down and see how much you figure would go into nontaxable institutions, such as charitable institutions, churches and schools, and so forth.

Mr. HAAS. I could not do it offhand.

Senator BYRD. You admit then, that if the A. T. & T. continues the dividend policy of 1934, as a corporation they would not pay any taxes?

Mr. HAAS. That is very clearly in the bill, but realistically they would pay taxes.

Senator BYRD. I differ with you there, because the earnings are already being distributed by the A. T. & T.

Mr. HAAS. Do you know, Mr. Senator, whether or not any of these earnings are received by corporations?

Senator BYRD. Do you know.

Mr. HAAS. No. I am not sure.

Senator BYRD. But you have made an estimate on something you have not gotten all of the information on it.

Mr. HAAS. In our estimates we have taken into account all corporations.

Senator BYRD. How many of the 600,000 stockholders of the A. T. & T., in your judgment, are in the taxable brackets? In other words, assuming we abolish the corporate tax on the A. T. & T. as this bill does, and they continue their present policy and they distribute this money to 600,000 stockholders, which it does; how many of those 600,000 will pay taxes and be in the taxable brackets?

Mr. HAAS. Now, Mr. Senator, I cannot answer that. We did not make our estimate up by taking the A. T. & T., Allis Chalmers, and all the different corporations of the country and then add those up. We based our estimate on reports which come to the Bureau of Internal Revenue and we have taken the totals, and have worked with them. But for each specific corporation, we did not attempt to find out how the tax would operate. That would have been a tremendous job and would not have been worth while, because we can arrive at our estimate from the total much more readily.

Senator BYRD. The point I want to make, Mr. Chairman, is that with respect to the A. T. & T. especially, they will cease to pay any dividends out of their surplus, and to that extent, of course, will reduce the dividends. It would be very foolish for any company to take dividends out of surplus and then be taxed to establish another surplus.

Senator BARKLEY. Let us take this A. T. & T. case, which seems to be one that is emphasized here. It is no more true of that company than any other corporation similarly situated. Assume that they pay out now all of their earnings in dividends, they are taxed 15 percent of the total of their earnings before distribution. After distribution, each shareholder pays on his individual income tax which is increased by the receipt of the dividends from the A. T. & T.

Mr. HAAS. That is right.

Senator BARKLEY. That is perfectly simple. There is nothing complex about it, and of course if this bill passes, the A. T. & T. will pay no corporate tax as long as it distributes its entire earnings to its stockholders.

Mr. HAAS. That is right.

Senator BARKLEY. But suppose next year it decided not to distribute any at all; to keep it all or to keep half of it. Then it would not be able to get off with a 15 percent tax, but would pay whatever tax the bracket of that earning would provide for in the bill.

Mr. HAAS. That is right.

Senator BARKLEY. And the other cases are of corporations almost as important as the A. T. & T., which makes no distribution at all now but keep all of their earnings, would be required under this bill to pay more than the 15 percent tax which they now pay.

Senator BYRD. Does the Senator from Kentucky feel that the A. T. & T. with 452 million surplus today, will want to add to that surplus and pay as much as 22 percent if they do not pay any dividends?

Senator BARKLEY. I do not know if they will, and so far as I am concerned I do not care. But the A. T. & T., which is probably an objectionable illustration because of its size, is now paying a 15 percent corporate tax, and the average shareholder is paying whatever the tax is that he pays on his distributed share of that corporate income, whereas there are large corporations that are making no distribution at all now are paying only 15 percent, which is the same as the A. T. & T. is paying, and the stockholders are paying nothing because they get nothing. It is impossible to level this proposition off, it seems to me, without relieving somebody of a corporate tax that is now paying a corporate tax.

Senator BYRD. What you have done is to level it off to relieve the rich corporations which already have surpluses?

Senator BARKLEY. If this change in the taxable principle on which we are levying taxes on corporations is a just and fair system, the fact that it may relieve some big corporation of a tax in a form in which it is now paying, seems to me to be of no consequence. You may lose a little levy by relieving the A. T. & T. or some other corporation of the corporate tax that it now pays provided it continues to distribute all of its earnings, but you are catching somebody else who is not distributing its earnings, and it evens itself up in the long run.

Senator BYRD. The A. T. & T. is one of many that will be relieved. Any corporation which has a large surplus and pays its earnings out will be relieved.

Mr. HAAS. One of the important factors in Senator Byrd's inquiry will come out tomorrow, and that is that you have not many of these large corporations making large distributions of earnings. The question as to whom the earnings are being distributed will come up in the discussion tomorrow.

Senator BLACK. Do you know how many associates and affiliates and interlocking corporations the A. T. & T. has?

Mr. HAAS. I do not know.

Senator BLACK. That will come out tomorrow?

Mr. HAAS. I believe so.

The CHAIRMAN. In your estimates, did you take into consideration these dividends that are paid to charitable and educational institutions?

Mr. HAAS. Yes, Mr. Chairman, we did. Out of the total figure of over 1½ billion dollars we estimated that only about 4 billions would go to taxable individuals. The balance would go to people who pay no taxes, to charitable institutions, and so forth.

The CHAIRMAN. That is the present law, is it not?

Mr. HAAS. They are exempt under the present law.

Senator BARKLEY. Let me ask you this——

Senator BYRD (interposing). Excuse me, Senator. They are exempt from the present law, but the corporation pays the tax now at the source. This bill would relieve the taxable source in many instances, and therefore these charitable institutions would pay no tax at all. They now pay it as stockholders in a corporation.

The CHAIRMAN. I want to know if in his estimate that they have taken that fact into consideration, and he says he has.

Senator BARKLEY. Let me ask you this. Without regard to what this bill may do to some individual corporation, I think we all might as well admit that some of them will pay less corporate tax than they now pay, some of them may not pay any, which now pay, but taking them as a group, in making your estimate of the net income to be raised by this bill, did you take into consideration that certain corporations that are now paying taxes will not pay corporate taxes after this bill is passed, if they continue to distribute all of their earnings or if they inaugurate the policy of distributing all of their earnings?

Mr. HAAS. Yes, sir, we did. In fact, we worked out the estimate on this basis: That if all corporations retained 10 percent; if they retained 15 percent; or 20 percent, and so forth. We adjusted the rates in such a manner that in any of those instances we would get our increase of $620,000,000.

Senator BYRD. Let us take for example the three Standard Oil Co.s, the Standard Oil Co. of Indiana, California, and New Jersey. They are not interlocking. They have aggregate surpluses today of $948,000,000. In 1934, they would have paid an averae of about 7 percent in taxes by the distribution for that year. What is to prevent these companies with these enormous surpluses from continually and for the future to come, of paying out their earnings, and thereby not paying any taxes at all?

Mr. HAAS. The corporation itself, as I said, may not pay taxes. You see, you do not have the complete picture, Senator, until the Treasury has fulfilled your request for this other information. You would have to know just who the stockholders of these Standard Oil Cos. are. If they are individuals, then they are subject to the regular surtax rates. If they are corporations owned by individuals, then you have an entirely different story, and you won't know that until tomorrow.

Senator BYRD. Will the information tomorrow take up a company like the A. T. & T. and the Standard Oil Co., and tell us who the largest stockholders are and how much more they will pay?

Mr. HAAS. I understand that is the request.

The CHAIRMAN. All right; proceed, Mr. Oliphant.

Mr. OLIPHANT. That concludes my general statement of principles of equality in the taxation that underlie this bill, and I can sum it up by saying, that with the fact now known that there has been this increase in business profits without a corresponding increase in the

other sources from which income taxes can be paid, and the further fact now known that the total additional permanent revenue required for these purposes can be obtained by stopping the avoidance of surtaxes through the corporate device, no other tax can be justified.

Senator COUZENS (interposing). That is the important question. I have never been able to get an answer to it. How much is there of that?

Mr. HAAS. $620,000,000.

Mr. OLIPHANT. $620,000,000.

Senator COUZENS. You do not mean to tell this committee that there is $620,000,000 tax avoidance through the conservation of excess earnings?

Mr. OLIPHANT. Yes.

Senator COUZENS. I doubt that statement because I have not seen any proof of it.

Mr. OLIPHANT. I will be glad to have Mr. Haas discuss that phase of the estimate.

Senator COUZENS. I cannot conceive that as a fact. I have seen no estimates.

Senator HASTINGS. Mr. Oliphant, how much would you have to increase the present rate on the same basis without doing anything more to change it than to change the rate, in order to raise the $620,000,000?

Mr. OLIPHANT. I understand if we propose to lay this added tax burden equally on all corporate earnings by a mere increase in the corporate income tax, that that rate would have to be 25½ percent.

Senator CLARK. You mean you would have to raise the present income corporation tax to 25½ percent?

Mr. OLIPHANT. To produce this amount of additional revenue. That is true if the capital-stock and excess-profits taxes are repealed.

Senator BAILEY. On what basis of national income do you figure that, Mr. Oliphant?

Mr. OLIPHANT. You do not mind my passing that question to the man who can give you a better answer?

Mr. HAAS. The estimate of $623,000,000 additional income to be received, provided this bill goes into effect, is based upon a corporate income of $7,200,000,000. I could give you comparable figures over a series of years, and you can form your own judgment as to whether or not that is a reasonable estimate.

Senator BAILEY. How does that compare with last year?

Mr. HAAS. Thirty percent greater than last year. One of the witnesses who was here testifying and discussing the estimates said that he felt that our estimate of additional yield on the basis of the new bill was too high, and his main reason for believing this was that he thought this estimate which I just gave you was too low. We were a little surprised; it is not an infrequent occurence that we have experts disagreeing with us, but you cannot make estimates mechanically. We have made voluminous studies of the relationship between different economic series, but in the final analysis we use this background, and the estimates are finally arrived at on the basis of our informed judgment.

Last fall when the President put out his budget summary, the estimates were attacked, and we had this type of statement appearing

in the press. You probably noticed it—it was by one of the best known experts. [Reading:]

> It is to be hoped that the estimated increase will be actually realized, but however high may be our hopes, the fact remains that the revenue collected up to the 4th day of October of this year was but $28,000,000 greater than the revenue collected during the same period in the fiscal year 1935. Can it by any chance be that the estimate of the revenue has been deliberately overstated?

This expert thought it was too high, and the witness who testified recently before the committee thought it was not high enough. Instead of being overstated, our actual income-tax receipts are a little over 1 percent more than the estimate.

Senator BAILEY. What about the accuracy of that statement that the corporate income this year is only $28,000,000 as compared with a similar quarter last year? I gathered that from that statement. Is that accurate or not?

Mr. HAAS. You are judging that on the basis——

Senator BAILEY (interposing). I am asking you.

Mr. HAAS. In this statement which I just read?

Senator BAILEY. Yes.

Mr. HAAS. I will repeat the statement that I read——

The CHAIRMAN (interposing). He was just wrong, was he not?

Mr. HAAS. He was wrong as the results indicated.

Senator BAILEY. Which one was wrong?

Mr. HAAS. We know that one expert was wrong. I think the other will also prove to be wrong.

Senator BAILEY. What was the increase in corporate income? You say that statement is wrong. Let us get the truth.

Senator BARKLEY. You would not have the increase for the first quarter of this year in the Treasury and you won't know anything about it until the income-tax reports of next year are known?

Mr. HAAS. That is correct. Senator Bailey, he was referring to the first quarter of the fiscal year beginning last July.

Senator BAILEY. And that was $28,000,000 in excess——

Mr. HAAS (interposing). And he used that as evidence to discredit our estimate at that time. He inferred that they may have been deliberately overstated.

Senator BAILEY. The excess for the first quarter of the fiscal year 1935 was $28,000,000 more than——

Mr. HAAS (interposing). The point is we make our estimates for an entire fiscal year.

Senator BAILEY. You say he is incorrect. I will take your word for it, but you are not answering the question. Can you tell me what was correct?

The CHAIRMAN. They came within 1 percent of their estimate. They collected 1 percent more than they estimated.

Senator BAILEY. This is a matter that happened something over 9 months ago. Can you tell us the fact?

Mr. HAAS. Yes.

Senator BAILEY. What was it?

Mr. HAAS. This expert inferred that we may have deliberately raised the estimates.

Senator BAILEY. I am not saying that.

Mr. HAAS. We actually know the results because the time has elapsed. We were 1 percent off. The receipts were 1 percent more.

Senator BAILEY. What were the figures?

Mr. HAAS. I will have to supply those. I do not carry them in my head. I will put those in the record for you.

Senator BYRD. What was the percentage of the total earnings of corporations distributed last year in dividends?

Mr. HAAS. In 1935?

Senator BYRD. I understood 70 percent of the total earnings of corporations are being distributed now in the form of dividends?

Mr. HAAS. You see, Mr. Senator, the 1935 data in the corporation income-tax reports are not yet available.

Senator CLARK. When you say 70 percent is distributed, what year was that?

Mr. HAAS. The figure for the 30 percent of total earnings retained is arrived at by taking an average over a number of years.

Senator CLARK. For the last fiscal year on which you have figures, what did the 70 percent amount to, and what did the 30 percent amount to in dollars and cents?

Mr. HAAS. Senator, the relationship of the amount retained to the amount paid out changes with the stage of the business cycle. In a depression a much larger proportion of the earnings is paid out than is paid out in a prosperous period.

Senator CLARK. All right. Just on the last fiscal year which you are taking into consideration, what does the 70 percent amount to, and what did the 30 percent amount to in dollars and cents? We are requested here to raise a specific amount of money. You say that the President's figures, his request was for $620,000,000. By some strange coincidence this particular tax has been stumbled on which also raises $620,000,000, and I am trying to find out what the basis is on which you arrived at the $620,000,000?

Senator COUZENS. "Stumbled on" is right.

Senator BARKLEY. It is hardly correct to say that this $620,000,000 is the amount of money that the tax is raising, because that is not accurate.

Senator CLARK. I understood it to be the testimony here that this particular tax in this particular bill would raise $620,000,000.

Mr. HAAS. Would raise $623,000,000.

Senator CLARK. $623,000,000 then; in addition to what we are getting now. I would like to know the basis on which that is figured?

Mr. HAAS. I would like, Mr. Chairman, to review this whole estimate again, and we would have to do it to convince the Senator. But you will have to take another day for it. It is all in the record.

The CHAIRMAN. I would like to say that Mr. Oliphant appeared here with a chart and gave an explanation to the committee the early part of last week, showing exactly how they raised this additional $623,000,000.

Comparison of actual and estimated income-tax receipts, fiscal years 1931–36, inclusive, daily Treasury statement basis—July 1–June 30

[In millions of dollars]

Year	Estimated	Actual	Percentage increase (+) or decrease (−), actual over estimated	Year	Estimated	Actual	Percentage increase (+) or decrease (−), actual over estimated
1931	2,190	1,860	−15.1	1935	1,051	1,099	+4.6
1932	1,140	1,057	−7.3	1936	1,434		
1933	860	746	−13.3	1936[1]	1,078	1,093	+1.4
1934	864	818	−5.3				

[1] July 1–May 14.

Senator CLARK. I would like to get an answer to that question, Mr. Chairman. The particular years that they took on this formula of 70 and 30, which arrived at $623,000,000?

Mr. HAAS. Mr. Senator, I can answer the question without going into the whole complicated estimate. The formula does not assume any particular percentage of distribution.

Senator BARKLEY. I understood you to say the other day and repeated it here today, that his 30 and 70 is a sort of an average arrived at over a period of 10 years without regard to any one year. It might be any different percentage in any one year, but over a period of 10 years, that is what it figures up.

Mr. HAAS. That is correct.

Senator CONNALLY. Your theory of this bill, as I understand the theory of the proponents, is that the percentage which is distributed does not make any difference. In the total under this bill the tax would be the same—whether it is distributed or whether it is not distributed—when it finally gets in to the taxpayer and is paid into the Treasury, it will be the same amount?

Mr. HAAS. That is right.

Senator CONNALLY. So therefore it is immaterial as to what percentage they retained and what they did not.

Mr. HAAS. That is correct. As far as the revenue is concerned, it does not make any difference.

Senator BYRD. What disturbs me is how you estimated the amount of taxpayers who would receive dividends. How many million stockholders are there in these different corporations in the country?

Mr. HAAS. We have also given information on that, Senator Byrd.

Senator BYRD. How many are there, roughly?

Mr. HAAS. I do not recall offhand, but we know from the income-tax return tabulations in what income classes the dividends fall, and our information on that is every bit as good as the mortality tables on which life-insurance companies base their business.

Senator GERRY. You have a lower bracket, and I asked how many taxpayers were in that lower bracket, of the corporations that were earning less than $10,000 a year. How many stockholders? I think you said you did not know but that you thought you could get that. Have you been able to get that?

Mr. HAAS. We have worked on that, Senator, and we cannot get the number of stockholders because one man may own a number of

shares of stock in each of several different companies. We can get from our statistics the number of individuals who receive dividends, but we cannot answer your question. We tried to make a new tabulation, but we just do not have the data. But those particular data as to the number of stockholders are not necessary in the computation of our estimates.

Senator GERRY. No; but it is important as showing how many stockholders who receive dividends from corporations that are earning less than $10,000 a year, and comparing this number to those of the large corporations. There may be a great many more. I do not know. Possibly there may be a great many more stockholders, for example, in these very large corporations, like the A. T. & T., which has been mentioned, or in others—some of the utilities—there may be a great many more of them receiving dividends from these than from the smaller corporations.

Mr. HAAS. I am sorry. There are just no data available which will answer that. I see why you are asking for it.

Senator GERRY. You said you thought you might be able to give it to us.

Mr. HAAS. I thought we could get it by running through some new tabulations, but it is not on the returns.

Senator BARKLEY. When an individual taxpayer gives his return, he does not give the number of shares he owns in any corporation, but he gives the amount of his income. He may even give the source of it. And when the corporation pays its tax into the Treasury, the corporation does not say how many stockholders it has or how much it has distributed to John Smith or Bill Jones. So there is no information contained in either the individual or corporate returns from which you can obtain the number of stockholders?

Mr. HAAS. That is right.

Senator BARKLEY. In order to obtain it, you would have to go to some other source?

Mr. HAAS. That is right.

Senator GERRY. If the Senator from Kentucky will permit me, I did not go to that question, but the Treasury said they thought there was some outside source that had the information, and I think it would be interesting to have it, and I thought the Treasury might get it.

Mr. HAAS. We have examined it, and to date we have not been able to find anything.

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

Mr. OLIPHANT. Now, as I say, we have gone over, there in the Treasury, these hearings very very carefully. We have two things as the result of it, the end product of that examination. We think that the criticisms directed to the complexity of the schedules have much to be said for them, and working on an idea which I think Mr. Parker worked out, we have here in mimeograph form, a single page covering rates which with such modifications as your own experts may think advisable, will replace about 10 pages of rates, et cetera, in the bill.

The CHAIRMAN. This gets the same results absolutely as in the four schedules of the House bill?

Mr. OLIPHANT. By adopting one of the tables and putting in it the possibility of a flat exemption to small corporations of a certain num-

ber of dollars. The amount of that possible exemption is left blank, because the necessary calculations have not been made to indicate how far you could go in the amount of the dollar exemption of the small corporations, i. e., how high you can go with that and how low you can come in the size of the corporation to which you will give that exemption. I do not want to mention any figures, because they are likely to become frozen in people's minds.

(Following is the proposed possible substitution presented by the witness:)

POSSIBLE SUBSTITUTE FOR SECTION 13 (A) AND (B)

(P. 14 to p. 24, line 13, of comparative print)

SEC. 13. *Tax on corporations.*—(a) Definitions: As used in this title—

(1) The term "adjusted net income" means the net income in excess of the credit provided in section 26 (relating to interest on certain obligations of the United States and Government corporations); and

(2) The term "undistributed net income" means the adjusted net income minus the sum of—

(A) The dividend credit provided in section 27; and

(B) A specific credit of ——; except that such credit shall be allowed only if the adjusted net income is not in excess of ——. If the adjusted net income is in excess of ——, the tax imposed by this section shall not exceed the tax which would be payable if such specific credit were allowed, plus the amount of the adjusted net income in excess of ——.

(b) Rate of tax in general: There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation a tax equal to the sum of the following:

Two-sevenths of the amount of the undistributed net income which does not exceed 14 per centum of the adjusted net income;

One-third of the amount by which the undistributed net income exceeds 14 per centum and does not exceed 29 per centum of the adjusted net income;

Three-eighths of the amount by which the undistributed net income exceeds 20 per centum and does not exceed 45 per centum of the adjusted net income; and

One-half of the amount by which the undistributed net income exceeds 45 per centum of the adjusted net income.

The CHAIRMAN. We would like to know how to raise this $623,000,000 additional. Will it bear an exemption of $1,000 of $20,000, or $15,000, or what?

Senator HASTINGS. Do you expect to suggest the amount later to the committee?

Mr. OLIPHANT. Those calculations are in the process of being made, and I am just told here that it is safe to say that it could be as much as $1,000 on corporations with incomes of $20,000, and the calculations we are now making is—how much higher could that sum be raised?

The CHAIRMAN. Do not find it much higher. We need more revenue.

Mr. OLIPHANT. We will attempt on this occasion as on other occasions to keep in mind the responsibility which we assume for all estimates and do the best we can.

The CHAIRMAN. On this basis, we can raise $623,000,000 on this method?

Mr. OLIPHANT. That is right.

The CHAIRMAN. And simplify the proposition?

Mr. OLIPHANT. That is right.

Senator CONNALLY. Is that on the first year of a corporation, Mr. Oliphant?

Mr. OLIPHANT. That is a different question. During the calendar year 1936, there will accumulate a tax liability to the United States of

the full sum of $623,000,000. I think that clarifies a thing that I am not sure everybody has been trying to make clear.

Senator BYRD. Does your new schedule bring in exactly the same amount?

Mr. OLIPHANT. We are running calculations to see what amount of exemption, on what size corporations, will produce the $623,000,000.

Senator BYRD. Are you prepared to show that this schedule would bring in $623,000,000?

Mr. OLIPHANT. Yes; and we are prepared to say that there can be an exemption here. How much, you do not want me to say now, I am sure.

The CHAIRMAN. You are settled at least on a $1,000 exemption up to $20,000 net income?

Mr. OLIPHANT. That is right.

The CHAIRMAN. We may go a little higher than that exemption and get $623,000,000?

Mr. OLIPHANT. That is right.

The CHAIRMAN. When will you let us know definitely about that?

Senator CONNALLY. You said that there will accrue for 1936 a tax liability to the Government of $623,000,000?

Mr. OLIPHANT. Yes.

Senator CONNALLY. Do you make a distinction between the liability and what the Government will receive?

Mr. OLIPHANT. No. Merely a difference in when it will receive it.

Senator CONNALLY. It will receive it in March 1937, will it not?

Mr. OLIPHANT. As I understand these figures—and I easily get beyond my depth when I get into figures—whenever you change the income tax, since you report on a calendar year basis, of course you always get a certain amount of lag in the time at which you actually get the money into the Treasury.

Mr. HAAS. They pay in installments.

Mr. OLIPHANT. Yes; they pay in installments.

Senator BARKLEY. Of course, the new rates carried in this bill may or may not take effect for the whole calendar year and become effective for the fiscal year? You won't raise the total amount during the calendar year 1936, would you?

Mr. HAAS. Mr. Senator, the House bill now makes the tax effective from January 1, 1936. The first installment will be due March 15 of the following year.

Senator BARKLEY. So that you must collect the tax as of March 15 subject to whatever installment payments would bring about a delay for the whole calendar year 1936?

Mr. HAAS. That is right.

Senator COUZENS. May I ask Mr. Oliphant if he is going to read this statement that he has submitted here?

Mr. OLIPHANT. I am happy to follow the wishes of the committee.

The CHAIRMAN. This is an explanation of this new schedule, is it not?

Mr. OLIPHANT. No.

The CHAIRMAN. This memorandum that you are speaking of now or which you are submitting now?

Mr. OLIPHANT. If I might come to that. The second thing is that the last-minute amendment in the House changing the dividend year so as to make it coincide with the taxable year will, as we see it,

necessitate a revision of section 27 (i) in the bill, so that I mention these two matters at this time: The simplification of the schedules, and a further revision of 27 (i) relating to intercorporate dividends.

As I say, we have gone through all of this voluminous testimony and have boiled it down and tried to get to what seemed to us the objections of greater importance and more serious weight, and after that had all been boiled down, it was subjected to further summation, and I have here a relatively brief statement of those particular objections, and what may fairly be said on the other side. I am prepared to make any disposition of that statement which the committee desires.

Senator LA FOLLETTE. I am anxious to hear it, as one member of the committee.

Senator BYRD. Before you start reading that, Mr. Oliphant, as I understand it, a corporation that has a debt greater than its surplus is placed in a 22½ percent class. Now, let us take two corporations—this has impressed me very greatly. Two corporations that have a surplus of $100,000. Let one have a debt of $101,000. That corporation gets the 22½ percent rate.

Mr. OLIPHANT. That is on the $1,000 only.

Senator BYRD. Let us say that they owe $200,000. Then they get 22½ percent on $100,000. Suppose another corporation has a debt with $100,000 surplus, of $90,000. By the terms of its indebtedness it is compelled to pay all of its earnings, by contract, each year. Then that corporation would have to pay 42 percent. Is that correct?

Mr. TURNEY. Unless the contract came within the provisions relating to——

Senator BYRD (interposing). Suppose it had no contract, but a mortgage coming due and that mortgage took all of its earnings. And that particular corporation, because the debt was a little less than the surplus, would have to pay 42 percent. To my mind that is a tremendous inequality.

Senator LA FOLLETTE. As I understand it, the Treasury is not responsible for the so-called cushioning provisions of this bill. The cushioning provisions were written in by the Ways and Means Committee. If the Senator is arguing about taking out the cushion provisions because they do not seem to be equitable, as I understand it, the Treasury has no position as far as these cushion provisions are concerned.

Senator BYRD. He is defending the bill as it stands, and I want his suggestion as to how to remedy this gross inequality as I see it, in the bill.

Senator LA FOLLETTE. As I understand Mr. Oliphant here, he does not defend the complexities of the bill.

Senator BYRD. If he does take that position. I want him to give the committee his opinion as to how we can correct this inequality.

Mr. OLIPHANT. I start out personally with the proposition that I have a hard time distinguishing between this corporation over here which is in debt, and the partnership or the individual who is in debt.

Senator BYRD. You do not believe in cushions?

Mr. OLIPHANT. The House in going over that, and we rendered every assistance we could to the committee, felt that an adjustment ought to be made.

Senator BYRD. Do you approve of the cushion of the Ways and Means Committee?

Mr. OLIPHANT. If this committee wants to go into that matter, we will render every assistance that we can.

Senator BYRD. What is your personal opinion as the general counsel about this cushion business? Are you for it or are you against it?

Mr. OLIPHANT. That is a pretty broad economic question that I would rather not answer at this time.

Senator BYRD. It was not in the original bill that you prepared, and it was put in by the House. I certainly think we are entitled to your opinion whether you are for or against any cushions for debts.

The CHAIRMAN. It is one of the things that is really worrying the committee very much. I know it worries the chairman of the committee very much. If this new schedule that has been submitted here should be substituted for the four schedules submitted by the House, then the question arises, what are we going to do with these debt-ridden corporations? So it is a question of very great importance to us, and if you have any views on it, we would like to get them?

Mr. OLIPHANT. I shall be glad to prepare an answer to that question and submit it to the committee. I do not want to extemporize on that question at this time.

Senator BYRD. You do not want to say yes or no to that question, whether you are in favor of or against cushions for debts?

Mr. OLIPHANT. I find in my work there are very few questions that can be answered in an illuminating fashion yes or no. I prefer at this time not to try to extemporize an answer to that serious question.

Senator BYRD. Will you prepare a memorandum?

Mr. OLIPHANT. I will.

Senator BYRD. Will you deal with these companies that owe a little less than the surplus, as well as those that owe more than the surplus?

Mr. OLIPHANT. I will ask Mr. Turney to make a particular note of those companies.

