Which Way to Relief from the Double Tax on Corporate Profits?

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Reprinted from
The Analysts Journal
February 1954

Published by
The New York Society of Security Analysts, Inc.
20 Broad Street, New York 5, N. Y.

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A TAX REFORM BILL is on the way, and it is universally expected to provide some relief from the double dividend tax. Apparently no one supports the principle of the "double bite"; its only excuse is the need for revenue. To eliminate the second tax entirely would cost the Treasury at least $3½ billion. In today's budget picture so large an annual sum can be neither foregone nor replaced by other levies. Investors must limit their initial hopes, therefore, to partial relief amounting perhaps to one fifth of the total involved. The prediction most generally made is that taxpayers will be allowed a credit against their tax bill of 5 to 10% of dividends received. This type of relief has already been granted by Canada. Others expect a flat exemption of a small amount of dividend income—say 10% or $200, whichever is less.

Much more effort has gone into condemning the double tax as unfair and destructive than into thinking about the most practicable and desirable forms of relief. It should be borne in mind at the outset that there are two basically different approaches to the problem. The first would tax the corporation only; the second would tax the stockholder only and exempt the corporation to the extent that profits are distributed. Both of these approaches have a background in our tax history, and have analogies in our present tax law. Each also has its own advantages, particularly in the direction of remedying unsound viewpoints and practices that have been generated by the heavy rates of tax.

In this article we shall consider some specific implications of the present system of double taxation, in relation to business and investment policies. We shall not discuss the generally discouraging effect on business enterprise of the heavy combined burden. This is a familiar subject of complaint. Contrariwise, the point should be noted that no substantial contraction in over-all business activity can *so far* be identified and blamed on the tax rates. This fact may be explained in part by the large nonmonetary or noncalculating component in American business, especially large-scale business—a theme not adequately explored by our economists and sociologists. More important, probably, is the factor of inertia or delayed reaction. Businessmen and investors do not now act as tax logic would have them act, because it takes a long time for an external consideration like tax rates to change ingrained attitudes and habits of business and life.

This will account also for the rather surprising failure of businessmen and investors to adopt specific policies—in the fields of organization form, capital structures, dividend attitudes and procedures, and so on—designed to minimize the tax impact as far as feasible. But, unless the burden is lightened in the future, it is safe to predict that these adaptations will be made at an increasing rate of speed. If our economy should ever come to be really controlled by tax factors—if all the implications of our tax laws and regulations should be fully reflected in our business and investment activities—the United States would find itself in a pretty pickle.

REACTIONS TO THE CORPORATE INCOME TAX

The corporate-tax portion of the double impost should logically produce two major counter-reactions or tendencies. The first should be the replacement of the corporate form, wherever practicable, by the partnership form—especially the limited partnership form. The second should be the introduction of the largest possible component of interest-bearing securities in the capital structure—preferably, income bonds—in order to enjoy the interest deduction from taxable profit.

There are limitations on the availability of both of these methods of defeating the corporate tax. It is inconceivable, of course, that our large corporations could ever be transformed into any form of partnership. But, when it is recalled that there are some 500,000 incorporated businesses in the United States, covering every possible gradation of size and ownership structure, it becomes apparent that there is room for far-reaching changes in the organizational forms of business. The recent imposition of an excess-profits tax—for the fourth time in about a generation, and in the last three instances applied only to corporations—has given an extra dimension to the gulf between corporate and partnership tax rates.

Years ago incorporation was adopted widely to *reduce* the tax impact on private business. With reinvestment of profits, thus avoiding the dividend tax, and with the corporate levy at the rate of 15% or less, arithmetic clearly favored a corporation over a wealthy partnership. Today, assuming no dividends at all but ultimate realization of profits through a capital-gains sale, the typical corporate proprietor faces a tax of about 63%. In most cases the effective tax burden is even higher.

It is fundamentally unsound to have the corporate and noncorporate forms of business affected by completely different tax systems. We shall comment on this point again later.

Bond interest is tax-deductible by a corporation; preferred and common dividends are not. Thus, if all present dividends could be paid in the form of bond interest, double taxation would be ended. For, by our assumption, whatever was paid out would be free of corporate tax, and whatever was retained would be free of individual tax. There are two ways in which this result could conceivably be attained. The first is by changing the law to put dividend payments on the same tax basis as interest payments; the second is by changing corporate capital structures so that all but a nominal amount of present capital is transformed into debt—presumably income bonds of long maturity.

The way in which traditional or "institutional" thinking prevents prompt adjustment of policy to new conditions is well illustrated by the failure of corporations to make use of the income-bond device for its tax-saving value. (The generally bad repute of income bonds is a strong factor here, of course, but a few issues put out by really strong companies would go far to break down this barrier). The Treasury and the courts will not permit the income-bond stratagem to be carried beyond certain limits—not as yet clearly defined—but the decisions on record clearly give far more leeway here than corporations are willing to accept.