Senator BYRD. In this bill there is a difference of 20 percent.

The CHAIRMAN. And in your answer, I wish you would give to us whether you think there should be a distinction between debt-ridden corporations paying 22 percent, and one that is free from debt paying on 15 percent.

Senator BLACK. Is there any provision of law now made for a distinction between a debt-ridden partnership or an individual, and one that is not debt-ridden?

Mr. OLIPHANT. No; they are all the same. Partnerships are all the same. Individuals are all the same.

Senator BYRD. And they are all taxed in proportion to their income, which this bill does not do with respect to corporations.

Senator BARKLEY. Is there any distinction in law now between a debt-ridden man and a non-debt-ridden man as to his paying taxes on his net income?

Mr. OLIPHANT. None, except in the amount of interest he has to pay on the debt, and Helvering looks at him with a glass eye.

The CHAIRMAN. Have you anything to say there in your statement about that question?

Mr. OLIPHANT. No; I will cover that with an appropriate memorandum.

The CHAIRMAN. You may proceed.

Senator KING. Some of us have been on the floor of the Senate, and that is the reason we were not here.

Mr. OLIPHANT. I am sorry you were not here, sir.

As I say, I will run over briefly what we deem the more important of these criticisms of the bill and indicate briefly what we think in all fairness can be said on the other side, and since they have a very wide ramification, I appreciate very much the extent to which you will bear with me in allowing some of these questions to be answered by those who have been working with me on these questions, because there is a limit to what one can keep in mind on questions of this magnitude.

Now, in the first place it has been urged by many witnesses that this bill does not represent an honest attempt to balance the Budget. I am omitting that introductory paragraph.

Senator CONNALLY. This next one, we all know is not going to balance the Budget.

Mr. OLIPHANT. Well, I hope it is going to keep faith with the present and prospective purchasers of Government securities.

Senator COUZENS. Let us read it. It has been criticized.

Mr. OLIPHANT. Any such attempt must begin first on the expenditure side. To answer this objection I need only briefly recapitulate the history of the bill. The President, in his Budget message, stated that he did not contemplate requesting of Congress any additional taxes at this session but that any expenditures additional to those provided for in the Budget ought to be financed by new taxes. And he had at other times referred to the possible invalidation of the existing tax. Since that time, the Budget as set forth in the President's message has been seriously upset by the invalidation of the Agricultural Adjustment Act and the passage of the soldiers' bonus legislation. This bill is intended only to restore the Budget to the position which it occupied prior to these upsets. Such reasons as may exist for a thorough review of our expenses so that they may be equated to our probable revenues existed last December before either of these events occurred and have not been changed one way or another by the circumstances which have led up to the consideration of this bill. I ask, therefore, that in all fairness the bill be considered from the point of view only of the limited objective set forth in the President's special Budget message, and that the matter of general budgetary balance should be treated on its own merits essentially as it would have been had this legislation not been necessary.

The second criticism: Are the Treasury estimates dependable?

Secondly, a word about the criticism which has been made of the Treasury estimates. In the first place, quite a bit has been made of the fact that only about half of the estimated revenue from incomes in the calendar year 1936 will be secured by the Government during the fiscal year 1937—i. e., that the estimated increase of revenues for the coming fiscal year will be only $310,000,000 instead of $623,000,000. There is nothing novel about that. This necessarily follows an enactment of any income tax because incomes are customarily reported for calendar years, whereas the fiscal year of the United States runs from July 1 to June 30. The same difficulty would be present

if we should raise the rate of the present corporation income tax, or increase the rate of the normal individual income tax or raise the rates of the surtaxes in the lower brackets or resort to any other new form of income taxation.

Finally, still addressing myself to the estimates, I have no doubt but that you have all been impressed by Mr. May's criticism of the Treasury's estimate of the proportion of corporation income which would be distributed in 1936, assuming a continuation of present law. Mr. May, you will recall, agrees substantially with the Treasury's estimates of the total income, but challenges the Treasury's estimate of the amount which will be distributed. Mr. May bases his challenge primarily upon a consideration of the average amount of statutory net income distributed by corporations over a period of years.

Many witnesses for the opposition have stated that averages are deceptive, and I believe that here we have a particular instance of that. Treasury estimates were based not merely upon a consideration of averages but on a consideration of the particular phase of the business cycle in which we now find ourselves. The proportion of corporation net earnings disbursed as dividends characteristically varies with the different phases of the business cycle—dividend disbursements substantially lagging behind net income, so that they fall behind it during periods of revival and run ahead of it during periods of decline, the net resultant of these variations being the averages which Mr. May and other witnesses have quoted. In estimating the distribution for 1936, the Treasury has not merely considered past years generally but has studied selected years in the business cycles which are considered most closely analogous with the year 1936. When all is said and done our best assurance as to the dependability of these estimates is the Treasury's past performance, and the record of that is before the committee.

Senator BYRD. What are the years? I am very much interested in that.

Mr. HAAS. Well, there are several years. One that I recall offhand as somewhat analogous is 1922. There were other years when we were emerging out of depressions that we studied.

Senator BYRD. 1922 was the rising time, as I recall.

Mr. HAAS. 1922 was sharply rising.

Senator BYRD. I would like to be supplied with the details on that.

Mr. OLIPHANT. Will you give that information?

Mr. HAAS. Yes. [Information referred to appended at the end of Mr. Oliphant's statement.]

Mr. OLIPHANT. All right. We will get that information.

Senator KING. Before leaving that, did you take into account, in the observations which you have just made, that further statement of Mr. May in which he called attention to the alleged difference of approximately a billion dollars between the statements submitted by the Commissioner and the statements submitted by the Secretary of the Treasury?

Mr. OLIPHANT. That was considered and the Secretary I think addressed a letter to the chairman of the committee indicating that there had been a somewhat unfortunate use of terms, that instead of saying "withheld from stockholders" the term should have been "not received by stockholders." Is that letter in the record?

The CHAIRMAN. That letter is in the record.

Mr. OLIPHANT. Thank you. In the next place, a number of witnesses who have suggested that objectives of this bill might be better attained by a stiffening of sections 102 and 351. I might first note in passing that all these suggestions have been couched in general terms and that no specific and concrete proposal for strengthening these sections has been presented to the committee. Frankly, I doubt the judgment of the people who advocate this as a real solution, since this Committee knows how great are the difficulties and how sparse have been the results of years of experimentation with these sections.

Even assuming, however, that these sections could have been provided with a real backbone, we would not have attained the objectives of this measure and those who so state, I believe, misunderstand these objectives. As typical of such misunderstandings, let me take Mr. May's classification of all corporations into three groups—namely, (1) the large group of small corporations which he states do not in any event constitute a source of tax evasion, which statement of his I repeat without proving, (2) the group of corporations, small in number but great in importance, which are publicly owned and whose dividend policies, according to Mr. May, are not at all governed by tax considerations, and finally (3) the small group of large closely held corporations against which he states the bill is directed. Mr. May compares the bill with Herod's massacre in which there was a great slaughter of innocents in an attempt, ineffectual in that case, to reach a single individual. Likewise, in this case, Mr. May contends there will be a widespread slaughter of innocents—the small corporations and their stockholders and publicly-held corporations and their stockholders—in order to reach a few offenders. Mr. May's analogy is poorly put, for I assure you that there will be no slaughter of innocents if this bill is adopted, and there are many using corporations to avoid surtaxes. Contrary to the supposition of Mr. May and of so many of the witnesses who have appeared in opposition to it, the bill is not directed solely against conscious tax evasion.

We are not interested in the motive of tax evasion but in the fact of lost revenue to the Federal Government which occurs when corporation earnings are neither distributed to stockholders and so subjected to the individual income tax, nor subjected to a compensatory tax in the hands of the corporation. Every corporation which would be subject to the proposed tax, those falling in Mr. May's first and second groups equally with those falling in his third, and the incorporated pocketbooks back of any and all of them would be equitably subject to it on this principle, and the contrary impression so widely prevailing among the witnesses who have appeared before this committee is based upon a complete misapprehension of purposes of the measure.

Does the bill favor the strong against the weak?

Next, I believe we should take up the allegation urged by practically every witness who has appeared in opposition to it, that this tax would stunt the growth of small and struggling corporations and discriminate against them and in favor of large and well-established corporations. I might first call your attention to the fact that, while you have heard a great deal from people who have heard that large and powerful corporations desire this tax in order to stamp out their small competitors, or who have heard of people who have heard of

this, no representative of a large corporation appeared before you to advocate this tax. On the other hand, representatives of large and powerful corporations have appeared before you to oppose this tax out of solicitude for their smaller brothers. I am surprised they did not employ the over-worked widows and orphans.

Let us look at the facts. We have urged that corporations, both large and small, can secure such capital as they need for the conduct of their operations by the sale of stock, either to stockholders or others, distribute notes to stockholders, or by distribution of optional stock dividends as provided in section 115 of the bill.

Senator BAILEY. That is one of your main points?

Mr. OLIPHANT. That is part of it.

Senator BAILEY. Under your theory the small corporation could always be able to sell stock and therefore get capital. Is that not your view of it?

Mr. OLIPHANT. Yes.

Senator BAILEY. Not by way of surplus earnings but by way of selling stock. That is the crux of this whole argument. I will just stay along with you if that is true, I will go along with you; but if it is not true then I have got to hesitate. I will tell you, I do not see how a small corporation can sell stock. I know of none in America today that are selling stock.

Senator KING. May I add right here, Senator, that the last record put out by the Securities Exchange Commission shows a very small sale, I think it is 5 or 6 or 7 percent of the issues of other years, and very much lower than Germany, Switzerland, France, Great Britain, or almost any other European country.

Senator BAILEY. I am willing for Mr. Oliphant to show me. I will go along with you. Show me how the small corporation, in lieu of money by way of savings, would be able to expand by way of selling stock. If that is easy to do, if that is feasible, I think it is all right. I would like to hear you on it.

Mr. OLIPHANT. If you will permit me to continue.

Senator BAILEY. Yes.

Mr. OLIPHANT. I am as eager to come to grips with that problem as anybody is. Nobody wants to do anything rash. This is not a game we are playing. I should like, if I may, to continue my general statement on this criticism and when I have finished it I will then address myself further to that question.

The CHAIRMAN. Go ahead. You may proceed.

Mr. OLIPHANT. The stock to be sold to stockholders could, of course, be taken up out of the cash dividends disbursed to such stockholders in an amount equal to the earnings which would have been directly reinvested in the absence of the tax. Mr. Ballentine urges that this proposed methodology is impractical since up to 79 percent of the dividends so distributed will be taken by the Government in income taxes and so will not be available for resubscription. This is, in fact, the case to the extent that such dividends fall in income brackets of individual distributees in excess of $5,000,000 but relatively few small and struggling corporations have principal stockholders whose incomes range to these figures.

Senator BYRD. How many income taxpayers are there with incomes of $5,000,000 and in excess of that amount?

Mr. OLIPHANT. I will give you the nearest figure I have. As estimated for 1936, under the existing law, there will be 86 income-tax payers with incomes in excess of $1,000,000. They are paying on an average income of $2,120,000.

Senator COUZENS. You mean $5,000,000 instead of $1,000,000, do you not?

Mr. OLIPHANT. I have only the figure for $1,000,000. I am giving you the best figure I have.

The CHAIRMAN. That is 86 income-tax payers?

Mr. OLIPHANT. Eight-six.

Senator BAILEY. You say "relative few small and struggling corporations have principal stockholders whose incomes range to these figures", that is, $6,000,000. That is just the point that I want to address myself to. They have incomes of less than 1 percent of $5,000,000, or one-tenth of 1 percent. If they had stockholders who had great big incomes they might sell them some stock, but they have small stockholders with very little income. You say you will address yourself to that later.

Mr. OLIPHANT. Yes; and to complete such partial answer to your question as I have here.

Under the proposed tax it is estimated that there will be an additional 212 individual income taxpayers with incomes in excess of $1,000,000, making a total of 298, and that group of 298 would pay on an average income of $2,360,000.

The CHAIRMAN. You mean in the event that this bill passed?

Mr. OLIPHANT. In the event that this bill passed. That is the estimate of the group of income taxpayers above $1,000,000.

Senator BYRD. How did you calculate that? On what basis did you make that calculation? Is that on the assumption that all dividends or earnings are going to be distributed?

Mr. OLIPHANT. Full distribution.

Mr. BYRD. You know that cannot occur.

Mr. OLIPHANT. Well, under the bill, from the standpoint——

Senator BYRD (interposing). Wait one second. You can retain 30 percent of the earnings and pay the same tax you pay now, namely 15 percent, and to base estimates on the assumption that every dollar of earnings is going to be declared in dividends is ridiculous on the face of it. You say you base these particular estimates on that.

Senator CONNALLY. What you mean, Mr. Oliphant, is you will have enough squeezed out of the corporation into the hands of the individual taxpayers to increase the number to 298.

Mr. OLIPHANT. Yes.

Senator BYRD. I want him to tell us how he made that up. If he does it on the assumption that all earnings are going to be paid out in dividends I think it is an erroneous assumption.

Senator COUZENS. I think you overlook the fact that they impose a compensatory tax on the corporation that equalizes the assumption of complete distribution.

Senator BYRD. Are your assumptions based on the complete distribution of earnings in this particular estimate?

Mr. OLIPHANT. The statement I just made is based upon a complete distribution of all earnings.

Senator BYRD. You know that is not going to occur, do you not?

Mr. OLIPHANT. If it does not occur under the bill the amount of taxes which the corporation will pay will compensate that loss of revenue, what would otherwise be paid to the Federal Government.

Senator HASTINGS. It would make your number receiving over $1,000,000 income less?

Mr. OLIPHANT. That is right.

Senator BLACK. But it would make the income to the Government the same.

Mr. OLIPHANT. That is right.

Senator BYRD. Let us go into that a little. What does a man with an income above $1,000,000 pay? It is 73 percent; is it not?

Mr. OLIPHANT. We have the effective rate right here.

Senator BYRD. Under this bill a corporation can pay from 1 to 42 percent in accordance with how it distributes its earnings, and 42 percent is not equal to 73 percent. Even though all their earnings were retained they would pay 42 percent, which this proposition would not do. As a matter of fact, what will happen will be that a great many corporations will completely avoid paying taxes and others will pay 7, 8, or 9 percent. That is a different matter from 73 percent. If a millionaire would have stock in some company and the company would pay the rate, the company would probably pay 10 percent, whereas if it was given to the millionaire he would pay 73 percent, and your estimate is based on the complete distribution of all earnings.

Mr. OLIPHANT. You are right in pointing out that my figure refers to the magnitude of present surtax avoidance. It was based on the assumption either that all earnings were distributed or that the corportation would pay an equivalent tax. I do want to emphatically state that my reference to that hypothetical case, which I see now could have been much clearer, does not concern at all the Treasury's estimate that this tax will produce $623,000,000.

Senator BYRD. What I take issue with you on, Mr. Oliphant, is where you say it makes no difference in the return that comes to the Treasury whether these earnings are distributed or not distributed. That is the statement you just made. It makes a good deal of difference, because in this instance the individual would pay 73 percent and the corporation withholding it may not pay over 5 percent.

Mr. HAAS. When Mr. McLeod was here he presented to the committee—you were probably absent, Senator Byrd—data showing that the rates in the House bill are such that they equalize the revenue which would be derived from the tax on undistributed earnings and that which would be derived in the form of surtaxes from individual distributees all the way down the line. It is true, of course, that if a corporation by paying a tax of 42½ percent withholds a dividend on which an individual recipient would have paid 70 percent the Government loses revenue by that particular deal. There are offsetting deals in the other direction, however, by which the tax paid on withholding is greater than the revenue loss through individual surtaxes. On the average, the Government will get about the same revenue regardless of the decisions of corporation directors to distribute or withhold corporation earnings.

Senator BYRD. I would like to have Mr. Oliphant correct the record. He made the statement with respect to these two-hundred-some-odd millionaires, 212 millionaires, that it would make no difference to the Treasury, that the Treasury would get just as much by the corporations not distributing as by the corporations distributing.

Mr. HAAS. That is in the aggregate.

Mr. OLIPHANT. That point is extremely well taken. I appreciate that. Shall I proceed?

The CHAIRMAN. Yes.

Mr. OLIPHANT. For most small corporations, the amount which will be available for resubscription would be substantially larger under the proposed plan than under the present law.

Senator BYRD. Let me ask you just one question. Do I understand that all your estimates are based on the theory that all earnings are going to be distributed, or just the 212 millionaires?

Mr. OLIPHANT. The Treasury estimate that this tax will yield $623,000,000 is not based on the assumption that all corporate earnings are distributed.

Senator BYRD. What percent of corporate earnings is it based on, the distribution of what percent?

Mr. OLIPHANT. It does not make any difference what percent is distributed, in view of the uniformity.

Senator BYRD. I just want to call your attention to one inaccuracy about this uniformity. You just stated in your written statement that it is a fact, and yet it is not a fact.

Mr. HAAS. May I answer the Senator?

Mr. OLIPHANT. Go ahead.

Mr. HAAS. The table which Mr. McLeod presented was made up, not as a part of the estimate for the $620,000,000, but to give to the committee some measure of this tax avoidance. One way to prevent such tax avoidance is to run all corporation earnings through the tax mill—the individual tax mill. The table was made up to show the magnitude of tax avoidance through withholding corporation earnings.

Senator BYRD. You state then that it is purely theoretical?

Mr. HAAS. It is an illustrative table.

Senator BYRD. I thought Mr. Oliphant stated that as a fact.

Mr. OLIPHANT. I am prepared to correct myself. My reference to that table, in response to your question as to how many people there would be in that group, is a mistake and I want to correct it. I want to make this clear, that this reference, assuming all corporate earnings are distributed, made by myself and made in the Secretary's statement, and others, is a statement of a hypothetical situation for the purpose merely of bringing out the magnitude of surtax avoidance, not evasion, surtax avoidance by means of keeping corporate earnings in the corporation, and that that hypothetical statement does not enter at all into the Treasury's estimate of the $623,000,000 produced by the bill.

Senator BYRD. What percentage of earnings were estimated to be retained by the corporation in making this $623,000,000?

Senator CONNELLY. Let me ask you a question in connection with that. Under your theory the revenue would be just the same if they distributed every nickel of it or if they did not distribute a dime, is that so?

Mr. HAAS. Yes; that is right.

Senator KING. Mr. Haas, can you demonstrate the validity of that conclusion? Is it not on its face a complete refutation of the fact that if you distribute every cent, or distribute it all through

surtaxes and through dividends, or retain a large part of it in the corporations for working capital, you get just the same tax?

Mr. HAAS. That is right. I could demonstrate that, I think, to your entire satisfaction if I had my materials here.

Senator HASTINGS. Mr. Haas, it seems to me it would be impossible to estimate. Now after these dividends are distributed the tax levied runs all the way from 4 percent to 79 percent; does it not?

Mr. HAAS. Yes.

Senator HASTINGS. It depends very largely on where they fall?

Mr. HAAS. That is right.

Senator HASTINGS. I do not know how you could possibly make that estimate.

Mr. HAAS. We do that every year in the Budget estimates. We have to estimate what the distribution of dividends will be, and our basis for that is the income-tax reports, which we tabulate by classes. So we have, as I said before, just as satisfactory basic information for such an estimate as a life-insurance company has in making up its mortality tables.

Senator KING. Well, the tax receipts would depend, would they not, in the aggregate on the amount that was paid as surtaxes and if you distribute your dividends to a large number, say several million, who would pay no surtaxes because of the limited amount of income which they derived or an insignificant amount of surtax, obviously you would not get as much revenue as if all of the money was distributed to large holders of stocks who had large surtaxes to pay.

Mr. HAAS. You are absolutely right, but there is no reason to suspect that the income now held in the corporation would go to a different group of people than the dividends which are now being paid out.

The CHAIRMAN. You took that into consideration?

Mr. HAAS. That is true.

Senator BYRD. Has the expert stated what percentage of the distribution of the earnings of all the corporations this bill was based upon, I mean, in regard to the estimate of $620,000,000?

Mr. HAAS. Well, Senator, we have the estimate worked out so that regardless of the percent retained we get substantially the same revenue, whether you keep 10 percent inside of the corporation and distribute the balance, and right on up the scale. We went over that, I think, with this committee, and also with the Ways and Means Committee. I would be glad to bring the materials up here.

Senator BYRD. No matter what happens, you will get the same revenue, whether the millionaires get the dividends or whether the corporations keep them or not?

Mr. HAAS. That is right.

Senator BYRD. You spoke of $620,000,000. As a matter of fact, the Secretary says that only $310,000,000 will be the highest for the fiscal year 1937.

Mr. HAAS. That is right. Do you want me to explain that?

Senator BYRD. You ought to make that clear, because the Secretary said that the first year it will be only $310,000,000.

Mr. HAAS. Mr. Oliphant explained that. Maybe you did not hear him. The estimate of $623,000,000 is the tax liability which accrues in the calendar year 1936, that is from January 1, 1936, to December 31, of that year. Now the Budget concerns itself with the collections of this tax liability. The fiscal year 1937 ends 6 months

after the close of the calendar year 1936. Under the regulations of the Bureau of Internal Revenue corporations and individuals are allowed to make their payments quarterly if they want to. So in the first 6 months of the calendar year 1937 when collections begin to come in, we estimate conservatively that we will get one-half of the tax liability for the calendar year 1936. Sometimes we get more.

Senator BYRD. And it would not be until 1938 that you get the $620,000,000?

Mr. HAAS. Yes; the full collection of that tax liability.

Senator BYRD. In the year 1938?

Mr. HAAS. Yes, the fiscal year 1938.

Senator CONNALLY. Well, you get some of it in the fall of 1937, in installments?

Mr. HAAS. Yes. The fall of 1937 is in what we call the fiscal year 1938.

Senator CONNALLY. Not the calendar year. He is speaking of the calendar year.

Mr. HAAS. That is right.

The CHAIRMAN. Proceed, Mr. Oliphant.

Mr. OLIPHANT. For most small corporations, the amount which will be available for resubscription would be substantially larger under the proposed plan than under the present law. As a matter of fact, the proposed plan would in this respect give small corporations an advantage which they have never had before. Let me read you in this connection an excerpt from Mr. Haas' statement, which I believe covers the matter very thoroughly [reading]:

> It is a good general rule that the principal stockholders in small, struggling, and newly established corporations are men of much smaller total incomes than the principal stockholders in large, prosperous, and well-established corporations. If, therefor, such principal stockholders subscribe back to the corporation for additional shares all or part of their dividend receipts, less the personal income tax thereupon, the proportion of the gross dividend receipts subscribed back by them will be much greater in the case of the average small corporation than in the case of the average large one. The great importance of the difference which exists because of the differing individual income-tax rates upon different income classes can best be seen when it is noted that while dividends which fall in the bracket between $10,000 and $12,000 of stockholders' individual incomes will be reduced by only a personal income tax of 11 percent, or less than the present corporation taxes, the dividends which fall in the income bracket between $100,000 and $150,000 will be reduced by a 62 percent individual income tax. In other words, a greater proportion of the earnings of small corporations will be available for reinvestment, when paid out to their stockholders, than of large corporations. I submit that this differential will give smaller corporations a chance to catch up upon their larger rivals which they never have had under any previous tax legislation.

Senator GERRY. Mr. Oliphant, would you mind if I interrupt you there?

Mr. OLIPHANT. By no means.

Senator GERRY. You said that there are more small stockholders in the small corporations than there are in the larger corporations.

Mr. HAAS. No; that was not the statement, Senator.

Senator GERRY. Have I got that wrong?

Senator LA FOLLETTE. The statement was that they were in the lower income group, or more likely to be.

Senator GERRY. There are more small stockholders that own two shares of stock, or a small number, in the small corporations than there are in the larger corporations? That is what I have been trying

to get at. Have you any statistics that show that that is true? For example, there are a great many people who own one or two shares of stock in some very large corporations.

Mr. HAAS. You are absolutely right, Senator.

Senator GERRY. Those are the statistics I have been trying to get all through the testimony. Now, I understand there is difficulty in getting those statistics.

Mr. HAAS. The statement concerns itself with the principal or, if you want to use the word, controlling stockholders of large corporations. The controlling stockholders of large corporations, in general, are men of larger income than the principal stockholders of small corporations. That is what his statement was.

Senator GERRY. I am not arguing with that, I am trying to get the other point.

Senator BYRD. Suppose these millionaires control a corporation and have to pay 73 percent, whereas the corporation would pay 42 percent, would they not pass it on to the surplus rather than pay that 73 percent? Will there not be tax avoidance under this bill?

Senator BLACK. Mr. Haas, they would be paying 27 percent more then under the present bill, would they not?

Mr. HAAS. The point is there probably will be some corporations of that sort, but, instead of having a hole an elephant can go through we will have reduced the tax avoidance to small dimensions.

Senator BYRD. You made the statement that certain big stockholders control a corporation and they happen to be in the million-dollar class and therefore would have to pay 73 percent. Would not they use their influence with the corporation not to declare the dividend and let the corporation pay 42 percent, thereby saving 30 percent, under your theory?

Mr. HAAS. There may be some of that.

Senator BARKLEY. There is a great difference between 15 and 42, even there.

Senator KING. Mr. Haas, do not your statistics in the Treasury Department, plus the investigations you have made indicate a gradual increasing diffusion or division of corporate stock so that there are, in the very large corporations, a large number, hundreds of thousands in some cases, of people with a small ownership, two or three or four or five shares, who of course would pay no surtax?

Mr. HAAS. There is no question that many stockholders of large corporations are people with small incomes—really small incomes. Such persons, however, as shown by our statistics, receive a very small proportion of total dividend disbursements. Persons with really small incomes save very little and what they do they are more likely to place in the bank or in some other liquid form. When they buy corporation stocks, however, they doubtless buy principally those of large corporations whose stocks are actively traded. When Mr. Oliphant was speaking of small stockholders in small corporations, however, he had in mind, as he mentioned at that time, those with incomes of, say, $11,000 or $12,000, which he contrasted with the much higher incomes characteristic of the principal stockholders of large corporations.

Senator CONNALLY. Well, Mr. Haas, what you said, as I understood you, was that the stockholders in the smaller corporations would be the men of smaller incomes than the ones in the big corpora-

tions that control those corporations and would not have as high an individual tax rate, and therefore a larger percentage of the net earnings in those corporations would be available for reinvestment than in the case of large corporations, because the large part of that would be taken away by the surtax.

Mr. HAAS. That is right.

Senator CONNALLY. That is what you said. Is that what you meant to convey?

Mr. HAAS. That is what I meant to convey. I meant the principal stockholders.

Senator CONNALLY. I understand.

Senator LA FOLLETTE. As a matter of fact, as I understood it, this was in answer to Mr. Ballantine's contention that 79 percent would be taken up in individual income taxes and would not therefore be available for reinvestment.

Mr. HAAS. And would affect small corporation growth.

The CHAIRMAN. All right; proceed, Mr. Oliphant

Mr. OLIPHANT. I might add, in connection with the point you just made, that the bill as it now stands provides that if later one of these stockholders to whom you refer as controlling the corporation ever takes that out of the corporation he will pay the full personal-income tax on it at that time, and it might very well be that he would hesitate a long time before embarking on that course of action.

Senator CONNALLY. Is it not true, Mr. Oliphant, that if you take two corporations with the same invested capital, the same net return, under this bill one would be taxed in one way and the other would be taxed in another way, and your theory is that on the average, in its entirety, you would get the same revenue?

Mr. OLIPHANT. That is right.

Senator CONNALLY. You are not overlooking the element of equality as between the two corporations situated exactly alike, are you?

Mr. OLIPHANT. That is right, and we have to, as I understand it, under the cases. That is, to carry this principle of equality that business profits from whatever source derived shall bear the same tax burden, to carry that out 100 percent, it would involve taxing the corporate earnings in the hands of the stockholders, whether distributed or not. That is, if you could treat all corporations as partnerships then this plan would not be subject to the limitations that you point out.

Senator CONNALLY. Corporations themselves need not be treated similarly, although they might be competing companies in the same field, is that not true?

Mr. OLIPHANT. Yes; that is true.

Senator BYRD. The Senator from Texas has brought up one of the greatest objections to this bill, that corporations competing, selling low-priced articles, pay an entirely different rate of taxes. Under this bill the taxes are going to vary from 1 percent to 42 percent. The taxes must be included in the cost of the article, with two companies competing with each other on some low-priced article, where a few cents makes a difference in the sale, and a vast difference in the payment of taxes.

Mr. OLIPHANT. That is true if they retain a different percent of earnings, but in the final analysis it will be true that the total group

to which that corporation must look finally for its capital will bear the same tax load in one case as in the other case.

Senator BYRD. Mr. Oliphant, you entirely ignore the conditions that exist. One corporation has a debt now and it has got to pay 42½ percent, and some other corporation competing with it will pay nothing, yet they have got to go on the market and manufacture articles and sell them on the market, having an entirely different rate of taxation.

Senator BLACK. That could be improved, could it not, as far as that goes, by doing away with the exemption for the debt-ridden corporation? That would avoid that difficulty, would it not?

Mr. OLIPHANT. That is true.

Senator BLACK. That would put them on an equality.

Senator BYRD. The Senator will pardon me, but it will not put them on an equality, because even then there will be a large variation in the taxes. They will vary from 1 percent or nothing up to 42 percent.

Senator BLACK. I mean, Senator, so far as that particular objection is concerned.

Senator BYRD. That is just one objection.

Senator BLACK. That objection would be removed by doing away with the exemption for the debt-ridden corporation.

Senator BYRD. I asked Mr. Oliphant whether or not he recommends it. He is going to furnish a memorandum tomorrow to state whether he does or not.

Senator KING. Senator Black, do you recommend a policy that will tend to destroy a small corporation that is in debt?

Senator BLACK. I do not recommend anything. I was calling attention to that provision on the ground that it produced an inequality. The individual who objects on the ground that it produces an inequality could escape it if he could have the entire paragraph stricken out.

The CHAIRMAN. We will proceed with Mr. Oliphant.

Mr. HAAS. May I make one remark, Mr. Chairman?

The CHAIRMAN. Yes.

Mr. HAAS. Senator Byrd, this tax, which is a tax on net income levied upon all merchants or owners of interests in merchandising concerns at rates graduated only according to individual net income, is, after all, not a cost. So your illustration, figuring out the relative cost position of the different companies, is not economically sound in this case.

Senator BYRD. He will pay the taxes on what it costs?

Mr. HAAS. No; from his net income.

Senator KING. Let me make an observation with respect to corporations in debt. If you do not give them any exemption they are subject then to the 42.5-percent tax, so you would force liquidation immediately.

The CHAIRMAN. Proceed.

Senator COUZENS. You are at the top of page 8.

Mr. OLIPHANT. Yes, sir. So much for the proportion of earnings of small corporations which would be available for reinvestment as compared with the proportion of earnings of large corporations which would be so available. How about the mechanical facility for getting the money back? As long as a corporation is really closely held, as most small and struggling corporations are, this facility is well-nigh

perfect. A year's earnings may be declared in dividends and resubscribed for stock and the whole operation completed in short order. Compare this flexibility, peculiar to the small corporation, with the more cumbersome process by which a large corporation may secure reinvestment in its business of sums disbursed as dividends, and I believe that you will agree that the facility with which small corporations may reach their earnings for additional invested capital under the proposed plan is in no way less than that which with respect to large corporations, and that, indeed, the bill insofar as it alters the situation at all, makes lighter the handicap of the small corporation in the race for supremacy.

The CHAIRMAN. Mr. Oliphant, in that connection somebody has said in connection with this matter that will be passed on by the Securities Exchange Commission. Have you any views on that?

Mr. OLIPHANT. I think that plans of this sort would be subject to that scrutiny in the case of dishonest corporations.

Senator COUZENS. They do not have to be dishonest, Mr. Oliphant, because if one corporation wanted to issue $100,000 of stock it would cost pretty near $50,000, and that can be wiped out by just a wave of the hand. That is a real situation.

The CHAIRMAN. Have you conversed with anyone in the Securities Exchange Commission in regard to that proposition?

Mr. OLIPHANT. Yes; the matter has been subject to general conversations.

Senator BARKLEY. As a matter of fact, the Securities Exchange Commission does not pass on the validity of stock issues. The corporation is only required to file information with the Commission as to its condition, and so forth. The Securities Exchange Commission does not in any way guarantee or underwrite or sponsor it.

Senator BYRD. But it authorizes you to do it. In Virginia, the State Corporations Commission has got to pass on all the issues of stock before the stock is issued at all.

Senator KING. I think, if you will pardon the interruption, that the Securities Exchange Commission have turned down a large number of corporation applications. That ought to have made very valid the original objection. I mentioned it a moment ago. I will put in the record in a moment—I have sent for it—the fact that the number of issues during the past few years in the Securities Exchange Commission is smaller than the issues in Denmark, Sweden, Switzerland, France, or Germany. In fact, we scarcely had any issues except for refunding.

Senator BARKLEY. That means fewer people have been skinned out of their money.

Senator KING. You can take any view you please. That is an argument against the contention that you can go out and get money to invest in these corporations that are in debt. You cannot do it.

The CHAIRMAN. You may proceed, Mr. Oliphant.

Mr. OLIPHANT. Here I should like to touch, in passing, upon the corollary objection that the bill would give an advantage to corporations whose stockholders are able to resubscribe their dividends for additional stock, as compared with corporations whose stockholders are not able to do this. Note that under the present law the alternative presented is that such sums be directly invested by the corporation, and so not disbursed as dividends at all. What, may I ask, are

the circumstances of stockholders who are perfectly able to forego dividends under the present law, but, if in receipt of them would be unable to resubscribe them. I submit that this inability must be merely another term for unwillingness; and I submit also that if they are unwilling to resubscribe such dividends then their judgment ought to be and must be final and that it is not the province of the Federal Government to question it. It is safer to let the real owners say when their funds shall be reinvested in a particular business.

Senator BAILEY. Do I get this from your statement, that if I was a stockholder in a small corporation and they declared to me a dividend and I do not invest it in stock because I want to support my family or keep a boy in school, that I am to be charged with unwillingness to resubscribe? It may be a case of necessity, is that not true?

Mr. OLIPHANT. That is one instance of unwillingness.

Senator BAILEY. I cannot resubscribe, I must use my money, I have got taxes to pay. All right. Here is the other fellow that is able to do it. When you sell him stock you increase your capital stock and you must give every subscriber the equal right to buy his proportionate share, but I am unable to buy. What position does that put me in? My relative holding in the company is reduced and the other man's is increased. Have you got any answer to that injustice?

Mr. HAAS. Mr. Senator, you pointed out that you received these dividends and you had some necessity to buy or some obligation to meet. What if you had not received them?

Senator BAILEY. What is that?

Mr. HAAS. Those earnings belong to you, not to the corporation. What if you had not received them, what would do about your necessity?

Senator BAILEY. I would have to go ahead, just as we have to do with a good many corporations that drew the money. I would want to use it myself. If it is there in the corporation I cannot help myself, but if it once comes out I would like to have a little liberty about using it.

Mr. HAAS. What this plan proposes is to give the owners of the corporation just the thing that you suggest, some liberty. If they want to spend it for necessities they are at liberty to spend it that way.

Senator BAILEY. How much liberty do you give a man who gets his dividends knowing that some others are going to increase their pro-rata share in the corporation? He needs his dividends. His pro-rata shares decline. How much liberty has he got under that situation?

Mr. HAAS. Well, the pro rata, Mr. Senator, does not affect you particularly.

Senator BAILEY. The pro rata of a man's interest in anything does affect it. If a man has one-tenth of the stock that is more important than if he only has 20 shares.

Mr. HAAS. For the purpose of control?

Senator BAILEY. Depending on how much the total is worth.

Mr. HAAS. What you are holding in the corporation is important.

Senator BAILEY. You are not going to tell me that my pro-rata holding in the corporation is immaterial?

Mr. HAAS. If you are interested in control then it is very important.

Senator BAILEY. Suppose I am very far from control, it is still very important. The dividends, when they are distributed, are distributed according to the interest, and as your interest increases and mine decreases, under your operation here my pro rata goes down and the other man's goes up. So the pro rata is of the utmost importance. That is why we have the law requiring that when stock is sold in a corporation each stockholder shall have the pro rata right to subscribe for his share. You would not say that that was unimportant, would you?

Mr. HAAS. You have sold some of your pro-rata share by not resubscribing.

Senator BAILEY. I did not sell it, the other fellow bought it from the corporation. I did not get anything for it but still my interest went down.

Mr. HAAS. You had the opportunity and let it pass by.

Senator BAILEY. I let it pass by because I could not help myself. The other fellow got it back.

Mr. HAAS. The question, Mr. Senator, is not clear to me. You say you could not help yourself, but if they left it in, then you could help yourself.

Senator BAILEY. I am not saying that. If they left it in it was there, I was helpless anyhow. If they distributed, then it is mine, but I have got to deal with my necessities.

Senator BARKLEY. Well, the proportionate number of shares held by one who cannot reinvest may be smaller than that held by others who do reinvest. The reinvestment made by others increases the value of the total, so the value that he holds is greater than it would be without the reinvestment of others. So he is not a loser.

Senator LA FOLLETTE. At least when it is paid out the individual stockholder has the right to decide what to do with it, instead of having the majority or minority stockholders decide for him as to what to do with it.

The CHAIRMAN. Go ahead, Mr. Oliphant.

Senator BYRD. I would like to ask Mr. Oliphant what investigation he made as to the laws of the different States that govern the sale of new stock. A large part of this goes into the distribution of dividends, and then when capital is needed for improvement, or something else, they have to sell stock. The laws in our State are very strict about it. I was just wondering whether you had gone into that fully, to see whether the small corporation you speak of, which may have had a surplus at times, whether it can sell any more stock and get the authority to sell it.

Mr. OLIPHANT. We had a great number of men examine all the statutes, the pertinent statutes in all States, and, as you point out, you will find a varying situation.

Senator BYRD. We are passing a uniform law, though, for the whole United States.

Mr. OLIPHANT. That is an embarrassment with which Congress is always confronted when it attempts to pass a law applicable to all the United States.

I might make this general observation with respect to the State Statutes. There is a broad difference, as the lawyer members of the committee will agree, I am sure, in the field of regulating corporate management, between the law on the books and the law in action,

that while, in some of the States you find what on the statute books looks like pretty stiff supervision, as a matter of fact the supervision is perfunctory and largely taken care of by filing the proper papers with the secretaries of the States.

Senator BYRD. It is not perfunctory in our State. They go into it very fully. I think it is very important. Of course, if every stockholder would only receive stock in proportion to what he now owns it would not make any difference, but new stock is frequently offered to the public.

Senator CONNALLY. Is not this beside the question? That is for the States to pass on. All we are concerned with here is the tax bill. When they have got the dividends we have no jurisdiction over it. We cannot make them repay it back under the Federal law. I think you have got a controversial question that has got nothing to do with the subject matter before the committee.

Senator COUZENS. As a matter of fact, it is driving them into the temple instead of driving them out of the temple.

Senator CONNALLY. What I am trying to say is that it is no concern of ours. It is dragged in here as an argument to bolster up the bill as against the criticism.

The CHAIRMAN. Mr. Oliphant was stating it could be employed in the event they distributed their earnings.

Senator KING. May I say, in view of the statement made by the Senator from Texas, that we are concerned, even in the tax bill, with the effect which it will have upon the American citizen. If the tax bill will drive men into bankruptcy because it will prevent them from getting money for the continuation of the business, we are concerned with that, directly or indirectly, and any provision in the bill that affects business or affects the solvency of institutions for individuals, it seems to me should receive cognizance at our hands. I am sure it must receive cognizance at the hands of the gentlemen who are now drafting it.

The CHAIRMAN. All right; proceed, Mr. Oliphant.

Mr. OLIPHANT. Next, in our presentation before your committee and before the Ways and Means Committee of the House of Representatives, we have urged that the proposed act would result in a greater measure of equality of opportunity between the three forms of business organization, i. e., individual proprietorships, partnerships, and corporations, than exists under the present law. Under the present law very small corporations are discriminated against since their net income is taxed at an average rate of approximately 15 to 16 percent, plus the individual income surtax on the amounts of income distributed (provided the recipients thereof fall within the surtax brackets), and this rate of taxation may be greatly in excess of the rate to which the recipients would have been subject had they been operating as individual proprietors or members of partnerships. On the other hand, the present law discriminates very greatly in favor of large corporations, since it permits the undistributed portion of their income to escape, with a flat tax of about 16⅔ percent, while the whole of their income, were it obtained from businesses conducted as individual proprietorships or partnerships, would be subjected to much higher rates of taxation.

It has been urged that this is unrealistic since, in fact, the types of business characteristically conducted by individual proprietorships,

partnerships, and corporations are quite different, and the three groups are essentially noncompetitive. It has been further urged that, insofar as they are competitive, the obvious remedy is for individual proprietorships and partnerships who do not like the discrimination to incorporate.

There is competition. For example, the chain stores are destroying our individual merchant class.

Senator BYRD. Mr. Oliphant, just at that point, are you familiar with the fact that the largest chain store in the country, the Atlantic & Pacific Tea Co., has a $98,000,000 surplus already accumulated that will not be affected by this bill; they have $54,000,000 of cash and call loans, and they have $42,000,000 in Government securities, and they can perpetually evade taxes under this bill simply by distribution of earnings they made and continue the whole $96,000,000 surplus. Yet you say they are destroying the individual merchants when the merchant must pay his tax; but the A. & P. Tea Co. will not pay any tax, and will never pay it, because they are the most liquid company of any companies that we have got. They have a surplus of $98,000,000; they have got $96,000,000 in cash and Government bonds.

Mr. OLIPHANT. I think the answer to that is the answer that I made a little while ago, that the total group which they represent—the thing we are after being equality of tax burden—the total group which they represent will pay the tax.

Senator BYRD. Mr. Oliphant, let me go on with this. In 1934 this company earned $20,000,000 and paid out $16,000,000; and under this bill, if they continue that, as a matter of fact, in my judgment, they would pay all the earnings; they would only have to pay $4,000,000 more in order to come within the complete freedom of taxation under the bill. That $4,000,000 going to the stockholders is not going to bring in anything like as much as the company now pays. Yet you put them in a position where they will be completely free of taxation to compete with all the merchants that must pay taxes on whatever they make.

Senator BARKLEY. Is it not true that the more completely they distribute their earnings, the fewer stores they will buy up?

Senator BYRD. They have got $96,000,000 in cash and in Government bonds.

Senator BARKLEY. That will run out sometime.

Senator BAILEY. I would like to have Mr. Oliphant explain how his plan would help the small merchant as against the Atlantic & Pacific Tea Co. Now remember the Atlantic & Pacific will have $98,000,000 in surplus.

Senator BYRD. $96,000,000 in cash and Government bonds.

Senator BAILEY. And no taxes to pay; but any small groceryman will have his taxes to pay, and the small corporation would have its taxes to pay. Now, how can they compete with the A. & P. Tea Co., under those circumstances? You have taken the side of the small man. I want to see how it will help the small man.

Mr. OLIPHANT. That may be boiled down to this—that bill should have come earlier.

Senator BAILEY. Oh, well; but it did not come earlier.

Mr. OLIPHANT. It did not. I am getting now pretty far afield, but I raise the question as to the wisdom of continuing a tax system

under which that condition developed, because there is still a great number of independent merchants and partnerships.

Senator BAILEY. You argued in behalf of the small merchant as against the chain store. The question then arises as to how the small merchant would stand the competition with the A. & P. T. under this legislation. We are not talking about what we should have had at the beginning of time. The question that I would like to have you answer is: How will the small man, with no surplus and a debt, paying taxes, ever be able to compete under this bill with the A. & P. T. with $98,000,000 of surplus and an established business all over the country and no taxes to pay? Now, if you ask me that, I will be much obliged to you.

Mr. OLIPHANT. This bill does not, nor did it undertake to, remove all the inequalities that exist.

Senator BAILEY. You agree that there is a glaring equality that you cannot explain away, do you not?

Mr. OLIPHANT. Well, I think you are asking me the question as to the wisdom of the policy of a statute which taxes existing surplus.

Senator BAILEY. No; I am asking you, since you take the side of the small merchant against the chain stores, how the small merchant would be aided against the chain store on the facts which are agreed here amongst us.

Mr. OLIPHANT. What I was trying to point out, I do not think the committee was correctly informed by the witnesses when they implied, by their statements, that there was no competition between corporations on the one hand and individual businessmen and partnerships on the other.

Senator BYRD. Mr. Oliphant, you do not deny the statements that I now make, that if the A. & P. T. has $98,000,000 of marketable securities and cash, and that they have a policy of paying out nearly all of the earnings, anyway, as shown by 1934, when they earned $20,000,000 and paid out $16,000,000, that there is no question in your mind that this company will pay out all of its earnings, resulting in little additional taxes, they will save $3,000,000 in taxes—that is what they paid in 1934—and then compete with complete freedom of taxes with a groceryman, a corner-store groceryman, who must pay taxes to the local and Federal Government, and whatever else he has to pay?

Senator CONNALLY. And if they do pay that out they will still pay the income taxes under this bill.

Senator BYRD. No; you are relieving the corporation of the $3,000,000 tax, because, Senator, they will distribute it.

Senator CONNALLY. You misunderstand. I say, if they pay the $3,000,000, as they do now, we will still get the $3,000,000, and if they distribute the balance we will get that in income taxes.

Senator BYRD. In other words, you give them $3,000,000 more to compete with the small merchants that you say you are trying to protect.

Senator BARKLEY. We will get them from the time they begin to set aside a certain amount of surplus which results in the accumulation.

Senator BYRD. They can easily abandon the policy, because they have got $98,000,000 in cash and Government bonds. They do not need any more.

Senator BARKLEY. That is a question.

Senator BYRD. It is the most liquid corporation on my list here, and I have a large number of them.

The CHAIRMAN. Mr. Oliphant, do you know any way of getting at these big concerns like the A. T. &. T? Can you do it by law? Can you go into some of these surpluses that these gentlemen are kicking about?

Mr. OLIPHANT. Preliminary to a more general answer to that question I am bound to say I think the discussion of this question would be much more illuminating tomorrow, when we have before us these things: First, the extent to which the figures quoted correspond to the figures in the Bureau of Internal Revenue; second, what the situation is with reference to corporations lying back of these corporations, and then we may be able to judge what the conduct of the men in charge of these large corporations will be. Now, I am embarrassed because I am under that limitation, in the absence of those facts, that I understand we shall have tomorrow.

Senator BAILEY. When you get those facts we will see how a small merchant can compete, under this bill, with the A. & P. T.

Mr. OLIPHANT. To answer more generally your question I think it has to be admitted that this bill does not attempt to remove all the inequalities that there are between large and small businesses.

Senator BYRD. Does it not increase the inequality in this specific instance that I called your attention to?

Mr. OLIPHANT. I think the long-time effect of it will be the other way. Those reserves will be exhausted, and there are other reasons for accumulating reserves.

Senator BYRD. Why will they be exhausted?

Mr. OLIPHANT. In time they will be exhausted.

Senator BYRD. I say, "Why?"

Mr. OLIPHANT. Because you start with a fixed sum. The process of subtraction will exhaust it.

Senator BYRD. Unless the company loses money it will not be exhausted because they will not pay out any dividends except from what they earn. I do not think they will lose $98,000,000.

Senator BARKLEY. They will buy more stores and add them to the chain.

The CHAIRMAN. Proceed, Mr. Oliphant.

Mr. OLIPHANT. Thank you sir. Granting there is no competiton, still I do not believe that these objections will stand close scrutiny. The first seems to assume that the bill aims to achieve tax equality merely between competing concerns. I challenge that. Retail merchants in New York and in California, barbers and makers f misses' dresses may hardly be said to compete, but I have yet to hear it urged that they should, therefore, be subject to differential rates of taxation upon their net incomes. The fact is that our quest for equality in taxation of business income is quite independent of competition, and your committee would not for a moment listen to a proposal that net incomes derived from some occupations should be taxed at higher rates than those derived from others. Neither do I believe that the gentlemen who have urged this point to your committee would favor any such proposition, if the question were put up to them squarely. But such is the inclination of all of us to justify

inequities which we find already existing, that there apparently seems to be no inconsistency between suggesting a lack of competition as a justification for taxing the earnings of stockbrokers, and if I may, lawyers, at a higher rate than those of manufacturers of children's rompers.

Let me turn next to the point that any one may escape this discrimination by incorporating. The most obvious reply to this is that it is not the business of Government to compel any such thing, granting it would be socially desirable. Moreover, in many cases it simply isn't possible.

It is a remedy which is not open, for example, to the legal profession, and I believe that the lawyer members of this committee will agree with me that it will be a dark day when legislation leads to the incorporation of our law firms in order to fit them into the framework of our tax system. Neither is the device of incorporation open, for example, to members of the New York Stock Exchange.

Arguing more fundamentally, however, and independently of such special cases, are we justified in asking that people adapt the form of organization under which they do business to the single motive of minimizing taxes? The conduct of a private or investment banking business by a partnership constitutes, for example, a real gesture of good faith. It means that each partner in the enterprise is prepared to stake his whole personal fortune upon the safety of the funds entrusted to it and to the integrity of its representatives and warranties. It also means that he will be subject to income taxes ranging up to 79 percent on the incomes which he derives from the business as compared with corporation taxes aggregating only about 16½ percent on the income of his competitors who are quite satisfied with the limited liability offered by a corporation. Here the discrimination in favor of the corporation and against the partnership constitutes nothing less than a surtax upon honor, and yet there are still partnerships of great size operating in these fields.

Senator BYRD. Mr. Oliphant, at that point, the chairman here stated—I have the greatest opinion of anything he says—that this bill was intended to put corporations on an equality with partnerships. That is the basis of it. Now, let us take a small corporation of $10,000; it owes a debt. It has, say, three partners. Now, a $10,000 corporation must pay that debt, must pay 29 percent. That is correct, is it not? If that money is distributed to the three partners and they have a debt, each partner getting $3,333, after taking the exemptions off they have to pay very little.

The same thing applies to a $50,000 corp[illegible]ation. If they have a debt and must pay it they have got to pay mo[illegible] than 29 percent, but if they have five persons and get $10,000 each they would not pay anything like the rate the corporation would have to pay. Therefore, in my judgment, this bill does not carry out the principle of treating corporations as partnerships. The partnership has a tremendous advantage.

Mr. OLIPHANT. I think the example may be somewhat extreme, but I think it is covered by what I have said before. If you wanted fully to carry out the principle of equity, namely, that all business income from whatever sources derived shall bear the same tax burden, it would be necessary to tax business profits in the hands of stockholders, whether they are declared out or not.

Senator BYRD. Under this bill a small corporation must pay a debt, or if it reserves some of its earnings for surplus it will pay much more taxes than a partnership say of two or three or four people.

The CHAIRMAN. When you give us a response on that question you will take that into consideration.

Senator GERRY. I have another question on that.

Senator KING. May I say, I should hate to think the aim of this bill was to destroy corporations by compelling them to enter into partnerships, to apply the same yardstick as to individuals. Corporations serve a great useful purpose socially as well as economically. Legislation aimed to destroy them I do not think is right.

The CHAIRMAN. I do not think anybody connected with this bill believes that the purpose is to destroy corporations.

Senator BYRD. I do not believe that at all.

The CHAIRMAN. The Senator intimated that.

Senator BYRD. The smaller corporation pays a much higher tax under a number of conditions than a partnership would pay under exactly similar conditions.

Senator GERRY. Is it not also true that after a corporation pays this tax, if it distributes later it must pay out on the amount it distributes, while after the partnership pays the tax it pays it once and for all and can keep what is distributed to them. So there is definitely an advantage in the case of partnerships.

The CHAIRMAN. Go ahead, Mr. Oliphant.

Mr. OLIPHANT. I am coming to point no. VII. I do not believe that the answers which have been made by the witnesses of the opposition to the constructive case on this point are entitled to carry conviction. Let us look therefore, to their own constructive case—to the reasons which they advance why corporation earnings should be taxed at lower rates than if they had accrued to individuals. These reasons, in all of the many forms in which they have recurred throughout the testimony which you have heard during the past 2 weeks, can be summed up into the general proposition that undistributed corporation earnings represent a form of savings, and that savings ought to be treated with a particular tenderness by the tax collector since they form the stuff from which our country has been built and are the only means by which its progress may continue.

There are economists who believe that under present circumstances we are suffering from oversaving rather than undersaving, but let us waive their arguments and go to the opposite extreme of granting for the moment the point made by these witnesses, that is, that corporation savings should be accorded special treatment. Do not these gentlemen prove too much? The aspect of this income which is alleged to justify such special treatment is not that it accrues to corporations but that it is designated for saving. If then, we are to accord a preferential tax treatment to funds saved by corporations, we ought equally to accord such treatment to sums saved by individuals. Are you gentlemen willing to go that far, realizing that to do so would completely vitiate the productiveness of the higher brackets of the individual income tax, and force us to raise the great bulk of the revenue for the support of the Federal Government by excises on consumption? The question answers itself.

Recurring then to the main point, if the savings of individuals are not to be accorded special tax treatment, neither should those of

corporations, and I believe you will find upon reflection that most of the testimony which has been presented to you with respect to the necessity of according special treatment to those portions of corporation income used for expansion of plant, increase in inventory, repayment of debt, and so forth, are covered by this general principle.

An argument upon which opponents of the proposed tax policy, Mr. Noel Sargent for example, have laid considerable stress is that it would tend to intensify both booms and depressions. This undesirable consequence is supposed to result from the effects of increased dividend disbursements in good times and reduced disbursements in bad times upon the course of the stock prices. As a matter of fact, common sense may be relied upon to establish just the contrary conclusion. The greater probability is that booms and depressions would be reduced rather than increased in severity as a result of the proposed new tax.

During the 'twenties the practice of reinvesting a large proportion of corporate earnings led to three notable developments. First, there occurred an excessive expansion of plant and equipment in certain industries, notably in some branches of the building industry. Second, there took place an accumulation of idle surplus funds in the hands of corporations, which reduced the purchasing power necessary to maintain a smooth flow of industrial products. Finally, there was a great increase in corporate loans to the stock market, these loans serving to augment speculation. As a concrete illustration of the accumulation of idle corporate funds during that period, we may cite the increase of $5.6 billions between 1926 and 1929 in the cash holdings of corporations reporting balance sheets to the Bureau of Internal Revenue. With respect to the financing of stock-market speculation, brokers' "loans for the account of others", representing very largely the lending of unneeded corporate reserves, increased from $600,000,000 in 1926 to $3,600,000,000 in 1929.

A wider distribution of corporation earnings during this period, in place of so large a volume of reinvestment of earnings, would have served to reduce the force of each of these three causes of overexpansion and speculation. Moreover, to the extent to which additional dividends were spent for consumers' goods, wholesome industrial activity would have been more amply sustained.

Some of your witnesses lay considerable store by the charge that the proposed tax is a step in the direction of Government regulation and regimentation of business corporations. Mr. Noel Sargent in particular makes this assertion, on the ground that the tax "sets up a basic standard amount which should be retained as reserves and puts a tax penalty upon reserves beyond such arbitrary fixed standards." This argument will scarcely bear examination. The low corporate surtax rates on the first 30 to 40 percent of reinvested income permit a moderate and reasonable use of this method of raising capital. If more is needed there are many other means of raising it, to some of which I have earlier referred in some detail. In view of these various and simple methods of increasing the capital of a corporation, it is to say the least an exaggeration to claim that the proposed tax involves "regimentation" and "planning." If the bill has the effect of bringing about a greater distribution of dividends, it will have the result, not as Mr. Sargent says of "substituting Government discretion for that of

management as to the amount of earnings which should be retained in the business", but of substituting the discretion of the actual owners of corporations, their stockholders, for that of their directors. So far as this might be accomplished, the effect of the bill would be democratic rather than autocratic, in the direction of a more liberal, rather than a regimented economy.

That concludes the statement.

The CHAIRMAN. Now, do any of the Senators want to ask Mr. Oliphant any questions?

Senator KING. Mr. Chairman, before we adjourn, I called attention a few moments ago to the remarkable decline in the issuance of securities by corporations in the United States since the Securities Exchange Commission and to the increase in the issue of securities in other countries. I have here the list to which I referred. I said I would put it in the record later on. I desire now the permission of the chairman and the committee to read a few sentences here and then put them in the record. This is from The Chase Economic Bulletin. [Reading:]

But even as modified by the amendments of 1934 and the intelligent rulings of the Securities and Exchange Commission, it remains unduly drastic, making responsible directors reluctant to assume the personal obligations involved in putting out new securities and especially new stock issues, so that the flow of new capital into corporations is greatly reduced. Moreover, what new capital corporations are getting is, to an undue extent, taking the form of bonds rather than stocks. The legislation on the other hand, imposes no liabilities and no regulation in the case of the United States Government, State, and municipal securities. The following table is significant as showing how the stream of new capital to American corporations has dropped almost to a trickle, while in most other countries, despite the depression, the drop has been very much less:

Indices of new domestic corporate capital issues in different countries [1]

	United States [2] (1923 = 100)	United Kingdom [3] (1923 = 100)	Germany [4] (1923 = 100)	Japan [5] (1923 = 100)	Switzerland [6] (1923 = 100)	Italy [7] (1923 = 100)	Netherlands [8] (1923 = 100)
1923	100.0	100.0	.....	100.0	100.0	100.0	100.0
1924	114.9	132.1	100.0	67.7	245.1	132.2	352.7
1925	136.7	195.5	266.6	88.2	226.5	225.9	296.6
1926	142.5	208.4	606.7	111.9	159.2	142.6	295.0
1927	176.7	260.5	634.5	102.8	169.1	79.4	229.6
1928	202.8	294.2	638.3	96.3	204.7	135.5	707.7
1929	303.6	233.9	382.2	70.3	253.2	182.8	505.5
1930	170.1	188.4	826.2	80.8	458.8	154.8	321.7
1931	58.9	63.0	349.1	37.6	560.8	168.8	67.7
1932	12.3	134.0	82.5	29.7	212.9	91.6	47.6
1933	6.1	140.7	92.0	76.6	273.2	84.0	15.9
1934	6.8	157.9	121.4	90.0	182.7	89.1	79.2
1935	15.3	239.6	.....	96.1	.....	.....	.....
1936 (first quarter)	18.8	.....	.....	.....	.....	.....	.....

[1] Because of the various ways of recording data in the above countries, the indexes for the different countries are not in all respects comparable. They do, however, show the trend in each country and, allowing for a small margin of error due to differences in items included in each series, the indexes may be taken as indicative of the relative movement of new issues in these countries.

Sources:

[2] Commercial & Financial Chronicle.

[3] Midland Bank Monthly Review.

[4] Statistiches Jahrbuch Fur Das Deutsche Reich, 1935. Figures do not include security issues by the railway company or the postal administration which function in part as private undertakings.

[5] Economic statistics of Japan, 1934-35.

[6] Statistisches Jahrbuch der Schweiz, 1930-34.

[7] Banca Commerciale Italiana Movimento Economico Dell' Italia and Annurio Statistico Italiano.

[8] Jaarcijfers Voor Nederland.

[9] Based on first quarter of 1923.

Senator BARKLEY. That is the statement issued by the Chase National Bank?

Senator KING. By Dr. Anderson.

Senator BARKLEY. He is the statistician and economist too?

Senator KING. Yes; those are based upon the figures he obtained.

Senator BARKLEY. I would like to reserve the right to insert the appropriate section from the report of the Securities and Exchange Commission on that subject.

The CHAIRMAN. I would like to state that in the morning we have asked the Secretary of the Treasury to be here with certain data. The session tomorrow necessarily will be executive, if he gives certain facts that have been requested. It will be an executive session in the morning at 10 o'clock.

I would like to ask Mr. Oliphant and the Treasury officials in the meanwhile, if one has not already been prepared, to begin at the retention of about 30 percent of your profits and put a 15-percent tax on them, and graduate it upward, raising it upward, where they retain 50 percent and more, to get enough revenue to make $623,000,000.

Senator BAILEY. You mean on the substitute proposition?

The CHAIRMAN. I just want to get those figures, so the committee can consider them with the others.

Senator BYRD. Is that on the basis of the substitute?

The CHAIRMAN. This is a proposition for the consideration of the committee, where we begin on a basis of 15 percent on corporation profits, and then graduate it upward, with a supertax on top of that.

Mr. OLIPHANT. You are assuming there the retention of the corporate income tax, is that it?

The CHAIRMAN. Yes; on the basis, say, of a 30-percent retention, 30 percent or under, say at 15 percent. That is about the present rate. Then graduate it upward, where they retain more than 50 percent, put it on a 60 percent basis. In other words, see if we can get $623,000,000 on that basis. The committee can consider that in connection with this other proposal.

Senator BAILEY. Could we have some data on the subject of the substitute?

The CHAIRMAN. That substitute will bring in, as was stated before, an income of $623,000,000, if you give a $1,000 exemption on $20,000 profit, and they are figuring whether or not they will go a little higher on the exemption.

Senator BYRD. Is this the substitute offered by the Treasury Department for the pending bill?

The CHAIRMAN. No; that is not a substitute particularly. You will recall that at the beginning of this hearing I requested some figures, and it is in response to that request that a more simplified form be prepared to take the place of these four schedules.

Senator BYRD. This does not necessarily have the endorsement of the Treasury Department?

The CHAIRMAN. No. That was prepared at our instance and I think this other estimate can be gotten out for your consideration in connection with this matter.

The committee will adjourn until 10 o'clock in the morning at which time we will meet in executive session.

(Exhibit referred to by Mr. Haas during the course of Mr. Oliphant's statement follows:)

INFORMATION WITH RESPECT TO CYCLICAL VARIATIONS IN THE PROPORTION OF CORPORATION EARNINGS PAID OUT IN DIVIDENDS

The following table shows the proportion of statutory net income paid out in cash dividends by all corporations showing net income, during the years 1922–33, inclusive, and the Treasury's estimates of such proportion for the years 1934, 1935, and 1936:

Statutory net income and cash dividends paid, corporations showing net income

[In millions of dollars]

Years	Statutory net income	Cash dividends paid, corporations showing net income	Ratio of cash dividends paid to statutory net income
			Percent
1922	6,964	3,183	45.7
1923	8,322	3,871	46.9
1924	7,587	3,995	52.7
1925	9,554	4,817	50.3
1926	9,673	5,530	57.2
1927	8,982	5,785	64.4
1928	10,618	6,585	62.0
1929	11,654	7,842	67.3
1930	6,429	6,841	105.4
1931	3,683	3,872	105.1
1932	2,153	2,320	107.8
1933	2,795	2,358	79.9
1934 [1]	4,100	2,540	60.2
1935 [1]	5,500	2,990	54.4
1936 [1]	7,200	3,540	49.2

[1] Estimated.

The years referred to in the above table are calendar years, and the data are not available for years prior to 1922 or subsequent to 1933. It will be noted that the Treasury's estimate of the proportion of statutory net income to be distributed by income corporations during the calendar year 1936 is substantially higher than that actually distributed during the somewhat analogous years 1922 and 1923, when corporations were recovering from the much less severe depression of 1921. It is also of interest that even in such years as 1925 and 1928, during which business was recovering from the relatively minor recessions of 1924 and 1927 respectively, the proportion of statutory net income distributed as cash dividends declined somewhat.

(Whereupon, at 4:50 p. m., the committee adjourned until 10 o'clock of the following day, Wednesday, May 13, 1936.)

Subsequently the following briefs, statements, and letters were received and ordered printed in the record.)

[Reprinted from hearings held before the Committee on Ways and Means, House of Representatives, 74th Cong., 2d sess., on the Revenue Act, 1936]

STATEMENT OF FRANK H. HALL, NEW YORK CITY, DIRECTOR AND GENERAL COUNSEL OF THE CORN PRODUCTS REFINING CO., AND REPRESENTING ALSO THE CORN REFINING RESEARCH FOUNDATION

Mr. HILL. Mr. Hall, state your name and the capacity in which you appear.

Mr. HALL. My name is Frank H. Hall, 17 Battery Place, New York City, director and general counsel of the Corn Products Refining Co.

Mr. HILL. And you are appearing here on behalf of that company?

Mr. HALL. Of that company and the Corn Refining Research Foundation.

Mr. HILL. How much time would you require for your statement?

Mr. HALL. About 10 minutes.

Mr. HILL. You are recognized for 10 minutes. Please proceed.

Mr. HALL. Mr. Chairman and gentlemen, I want to speak only with relation to that part of the proposed tax bill which is referred to in section 24 of the subcommittee report, particularly on page 9. That is the "windfall" tax. That sentence on page 9 reads:

"The selling price should be adjusted by the deduction of any amounts subsequently repaid to the purchaser, on or before March 3, 1936, or pursuant to a bona-fide written contract entered into on or before March 3, 1936, as reimbursement for the amount included in the price on account of the excise tax."

I am really speaking in behalf of the second class of concerns mentioned in the beginning of section 24.

"Dealers who included the amount of a Federal excise tax in the price of goods sold by them but who were subsequently reimbursed by their vendors for the amount of the tax."

Immediately following the decision of the United States Supreme Court on the constitutionality of the Agricultural Adjustment Act, the corn refiners sent to the press or released to the press and sent out to the trade the following notice:

"The Corn Industries Research Foundation announces today that 10 corn-refining companies who have tax refunds coming to them as a result of the decision of the Supreme Court, invalidating the Agricultural Adjustment Act, have advised the foundation that their companies neither desire nor intend to derive any profit from the return of these taxes, and that it is their intention that these refunds shall be passed on to their customers just as soon as the way is legally clear and the necessary preliminary computations and adjustments can be effected.

"Says the foundation: 'The burden of processing taxes in general was borne by the ultimate consumer, and this industry would feel itself unjustly enriched unless it attempted, to the best of its ability, to restore these taxes to the people who acually paid them.'

"The following corn refiners are members of the foundation: American Maize Products Co., Anheuser-Busch, Inc., Clinton Co., Corn Products Refining Co., the Hubinger Co., the Huron Milling Co., Inc., the Keever Starch Co., Penick & Ford, Ltd., Inc., Piel Bros. Starch Co., A. E. Staley Manufacturing Co., Union Starch & Refining Co."

Under date of February 4, 6, and 10, three of the companies interested in the industry sent notices to the entire trade. One of those contained this clause:

"There has been some discussion about Congress passing a retroactive excise tax which would oblige us to pay these refunds over to the United States Government. There is some uncertainty concerning the regulations of the Treasury Department in connection with the income-tax laws.

"It may be some time before we will know definitely that we are free of the possibility of having to pay all or a portion of these refunds to the Government. We are, of course, hopeful that these uncertainties will be eliminated by the time our computations are completed."

In a second letter to the trade there was this paragraph:

"As you have doubtless seen in the public press, various proposals are being made in Washington which include the possibility of the levying of a retroactive excise tax equivalent in amount to the invalidated processing taxes. If Congress should put into effect this, or a similar proposal, then the fund which we now hold would have to be paid to the United States Government, and not to our customers. It follows that the distribution of the fund must await the time when we can determine with reasonable certainty the action which Congress may take. Obviously, it would be unreasonable to expect that we should distribute this fund to our customers so long as we are threatened with the possibility of having to repay the fund to the United States Government."

The first of those letters went out February 4 and the second February 6. On February 11 our own company sent this letter to its entire trade:

NEW YORK, N. Y., *February 11, 1936.*

Re: Refund of processing taxes.

To Our Customers:

In order to be prepared to promptly comply with the announced policy of our industry, this company is now engaged in computing the adjustments due our customers on account of the processing taxes previously impounded by the court and now returned to us or withheld from payment.

We can be greatly assisted in this work if our customers will promptly furnish us with the dates and numbers of our invoices covering goods shipped them between July 31, 1935, and January 7, 1936.

Do not include invoices covering crude or refined oil, hydrol, or feed, as the tax on these items was absorbed by the manufacturer and was not included in the price.

Yours very truly,

CORN PRODUCTS SALES CO.,

_____,

Accounting Department.

On March 3, I have a copy of a letter here which I sent to a number of our customers in response to demands, "Why don't we get the money? It is safer in our hands than yours." And I would like to read from that letter:

"Our company is now engaged in preparing to make distribution of these refunds, but feels, in view of the announced policy of the administration and the tax laws proposed to be submitted to Congress, that we cannot actually make any of these refunds until we know more definitely the final action to be taken by the Senate and the House of Representatives on this matter.

"We sincerely hope that no legislation will be enacted which will prevent our paying over the recovered taxes to those of our customers who we feel should be entitled to receive the refunds and who we expect, in turn, will account therefor to their customers in those cases where the tax was reflected in their prices."

Briefly, then, gentlemen, I am only speaking regarding the limitation which the subcommittee has recommended, that credit be allowed in connection with the "windfall" tax for any refund which the processor may have made to his customer prior to March 3, 1936, or pursuant to a written contract made prior to that date.

In other words, if you will take the description of the dealer which appears in the first part of this paragraph of the subcommittee's report, the dealer who included the amount of the Federal excise tax in the price of goods sold by them, but who were subsequently reimbursed by their vendors for the amount of the tax, and no matter when they were reimbursed, permit the processor to satisfy his trade, if his trade did pass the tax on in the price, he, in turn, to make a report and account for it.

I trust I have made the point clear, gentlemen. I am only speaking of the limitation that, as things stand now, in case a processor has, prior to March 3, repaid his customers whatever tax he may have recovered by virtue of the decision of the Supreme Court, that is passed, and this "windfall" tax does not apply.

In our industry we promised the money to our customers, but in an excess of caution, perhaps, waiting to see what the legislation would be, we have not yet paid it off but have set it aside in a fund. We promised it to our customers, and we ask you to give us the same opportunity to refund it to them.

Thank you.

MEMORANDUM RELATING TO THE NATIONAL REVENUE BILL OF 1936 (H. R. 12395)

By Associated Industries of Rhode Island and Rhode Island branch of the National Metal Trades Association

The Associated Industries of Rhode Island and the Rhode Island branch of the National Metal Trades Association, on behalf of our members, desire to express our agreement with the presentations made by other witnesses as to the dangers and difficulties presented to corporate enterprise by the form of taxation incorporated in the national revenue bill for 1936.

We particularly desire to approve and endorse the statement of John W. O'Leary, president of the Machinery and Allied Products Institute, of Chicago, Ill., with which many of our metal-working concerns, through their several trades association, are affiliated. We also wish to approve and endorse presentations by witnesses on behalf of both the National Association of Manufacturers and the United States Chamber of Commerce, with which many of our individual members are allied.

Briefly, we desire to present the picture of the economic conditions under which Rhode Island is now struggling and what we conceive will be the practical working out of the proposed legislation, if passed in its present form.

"Results", said the small boy, "are what we expect. Consequences are what we get."

The statistics of income for 1933 compiled from income-tax returns by the United States Treasury Department, Bureau of Internal Revenue, are the latest State figures available in which corporation returns are broken down for the State of Rhode Island.

The figures for Rhode Island for 4 years of prosperity (1926–29), inclusive, and 4 years of depression (1930–33), inclusive, the latest figures available, are as follows, money figures in thousands of dollars:

Year	Returns showing net income					Returns showing deficit			
	Total number of returns	Number with net income	Gross income	Net income	Tax	Number with deficit	Gross income	Deficit	Number of returns showing no income data
1926	2,566	1,398	616,015	43,396	5,477	1,198	252,858	22,640	.....
1927	2,688	1,536	735,728	49,046	5,791	947	180,030	16,193	205
1928	2,671	1,628	691,950	51,737	5,585	1,009	187,610	15,197	243
1929	2,964	1,650	683,002	54,457	5,504	1,067	231,863	19,731	247
Total	.....	.....	.....	198,661	22,357	.....	.....	73,671	.....
1930	3,068	1,370	380,338	23,343	2,677	1,450	370,685	57,783	248
1931	3,127	1,217	265,321	18,154	1,887	1,655	373,103	55,867	255
1932	3,134	562	127,045	9,290	1,147	2,327	347,445	62,012	245
1933	3,272	846	314,510	22,401	3,148	2,143	217,066	37,079	283
Total	.....	.....	.....	73,220	8,859	.....	.....	212,741	.....

While individual State returns in the above form for 1934 and 1935 are not available as yet, official Government data on national income produced, business savings or losses, and income paid out are available for 1934. The November 1935 Survey of Current Business, published by the Department of Commerce, gives the national income as follows:

TABLE 1.—*National income paid out and produced*

[Millions of dollars]

Item	1929	1930	1931	1932	1933	1934
Income produced	81,034	67,917	53,554	39,545	41,889	48,561
Business savings	2,402	−5,015	−8,120	−8,817	−3,051	−1,628
Income paid out	78,632	72,932	61,704	48,362	44,940	50,189

Current reports and official releases issued since November 1935 give a fairly accurate picture of the national income for 1935. We purposely avoid reference to continuing studies such as that of the National Bureau of Economic Research and other research bodies. We believe that upon the official record and recent administration statements it is fair to assume that while conditions in Rhode Island, for various reasons, have somewhat improved since 1933, the returns for 1934 show a very substantial loss and that for 1935 they will show that a balance between net income and deficit was almost reached.

The 3,273 Rhode Island corporation income-tax returns for 1933 prove conclusively, when related to population and Government figures of the gainfully employed, that the average taxpaying corporation of Rhode Island is small.

Although noted for its density of population and proportionate industrialization, as well as its lack of geographical area, it should be kept in mind that even in Rhode Island industrial wage earners constitute on the average less than half of those gainfully employed. Also that in 1933, while the Census of Manufacturers reported only 1,254 employers, corporate income-tax returns

for that year, including all others, totaled 3,273. The latest available Census of Manufacturers' figures for Rhode Island are those of 1933, which follow, with those of 1929 for a basis of comparison:

Census of Manufacturers' Figures for Rhode Island

Year	Number reporting	Wage earners
1929	1,701	126,068
1933	1,254	92,512

The substantial drop in both the number of manufacturers and wage earners in Rhode Island for 1929 to 1933 tells its own sad story and needs no comment. It is also directly connected with our unemployment and relief problem. All figures and relationships are, of course, directly or indirectly connected with the tax problem, both local and national. The statement that less than 1 percent of the manufacturers of the country employ as many as 1,000 and that less than one-tenth of 1 percent employ as many as 2,500 is, therefore, substantially verified in Rhode Island.

Rhode Island Federal corporation taxes for 1934, amounting to $3,857,410.55, increased in 1935 to $4,694,121.34, an increase of approximately 22 percent. The grand-total Federal-tax payment for Rhode Island, amounting to $14,933,135.50 in 1934, increased to $15,450,061.45 in 1935, an increase of 3 percent.

Every intelligent employer realizes that taxes must be paid. They view them as a necessary incident of doing business, the same as cost of materials, labor, or general overhead expenses. Every thinking person also must realize that the burden of taxation is necessarily going to increase in the years immediately ahead. Many students of the problem of taxation, while accepting the necessity of an increased tax burden, seriously believe that fundamental American institutions, such as democracy and liberty itself, are perilously at stake.

Regardless of partisan politics, or honest differences of opinion as to the relative value of temporary expedients or long-term objectives, our members—and we believe the vast majority of our citizens—believe in the preservation of our institutions, including the much-maligned profit-and-loss system.

Senator Wagner recently said:

"The single question worthy of debate concerns, not what must be done but rather the respective spheres that Government on the one hand and private industry on the other should occupy in doing it, and the extent to which their efforts should coalesce."

He also said:

"If we are resolved to purify rather than to discard our American system, governmental action must play second fiddle to the voluntary efforts of industry and labor, working together."

President Roosevelt also recently said:

"Legislation has its place. Often it has been necessary for the welfare of labor or capital, or both, but it is a remedy to be taken with great caution, or it may prove worse than the disease."

Administration studies and reports on the balance sheet of all American business, whether reviewed from the standpoint of the depletion of reserves or the excess of income paid out over income produced, conclusively prove that during the depression more than $20,000,000,000 was wiped out by the end of 1933. Rhode Island returns for that period also clearly indicate that we suffered our proportionate loss.

National returns for 1934 clearly indicate that substantial loss, although decreased, continued in that year.

Tentative figures for 1935, according to Harold L. Ickes, approached a balance. Quoting from the New York Times of February 2, 1936, in which he is reported to have said:

"A recent report issued by the Department of Commerce shows our success. The national income produced is at last within striking distance of the income paid out."

Although State and local taxation, both of which are also increasing, are not directly concerned, they cannot be entirely forgotten in any consideration

of the tax burden, our social, economic, and political institutions can carry, "if we are resolved to purify rather than to discard our American System."

Any plan of taxation at the present time must necessarily call for high rates of tax in order to provide the needed revenue. With that thought in mind, we would respectfully suggest that in the approach to a proper balance, more emphasis be placed upon reduced Federal expenditures rather than upon increased taxation.

Regardless of the necessary amount of the burden, whatever it may be, our main objection is to the inevitable confusion, inequities, and injustices that are bound to result from passage of the bill in its present form. With the purpose of the undistributed earnings tax, stated to be to prevent avoidance of surtax by individuals through unreasonable or unnecessary accumulation of income by corporations, we have no quarrel. However, in this State such cases are a rare exception rather than the general rule. It is also our opinion that it is a fundamental error to establish a general rule for all corporations based upon exceptional cases.

We desire to particularly direct your attention to:

1. The serious impairment of capital surplus and assets that has already taken place.

2. The credit position of our corporations with both the local banking institutions and the Reconstruction Finance Corporation.

3. The necessity for expansion of credit, particularly in the durable and capital goods industries that have already suffered the most and in which unemployment is the greatest.

4. The indirect as well as the direct effect upon the capital-goods industry. Failure to expand or modernize illustrate the point; and

5. Most important of all, the practical effect if this law had been in force prior to and during the depression.

The Government statistics for all Rhode Island corporations for the 8-year period, 1926 to 1933, inclusive, given above, indicate that for that period there was a net deficit of $13,991,000. It should be noted that 4 years of exceptional prosperity, as well as 4 years of our worst depression, are included in that period. It should also be noted that the net income of all Rhode Island corporations of more than $125,000,000 accumulated during the 4 years of prosperity was more than wiped out during the 4 years of the depression and an additional deficit of nearly $14,000,000 was left at the end of 1933. The net results for all Rhode Island corporations for the 8-year period, 1926 to 1933, inclusive, covering 4 years of exceptional prosperity and 4 years of exceptional depression, was therefore a net deficit of approximately $14,000,000.

The Rhode Island figures of the Census of Manufactures given above indicate that in 1933 there were approximately 450 fewer manufacturers in that State than there were in 1929. What would have been the effect had this tax bill been in effect? The banks and the Reconstruction Finance Corporation can supply part of the answer.

The following Rhode Island corporations, with which we are familiar, are typical illustrations of the way the proposed law would work out in practice:

Corporation A.—This company has been established for a great many years. It has been prosperous, and over a long period of years has built up a large surplus which is sufficient to protect it against practically any contingency that may arise. Its plant and machinery are modern and up-to-date, and even through the years of the depression it has continued to make profits. Controlling interests are persons having high incomes and subject to high rates of surtax. Some years ago counsel advised the company that in view of the provisions of section 102 (formerly sec. 220) of the various revenue acts it should adopt the policy of paying out all of its earnings as dividends.

Under the new bill the company would be able to continue to pay out all of its earnings and will not be taxed. The Government will therefore lose the taxes amounting to approximately 16 percent of the annual income of the corporation which it now receives. In view of the fact that the stockholders are already receiving and paying surtaxes on the company's entire income, due to the fact that it is all distributed, the only gain to offset this loss of 16 percent will be the 4-percent normal tax which the shareholders will pay on dividends under the new law.

Corporation B.—This company was in bankruptcy about 10 years ago. A reorganization was effected and new management was brought into the picture. The company had an old plant and obsolete equipment. It was faced with

every conceivable handicap, except with respect to management. The new management was energetic and intelligent. As earnings developed they were plowed back into the business. By doing this the company was able to revamp its plant, replace the old equipment with the very latest equipment, and to build up a surplus as a protection for the future. During the entire period only one dividend of $1 per share was paid. The stockholders were not people of wealth in the high surtax brackets, but they permitted such use of the earnings because they realized that it was the only way to put the business on a sound and profitable basis. Through these policies a splendid business has been developed and the number of employees has been substantially increased, with employment and wages well maintained even through the depression period, and a substantial profit realized each year.

The company is now in such a position that the proposed tax measure will cause it no particular direct hardship. Called upon to distribute all of its earnings, the further use thereof for expansion and equipment will cease, but the company can endure this because of the fact that it has been able to accomplish its major objectives in prior years. Had the proposed tax, however, been in operation during the past few years, the company could not have accomplished its restoration, for it could not have paid out its earnings in dividends and at the same time have borrowed for machinery, equipment, and plant expansion. It would have been compelled to retain an old and out-of-date plant and doubtless would have fallen by the wayside long before this.

Corporation C.—This company was badly embarrassed about 10 years ago. Its working capital was inadequate. It had an overdue mortgage and heavy bank loans. It was a member of an industry in which competition was severe and margin of profit slight. The banks were consulted and were persuaded that their only hope of any material repayment lay in continuation of the business. Through excellent management, constant hard work, and careful planning the company has paid off its mortgage debt and the bulk of its debts, and although it has lost money in some years it has shown a substantial profit for the period. It has been necessary, however, for the company to use all available funds for debt reduction, and it has been forced to struggle along with old machinery and equipment. It has also been compelled at all times to operate on a minimum of working capital. The company is now in a position where it cannot continue longer in successful competition with better situated concerns unless it brings its plant and machinery up to date.

The banks understand the situation and are willing to permit the company to devote the profit of the past year to such uses, rather than toward paying off further portions of the bank indebtedness. They would not, of course, be willing to permit the payment of these earnings out as dividends, and if the proposed tax had been in effect the result would have been that only 57½ percent of those earnings would have been available for the rehabilitation program, an inadequate sum for present needs.

GENERAL CONCLUSIONS

Although not susceptible of statistical proof, the $26,631,000,000 excess of national income paid out over the national income produced is substantial proof that a heavy tax upon undistributed earnings, such as the possible 42½ percent in the national revenue bill of 1930 now pending in the Senate, would have played havoc with industry had it been in effect during the last 10 years.

If the reserves had not been created, obviously they would not have been available for distribution during the emergency. What the effects upon unemployment and suffering during the depression would have been nobody can definitely say. However, there can hardly be any reasonable doubt about the increase in bankruptcy with its disastrous effect, not only upon corporations and their stockholders but upon employees and the general public as well.

The new, small, and struggling concern, unable to create reserves except at prohibitive cost, would operate, if at all, under an unfairly heavy handicap. Reserves created in the past by the large and strong would place them in the position of practical monopoly in competition with their smaller or weaker competitor.

The confusion, inequity, and injustice in the manifold ramifications of the application of the law to the diverse corporate circumstances are too apparent to need amplification.

We prefer and advocate the constructive position of lower taxes through reduced Government expenditures. Coupled with a rising tide of business, which would mean increased Government income, a sound, healthy financial condition could thus soon be achieved.

On general principles, may we again point out the necessity for increased production and a wider distribution at lower costs if the welfare of all is to be served A constantly rising standard of living for all necessitates an ever-increasing volume of production and its wider distribution at a cost within the reach of all. Plenty, not scarcity, is the crying need of the times. Organization, science, and invention have placed it within our reach, if we but have the intelligence to grasp the opportunity. Cooperation, not strife, is the keynote of the future. Democracy and liberty, founded upon justice and accompanied by Christian charity, should be our goal. Condemnation and tearing down of those who are largely responsible for the creation of the possibility of plenty is not the answer. Distribution is essential, but permanent and wide distribution can only be maintained upon a sound basis. Production precedes distribution. A spiritual, moral, and social awakening, as well as material, is what we need.

FINAL CONCLUSION

In conclusion, we believe that the proposed bill is unduly complex, involved, and confusing. That the undistributed-earnings tax as applied is economically unsound. That serious inequalities and injustices would result, even if it did not ultimately prove disastrous. That the holding-company provisions are unnecessary and unwise. Therefore, for these reasons, among others, believing that the proposed national revenue bill of 1936 in its present form is economically unsound, impractical, and unwise, we most strongly urged that you oppose its passage.

Respectfully submitted.

RHODE ISLAND BRANCH OF THE NATIONAL METAL TRADES ASSOCIATION,
By THOMAS A. BARRY.
ASSOCIATED INDUSTRIES OF RHODE ISLAND,
By JAMES A. ROGERS.

SUPPLEMENTAL MEMORANDUM RELATING TO RATES OF TAX ON UNDISTRIBUTED PROFITS IN PROPOSED REVENUE ACT OF 1936 (H. R. 12395)

By Associated Industries of Rhode Island and Rhode Island branch of the National Metal Trades Association

This memorandum is supplemented to a memorandum already filed. Its purpose is to discuss the proposed rates of tax in the pending revenue bill (H. R. 12395) and to point out their actual effect.

The tax rates as expressed in the bill are highly deceptive. They are expressed with relation to adjusted net income rather than with respect to undistributed net income. Yet undistributed net income is all that the corporation will have left in its possession and available for its own purposes after paying dividends and taxes.

Thus the suggested brackets and rates applicable to an income of $10,000 are as follows:

Undistributed net income	Percent of net income	Rate (percent) of tax on net income	Amount of tax
$1,000	10	1	$100
$2,000	20	3.5	350
$3,000	30	7.5	750
$4,000	40	13	1,300
$5,000	50	18.5	1,850
$6,000	60	24	2,400
$7,000	70	29.5	2,950
$7,030	70.3	29.7	2,970

The effect of the foregoing rates, calculated in percentages of the amount of retained or undistributed income, presents quite a different picture from the rates as applied to the net income:

Undistributed net income	Amount of tax	Percentage of tax in relation to undistributed net income
$1,000	$100	10
$2,000	350	17½
$3,000	750	25
$4,000	1,300	32½
$5,000	1,850	37
$6,000	2,400	40
$7,000	2,950	42

The brackets and rates suggested for corporations having net incomes of more than $10,000, applied to a net income of $100,000, are as follows:

Undistributed net income	Percent of net income	Rate of tax on net income, percent	Amount of tax
$10,000	10	4	$4,000
20,000	20	9	9,000
30,000	30	15	15,000
40,000	40	25	25,000
50,000	50	35	35,000
57,500	57.5	42.5	42,500

The taxes payable, according to the foregoing table, calculated in percentages of the retained or undistributed net income, show the consuming effect of the suggested rates:

Undistributed net income	Amount of tax	Percentage of tax in relation to undistributed net income
$10,000	$4,000	40
$20,000	9,000	45
$30,000	15,000	50
$40,000	25,000	62.5
$50,000	35,000	70
$57,500	42,500	73.9

Proponents of the measure have stressed the fact that a corporation which retains only 30 percent of its net income will pay a tax of only 15 percent of its net income, which is no greater than the tax it pays under the present law. This loses sight of the fact that under the present law the corporation may, if business needs require it, retain all the income, except such 15 percent for taxes, so that the tax itself will constitute only about 17½ percent of the amount retained. Under the proposed law a tax of 15 percent of the net income will constitute 50 percent of the amount retained.

Furthermore, it is frequently necessary for corporations to retain more than 30 percent, not for the purpose of avoiding surtaxes upon their shareholders, but for good and conservative business reasons. Contracts with lenders very often impose restrictions upon distributions. Requirements of State laws, replacement of losses of previous years, building up working capital to a proper point, replacement of machinery or installation of more modern machinery, and many other circumstances may compel the properly managed corporation to retain more than 30 percent.

Except for certain limited classes of cases falling within the narrow confines of exceptions provided in sections 14, 15, and 16, the taxes which must be paid by such corporations which are compelled to retain more than 30 percent are excessive and beyond all reason.

Senator Hastings has pointed this out effectively in a statement made on May 5. His analysis shows that under the proposed rates the corporation having an income of no more than $10,000 must pay 55 cents in taxes for every dollar retained in excess of 30 percent and every corporation having income in excess of $10,000 must pay a dollar in tax for every dollar retained in excess of 30 percent of its adjusted net income.

Examining in detail only the second case, if a corporation has an income of $100,000, the tax advances as follows:

Income	Reserve	Tax	Percentage in relation to amount retained
First 10 per cent	$10,000	$4,000	40
Second 10 per cent	10,000	5,000	50
Third 10 per cent	10,000	6,000	60
Fourth 10 per cent	10,000	10,000	100

Each $10,000 retained after the first $30,000 is taxed at the rate of 100 percent for each $10,000—or dollar for dollar.

Also, the small corporation with a $10,000 income is subject to a tax (in reality a penalty) of $550 for each $1,000 of retained reserve after the first $3,000.

It is impractical for any corporation to maintain any substantial reserve in the face of such provisions. The penalty is too great. As Senator Hastings said:

"The purpose of the bill is to compel the corporation to pay out all of its profits to its stockholders. It really is not a tax bill from the corporation's point of view. It is a regulatory bill in that it sets forth a policy which the administration thinks the corporation ought to follow and then it adds severe penalties upon failure to follow such policy. This violates every principle of taxation * * *."

In conclusion, may we repeat that we believe that the proposed bill is unduly complex, involved, and confusing; that the undistributed earnings tax, as applied, is economicaly unsound; that serious inequalities and injustices would result, even if it did not ultimately prove disastrous; that the holding-company provisions are unnecessary and unwise. Therefore, for these reasons, among others, believing that the proposed national revenue bill of 1936, in its present form, is economically unsound, impractical, and unwise, we most strongly urge that you oppose its passage.

Respectfully submitted.

ASSOCIATED INDUSTRIES OF RHODE ISLAND,
By JAMES A. ROGERS.
RHODE ISLAND BRANCH, NATIONAL METAL TRADES ASSOCIATION,
By THOMAS A. BARRY.

LANGENDORF UNITED BAKERIES, INC.,
San Francisco, May 8, 1936.

SENATE FINANCE COMMITTEE,
Senate of the United States, Washington, D. C.

HONORABLE SIRS: We respectfully take this opportunity to address you on the subject of the proposed 1936 revenue bill, hearings on which have recently been held by your committee, and appreciate your indulgence in permitting us to present our problems to you in this manner.

Our particular concern is with respect to the tax on unjust enrichment and with the floor-stocks refund adjustment contained in sections 501 and 601 of H. R. 12395.

Langendorf United Bakeries, Inc., is a manufacturer and distributor of bread and bakery products in the more important metropolitan centers of the Pacific coast area from Seattle to Los Angeles.

Throughout the period during which the processing taxes were in force and effect the prices charged by processors to the Langendorf United Bakeries, Inc., for flour and necessary bread ingredients included an amount sufficient to cover the processing taxes assessed against the processors, and supposedly due to the Government by them. No increase in prices was made on bread sold by us by reason of the enactment of the Agricultural Adjustment Act in May 1933. In fact, the prices charged by the Langendorf United Bakeries on bread have been the same for many years last past. During the entire period that the processing tax was in force and effect the burden of said tax was borne by us inasmuch as the prices charged us by our processors were increased by the amount of the tax, whereas the prices to our vendees were not so increased.

In this particular we respectfully point out that our situation is not common to the baking industry generally, but we are informed that with few exceptions the bakers throughout the country did, subsequent to the enactment of the Agricultural Adjustment Act, increase the prices charged by them on bread to their vendees. By reason of these particular circumstances we respectfully submit that that portion of subsection (b) of section 602 of H. R. 12395, which limits a refund on floor stocks held on January 6, 1936, to an amount not in excess of "the amount by which the claimant reduced the sale price of the article on account of invalidation of the taxes under Agricultural Adjustment Act", works an undue hardship upon the undersigned corporation. Where, as in our case, the price of the article had never been increased by reason of the enactment of the Agricultural Adjustment Act, it would, we respectfully submit, seem only proper to permit a refund upon its being declared invalid, even though the price at that time was not reduced to the vendees.

We urgently request that your committee give consideration to the addition to that section of the House bill of a proviso which would not preclude refund on account of floor stock, even in the absence of a reduced price to the consumer upon invalidation, in those situations where the price has not been originally increased at the time of enactment of the processing tax.

We are informed that Mr. Harold R. Young appeared before your committee on Tuesday, May 5, on behalf of the National Retail Drygoods Association, the National Retail Furniture Association, the National Association of Shoe Retailers, and the National Association of Retail Grocers. We understand that at that time he presented arguments to your committee somewhat similar in purport to those herein urged by us. We respectfully refer your committee to the testimony given before you by said Mr. Young in reference to the matter herein urged, and incorporate herein by reference such additional matters as he may at that time have brought to your attention.

Referring to section 501 of H. R. 12395 (tax on unjust enrichment), we wish particularly to call your attention to subdivision (e) (3) thereof, which stipulates that in determining "selling price" there shall be subtracted such "amounts subsequently paid by the processor to the purchaser on or before March 3, 1936, or pursuant to any bona-fide agreement in writing entered into on or before March 3, 1936, as reimbursement for the amount included in such price on account of a Federal excise tax."

The treatment accorded to our processors with respect to their ability to deduct reimbursements made to their vendees (such as ourselves) is vitally important to us for the reason that under subsection (a) (2) of the House bill we would not be subject to an unjustment enrichment tax did we receive reimbursement from our processors for the reason that, as defined in the bill, we did not in fact pass the burden of the tax on to our vendees.

The fact is that in the contracts with our processors a provision is contained for the adjustment of prices in the event of a reduction or change in the amount of the processing tax on the commodities therein agreed to be sold. Our processors now maintain that the provisions of the contracts do not require them to reimburse us for any amounts whatsoever attributable to the processing tax, whether or not such amounts were not paid by them to the Government or were impounded and subsequently recovered by said processors. In the event, however, that we are hereafter able to establish in a court of competent jurisdiction that the said contracts require the processors to reimburse us, then, of course, our rights are adequately protected by the bill as passed by the House of Representatives.

As we have pointed out above, we would be subject to no unjust enrichment tax were we to receive reimbursement, voluntarily or otherwise, from our processors. It would therefore, we respectfully submit, be highly inequitable to fix a March 3, 1936, date as the last period of time at which voluntary repayments by the processors to their vendees would protect the said processors from the levy of an unjust enrichment tax.

We request that your committee consider a date such as December 31, 1936, as the final date for voluntary reimbursement by the processor to its vendees, on the ground that such later date would enable the peaceable and more orderly settlement of claims as between processors and their vendees, and that the equities of the situation would thereby more adequately be preserved.

Respectfully submitted.

LANGENDORF UNITED BAKERIES, INC.,
By S. S. LANGENDORF, *President*.

NATIONAL CANNERS ASSOCIATION,
Washington, D. C., May 5, 1936.

Memorandum concerning section 601 (a) of H. R. 12395.

As it passed the House this section limits refunds of processing taxes on commodities used in the manufacture of exported articles to cases where exportation took place prior to January 6, 1936. This limitation is founded presumably on the theory that on unexported articles, held on January 6, 1936, a refund would be available under and subject to the provisions of section 602.

Approximately 1,750,000 cases of Pacific coast canned fruits, packed and earmarked for export, remained unexported on January 6 last. These products were packed during 1935 with tax-paid sugar; and at the average of 4½ pounds to a case the taxes involved total in excess of $41,000. A comparable situation exists in respect to Florida citrus fruits canned for export and unexported on January 6 last. Export prices were established on the assumption that this sugar tax would be refunded on export. Advices from the coast are that price declines since January 6 have resulted in most export sales being made at a loss, so that the failure to secure this refund means a direct further loss to the canners who had assumed it would be forthcoming.

Such refunds upon exportation are provided in section 17 of the Agricultural Adjustment Act as amended, which authorized a refund upon export of any article processed "partly from a commodity" upon which a tax had been paid. This section 17 permitted the refund even though the tax had been wholly terminated. Section 17 should not be confused with section 16, which both levied the original floor stocks taxes and provided for refunds in the event the tax was terminated. Section 16 applied only to articles "processed wholly or in chief value" from a taxable commodity. The refund section did not apply to any article processed wholly or in chief value from sugarcane or any product thereof. This was because in the original Jones-Costigan Act (section 17) no floor stocks taxes have been levied on such articles processed wholly or in chief value from sugarcane or any product thereof.

The provisions of section 17, however, applied even though the exported product contained a small portion of the taxable commodity; that is, was not processed in chief value from such taxable commodity. Section 21 (d) (2) of the amended A. A. A. Act provided that the refund provisions of section 16 for products in chief value of a taxable commodity should be applicable in the event that the processing tax was terminated by court invalidation and imposed certain limitations upon collection. Section 602 of H. R. 12395 continues the provisions of section 21 (d) (2) and imposes certain further limitations. But the refund provisions of section 602, unlike section 17 of the A. A. A. Act, are limited to articles processed wholly or in chief value from a taxable commodity.

The striking injustice of the limitation in section 601 (a) is thus apparent. In the case of canned goods manufactured with tax-paid sugar, but which cannot be said to be wholly or in chief value of such sugar, the refund provisions are limited to exportation prior to January 6, but it is not possible to secure refunds on such stock under section 602. The fact that no floor stocks taxes were originally levied in 1934 on such canned goods is immaterial because, first, on June 8, 1934, the new packing season was about to begin and export stocks had been fully shipped; and second, and most important, section 17 permitted refunds in such cases where tax-paid sugar had actually been

used in manufacture irrespective of what had been covered by floor stocks taxes. The net result is that Pacific coast and Florida canners who purchased and used tax-paid sugar during the 1935 packing season, and set their export prices last fall on the basis that they would get a refund of the tax, are now faced with terrific losses on such exports.[1]

It is respectfully submitted that section 601 (a) be amended to provide that the refund should be available on the export of articles which were manufactured prior to January 6, 1936, from taxable commodities on which the tax was actually paid. This can be accomplished by providing that "the articles exported have been manufactured from tax-paid commodities prior to January 6, 1936." Or substantial justice can be achieved by advancing the date by which exportation must take place to January 1, 1937.

Respectfully submitted.

NATIONAL CANNERS ASSOCIATION,
By H. THOMAS AUSTERN.

MEMORANDUM CONCERNING SECTION 602 OF H. R. 12395—STOCKS OF TAX-PAID SUGAR HELD OF JANUARY 6, 1936, BY MANUFACTURERS FOR USE IN MANUFACTURING OPERATIONS

Section 602 (a) of H. R. 12395, as passed by the House, provides for the refund of processing taxes to any person (other than a processor) who on January 6, 1936 "held for sale or other disposition any article processed wholly or in chief value from a commodity subject to processing tax * * *."

Subsection (b) of section 602 limits the amount of such refund to the amount which the processor shifted to the claimant, and further provides that any refund shall not be in excess of "the amount by which the claimant reduced the sale price of the article on account of the invalidation of the taxes * * *."

It is obvious that this section was drafted primarily to meet the situation of the wholesaler or retailer who on January 6 held stocks of articles manufactured wholly or in chief value from a taxable commodity on which the tax had been paid. The theory of the section is that if such wholesaler or retailer had paid the tax in the price he paid for such articles, he will be given a refund only if he had in turn reduced the price of the articles held on January 6 when he later sold them.

As drafted, however, section 602 (b) is inapplicable to manufacturing concerns (other than processors of the taxable commodity) which on January 6 held tax-paid stocks of such commodities or articles processed wholly or in chief value from such taxable commodities. These manufacturing concerns did not hold such stocks for the purpose of resale but for utilization in manufacturing operations.

The principal commodity involved is refined sugar, and the typical case is that of a canning company, a candy manufacturer, or a soft drink beverage manufacturer, who on January 6 held large stocks of sugar on which the processing tax had been paid and for which sugar these manufacturers had paid a price which included such processing tax. In the case of canners, particularly fruit canners who pack their products in sugar syrup, the shortage of the 1935 fruit crop in many cases resulted in a large carry-over of stocks of sugar from the 1935 to the 1936 packing season. In one area alone an amount probably in excess of 80,000 bags had been carried over. This is principally sugar purchased during 1935 at a price which included the processing tax. It was held on January 6 last because the 1936 packing season had not yet begun. As is commonly known, the price of sugar dropped shortly after January 6 from $5.25 to $4.75, roughly reflecting the amount of the processing tax. Competitors of concerns carrying these large stocks of tax-paid sugar, who held no sugar stocks, were able following January 6 to purchase sugar for manufacturing at prices ranging from $4.75 to $4.55 per bag. Obviously, canners holding stocks of tax-paid sugar on January 6, 1936, have

[1] It might not be amiss to mention that these same canners suffered considerable losses in 1934 because of the peculiar provisions of sec. 17 of the Jones-Costigan Act, and the Treasury regulations thereunder, because most of their sugar was delivered to them after April 25 and had not been held under contract. If sec. 601 is not changed, the effect will be that they were unwittingly discriminated against when the sugar tax was first enacted and will again be discriminated against by this enactment.

suffered and will suffer under the bill as drafted a considerable competitive disadvantage.

It is believed that the present draft of subsection 602 (b) which causes this unfair situation is wholly inadvertent, and that there was no intention to place such manufacturers in a disadvantageous position when both wholesalers and retailers identically circumstanced are permitted refunds under section 602.

Accordingly, it is respectfully submitted that simple justice requires that there be added to the subsection (b) language somewhat similar to the following: ", or in the case of such articles not resold but used in manufacturing the amount by which the market price of such articles was reduced on account of such invalidation during the 30-day period following January 6, 1936."

Respectfully submitted.

NATIONAL CANNERS ASSOCIATION.
CANNERS LEAGUE OF CALIFORNIA.

NEUSS, HESSLEIN & CO., INC.,
New York, May 8, 1936.

Senator PAT HARRISON,
Chairman, Finance Committee, Washington, D. C.

DEAR SENATOR: We have followed with interest through the newspapers the hearings conducted by your committee on the proposed new revenue bill, especially in connection with sections 601 and 602 of the proposed act.

Re section 601: Under date of April 24, 1936, the Textile Export Association sent a telegram to you suggesting the incorporation in this section of a provision similar to paragraph E of section 602—i. e., that no claim shall be disallowed on the ground that a tax with respect to the article or commodity from which processed has not been paid.

We are heartily in accord with the telegram, because we feel that it is not equitable to have the exporters prove payment of processing tax in order to get a refund when exporters had absolutely no control over the collection or payment of processing taxes.

When exporters purchased goods for export they relief upon the tax being paid by the processors and ant'cipated no trouble in collecting the refund from the Treasury Department if they could prove that the goods had been exported. Why the fact that the tax has been paid should be a controlling factor as to whether the exporter gets a refund does not seem in any way fair, and we respectfully urge that your committee incorporate the provision requested.

Re section 602: We urge that paragraph B of this section be changed so that there will not be endless controversy as to whether or not the payment on items in inventory January 6, 1936, should be made. We suggest that payments on floor stocks as of January 6, 1936, be made on the basis of the conversion factors controlling refunds which were in effect immediately prior to January 6, 1936, less the amount of any credits that were received from the suppliers against such floor stocks held. This would be most equitable, and is exactly what each holder of floor stocks as of January 6, 1936, should be entitled to. If a holder of floor stocks should make any abnormal gain because of the payment on this basis, the Government would benefit by the larger income tax received from such abnormal gain. The wording of section B as it is today would cause too much confusion because of the many factors that enter into the market prices of each commodity.

We sincerely trust that your committee will not give any consideration to suggestions that have been made to make payments in respect to floor stocks on the basis of the tax paid on floor stocks on August 1, 1933. This would be most unfair, especially to those firms that had larger inventories on January 6, 1936, than on August 1, 1933, and would mean an unjust enrichment to those firms that had large inventories on August 1, 1933, and small inventories as of January 6, 1936.

We respectfully request your consideration of the above items, and in order to present these views orally we wired you for an appointment.

Respectfully yours,

NEUSS, HESSLEIN & CO., INC.,
H. G. EMBOCKER, *Secretary.*

STATEMENT BY JAMES J. DONNELLY, EXECUTIVE VICE PRESIDENT, ILLINOIS MANUFACTURERS' ASSOCIATION, CHICAGO, REGARDING H. R. 12395, SUBMITTED TO SENATE FINANCE COMMITTEE, WASHINGTON, D. C., MAY 8, 1936

The principle of taxation involved in H. R. 12395, now the subject of hearings before the Senate Finance Committee, has been given careful consideration by the taxation committee and by the board of directors of the Illinois Manufacturers' Association. They are convinced that this proposal to fix the rate of taxation on corporation earnings in proportion to the net income reserved for corporate purposes is unsound and would prove impractical in operation.

This bill has been introduced into our Federal Congress before adequate consideration has been given to ways and means by which reduction in Federal expenditures could be accomplished. We respectfully submit that the proposal is not essentially a revenue measure but an attempt to regulate the management of American corporations at a time when productive enterprise is substantially hampered by governmental restrictions. We believe that the adoption by our Federal Government of the principle of taxation incorporated in the pending revenue measure will eventually tend to—

Jeopardize the financial position of the corporation.

Impair bank credit.

Impede rehabilitation, expansion, and growth.

Make difficult or impossible the liquidation of indebtedness.

Result in many instances in undue reduction of working capital, with proportionate reduction in volume of business carried on and with consequent reduction in purchases of materials and distribution of finished product, with accompanying curtailment of operations and employment.

Necessitate immediate and drastic reduction in working forces, salaries, and wages (and in many instances force the discontinuance of operations) if business reverses are encountered.

Facilitate Government domination or control of many small companies who by reasons of their impaired working capital are obliged to secure financial assistance from the Government.

Impair the value of securities of corporations.

Prevent the growth of small manufacturing and mercantile establishments into larger enterprises that would relieve unemployment. The meat packing, mail-order houses, large machinery and electrical concerns, building supplies, and large mercantile establishments of Illinois all started from small units.

It is a common fallacy to think of manufacturing corporations in terms of very large units. As a matter of fact, nearly 88 percent of the manufacturing industries in Illinois (and probably the situation in Illinois is representative of the country generally) employ less than 100 persons. Moreover, a large proportion of the manufacturers, probably far in excess of 50 percent, are on a hand-to-mouth basis. It is probable whether the average small manufacturer in Illinois has a cash working capital of his own much greater than 10 percent of the annual pay roll. Most of the large manufacturers in Illinois are not much better off in this respect.

An independent survey conducted by the Illinois Manufacturers' Association in the Chicago district showed that 69.6 percent in the Chicago district employed less than 50 persons and 81.6 percent employed less than 100 persons, 9.3 percent employed from 101 to 250 persons, 4.8 percent from 251 to 500, 2.5 percent from 501 to 1,000, and 1.8 percent over 1,000.

Thirty-one percent of the firms in the Chicago district had a capitalization of less than $25,000, 15.2 percent had a capitalization of $25,000 to $50,000, and 14.4 percent were capitalized from $50,000 to $100,000. Those that were capitalized from $10,000 to $250,000 constituted 16 percent; $250,000 to $500,000, 8.2 percent; $500,000 to $1,000,000, 5.5 percent; and corporations capitalized over $1,000,000 embraced 8.8 percent of the manufacturers listed in the Chicago district.

The injury which this proposal would cause to stockholders in manufacturing industries would be especially acute. Most corporations have had a difficult experience during the last 4 or 5 years. Their working capital has been seriously impaired, and their plants, machinery, and equipment have run down.

It is interesting to note what the effect of conservative management will be upon the stockholder in event this unsound proposal is enacted into law. For instance, if the corporation found it necessary to retain for corporate purposes as much as 57½ percent of the entire net income, then the entire bal-

ance of the entire net income is confiscated by the Government, and nothing is left for the stockholders. It is out of the amount otherwise available for stockholders that the Government takes its tax. If the corporation retains as much as 47 percent of its entire net income for corporate purposes, then of what is otherwise available for stockholders, the Government takes the lion's share—more than three-fifths—and the stockholders get what is left—less than two-fifths.

It is the stockholder who is burdened by this tax—it is out of what would otherwise be available for the stockholder that the tax is taken. It makes no difference that in form the tax is paid by the corporation. It makes no difference to a taxpayer that the tax comes out of his left-hand pocket rather than out of his right-hand pocket. The tax is his burden in either case.

More than 80 percent in number of all stockholders in our large corporations own less than 50 shares each. A very great proportion of these small stockholders do not pay any personal income tax, and a much larger proportion of them do not get into the surtax brackets at all. If a sizable corporation is retaining 50 percent of its earnings for corporate purposes, the interest of the small (non-income-tax paying) stockholder in the earnings of such a corporation is now taxed at the rate of from 16 to 18 percent. Under this new plan that small stockholder's interest in the earnings of that corporation will be taxed 35 percent. In other words, the small (non-income-tax paying) stockholder in a sizeable corporation that retains 50 percent of its earnings for corporate purposes will have the tax on his interest in the earnings of that corporation approximately doubled.

The interest of a large stockholder in such a corporation whose dividends are now within the 40-percent surtax bracket would now be taxed about 30 percent. Under the new plan his interest would be taxed about 50 percent. A comparison of the increased tax burden on the small stockholder of 100 percent, with the increased tax burden on the large stockholder of 66⅔ percent, shows pretty clearly who will be hurt the most under this new plan.

It seems reasonable to expect that the average sizable corporation, considering its necessities following the last 5 years of depression, will find it necessary to retain as much as 50 percent of its earnings for corporate purposes, so that the above example is an entirely reasonable one to assume to be common.

It seems to be overlooked generally, not merely by the proponents of this tax plan but also by current commentators, that the ordinary average corporation, in determining what part of its earnings will be retained in the corporation, is governed by business principles—that is, by a consideration of what is needed to be retained by the corporation for corporate purposes—such as working capital, plants, machinery, research, reserves for hard times, etc.

It is only in the rare instance that the amount to be retained undistributed to stockholders is determined by considering what will the personal income tax of large stockholders be if a large part of the earnings is distributed as dividends.

Because there have been abuses in isolated instances, the proponents of this new tax overlook what is the ordinary course of business in the ordinary corporation, and in their zeal to get at these isolated instances of abuse, are promoting a program which, if enacted into law, will injure a great majority of corporations, hundreds of large corporation stockholders, and millions of small corporation stockholders.

In the case of corporations for whose rehabilitation it is essential, during the next few reconstruction years, to retain upward of 57½ percent of their earnings—this new tax plan will mean ruin—because under it the Government would confiscate all that is retained over 57½ percent of earnings.

If the Government severely deprives our depleted industrial corporations—and severely deprives those whose means are essential to the rehabilitation of our depleted industrial corporations (investors in corporation securities)—it will inevitably, as a result, severely deprive the millions of workers who are dependent upon the rehabilitation of our depleted industries for their jobs—their livelihood.

The condition of the ordinary average industrial corporation is not reflected by the glaring headlines respecting isolated instances of remarkable business recovery. The job of rehabilitating American industry and reemploying the unemployed American worker is yet to be accomplished.

We respectfully submit that this proposal if enacted into law would work a severe and unwarranted injury upon the employer, the worker, and all other

elements in our economic life. We accordingly express the hope that the measure will be rejected by the Senate Finance Committee.

Respectfully submitted.

JAMES L. DONNELLY,
Executive Vice President, Illinois Manufacturers' Association.

MAY 8, 1936.

BRIEF PRESENTED TO COMMITTEE ON FINANCE, UNITED STATES SENATE, BY HERMAN FAKLER, VICE PRESIDENT, MILLERS' NATIONAL FEDERATION, WASHINGTON, D. C., CONCERNING TITLES III AND IV, H. R. 12395, PROPOSED REVENUE ACT OF 1936

Mr. Chairman and gentlemen of the committee, I present this brief in behalf of the Millers' National Federation, which is the national trade association for the wheat-flour milling industry. Membership in the association consists of 620 wheat-flour mills located in 37 States and the District of Columbia. The production of these companies represents approximately 85 percent of the commercial wheat-flour production in the United States.

Title III of this bill advances a tax proposal which is novel. No exact precedent for it can be found in the annals of our tax experience. This is occasioned by the fact that the situation which brought about the proposal is unprecedented. The invalidation of the Agricultural Adjustment Act was forecast by the decision of the Supreme Court invalidating the National Recovery Act and by the decisions of lower courts on the Agricultural Adjustment Act itself and further by the adoption by Congress of amendments to the latter in the summer of 1935.

The Federal courts met this situation by granting injunctions preventing further collection of taxes under the Agricultural Adjustment Act until the Supreme Court could pass upon its validity. The Court, in the case of *United States* v. *Butler et al.*, held the act to be invalid, and in the *Rickert Rice Mills case* ordered the return of funds held in escrow by the courts.

The Congress is now asked to enact legislation which will cover these funds into the Treasury of the United States, even though the Supreme Court has said the Government did not have the power to require their payment into the Treasury in the first instance. The power of Congress to accomplish this result has been questioned before your committee. I leave a discussion of this problem to those who are better able to discuss it than I am and its solution to the able members of this committee.

I desire, however, to offer some observations with respect to the application of the proposal contained in the pending bill to the wheat-flour milling industry in the hope that their equity and fairness will appeal to you. I shall also offer some suggestions with respect to the reenactment of certain sections of the Agricultural Adjustment Act dealing with refunds and floor-stocks adjustment.

TITLE III

SECTION 501. TAX ON NET INCOME FROM CERTAIN SOURCES

This section contemplates the imposition of a tax equal to 80 percent of that portion of the net income from the sale of articles with respect to which a Federal excise tax was imposed, but not paid, which is attributable to shifting to others the burden of such Federal excise tax.

The net income is to be computed by deducting from the gross income from the sale of the articles with respect to which the excise tax was imposed, but not paid, the allocated portion of the deductions from gross income for the taxable year which are allowable under the applicable revenue act.

The extent to which the burden of the excise tax was shifted is to be established by a presumption to be computed by deducting from the selling price of each article the sum of (1) the cost of the article plus (2) the average margin with respect thereto.

"Selling price" is defined as the selling price of the article minus the sum of (1) the amount refunded to customers plus (2) the allocable portion of legal fees and expenses.

"Cost" is defined as the cost of materials entering into the article.

"Average margin" is defined as the average difference between the selling price and the cost of similar articles sold during the base period of 5 years.

Congress undoubtedly has the power to classify income for the purpose of assessing income taxes. However, we have here not only a classification of income but also a segregation within the class. In other words, only that income is to be considered which results from specific transactions, and if there is a margin on such transactions over and above the margin on similar transactions in the base period, a tax is to be levied against that income, irrespective of other transactions which may involve losses, and also irrespective of whether or not a net income was earned on the entire year's business.

Furthermore, the segregation and detailed examination of each individual transaction during the taxable year, and the segregation and detailed examination of similar individual transactions in the base period, and a comparison of these transactions involves a burden of accounting which is tremendous and in all probability will not result in an accurate calculation in any event. Such a comparison of the margin in individual transactions in 1935, for example, with that which existed in any prior period will, of course, disclose a difference, either greater or smaller than the base period, but there are so many other factors besides the processing tax which have a bearing on each individual sale that to attribute any difference on the average to the processing tax is not accurate and is purely arbitrary. In our judgment also, it will prove neither equitable nor satisfactory, either to the Government or to the taxpayer.

The processing tax on wheat was taken into account in arriving at the cost of flour just as the cost of wheat or any other item of expense. Once the cost of the flour for any particular sale has been established by the mill, the price at which it is sold becomes a matter of bargain between the mill and its customer. If the price must be reduced by the mill, either to meet competition or to reach a point at which the customer will buy, no one can determine whether part of the processing tax has been absorbed by the mill, or whether some other item of expense has been absorbed, or part of each. Unquestionably under keen competitive conditions as exist in the milling industry the mills have absorbed a considerable portion of the tax.

Labor cost is an essential factor in determining the cost of flour. The rate of operation of the mill is another important factor in determining the unit cost. To pick out individual transactions, therefore, without giving weight to these important factors will not produce an equitable nor an accurate result.

Inasmuch, therefore, as any calculation must of necessity be arbitrary, the Congress, I am certain, will want to select such a method as will be possible of administration and be both fair and equitable to the Government and to the taxpayer.

It may be that no better method can be found than that which is contained in the pending bill. If that be so, certainly some latitude should be allowed so that the Commissioner of Internal Revenue, in his judgment, may adjust the method or provide alternatives to meet peculiar and unusual situations as they arise.

For example, we believe it highly desirable and equitable to permit the Commissioner of Internal Revenue, whenever necessary, to determine the average gross margin and the allocable deductions for the period during which the excise tax remained unpaid on the basis of the relationship which the tonnage sold and shipped during that period bears to the total tonnage sold and shipped during the entire taxable year.

In determining the extent to which the tax burden was shifted, the average cost of materials and the average cost of labor should be taken into account in calculating the average gross margin. Labor costs during the taxable period were very much higher than during the base period, and this factor, as well as the difference in cost of materials, should be taken into consideration in establishing the original presumption of shifting the burden of the tax.

Under the procedure now provided, the taxpayer is required to set up a presumption which is obviously incorrect and then is required to rebut that presumption with a showing of actual cost experience. The sounder method, it seems to us, would be to establish the most adequate presumption possible in the first instance and then provide for rebuttal to take care of unusual cases.

The full effect of the processing tax on the profit or loss position of a mill cannot be determined by taking a period which ends on December 31, 1935, or January 6, 1936. There are many incidental effects which were not brought into the picture until during the months since January 6.

There are some milling companies, which, because of their location and the practice followed by other industrial concerns in their general locality, have kept their books on a calendar-year basis and filed their income-tax returns

accordingly. Following the decision of the Supreme Court in declaring the National Recovery Act invalid, and the decisions of lower courts, particularly the Circuit Court of Appeals in Boston, Mass., in the case of the Hoosac Mills, declaring the provisions of the Agricultural Adjustment Act invalid, it was difficult, if not impossible, because of competitive conditions, for flour millers to pass on all of the amount of the wheat processing tax. During the period which ensued up until the decision of the Supreme Court in the *Hoosac Mills case*, many millers entered into contracts for the sale of flour, the price of which included only a small part of the tax. In other words, because of competitive conditions, they were forced to reduce their price of flour to a point at which the flour could be sold. Following the decision of the Supreme Court in the *Hoosac Mills case*, millers were compelled to reduce their prices on contracts which were in existence at that time, portions of which still remained unfilled, by the full amount of the tax determined by conversion factors set up by the Secretary of Agriculture, which amounted to $1.38 a barrel. Inasmuch as the prices included in these contracts did not, in the first instance, contain the full incidence of the tax, the miller is faced with an actual loss in allowing a deduction of $1.38 per barrel from the contract price on that portion which is to be filled during the period since the Hoosac Mills decision. Some of these contracts are still in process of liquidation, which will probably be completed by July 1, 1936.

Such a mill, having closed its books on a calendar-year basis as of December 31, 1935, and filed its income-tax return, is in the position of having the 80-percent tax assessed on its income for 1935 without any opportunity to offset losses which may occur as a result of its existing contract position in the first few months of 1936.

In order to meet this situation, it is suggested that (1) a miller who closed his books on December 31, 1935, be granted the privilege of calculating his income, against which the "windfall" tax is to be assessed, in conjunction with his 1936 income, so that losses caused by the invalidation of the act may be clearly proved; or (2) that the miller who closed his books on December 31, 1935, be given an option to file an income-tax return with the Commissioner of Internal Revenue for the taxable year ending June 30, 1936, with the understanding that subsequently he would close his books on that fiscal year basis instead of a calendar year basis.

This same situation applies to those mills whose fiscal year ended sometime during the period in which court determinations were pending or in effect. Consideration should be given, therefore, to a provision affording sufficient flexibility to meet varying conditions as they actually exist without penalty to the taxpayer.

SECTION 501 (D)

This section provides a formula for setting up a presumption of the extent to which the taxpayer shifted to others burden of the Federal excise tax. The last sentence of this section beginning in line 18, on page 221, reads as follows:

"The balance (to the extent that it does not exceed the amount of the Federal excise tax) shall be the extent to which the taxpayer shifted to others the burden of such Federal excise tax with respect to such article."

The parenthetical clause in the foregoing sentence is evidently intended to refer to the amount of the Federal excise tax imposed but not paid. As it reads now, however, it is likely to be construed to mean all of the Federal excise taxes, paid and unpaid. We suggest, therefore, the addition of the words "imposed but not paid" after the word "tax" and before the close of the parenthesis in line 19. This parenthetical clause would then read—

"(to the extent that it does not exceed the amount of the Federal excise tax imposed but not paid)."

SECTION 501 (E) (3)

In this section the term "selling price" is defined to mean the selling price "minus (A) amounts subsequently paid to the purchaser on or before March 3, 1936, or pursuant to any bona fide agreement in writing entered into on or before March 3, 1936, as reimbursement for the amount included in such price on account of a Federal excise tax."

Practically all wheat flour millers used a form of contract, which, while the language differed in specific cases, in effect, stated that the price included an amount represented by the processing tax and if any decrease in the tax were brought about by legislative or administrative action, such decrease, to the

extent the processor was relieved of paying the tax on the unfilled portion of the contract, would be reflected to the benefit of the buyer.

It is not clear whether or not under such a contract a miller is obligated to refund to his customer the amount of tax returned to the miller by reason of judicial determination, and probably this liability cannot be determined without court action. It would be desirable, therefore, to permit deductions of only such amounts as were actually refunded prior to a certain date, say, March 3, 1936, and provide that credit would not be given for refunds made after that date. If this is not done, millers having such contracts will not be able to make a return to the Bureau of Internal Revenue on the "windfall" tax until this liability has been determined, or will be in the uncertain position of not knowing whether they have a liability to the Government or to their customers, or to both.

In any event, whether or not wheat flour millers under the contracts to which I have referred have a legal obligation to refund any amounts to their customers, claims are being and will continue to be asserted against them in court by their customers, and any amounts paid either by court order or in compromise of these claims, it seems to us, should be deductible. It may be that the present language is sufficiently comprehensive to include a situation of this kind. Nevertheless, it would seem desirable to have specific provision made to this effect to remove any doubt. It is suggested that clause (A) of section 501 (e) (3) be amended to read as follows, the underscored language being the suggested additions:

"(A) amounts subsequently paid to the purchaser on or before March 3, 1936, or thereafter pursuant to any bona-fide agreement in writing entered into on or before March 3, 1936, or in the bona-fide adjustment of claims arising thereunder, as reimbursement for the amount included in such price on account of a Federal excise tax."

SECTION 502. CREDIT FOR OTHER TAXES ON INCOME

Provision is made in this section for a credit against the total amount of taxes imposed by section 501 (a) of an amount equivalent to the excess of Federal income and excess-profits taxes payable by the taxpayer over the amount which would have been payable if his net income were decreased by the amount of the net income taxable under section 501 (a). This is an extremely desirable provision so far as Federal income taxes are concerned.

In this connection your attention is directed to the fact that in the case of a number of milling companies the processing taxes which were not paid accrued in different fiscal years. For example, a mill operates on a fiscal year ending May 31, 1935. Part of the processing taxes of this mill which were involved in judicial proceedings accrued during that fiscal year, whereas the rest of the unpaid taxes accrued during the fiscal year ending May 31, 1936. In order to arrive at an equitable result, therefore, it should be made clear that this credit may be taken even though an income-tax return for a past fiscal year has already been made.

State income taxes.—Many States have State income-tax laws, and in computing the amount of tax under such State law no deduction is permitted for Federal taxes paid. Furthermore, the State tax will apply against the entire net income of the mill, including the amount subject to tax under section 501 (a) without the deductions permitted in section 501. Such double taxation might easily result in the payment of taxes, both State and Federal, in excess of the amount of the unpaid Federal excise tax.

It has not been possible to examine all of these State laws in detail. However, we do know that the following States have corporation income-tax laws, and millers located in those States would be subject to the double taxation to which I have referred:

Alabama	Massachusetts	Oregon
Arizona	Minnesota	Pennsylvania
Arkansas	Mississippi	South Carolina
California	Missouri	South Dakota
Connecticut	Montana	Tennessee
Georgia	New Mexico	Utah
Idaho	New York	Vermont
Iowa	North Carolina	Virginia
Kansas	North Dakota	Washington
Louisiana	Oklahoma	Wisconsin

State and local property taxes.—Inasmuch as most millers, because of the uncertainties surrounding the legislative situation, have made no distribution of the funds returned to them as a result of judicial proceedings, these amounts become subject to State property and local personal-property taxes. Such taxes will have to be paid irrespective of the allowances provided for in section 501 of the Federal revenue act, and here again a very serious situation is presented.

In addition to the credit provided in section 502, therefore, additional credits should be allowed for State income taxes paid, as well as State property and local personal property taxes paid on the amounts subject to tax under section 501 (a) of the Federal act.

SECTION 503 (B)

This section provides that for any taxable year ended prior to the date of the enactment of this act, the return shall be filed and the total amount of the taxes shall be paid not later than the 15th day of the third month after the date of the enactment of this act, in lieu of the time otherwise prescribed by law.

A considerable number of suits have been commenced against millers by their customers for refunds of amounts which the customers claim they have paid to millers, and these are in the process of adjudication by the courts. Until the legal liability of the miller is determined by the court, the miller cannot make a full and complete return to the Government, and it is felt that the limitation referred to above does not provide adequate time for completing settlements of these law suits, and that millers may still be engaged either in court procedure or in negotiation for settlement when the return is due. It seems to us, therefore, that the date for making returns and paying the taxes for taxable years ended prior to the date of the enactment of the act should be postponed at least 6 months after the enactment of the act. If this is not practical, some provision certainly should be made so that the miller may apply to the Commissioner for an extension if he has lawsuits pending, or the Commissioner should be given authority to provide by regulation that the miller may file an incomplete return to be amended later when the court action has been completed.

SECTION 505. GEOGRAPHICAL SCOPE OF TITLE III

For the purposes of title III the term "United States" as used in any provision of law includes the Philippine Islands. I assume that the intention of the House in adopting this definition was to reach any refunds made by processors in the United States to customers in the Philippine Islands, and that such refunds, if they are determined to be "windfalls" or "unjust enrichments", would become subject to the tax assessed under section 501 (a) (2). I direct the committee's attention, however, to the fact that under the original Agricultural Adjustment Act the Philippine Islands were regarded as a foreign country.

I direct attention to section 10 (f) of the original Agricultural Adjustment Act, which states—

"The provisions of this title shall be applicable to the United States and its possessions, except the Philippine Islands, the Virgin Islands, America Samoa, the Canal Zone, and the island of Guam."

Again, in section 17 (a) of the Agricultural Adjustment Act dealing with exportations, we find the following language:

"Upon the exportation to any foreign country (and/or to the Philippine Islands, the Virgin Islands, American Samoa, the Canal Zone, and the island of Guam) of any product processed wholly or partly from a commodity with respect to which product or commodity a tax has been paid or is payable under this title, the tax due and payable or due and paid shall be credited or refunded."

In other words, there was no processing tax in effect in the Philippine Islands and exportations to the islands from the United States entitled the exporter to the export refund.

It seems desirable, therefore, in referring to the Philippine Islands in section 505 that it be made clear that this refers only to the tax provided for in section 501 (a) (2) so that its application will not be so broad as to interfere with refunds on deliveries for charitable distribution and exports to the Philippine Islands.

TITLE IV

SECTION 601. REFUNDS ON EXPORTS AND DELIVERIES FOR CHARITABLE DISTRIBUTION

This section provides for the reenactment of the pertinent sections of the Agricultural Adjustment Act in order to allow refunds on exports and deliveries for charitable distribution as contemplated by the original act. However, section 601 (b) provides:

"No refund under this section shall be made to the processor or other person who paid the tax with respect to the articles on which the claim is based."

SECTION 602. FLOOR STOCKS AS OF JANUARY 6, 1936

Subsection (a) of this section provides for a refund on floor stocks held for sale or other disposition at the first moment of January 6, 1936, "except that no such payment shall be made to the processor or other person who paid or was liable for the tax."

The report of the Ways and Means Committee of the House, in explanation of these exceptions, states that the rights of the processors to such refunds are governed by section 21 (d) of the Agricultural Adjustment Act. We do not believe that adequate relief can be given under section 21 (d).

In the first place, section 21 (d) as now written specifically excludes such refunds from its provisions. It states—

"The provisions of this subsection shall not apply to any refund or credit authorized by subsection (a) or (c) of section 15 (charitable refunds), section 16 (floor stocks), or section 17 (exports) of this title, or to any refund or credit to the processor of any tax paid by him with respect to the provisions of section 317 of the Tariff Act of 1930."

During the entire period up to January 6, 1936, all millers made deliveries for charitable distribution and direct exports without including the amount of the tax in the price of the articles so delivered or exported. Immediately following the action of the Supreme Court of the United States in the case of *United States* v. *Butler et al.*, flour on hand on January 6, 1936, was sold by millers at a price which did not include any part of the tax. In view of the fact that some millers continued to pay their taxes until the action of the Supreme Court was announced, and still others obtained injunctions under which the amount of money represented by the tax was held in escrow by the courts and later returned to these mills in accordance with the Supreme Court's decision in the rice millers' case, two different situations are presented.

Those millers who continued to pay the tax are just as much entitled to make claim for refund on their deliveries for charitable distribution, exports, and floor stocks as of January 6, 1936, as are wholesalers, bakers, jobbers, or retailers. Some provision therefore should be made for direct refunds to those millers who continued to pay their processing taxes.

In the case of those millers who secured injunctions and by reason of court action secured a return of the money, it is probably assumed by the committee that such millers are not entitled to refunds on the ground that their original taxes were not paid. However, should the Congress enact the tax provided for in section 501 (a), then this group of millers would be in the same position as though they had paid all their taxes originally, and therefore they should also be entitled to refunds on their deliveries for charitable distribution, exports, and floor stocks as of January 6, 1936.

With respect to this second group of millers, some provision should be made in connection with the tax levied by section 501 (a), either for a deductible allowance before the tax is assessed or for a refund after the tax has been assessed.

While, as I have stated, the report of the Ways and Means Committee of the House indicates that these exceptions from refunds are made because the processors may secure their refunds under section 21 (d) of the Agricultural Adjustment Act, it is feared that in addition to the limitations now contained in that section, the broad statement that "no such payment shall be made to the processor or other person who paid or was liable for the tax", is subject to the construction that such person is entitled to no refund under any circumstances. If it is the intent of Congress to require processors to secure their refund under section 21 (d), it should so be stated in section 601 (d) and section 602 (a), and a proper revision of section 21 (d) of the Agricultural Adjustment Act should be made to allow such refunds under that section.

I suggest, therefore, the addition of the words "except as provided for in section 21 (d)", after the word "based" in line 5, section 601 (b), page 230, and also after the word "tax", line 12, section 602 (a), page 231. I suggest further a proper modification of section 21 (d) of the Agricultural Adjustment Act to permit these refunds to be made to millers under that section of law.

SECTION 602 (B)

Subsection (b) of section 602 provides that the payment of refunds on floor stocks shall not be in excess of the amount by which the claimant reduced the sales price of the article on account of the invalidation of the taxes under the Agricultural Adjustment Act, as amended. It is contended that when the original floor stocks tax on wheat products was assessed in July 1933, bakers and other retailers, for example, did not immediately reflect this floor stocks tax in an increase in the price of bread, and, therefore, to that extent absorbed their original floor stocks taxes. Neither were these bakers able immediately to reduce their bread prices after the Supreme Court decision on January 6, 1936. Not being able, therefore, to show that they have reduced the sale price of bread by the amount of refund claimed, they would be denied the refund. Such a showing was not required under the original Agricultural Adjustment Act, and the present requirement seems to be entirely inequitable and should be eliminated.

SECTION 602 (E)

When the original floor stocks tax on wheat products was assessed in July 1933 there was no limitation upon the amount to be paid. However, section 602 (e) contemplates that no refund shall be made in an amount less than $10. This suggestion, therefore, does not conform to the imposition of the floor stocks tax on the effective date of the tax, nor to the original intent of the act

In order to equalize competition between wholesalers and retailers, these elements in the trade are going to look to someone for a refund on their floor stocks as of January 6, 1936. If the Government declines to make such refund except in the amount of $10 or more, such elements of the trade are going to attempt to secure the refund from those from whom they bought the articles, which, in our case, would be the wheat-flour millers. As a practical matter, therefore, flour millers will be compelled to make these adjustments and will not be relieved of either the cost of handling such claims nor the payment of the amount involved, and can secure no reimbursement from the Government. In equity and fairness, therefore, this limitation should not be enacted into law.

We think it would be most desirable to include in the bill a provision that customers of millers or processors who take advantage of these refund provisions should relinquish all claims against the processors arising out of processing taxes. It seems to us this would be an equitable provision.

My suggestions may be summarized for your convenience in the following manner:

TITLE III

Section 501: Provide flexibility and alternative methods for determining net income and the extent to which the burden of the excise tax was shifted.

Section 501 (d): Clarifying amendment to the parenthetical sentence beginning in line 18, page 221, so that it will read "(to the extent that it does not exceed the amount of the Federal excise tax imposed but not paid)."

Section 501 (e) (3): Clarifying amendment, so that section will read:

"(A) amounts subsequently paid to the purchaser on or before March 3, 1936, or thereafter pursuant to any bona-fide agreement in writing entered into on or before March 3, 1936, or in the bona-fide adjustment of claims arising thereunder, as reimbursement for the amount included in such price on account of a Federal excise tax."

Section 502: Provide for credit for State and local taxes to be paid on total amount subject to Federal taxation under section 501 (a).

Section 503 (b): Postponement of time for filing returns.

Section 505: Clarifying status of Philippine Islands.

TITLE IV

Sections 601 and 602: Clarify intent of these sections with respect to refunds to be made to first processors.

Section 602 (b): Eliminate requirement that bakers, retailers, and wholesalers must show they decreased their prices on January 6, 1936, in order to secure refund on floor stocks.

Section 602 (e): Eliminate limitation on floor-stocks refunds to amounts in excess of $10.

New processing taxes on agricultural commodities.—The imposition of new processing taxes on agricultural commodities has been suggested as an additional source of revenue. The House of Representatives apparently took the position that it was not necessary to employ this source of revenue to supplement the revenue to be derived from the corporation taxes included in the bill as it passed the House. The chairman and members of the Finance Committee apparently entertain the same view, as no suggestion has been made by the chairman that the views of witnesses on this subject were desired by the committee.

However, in view of the fact that the Secretary of the Treasury has renewed the suggestion, I should like to make some brief observations on the subject.

Unquestionably, when the administrative branch of the Government indicates it must have income to meet its expenditures, it is the responsibility of the Congress to seek sources of revenue and to impose taxes to provide the necessary income. It is also the responsibility of Congress to impose such taxes as will impose the least possible burden on those least able to withstand the burden of taxation.

The imposition of excise taxes on the processing of agricultural commodities is nothing more than the imposition of a sales tax on food and clothing, resulting in increased cost of necessities of life to those whose income is most largely spent for these necessities and who can least afford such increase in cost. If only specific articles of food and clothing are included in the list of taxed articles, the consumer turns away from them and goes to untaxed articles. If all articles of food and clothing were included, which has not been suggested, the consumer would not be able to do this, but he would be forced to reduce the volume of his purchases.

As an illustration, the figures on production of wheat flour for the United States as a whole, gathered and compiled by the United States Department of Commerce, show that during the crop year July 1934 to June 1935, inclusive, during which time the processing tax on wheat was in effect, the monthly production of wheat flour was from 500,000 to 1,000,000 barrels less each month than the average for the corresponding months in the preceding 10-year period, including 1934–35. The figures indicate that the annual production was approximately 9,000,000 barrels less during 1934–35 than it was on the average for the 10-year period. This means an annual reduction in domestic consumption of wheat in the form of flour of approximately 45,000,000 bushels.

A comparison of monthly production in the last 5 months for which figures are available, including March 1936, with the same 5 months a year ago also discloses that when the processing tax on wheat was terminated on January 6, 1936, production of flour immediately rose and began to approach more nearly the 10-year average.

Month	Production (barrels)		Increase (barrels) 1935–36 over 1934–35
	1934–35	1935–36	
November	8,210,876	8,274,270	63,394
December	7,546,600	7,174,915	[1] 371,685
January	8,315,685	8,643,912	328,227
February	7,599,414	8,400,698	801,284
March	7,985,963	8,253,004	267,041

[1] Decrease.

The figures I have cited tell their own story and indicate clearly how an excise tax on wheat dislocates the normal consumption of flour, and thereby not only deprives the consumer of the food he would like to have but seriously affects the farmer himself.

I venture to express the hope of this industry that the Finance Committee will agree with the position taken by the House and that no new processing taxes will be included in the bill.

Respectfully submitted.

HERMAN FAKLER,
Vice President, Millers' National Federation.

SOUTHERN STATES INDUSTRIAL COUNCIL, INC.,
Nashville, Tenn., May 9, 1936.

HON. PAT HARRISON,
Chairman, Senate Committee on Finance, Washington, D. C.

MY DEAR SENATOR HARRISON: As spokesman for the Southern States Industrial Council, representing a constituency of approximately 12,000 manufacturing and business firms in the South, may I briefly outline to your committee the reaction of southern business to the proposed corporation-tax bill, which was recently passed by the House and is now before your committee for its consideration.

Without fear of contradiction, I believe that I can say that this bill has caused more genuine concern to southern industry and business than any other bill that has been proposed or enacted during the last two sessions of Congress. To the average businessman, who has found through years of experience that the ultimate prosperity, and, indeed, the chances of survival of his business, depends to a large extent upon a sound financial policy, this proposed bill appears entirely unreasonable and lacking in the very fundamentals which have made it possible for business to withstand the effects of depression to the remarkable extent which we have witnessed during the past 5 or 6 years.

Perhaps the South, as no other section, has realized the value of reserves, and therefore has developed a conservative attitude, which has changed to one of astonishment upon learning what is proposed in this tax measure.

Because of the scarcity of capital in the Southern States, the southern manufacturer, through necessity, has developed his business by plowing back profits, and from such an accumulation gradually expanded his plant and equipment. Conservatively speaking, however, the southern manufacturer is not nearly as well equipped as those in the North. This was brought out very forcefully in the report of the President's Committee on the Textile Industry. One of the causes of the deplorable state of that industry is due to antiquated and obsolete equipment. If manufacturers, through the imposition of this tax, will not be able to accumulate reserves with which to buy new equipment, how are we ever to modernize and thus remedy a condition which has had far-reaching effects upon the efficiency of southern industries? If manufacturers cannot buy new equipment because they will not be allowed to accumulate money with which to buy, it is clear that those industries which supply machinery will also be greatly affected, and unemployment will increase in that part of our industrial set-up which has experienced the greatest difficulty in reemploying workers.

To illustrate this point may I quote from a letter received from a typical southern plant:

"This company started in business nearly 50 years ago and has grown from a company with an investment of $40,000 and employing 40 or 50 people to a company now with an invested capital of several million dollars and employing more than 1,000 people. This growth was only accomplished by the practice of thrift, economy, and efficiency in business, and applying back into the business a goodly proportion of the profits made in profitable years. During the 4 years of the depression the surplus account of this company decreased from $500,000 to $250,000 in the red. We certainly could not have furnished steady employment to nearly 1,000 people during these particular years if we had not had a substantial amount of capital to carry on the business, which was represented by profits made during the last half century.

"If there ever was a monopolistic bill being considered, it is this corporation tax bill now before the Senate for consideration. What chance on earth is there for a newly organized company to prosper and grow and to conduct its business in a conservative manner if it is to be penalized for conserving profits and

building up a surplus for eventual bad years? Also, how can any company consider making any large plant extensions or improvements if it is to be penalized from 30 to 40 percent for making such expenditures out of earnings? As a matter of fact, the directors of this company at this very time have under consideration the possible expenditure of $150,000 to $200,000 that we would expect to pay for out of earnings, but we are holding up decision in regard to this matter, for we cannot afford to go ahead and make these improvements and pay for same out of earnings if we are to be penalized and taxed in an exorbitant manner on such expenditures.

"Furthermore, this company in 1928 entered into a contract for the purchase in 1938 of the power plant used in connection with our mill for the sum of $500,000. In the meantime we have been paying an annual rental for the use of this property. In June 1938, as stated above, we are under contract to pay $500,000 for this power plant, and it is our hope and expectation that we will be able to purchase this power plant and carry out our obligations and contract out of earnings that we hope to be able to make by that time. If we are going to be practically forced to pay out all of our earnings, how in the world are we going to carry out this contract obligation to purchase this power plant for a stated consideration of $500,000 in June 1938? Are we going to be penalized 30 or 40 percent for the privilege of paying our debts and carrying out a future contract obligation entered into several years ago?"

The manufacturers and businessmen of this section, because of their innate conservatism, are extremely anxious for the Federal Government to set its financial house in order by reducing its tremendous debt, and that to do this it is obvious that greater revenue must be secured, and that the only source of revenue which the Government has is from the earnings of its citizens. Whether a tax is applied to corporate earnings or to the income of the individual, the net result is practically the same, for such a large part of the investment in industry and business in this country comes from the savings and accumulations of our citizens.

The constituency of the council, which represents a cross section of southern business, is unalterably opposed to this new philosophy of taxation for the destruction of reserves; and while we are not prepared to attack the technicalities of the bill, yet we do want to register our strong opposition to the premise upon which it is based.

May we call special attention to those sections dealing with refunds of the processing tax imposed under the invalidated A. A. A. In title 4 of section 601 (b)–602, it seems that the processor is deprived of the right to a refund in cases where the tax involved has been paid to the Government simply because the claims of such persons are within the provisions of section 21 (d) of the A. A. A.

Section 21 (d) has to do with claims on account of floor stocks held at the time of the invalidation of the A. A. A. The articles which would be the subject of claims under section 601 (a) were the accumulations of floor stocks on January 6. Transactions which occurred as early as March, April, and May 1935 are properly claimable under section 601 (b). The articles involved have, in most cases, passed through the channels of trade into consumption long before the act was invalidated on January 6, 1936.

Section 602 (a) provides for refund of tax involved in any floor stock held for sale or other disposition of January 6, 1936. The last phrase of this section reads as follows:

"Except that no such payment shall be made to the processor or other person who paid or was liable for the tax."

This language should be removed from the bill. If enacted into law, it would deprive processors of refunds to which they are equitably entitled.

There is a strong moral obligation upon the Government to make refunds of tax paid on all floor stocks held at the time the tax was removed. Such provision was contained in section 16 of the A. A. A.

May we recommend that your committee give serious consideration to the effects of this bill, for you may be sure that the strenuous opposition of our businessmen to the new tax philosophy introduced by this bill arises from a deep conviction that such a departure from the known benefits of economy and conservative planning would unquestionably be disastrous.

Very sincerely yours,

J. E. EDGERTON, *President.*

MIDDLETOWN, OHIO, *May 8, 1936.*

Re your telegram.

Hon. PAT HARRISON,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SIR: Our corporation has been in existence for 25 years. We are engaged as converters, converting paperboard into cartons and boxes for various industries—food, textile, etc.

We do not produce our raw materials, and up to about 1927 or 1928 we were able to make fair progress in competition with integrated larger concerns, who produced their own raw materials (paperboard) and converted same.

Since 1927 or 1928, however, competitive conditions have become very serious, and we therefore have devoted much time and money to developing new products. In the interim there have been dividends declared of approximately 1 percent, during these 6 or 7 years, as we have devoted whatever profits were made to expenditures in developing new products and reinvesting in equipment.

We have directed our attention in developing a very important phase of packaging, namely, providing a greater degree of protection against deterioration of foods, after same are packaged, than has been possible heretofore in paper containers. As an example:

1. The United States Department of Agriculture has been endeavoring for many years to have the dairies market dry milk, and the only possible type of container in which such products could be distributed, being protected against the deteriorating effects of the moisture in the air, would be either in glass jars or tin cans; and as both these containers are too expensive in relation to the cost of the product, it has, up to the present time, not been possible to market this product.

2. Such products as raisins, prunes, apricots cannot be marketed in summertime, due to the fact that these products become infested, due to the warm climatic conditions prevailing in summer.

3. Such products as coffee are packaged in tin cans, or, as in a great many cases, in vacuumized tin cans, to prevent rancidity. Thus, the expense of the tin can is at least 20 percent of the retail selling price of coffee.

4. Such products as pancake flour and products made from buckwheat flour and barley flour cannot be distributed in summer, also due to the fact that they become infested with bugs.

Now, after having reached the point where we can offer paper containers that will provide the necessary protection for products mentioned above and others, we will not be able to make provisions to increase our capacity to supply the demand, unless we are willing to sell some of our stock, for which there is no ready market available, and for that reason it would mean offering such stock and endeavoring to sell it at a price much below its intrinsic value, or else subject ourselves to a heavy penalty as provided for in the pending income-tax bill, if increases were made from profits.

There must be many small and medium-sized concerns who will, of necessity, be similarly handicapped for either the same or other reasons. It is the opinion of our company that large concerns, having their stock listed on the exchanges, can more readily dispose of additional stock to the public, or, having built up a large reserve or surplus, will be less handicapped under this bill than the small and medium-size concerns.

We therefore urge the Senate committee to eliminate penalties on surpluses, as it will of a certainty affect developments and expansion of plants and will result in loss of employment, and therefore increase the problem of unemployment.

As a medium-size concern, we urge that every encouragement be given for the development and expansion to large and small concerns.

Yours very truly,

THE INTERSTATE FOLDING BOX CO.,
S. BERGSTEIN, *President.*

MEMORANDUM IN RELATION TO PROPOSED REVENUE ACT OF 1936

The revenue bill of 1936, having passed the House, is now before the Senate Finance Committee.

While the bill was before the Ways and Means Committee of the House this memorandum was being written but could not be completed in time for presenta-

tion. An application was made to the Senate Finance Committee for leave to present the views embodied in it, but the limited time scheduled for hearings was filled and the suggestion made that it be submitted to the committee.

Some of the views contained in this memorandum have been expressed by others who have appeared before the committee; others have not been presented. Insofar as there is repetition of opinions expressed by others, it will not be amiss, for the infirmities of the proposed bill are so great that they cannot be overemphasized.

The proposed bill represents the adoption of a totally new theory of taxation upon the income of corporations. It proposes to levy an income tax upon the shareholders of corporations in the same manner that income taxes are levied upon members of partnerships. Realizing, however, the impossibility of imposing the tax in that form because of the inherent differences between the corporate and copartnership entities, the bill proposes to accomplish the desired result through the medium of imposing graduated taxes upon the income of corporations to the extent that they are not distributed to the stockholders. The purpose is to compel such distribution by the corporation to avoid punitive taxes.

It has been popularly supposed that Congress is actuated by the desire to raise in the aggregate such sums as are necessary to meet the expenses of maintaining the Government with the least disturbance to our economic system. It has been charged that a departure from that attitude is evidenced by the present bill in that its primary purpose is not the raising of additional revenue so much as the bringing about of a reform in our economic system, and the justification for that charge is inherent in the bill itself.

The most important point to be considered is whether there is adequate, if any, justification for attempting so drastic a change in our system of taxation as will be brought about by the passage of the act in its present form. Discussion of it necessarily involves various phases difficult of separation, for they impinge one upon the other. One of these phases has not been sufficiently emphasized in the committee hearings. It has to do with the economic waste and uncertainty attendant upon the adoption of a new experiment in taxation.

We have been dealing with income- and excess-profits taxes for approximately 20 years. These acts have been complicated and difficult of administration; so complicated, indeed, that not only could those directly affected not handle their affairs intelligently, but even lawyers, specializing in the field, were unable to advise them with any degree of assurance. Endless litigation, with its attendant economic waste, ensued. The revenue acts have been so prolific a source of legal controversy that not only the entire time of the Board of Tax Appeals, a special tribunal created for the purpose, but also a tremendous proportion of the time of all Federal judicial tribunals has been taken up with the disposition of these controversies. Whether this economic waste could have been avoided by adherence to broad principles instead of attempting to have a statutory rule for every situation is a matter of opinion upon which men may differ. In any event, no purpose is to be served by discussion of that subject. Suffice it to say that as a result of that litigation, we finally reached a reasonable understanding of our tax obligations.

It is now suggested that we scrap what we have accomplished at such enormous cost, sacrifice the degree of certainty which we have achieved, and embark upon new and uncharted seas. That such a course will again flood the country with litigation and with a repetition of the economic waste that has gone before is not open to doubt. We shall have constitutional tests directed at the bill as a whole and at its parts, the result of which no man, however learned, can predict with assurance. Questions have already been raised concerning the constitutionality of certain provisions because of special treatment to certain corporations, but there seems to have been no general suggestion of its unconstitutionality in a broader aspect.

Without expressing any views upon the subject, it is well to bear in mind that in the last analysis this phase of the bill taxes the nondistribution of income rather than the income itself, and this regardless of whether there is any element of fraud o revasion in such nondistribution; that it seeks to compel the directors of private corporations to make distributions of earnings by the imposition of punitive taxes upon their failure to do so, although there is no congressional power to compel such distribution. Viewed in this light, it is by no means safe to assume that no question of validity is involved. From the fact that by adherence to our present system of taxation upon corporate earnings and by raising the rate thereof in one form or another, the

same result could be achieved, the inference becomes strong that the congressional purpose is to compel distribution rather than to raise revenue.

It has not heretofore been found necessary, in order to raise additional revenue, to depart from the system of taxation which has been employed for so long a time. It has been adequate to meet all our necessities. The question naturally arises, therefore, whether the present proposal is a tax measure in its true essence or one of social, financial, or economic reform.

One would suppose that there must be tremendous advantages to be gained to justify the proposed change from an established to an uncertain system. The advantage claimed is that corporations will be forced to distribute a much larger share of earnings among their stockholders, which will be subject to levy in the hands of the recipients, and that a greater aggregate revenue will accrue to the Government as a result. The data presented by the Treasury Department upon this subject is far from convincing. Indeed, facts and figures have been presented to the committee which appear to demolish these contentions. Among other things, it has been disclosed that declarations of dividends over a substantial period of years very nearly approach earnings over the same period. It has been pointed out by Senator Byrd that the scheme bids fair to completely exempt the richest and largest corporations in the country. One thing is certain, and that is that it is impossible to accept the conclusions of the Treasury Department, for nothing short of an investigation, extending over a long period of time, will disclose whether the proposed method is sound or will accomplish anything like the results which its sponsors seek.

Looking at the provisions of the proposed bill dealing with the taxation of undistributed earnings, we are instantly confronted with features so objectionable as to make its ultimate enforcement uncertain. No one with regard to truth can deny that thousands of corporations would not dare to distribute their earnings to stockholders, some because they have no reserve adequate to meet adverse business conditions, others because they are in a state of expansion and must finance that expansion out of current earnings, still others because they have capital deficits or are under contract to defer dividends until loans are repaid. Do we not wish these companies to have reserves to meet the adversities of the future Do we not want plant and business expansion, with its promise of increased employment? Are we to penalize those who cannot declare dividends because of capital deficits or contractual obligations?

The bill, as it has passed the House, makes provision for some of these special cases; and when it is suggested that these exceptions create questions of constitutionality, it is answered that they do no more than classify taxpayers. With due deference to the high authority that makes these answers, the conclusion seems irresistible that such a proposal does not clarify but merely gives preference to some as against others, despite the fact that there is not the slightest fundamental difference between the earnings of the one and the other. Under such proposal, the deserving in many cases will be mulcted, while the undeserving will be rewarded for maladministration; the industrious, the thrifty, and the able will be punished that the waster and the incompetent may prosper. If that philosophy is put into practice, the rainbow of prosperity will be long missing from our horizon.

What we have said is by no means theoretical. Men in active practice of the law are constantly confronted with practical illustrations of the working of such a proposal. We have in mind a corporation engaged in mining. It started from bedrock; most of its capital was borrowed and was repayable out of earnings. Such capital has since been paid. As it continues to receive income from production, it plows the income back for further exploitation, for the building of new mills, the employment of additional labor, increase in the facilities for housing and recreation of its workers. More than half of its production is exported. All of this is designed for the increase of business, the expansion of employment, the creation of new wealth. One would think that the choice between assisting such undertakings and curtailing them would not be difficult to make. Such assistance is not furnished by compulsory distribution of earnings. On the contrary, the very purpose which we seek broadly to accomplish is thus frustrated. By the proposed process, we raise the ramparts of entrenched wealth and make them impregnable to competitive attack. We prevent the creation of wealth and curtail employment and destroy initiative. Forced to distribute earnings or pay heavy penalties, the pioneers will be forced into the hands of stronger units in their industry.

It is contended also by the proponents of the bill that it does no more than place the stockholders of corporations in the same position as the members of a partnership. Such a contention will not withstand analysis. It loses sight

of the fundamental difference between the two entities. In the case of the partnership every member is the owner of the copartnership property, entitled to the income therefrom, and it is immediately credited to his capital account. Each member is chargeable with full liability for the obligations of the partnership, without limitation. As a rule the number of members is small, for it is a practical impossibility to carry on a great venture in copartnership form. As a matter of fact, the very purpose of the passage of corporate laws was to make possible and to encourage large undertakings by permitting great numbers of individuals to combine their resources, vesting them in the corporate body, depriving them of individual participation in the management of its affairs, at the same time limiting their liability for the debts and obligatons arising from its activities. The stockholders have no tangible but only an equitable and inchoate right in the property are not entitled to participate in the corporate earnings except as and to the extent declared by the directors or trustees, and no power to compel the distribution of such earnings except in cases of fraud. It is obvious that the earnings of the corporation cannot be taxed to the stockholders. It is not possible to place them in the same category as the members of a partnership.

The right to compel the directors to make distribution of such earnings under the whip of punitive taxes is, as we have said before, open to question, but more important is the fallacy of supposing that there is any economic benefit to be derived from such distribution. The result may be the destruction of the shareholder's property. The corporation, forced to distribute, weakens its financial stability and its ability to expand its activities. Taxpayers would be stupid to retain investments so endangered by governmental coercion. Only governments which have unlimited sources of revenue can indulge in the luxury of unfettered dissipation. Business concerns must keep their houses in order.

We have two goals before us—one is to meet the present necessity; the other to establish a permanent system of taxation which will be flexible enough to meet the varying needs of the Government by the more expedient of raising and lowering rates; which will take into consideration the sources of revenue available to Federal, State, and local governments; which imposes the least burden upon the economic system; and which, above all, imposes taxes rather than inflicts punishments.

Confronted with the immediate necessity of raising additional revenue, the most obvious procedure is, of course, to raise the rate of taxation. It has also been suggested that the base be broadened. Upon that subject we have written repeatedly to Members of the House and Senate recommending for favorable consideration the reduction of exemptions to the vanishing point. They have, if any, only a negligible economic justification. In a greater or less degree every person in the United States enjoys the benefits of government. The subject is perhaps controversial, but it might be argued with considerable force that those benefits are enjoyed to a greater extent by the poor than by the rich. However that may be, everyone who enjoys the benefits accorded by organized government should contribute, to the extent of his ability, to the cost of maintenance of that government; and we are in full accord with one of the witnesses, who predicted that this theory must and will eventually be put into practice. In line with this suggestion, we recommend the abolition of exemption of dividends from the normal tax.

If the present act will not produce sufficient revenue, concerning which there is considerable doubt, and assuming that broadening of the base, as heretofore suggested, will not suffice, an excess-profits tax substantially identical with that which was in effect during the war period has unquestionable advantages over the proposed assessment. One of its advantages was that the taxes imposed took into account fundamental economic factors, one of which was the amount of capital entering into the production of income, with sufficient consideration being given to cases where invested capital was nominal or where exceptional circumstances required special treatment. Another advantage which might well be placed first is that the country has had considerable experience under such legislation, fundamental questions have already been judicially settled, and the procedure under it is reasonably well understood both by the Treasury Department and the taxpayers. If revenue is the object to be achieved, such a system offers a more certain promise than that of laying higher graduated rates of taxes upon undistributed earnings, and its validity is not open to question.

In suggesting the enactment of the Excess Profits Tax Act, we merely express a preference for it over the present proposal. It is not simple and it is not,

to our mind, the most desirable method. Its appeal is to be found in the necessity of immediate action.

The ideal system of taxation, if such a thing is possible, can be achieved only after thorough study and investigation. It is to our everlasting discredit that this subject has never received the treatment which it deserves and which every thinking man would expect to be given to it. It touches the economic existence of every person in the United States. Badly conceived or badly administered, it can poison the blood stream of commerce and industry; more than any single thing, it aids or retards prosperity. Despite all this, it is never treated as a matter for scientific study; as a matter of fact, it is polluted always with political considerations.

No reform in government could be comparable in its beneficial effects to that afforded by a permanent system of taxation, one so designed that the needs of the Government can be met from time to time by the simple expedient of raising or lowering rates as the circumstances justify. The constant search by the Government for new sources of revenue is disheartening to the people and upsetting to business. It would be encouraging and refreshing to hear the thought again expressed that the people are entitled to the enjoyment of the fruit of their efforts, diminished by the necessities and not the extravagances of government.

With income and inheritance taxes as its backbone, a revenue act can be constructed that will be permanent insofar as the subjects and methods of taxation are concerned. It must be drawn by a body of experts consisting of representatives of the Treasury Department and its counsel, of outstanding businessmen and of lawyers who have had large experience with the substantive and administrative advantages and disadvantages of past revenue acts. If we accomplish nothing more than the laying of uncertainty, which is but a mite of what may be accomplished, the gain would be worth the effect.

In defense of the bill, Mr. Oliphant has asserted before the committee that the bill is not directed against conscious-tax evasion, that the administration is interested only in the loss of revenue which occurs when corporate earnings are neither distributed to stockholders and so subjected to individual income tax nor subjected to a compensatory tax in the hands of the corporation. The meaning and intent of that can only be that the Government not only has the right to tax the income once, but twice, and that narrows down again to the point that it seeks to impose a penalty upon nondistribution of earnings.

No doubt the view expressed is a sincere one, but it is difficult to understand why, if the Government is interested only in revenue and not in regulation of corporate affairs, it should not tax the income of the corporations in the first instance at a higher rate and cease worrking about whether corporate earnings are distributed to stockholders or not.

Far too much emphasis has been placed by the Treasury Department upon the evasion and avoidance of taxes. In the first place, there is no evasion of tax inherent in the failure of a corporate to distribute its earnings. There is not even an avoidance of tax involved except in an academic sense, and such avoidance cannot be criticized except in those cases which are contemplated by the sections of the present revenue act dealing with unnecessary accumulations of surplus. Rather an anomalous situation is created when we attempt to punish the innocent because we have difficulty in convicting the guilty. As a matter of fact, we are firmly convinced that an investigation would indicate that the amount of money involved in conscious tax evasion or avoidance by unnecessary accumulation of corporate earnings is negligible.

It has been suggested in recent sessions of the committee that a compromise be effected by raising the rate on corporate incomes and at the same time retaining some form of tax on undistributed corporate earnings. Such a proposal has nothing to recommend it. Not a sound argument has been advanced in support of a tax on undistributed earnings, and we are sure the President, merely because he suggested it as a means of raising revenue, does not desire to have it adopted if unsound merely as a compliment to him.

Our revenue acts are far too complicated now for proper administration. Sound discretion would point to the advisability of retaining in an emergency the framework that we already have and of postponing drastic changes until a time when the whole tax structure may be considered calmly and a thoroughly sound system evolved.

We desire to direct the attention of the committee to the oft repeated economic conception that increasing rates of taxation to the point where they become burdensome results in diminishing the returns to the Government.

The reverse is equally true. When the need for additional revenue arises, legislative bodies seem to turn instinctively to the raising of rates. Such action is sound enough when its application is limited to incomes, inheritances, and excises or transactions over which the taxpayers have no control, or incomplete control. Where, however, they have it within their power to enter into a transaction for profit or to consummate it, with the resultant heavy impost, legislative action of the kind referred to defeats its very purpose.

We believe that the Congress should consider seriously whether or not the flat rate of 12½ percent on capital gains would not bring far greater revenue than the present system. Vast increases have occurred in the values of securities acquired in the last few years. Many people would be glad to realize profits which have accrued but for the exorbitant rates applicable to capital gains made within the first year or two after acquisition of the property out of which the gain arises. We do not speak of the speculator and the trader, but of the investor, whose natural inclination is to shift investments when a reasonable profit has accrued. There is no reason to discourage such transactions. Twelve and a half percent participation in the profits thereof would, we believe, add materially to the Federal revenue.

THE WINDFALL TAXES

It appears from newspaper reports and the consensus of opinion seems to be that Congress will pass, in some form, the so-called windfall taxes, upon which the President seems to set so much store. This is much to be regretted because the proposal involves an attempt to punish citizens who have had the temerity to assert their constitutional rights. It can be viewed in no other light for since the citizens are the ultimate source of revenue, and since it is within the power of Congress, by accepted methods, to raise the revenue necessary to replace any that may have been lost, there is no other reason to propose a special tax to fall upon only that class. Furthermore, the proposed impost resolves itself somewhat into a second attempt to collect what was unlawfully taken in the first instance. The theory is that the taxpayers in the limited class affected by this impost have been unjustly enriched because they have passed it on to the consumer. The vice of this argument is that the tax was unlawfully exacted from them in the first instance and they have the right to its recovery. It does not appear to us to be a concern of the government that the consumer may have, in some instances, borne the unlawful impost. It would seem to be quite in order in such cases to leave the consumer in a position to exercise his own right of recovery.

The question of constitutionality was raised before the House Ways and Means Committee. We believe Mr. Oliphant said that they considered the tax constitutional because it was an income tax. While it appears to be a bit far-fetched to attribute income to one who receives back money unlawfully exacted from him, is not the classification of this income under which 80 percent is exacted so arbitrary and capricious as to amount to confiscation? It would be rather confusing, would it not, to have the taxpayer remain liable to the consumer for the refund which he alone has the legal right to claim after the Government had already confiscated it? If the consumer to whom the tax was passed on has a right to reclaim it in the hands of the taxpayer to whom it was refunded, it would be interesting to learn upon what theory the Government can subject it to a levy in the hands of the original taxpayer. Are there not many other forms of unjust enrichment upon which the usual rate of taxation is assessed and which are not singled out for special punitive treatment? The fact that few are affected by it seems to be the only justification for the remark of the Secretary of the Treasury that there is no general opposition to it. Obviously, people not affected by it will confine their attentions to things more pregnant with interest to them, but all thinking people should be opposed to the narrowness of view which impelled the proposal.

Furthermore, it would be very unfortunate if it should appear that these taxes are levied in a spirit of defiance of the mandate of the Supreme Court, which should be accepted with good grace by everybody. It would be even more unfortunate if so transparent an evasion of its judgment is attempted as the levying of an 80 percent tax on the money which it has declared was unlawfully exacted and it should also be declared unconstitutional by the Court, a result which may very readily be expected.

It is not difficult to see where such practices lead, for if this attempt succeeds, Congress may collect unlawful and unconstitutional imposts of all kinds through the simple expedient of taxing all refunds of such taxes 100 percent.

In conclusion may we say that this memorandum is submitted with the desire to be helpful. We should like to see the Budget balanced and emergency taxes levied with the least possible disturbance to business. Above all, we hope that some action will be taken looking toward the formulation of a permanent and comprehensive system of taxation.

Respectfully submitted.

ARTHUR B. HYMAN,
2 Rector Street, New York, N. Y.

LOS ANGELES, CALIF., *May 1, 1936.*

Hon. WILLIAM G. McADOO,
Senator, Washington, D. C.:

We object strenuously to the inclusion of rents in corporate income-tax bill now pending, and ask your help to eliminate this very burdensome feature.

SUBWAY TERMINAL OFFICE BUILDING CORPORATION.

SAN FRANCISCO, CALIF., *May 1, 1936.*

Hon. WILLIAM G. McADOO,
United States Senate, Washington, D. C.:

Respectfully request that you vote against H. R. 12395, and particularly against including companies receiving 80 percent of income from rents in personal holding companies class, as taxes against real-estate owners already too onerous.

JAMES FLOOD.

SAN DIEGO, CALIF., *May 1, 1936.*

Senator WILLIAM G. McADOO,
Washington, D. C.:

Please oppose H. R. 12395.

THOS. O. SCRIPPS.

POWELL & SMITH,
Philadelphia, May 13, 1936.

Hon. PAT HARRISON,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR: I feel it would be remiss of me not to answer what Secretary Wallace was reported to have said when appearing before your committee yesterday with regard to the so-called "windfall" tax.

Of course, the figures with regard to the large packers are more available to him than they are to me, so that I will accept his statement as correct that perhaps $50,000,000 of the windfall tax will come out of approximately 10 of the very large packers.

I do not represent any of the 10 largest packers, but when I appeared before your committee last week I appeared there as representing a few hundred of the small pork packers, who are the ones who suffered most from the processing tax due to the fact they had no opportunity to make up the losses incurred during the time that tax was in effect by the sale of other meat products, as their business was practically nothing but pork. Therefore the large packers did not suffer proportionately as their operations might only have been some 25 to 30 percent pork as against their other meat sales.

Mr. Wallace, however, utterly failed to call your attention to the fact that if the small independent pork packers, who were in your committee room to the number of upward of 150 and representing quite some few hundred additional, are obliged to pay this windfall tax, over 75 percent of them will go into the hands of receivers, as was shown by the testimony of those witnesses whom I produced.

If I held a brief for the large packers instead of only for the small pork packers, I would suggest the passing of the windfall tax in its identical terms as passed by the House, for it would undoubtedly mean that while the large packers might have to return many millions of dollars, they would gobble up the small ones and then, with the complete control of the meat market in their hands, would be in a position in a very short time to reimburse themselves through lack of competition not only for the windfall tax but for many

millions of dollars for years thereafter, and the people who would foot this bill would be not only the consumers but the farmers who raise the livestock.

I know the argument has been presented that no small packer will be injured unless he passed on the tax, but I submit that it is utterly impossible for the small packer to prove that he did not pass on the tax, or any portion of it, and hence the bill, if passed in its present form, will be his death warrant.

In addition, the bad effects of the processing tax on the pork packer are still evident in the resentment of the consumer at the high prices, shown by his purchasing other competing articles instead of pork, so that I believe practically all packers, 80 percent or more of whose business is pork, have lost money this year and expect to continue to lose it at least until the supply of hogs becomes nearly enough normal to enable the packers to reduce the prices to the consumer.

I wish to take this opportunity to thank you for the courtesies extended during the hearings and I will appreciate it if this letter is made part of the record.

Yours sincerely,

HUMBERT B. POWELL.

NEW YORK CREDIT MEN'S ASSOCIATION,
New York, May 15, 1936.

Hon. PAT HARRISON,
Chairman, Finance Committee,
Senate Chamber, Washington, D. C.

DEAR MR. HARRISON: This association wishes to have recorded with your committee its carefully considered opinion on the proposal for an undistributed profits tax on corporations, as outlined in the enclosed resolution recently adopted by the association.

Our organization is made up of businessmen who devote their lives to credits and to the building of a sound commercial credit structure.

I hope you will feel that their conclusions are worthy of the consideration of your committee.

In full appreciation of the difficult task which confronts you and your committee, we are,

Very respectfully yours,

W. W. OAK, *Secretary.*

CREDIT MEN'S ASSOCIATION AND CORPORATIONS' UNDISTRIBUTED-PROFITS TAX PROPOSAL

The New York Credit Men's Association places itself on record with the Finance Committee of the United States Senate in opposition to the proposals for an undistributed-profits tax on corporations, its reasons being:

1. That any tax having as its object the distribution to stockholders of the profits of any year, and that penalizes a corporation that transfers to reserves such part of its profits as the management may feel should be set aside for expansion or to strengthen the financial and credit structure, is economically unsound because—

(a) It works against the accumulation of reserves essential to industrial development;

(b) It tends to weaken the credit position of a corporation and especially of corporations not strongly entrenched financially, impairing their ability to borrow during periods when operations are carried on at a loss;

(c) It lessens the corporation's ability to weather protracted depression periods, to maintain in time of slack periods its schedules of employment, and to serve the community when the people most need to have in their midst a strong institution well fortified financially.

We appreciate the necessity of providing for the vast commitments of the Government, but we urge with all earnestness against the principle of the undistributed-profits tax as a form of taxation certain to weaken the broad base upon which our credit structure rests.

We especially call attention to the failure of the tax bill now before the Senate committee to provide properly for the taxation of corporations in reorganization except those in receivership.

As an association having much to do with corporate reorganizations, we strongly urge that consideration be given by the Finance Committee to an amendment to section 105 of the pending bill to provide that any corporation operating under a contract of extension or amortization of indebtedness with

banks or commercial concerns may, upon the approval of the Commissioner of Internal Revenue, continue to pay a tax equal to 15 percent of the next income during the term of such extension agreement.

LETTER SUBMITTED FROM THE CLEVELAND HARDWARE & FORGING CO., CLEVELAND, OHIO

MAY 8, 1936.

HON. ROBERT J. BULKLEY,
Senator, United States Senate, Washington, D. C.

DEAR SENATOR BULKLEY: Appreciate very much indeed your prompt reply of May 5, and, agreeable to your suggestion, we will try and give you a brief of our situation.

I came with the Cleveland Hardware & Forging Co. (hereinafter referred to as the company), in January of 1932, and since that time have occupied the position of vice president, secretary, and general manager. As such I have exercised supervision over the sales, manufacturing, and financial end of the business.

When I came with the company in January of 1932 the business and the finances of the company were in a difficult condition. The company had sustained successive losses since the fiscal year ended August 31, 1929, these losses, after depreciation and obsolescence, being as follows:

Year ended Aug. 31, 1930	$272,704.93
Year ended Aug. 31, 1931	584,474.50

During the first years of the conduct of the business under my supervision, the losses, after depreciation and substantial write-offs for obsolescence, were—

Year ended Aug. 31, 1932	$1,025,150.68
Year ended Aug. 31, 1933	147,422.61

It will be seen that the aggregate losses of the company during this period amounted to $2,029,752.62.

The causes for these successive losses are partly found in the conditions of this company and partly in the conditions of the drop-forging industry as a whole.

Speaking with reference to conditions in the company, it should be observed that the company was organized in 1881, and for many years engaged in the manufacture of carriage, wagon, and top hardware. These lines gradually became obsolete and were abandoned, with the exception of wagon hardware which is still continued, but which has diminished to relatively small proportions. In the place of this business, forgings of automobile parts have been undertaken, but this business has become more competitive and sales had undergone a marked shrinkage even prior to the advent of the depression. The gross sales of the company in 1920 were $9,387,098. This figure shrank to $2,883,237 in 1927, and while there was an increase to $4,310,539 in 1929, a marked shrinkage thereafter occurred, with the result that the sales in 1933 were reduced to $508,716.

It should also be mentioned that prior to the time that I came with the company in 1932, the management had experienced no change, almost since the time of organization. The company for a number of years had paid dividends consistently, and these dividends were continued through the year 1930, notwithstanding the large losses that were incurred. This was accomplished through the realization of accumulated surplus. The comparative balance sheet indicates that investments in United States bonds and other securities were reduced from $730,026.50 in 1927 to $3,823.50 at the close of the 1935 fiscal year. To a partial extent these securities were used to pay off bank indebtedness that had been incurred subsequent to the year 1927.

This combination of circumstances, but principally the large recurring losses, had detrimentally affected the working capital position of the company by the end of the fiscal year ended August 31, 1932, as will be observed from an analysis of the balance sheet.

Aside from financial difficulties then experienced by the company, the prospects for the future in November of 1933 and for some time prior thereto, were extremely doubtful. The company was beset with various difficulties, among which might be mentioned the following:

1. The company was faced with the vital necessity of increasing its business, the sales having dropped to the low point of $508,716 for the 1933 fiscal

year as compared to sales of $4,310,539 in 1929. The demand for general hardware forgings was at a low ebb. Automotive business had decreased. Manufacturers of automobiles were constantly requiring closer tolerances which were not observed by the company prior to my connection and the company had lost considerable business because of the failure to observe such requirements. We were then faced with the necessity of reestablishing the company's reputation in the automotive field.

2. In the face of these difficulties, conditions in the industry became more competitive. As indicated in the survey of the drop-forging industry published by the United States Department of Commerce in 1931, the industry, in the face of decreased business, actually increased its capacity 70 percent from 1929 to 1931. The condition of the industry is shown graphically in the chart prepared by the drop-forging association, copy of which is appended hereto. This chart shows the tremendous drop in the price per pound of forgings which began as early as 1924 and dropped more precipitously after the beginning of the depression. The chart also shows the accompanying sharp decrease of shipments during these years.

Aside from the 70-percent increase in the capacity of the industry, the drop-forging industry literally encountered competition in the plants of their customers by reason of the great increase in forging facilities developed in the plants of automobile manufacturers. Ford Motor Co., Chrysler Corporation, and General Motors Co. have so extended their forging equipment that they produce in their own plants from 50 percent to 95 percent of their requirements.

3. In addition to all the foregoing, the company was forced to compete with more modern equipment owned by its competitors, the equipment in the company's plant being for the most part from 10 to 20 years old.

4. The company was required to conduct its manufacturing operations in a plant that was in a dilapidated condition. The company has steadily permitted the condition of these buildings to deteriorate since 1929. A substantial part of the plant now in use is of frame construction. Complete repair of the buildings, however, would not develop a plant of great efficiency, for the reason that the properties themselves are not suitably laid out for an efficient forging plant. The main forge building was erected about 1906, and the newest frame buildings were erected in 1919–20.

It will thus be seen that the company, in the midst of the general business depression and forced to operate without sufficient working capital, was beset by difficult conditions, some of which were peculiar to this company, and some of which were common to the entire industry. These conditions have not yet been overcome and the company has carried on only by virtue of rigorous operating economies.

The late O. E. Adams, Mr. T. P. Robbins, and other principal stockholders interested in the company, have consistently refused to endorse any paper of the company for the securing of loans since I have had any connection with the company, and have been unwilling to make any loans to the company, thus indicating their lack of faith in the future prospects of the company.

THE CLEVELAND HARDWARE & FORGING CO.

We give below the sales of the company—fiscal years 1920 to 1935, inclusive:

Fiscal year ending August 31—	*Gross sales*
1920	$9,387,998.00
1921	4,738,248.00
1922	8,775,745.00
1923	6,517,524.00
1924	5,784,933.00
1925	4,874,268.10
1926	4,527,316.77
1927	2,883,237.43
1928	3,034,871.13
1929	4,310,539.84
1930	2,052,295.51
1931	944,259.34
1932	655,339.30
1933	508,716.53
1934	1,086,855.16
1935	1,503,519.51

For your perusal and in support of our contention, we attach hereto a comparative statement of the sales, income or loss, and dividends declared, and other items affecting surplus and the reduction in surplus and additions thereto, for each of the fiscal years ended August 31, 1925 to 1935, inclusive.

Fiscal year ended Aug. 31—	Sales	Earnings or loss less Federal taxes [1]	Obsolescence and depreciation charged to surplus	Additions to surplus during year	Net columns 2, 3, and 4	Dividends paid [2]	Increase or reduction in surplus for year
1925	$4,874,268.10	$5,334.43			$5,334.43	$339,945.00	$334,610.57
1926	4,627,816.77	301,471.80			301,471.80	281,373.60	20,098.20
1927	2,883,237.43	78,386.79			78,386.79	189,918.00	91,531.21
1928	3,034,871.13	70,725.15		$16,417.85	54,307.30	225,537.50	390,845.80
1929	4,310,539.84	100,091.89			100,091.89	189,919.00	89,827.11
1930	2,052,295.51	148,696.87	322,473.06		271,704.93	170,713.00	443,417.93
1931	944,259.34	499,536.31	85,088.19	1,830.00	583,454.50	83,498.00	666,952.50
1932	655,339.30	379,783.14	708,181.85	12,744.33	1,075,160.66		1,075,160.63
1933	508,716.53	118,281.71	80,910.37	1,709.47	147,422.61		[3] 147,422.61
1934	1,086,853.16	85,927.65		1,134.08	84,793.97		84,793.97
1935	1,503,519.51	55,260.16			55,260.16		55,260.16
Total	26,381,219.62	746,785.65	855,593.48	33,835.73	1,556,488.40	1,584,897.00	2,951,385.40

[1] After deduction of income taxes.

[2] The change in surplus shown for 1933 does not take into account the transfer of $2,104,800 effected Oct. 5, 1932, from capital to capital surplus and the charging of the surplus deficit of $1,653,248.05 against the capital surplus.

[3] Total dividends paid in cash and in United States Fourth 4¼ Liberty bonds since Jan. 1, 1899, to Oct. 2, 1930 ..... $5,112,445.85
Sept. 1, 1919, to Oct. 3, 1917, stock dividend declared 1,548,750.00

Total distribution of surplus to stockholders paid in cash, U. S. Liberty bonds, and stock dividends 6,661,195.85
Total amount paid in United States Federal income taxes since 1918, approximately 950,000.00

NOTE—Italic denotes red figures.

On October 17, 1930, the company paid out, in retirement of 2,000 shares of stock, $198,170 to the stockholders of this company, which was paid with money derived from the sale of land and buildings to the Cleveland Twist Drill Co., no longer needed in connection with the operation of the business, which figures are not included in the above surplus computations. The difference between $200,000 in retirement of stock and $198,170 paid out in cash was credited to the surplus account of the company in the amount of $1,830, representing fractional shares.

With reference to the capital structure of the company, it should be mentioned that the company was incorporated in Ohio in June of 1881. The original capital consisted of $100,000, which was increased at various times to a maximum of $5,000,000, consisting of 50,000 shares of common stock with a par value of $100 per share. The maximum number of shares ever issued was 28,310, representing an aggregate par value of $2,831,000. This stock was reduced $200,000 on October 17, 1930, by retiring 2,000 shares by payment of cash in that amount realized from the sale of a part of the Lakeside Avenue plant to the Cleveland Twist Drill Co. By 1932 the losses of the company had been so severe that it was considered advisable to reduce the par value of the stock in order to eliminate the large surplus deficit. This surplus deficit as of August 31, 1932, was $1,553,248.05. On October 5, 1932, the 26,310 shares with a par value of $100 were reduced to the same number of shares with a par value of $20 each.

The amount of this reduction ($2,104,800) was allocated to capital surplus, and the surplus deficit was thereupon charged against capital surplus, resulting in a capital surplus as of the end of the 1933 fiscal year in the amount of $507,821.78. Since that time further operating losses of $125,214.25 and other adjustments of $3,271.16 to capital surplus reduced the net surplus as of August 31, 1934, to $379,336.37.

The book value of each share of stock as of the close of the fiscal years ended August 31, 1925 to 1935, inclusive, computed from the attached comparative balance sheets, is as follows:

Year [1]	Capital	Surplus	Reserve for dividends	Total	Shares outstanding	Book value, each share
1925	$2,834,000	$893,164.38	$53,407.00	$3,780,571.38	28,340	$133.40
1926	2,834,000	902,088.90	26,553.50	3,762,672.40	28,340	132.77
1927	2,834,000	835,771.31	26,561.50	3,696,332.81	28,340	130.43
1928	2,834,000	564,312.77	26,585.00	3,425,097.77	28,340	120.86
1929	2,834,000	497,687.06	26,586.00	3,358,473.06	28,340	118.51
1930	2,831,000	84,557.13	26,498.00	2,912,055.13	28,310	102.86
1931	2,631,000	[2] 528,087.37		2,102,912.63	26,310	79.93
1932	2,631,000	[2] 1,553,948.05		1,077,751.95	26,310	40.96
1933	[3] 526,200	404,129.34		930,329.34	26,310	35.36
1934	[3] 525,900	379,336.37		905,236.37	26,295	34.43
1935	525,900	434,906.53		960,806.53	26,295	36.52

[1] All figures as of Aug. 31.
[2] Deficit.
[3] Par value of each share reduced from $100 to $20 during 1933 fiscal year, increase credited to surplus.

In addition to the above we also attach hereto—

1. Comparative balance sheets of the Cleveland Hardware & Forging Co. as of the fiscal years ended August 31, 1925 to 1935, inclusive.

2. Reconciliation of surplus of the Cleveland Hardware & Forging Co. for the fiscal years ended August 31, 1925 to 1935, inclusive.

At this time we wish to quote from the annual address of the late Charles E. Adams, former chairman of our board of directors, to our stockholders on October 5, 1933:

"We have been letting the plant run down since 1929, and we did it deliberately; but we have come to the point now where we have got to begin to rebuild the plant, and that will be to the credit of your stock."

In view of the conditions set forth in our exhibits and the foregoing, we feel that cases such as ours should be given special consideration, at least until we have had an opportunity to build up a surplus to reconstruct our plant and replace our machinery, which is very badly run down.

As of April 1, 1936, our land and buildings, including machinery and equipment now in use for manufacturing purposes, stand on our books at $515,464.59.

Our surplus account at the same date was $457,037.89, which we would call to your attention is not an earned surplus as represented by cash or its equivalent, but a paid-in surplus resulting from a reduction in the common stock of the company by exchanging each $100 share of common stock for a $20 share of common stock, and said surplus is not represented by the type of assets that can readily be turned into cash.

We feel that we should be permitted to increase the capital surplus mentioned as of April 1 by the amount represented by our land, buildings, plant, machinery, and equipment of approximately $500,000. Otherwise there is no possible chance for our company to regain its proper place in our line of business.

It is absolutely necessary for us to rebuild our plant from earnings, and in the ordinary conduct of business we should build up a surplus to carry us through possible slumps.

We want to emphasize at this time that this policy of putting our earnings back into the rebuilding of plant and machinery was heartily approved by our stockholders, who are fully aware of conditions mentioned heretofore in this letter. Our stockholders realize that any other policy means that it will be only a short time until we are forced out of business, owing to our inability, due to lack of proper buildings and equipment, to meet the competition of modern shops.

In conclusion, we feel that our situation is a serious one, in view of the present pending tax legislation, and if we have not made our case clear to you we would be only too glad to appear before you and explain matters in more detail.

Please bear in mind that the figures we have used are those shown in our Federal income-tax returns.

Respectfully,

THE CLEVELAND HARDWARE & FORGING CO.,
A. J. SANFORD, *Vice President.*

BULLETIN No. 13

DROP FORGING ASSOCIATION,
Cleveland, Ohio, November 29, 1935.

Steel prices, first quarter of 1936.—This office has today received authentic information that there will be no advance in the price of carbon steel bars and alloy steel bars for the first quarter of 1936.

The association office is glad to be in a position to report this important item with reference to steel prices.

Labor wage report.—It is now planned to have our fourth quarter labor wage report cover any 1 week which the individual plant may select as being most representative of the plant's operations during the period of November 17 to December 14, inclusive. Formal notice will go forward later, but this advance information may be helpful.

Social Security Act.—The Internal Revenue Bureau has not yet issued or approved forms for keeping books, employment records, or any other statistical data which the law indicates may be necessary. Moreover, no forms suggested by private agencies have been approved. However, it is understood the Bureau desires to avoid complicated or costly systems which would necessitate completely revising present methods.

Your association office is carefully following this question and will advise industry members immediately if any approved forms are set up.

"Essentials of Drop Forging Accounting."—This office has several copies of this book, which was prepared by the cost committee of the American Drop Forging Institute and copyrighted in 1924. Although the book is several years old, and it is our hope some time to revise it, it is of particular value even now. We would be glad to send a copy to anyone who would like to have it.

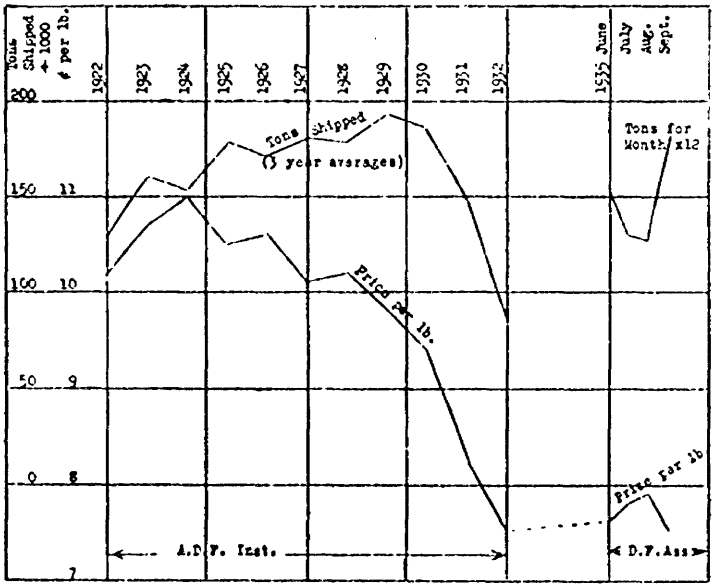
Die sinkers definition.—During the group meetings there was considerable interest in these sheets, which were prepared some time ago and mentioned in one of our bulletins.

The office had several requests for these definitions, and if anyone else wishes a copy we shall be glad to mail it upon request.

Group meetings.—Watch for our bulletin early next week, which will cover in detail the subjects presented for discussion at the group meetings.

Social security taxes—percent of pay roll

	Employer unemployment	Employer old age	Employer old age	Total
1936	1			1
1937	2	1	1	4
1938-39	3	1	1	5
1940-42	3	1½	1½	6
1943-45	3	2	2	7
1946-48	3	2½	2½	8
1949 and later	3	3	3	9


Tons Shipped ÷ 1000
¢ per lb.
1922
1923
1924
1925
1926
1927
1928
1929
1930
1931
1932
1935 June
July Aug. Sept.
200
150
100
50
0
11
10
9
8
7
Tons shipped
(3 year averages)
Price per lb.
Tons for Month x12
Price for 1b
A.A.A. Inst.
A.A.A. Ass

Balance sheets of the Cleveland Hardware & Forging Co., Cleveland, Ohio (formerly the Cleveland Hardware Co.)

ASSETS	Fiscal year ending Aug. 31—										
	1925	1926	1927	1928	1929	1930	1931	1932	1933	1934	1935
Banks and cash	$24,460.77	$18,087.25	$15,703.79	$17,101.36	$17,568.81	$11,823.69	$14,545.80	$9,572.52	$16,388.76	$23,478.66	$63,540.23
Notes receivable	4,942.84	351.00	2,504.38	4,344.56	7,023.67	2,909.04	88.74	1,003.65	198.12	52.96	
Accounts receivable	391,852.53	359,879.10	221,716.42	366,248.71	358,712.02	168,156.23	67,240.45	39,551.07	88,852.64	83,679.60	115,436.79
Inventories Sept. 1	809,921.93	754,168.79	567,034.51	641,267.40	610,806.59	467,701.62	290,499.43	169,744.87	140,077.72	131,758.72	175,691.08
United States bonds, at cost	609,319.73	521,989.97	730,026.56	667,615.13	641,365.13	287,530.44	134,823.94	57,345.00	26,970.00	5,152.50	3,823.30
Other securities, at cost	14,620.55	13,333.00	13,333.00	7,031.50	7,031.50						
Received interest on same	9,935.14	8,505.85	10,807.62	8,966.32	8,484.27	4,509.72	1,716.70	620.91	252.07		
Other assets:											
Note deposit		5,189.00	4,339.00	3,489.00	4,116.00	4,116.00	3,048.00	2,148.00	2,148.00	2,148.00	2,148.00
Employees and miscellaneous received	1,359.93	3,096.34	2,156.19	2,183.80	2,056.41	342.68	653.39	68.10	1,221.76	83.90	782.19
Kingsbury Realty Co., in lieu of transfer of East 79th & East 80th St. Property Co. Stores	5,981.24	3,787.28	1,784.23	2,047.02	2,743.81	1,109.70	828.65			45,663.57	5,663.57
Capital assets:											
Land	164,926.16	167,866.46	171,506.33	165,151.44	170,303.09	174,138.85	151,971.47	160,382.76	171,343.08	98,760.65	100,569.12
Buildings	627,374.36	632,654.12	637,157.48	628,543.81	629,193.45	634,875.51	556,409.80	386,120.26	329,834.70	289,779.63	270,697.09
Machinery and equipment	1,741,882.38	1,651,446.72	1,512,098.43	1,459,206.90	1,461,755.86	1,325,037.82	979,687.93	389,924.43	332,082.18	328,857.27	308,320.32
Investment for obtaining city steam			10,368.34	9,310.67	7,472.54	5,604.41	3,736.28	1,868.15			
Tools and dies (nominal)								1.00	1.00	1.00	1.00
Prepaid expenses	41,564.08	7,561.82	3,193.83	7,829.54	4,547.78	6,634.40	5,551.47	7,153.23	5,773.24	5,909.41	8,793.18
Improvements in process											501.43
Total assets	4,446,351.84	4,147,816.70	3,923,736.11	3,990,467.16	3,929,180.93	3,104,550.11	2,210,991.75	1,224,706.00	1,135,143.27	1,025,334.87	1,096,056.68
LIABILITIES											
Bills payable to banks	200,000.00			160,000.00	225,000.00			50,000.00	55,293.22	26,000.00	
Bills payable to others								5,264.49			
Amounts payable:											
For purchases, expenses, etc	230,628.86	178,630.33	90,173.62	266,389.85	216,617.51	99,567.21	51,484.72	33,582.79	56,584.99	36,694.91	72,099.61
For accrued factory wages	122,556.85	73,177.06	45,017.27	77,783.87	62,403.67	37,658.33	17,400.08	8,338.23	15,631.34	9,052.97	23,043.40
For accrued expenses		5,440.80	3,561.88	3,534.62	3,973.79	2,897.39	1,945.69	1,389.80	791.30	1,506.50	1,907.90
Customers' credit balances	1,852.08	457.79	558.38	542.92	1,068.69	857.26	464.74	532.54	918.83	481.52	595.78
Accrued taxes	83,961.62	83,713.04	51,616.37	41,142.62	34,227.73	36,525.68	24,345.55	41,833.53	69,351.36	44,800.65	28,828.32
Provision for United States taxes											9,500.00
Deferred liabilities	46,831.07	43,735.28	36,465.78	15,915.51	17,416.48	14,989.11	12,438.34	6,014.67	6,242.79	1,561.95	1,585.14
Nominal:											
Capital stock	2,834,000.00	2,834,000.00	2,834,000.00	2,834,000.00	2,834,000.00	2,831,000.00	2,631,000.00	2,631,000.00	526,200.00	526,000.00	525,900.00
Surplus	803,164.36	902,068.93	835,771.31	564,512.77	497,867.06	64,557.13	[1] 528,087.37	[1] 353,248.03			
Reserves for dividends	53,407.00	26,553.50	26,561.50	26,585.00	26,586.00	26,498.00					
Capital surplus									507,821.78	504,550.62	504,550.62

Less: Profit and loss deficit									103, 692. 44	125, 214. 25	60, 954. 09
Total									404, 129. 34	379, 336. 37	434, 596. 53
Total liabilities	4, 446, 351. 84	4, 147, 816. 70	3, 923, 736. 11	3, 990, 407. 16	3, 929, 180. 93	3, 104, 560. 11	2, 210, 991. 75	1, 224, 706. 00	1, 135, 143. 27	1, 025, 334. 87	1, 098, 056. 68

[1] Deficit.

Reconcilement of surplus of the Cleveland Hardware & Forging Co., Cleveland, Ohio (formerly the Cleveland Hardware Co.)

Detail	Fiscal year ending Aug. 31—										
	1925	1926	1927	1928	1929	1930	1931	1932	1933	1934	1935
Surplus balance at beginning	$881,417.34	$893,164.28	$902,068.00	$835,771.31	$564,512.77	$407,887.06	$54,557.13	[1] $528,087.37	[1] $1,553,248.05	$404,129.34	$379,336.37
Reserve for dividends	393,252.00	53,407.00	26,553.50	25,561.50	26,580.00	26,580.00	26,498.00				
Reserve for Federal tax	6,412.50		38,047.28	12,811.66	3,202.80						9,500.00
Total	1,281,181.93	946,571.28	966,669.68	875,144.47	594,300.67	524,473.06	81,055.13	528,087.37	1,553,248.05	404,129.34	388,836.37
Net profit or loss for years before depreciation	183,912.73	503,358.90	311,678.65	70,715.43	252,492.84	[1] 90,363.91	[1] 365,771.21	[1] 250,073.78	[1] 49,547.32	39,171.20	120,150.26
Less depreciation	135,786.66	198,468.42	195,080.71	131,831.82	149,198.55	149,939.87	133,615.10	79,709.37	68,674.39	65,098.25	64,890.10
Profit or loss for year	48,126.07	304,890.48	116,597.94	[1] 61,116.39	103,294.29	[1] 240,303.78	[1] 499,386.31	[1] 329,783.15	[1] 118,221.71	[1] 25,927.05	55,260.16
Other adjustment to surplus:											
Federal taxes paid	42,791.62	3,401.68	38,211.15	9,608.76	3,202.90	2,923.09					
Dividends paid in cash						[169,963.00					
Monthly	330,945.00	281,373.50	169,912.00	169,856.50	169,919.00	750.00	26,498.00				
2 percent extra Oct. 8, 1927				56,680.00							
				226,536.50							
Obsolescence charged off							85,088.19	127,756.74	30,910.37		
Additional depreciation for prior years:											
On equipment						29,478.06		1,347.20			
On buildings								191,312.01			
Balance of dies and tools written down								228,799.55			
Correction in listing into company		17.00						158,906.36			
Total adjustments	382,736.62	284,792.18	208,123.15	236,145.26	173,121.90	203,114.15	111,586.19	708,121.86	30,910.37		
Additions to surplus:											
Surplus arising from appropriation of assets account sales				16,417.85							
Account liquidating dividend Oct. 8, 1930							1,830.00				
Refund of taxes								[2] 733.02			
Adjustment of assessed taxes								12,011.31	1,709.47	984.08	
Account fractional shares retired from exchange of stock										150.00	
Total additions				16,417.85			1,830.00	12,744.33	1,709.47	1,134.08	
Net adjustment to surplus account for year	[3] 334,618.55	[4] 20,098.30	[3] 91,525.21	[3] 280,843.80	[3] 69,827.61	[3] 443,417.93	[3] 609,142.50	[1] 1,026,821.83	[3] 147,422.61	[4] 24,792.97	[3] 55,260.16
Surplus accounts at end of year	946,571.38	966,669.68	875,144.47	594,300.67	524,473.06	81,055.13	[5] 528,087.37	[1] 1,553,248.05	[3] 1,400,670.66		

Capital surplus credit from exchange of stock Oct. 5, 1932										2,104,800.00		
Net surplus after exchange of stock										404,129.34	379,336.37	444,096.53
Surplus (net)												434,596.53
Reserve for taxes												9,500.00
Total												444,096.53

[1] Loss.
[2] United States.
[3] Reduction.
[4] Addition.
[5] Deficit.