Our prediction would be that the weight of double taxation will eventually overcome the traditional objections to income bonds—or other debt with "escape clauses" for the issuer—and that, once the new procedure is firmly established, it will spread more and more rapidly. This will serve to create a tax gulf between companies with and those without full-scale debt structures. Such a development could hardly be welcomed. For much too much of apparent earning power and investment value would then depend on the choices made concerning capital structure. Furthermore, the contribution of different companies to tax revenues would vary widely and undeservedly.

This analysis suggests that one of the best ways to grant relief from double taxation would be to allow as large a portion as possible of dividend payments to be deducted from taxable income. If we assume that the Treasury's loss is to be limited at the outset to, say, $500 million, the initial deduction or credit could be no more than about 10% of the distributions. But just as with other possible forms of relief, this percentage could be increased when and as Congress decides that further reform is feasible.

The end result envisaged by such a policy would be the (approximate) equalization of tax rates for corporations and other business enterprises. For, if all dividends were eventually deductible by the company, and if the regular corporation rate were about equal to the composite individual tax rate on dividends, then the total tax take would be the same, regardless of the amount disbursed—and this take would be the same as from an equivalent amount of partnership or proprietorship income. Readers with long memories will recall that this was the avowed objective and pattern of the original Administration draft of the tax bill of 1936—which was later transformed into the undistributed profits tax provision, on which so much obloquy has been heaped. What started out as potential relief ended as penalty, because the old corporate tax was retained and the new tax added on. If this time the tax relief provisions start out modestly, they would be in no danger of distortion into an additional burden.

Current and recent tax provisions include two precedents for treating dividend payments as tax-deductible by the corporation. One was the deductibility accorded by the Revenue Act of 1942 to certain preferred-stock dividend payments made by public utility companies. (This was limited to the so-called normal tax.) The other relates to regulated investment companies (mutual funds, etc.) under section 362 of the Revenue Code. Corporations coming under and complying with these special provisions incur no tax on profits paid out to stockholders.

An overlooked aspect of our present tax system is that it makes the Government a 50% partner with corporations in their net profits, but not a part owner of their net assets. Suppose a company can earn just enough *before taxes*—say 10%—to support the realizable value of its capital. After the 50% take these earnings are cut in two, and the value of the business as a going concern apparently becomes only half of what it would be if it sold out or shut up shop. The higher the rate of tax, the greater the percentages of businesses that are worth more asset-wise than earning-wise. An allowance or deduction for a moderate dividend on invested capital *before* dividing with the Treasury would go far to mitigate this unsound factor in the present economy.

RELIEF TO THE STOCKHOLDER

If we turn now to the stockholders' tax position, the most obvious way of easing his burden is by exempting his dividend income from the second tax. For the greater part of our income-tax history—from 1913 through 1935—such exemption was in fact accorded with respect to normal tax but not surtax. The theory was that the corporate tax about corresponded to the normal tax on individuals, so that the credit saved him from two normal taxes. This simple reasoning is no longer applicable in our present complicated system, where the corporate levy itself contains both a normal tax and a surtax, and where the corporate rate is much higher than the individual rate for some stockholders and much lower for others. Nevertheless, it would still be feasible to grant welcome relief by again exempting dividends from the lowest bracket of personal tax—now set at 20%.

There is a special economic distortion created by the present dividend tax, and that is the growing tendency of high-income investors to favor capital gains over ordinary dividend income. Since the maximum tax rate on long-term gains is now 25%, its advantage for high-bracket people is tremendous. This disparity in rates has great capacity for mischief. It can undermine sound distinctions between investment and speculation, create schizophrenic thinking on dividend policies, and set the interests of large investors in direct conflict with those of small stockholders. If the burden of double taxation is to be lightened at all, there would be a special advantage in doing so in such a way as to bridge the tax gulf between capital gains and dividends.

A neat method of accomplishing just this would be to treat all domestic dividends as the equivalent of long-term capital gains. There is a precedent for this in our present tax law, which already provides, in section 362, for "capital-gain dividends." These are distributions made by regulated investment companies out of their own capital gains, and they are taxed at *capital-gain rates* to the receiving stockholders. If this reform were adopted 100%, it would probably reduce the present tax on dividends by about two thirds, an inadmissible concession to begin with. But any desired measure of relief can easily be accorded by designating some portion of dividend income to be treated as capital gains, the remainder to continue to be taxed as at present. Similarly, if special relief is wanted for the small investor, this could be achieved by giving, say, the first $400 of dividend income the same tax status as capital gains.

THE TWO APPROACHES COMPARED

If we assume a retreat from double taxation, is it better to reduce the burden on the corporation or on its stockholders? Considerations of equity and broad economic strategy would favor equalizing the tax position of corporate and noncorporate business, except for a moderate franchise tax on companies, in return for their various immunities. Probably the most advantageous method of procedure would be to allow a credit to corporations for dividends paid, similar, on the one hand, to the present interest-paid credit or, on the other hand, to the excess-profits-tax credit. We have pointed out important collateral benefits from this approach.

From the standpoint of common-stock valuation, relief given to corporate earnings will probably have a more beneficial effect than relief given to dividend recipients. The reason is that the effect of the former can be computed directly in terms of higher earnings per share, whereas a lower tax on dividend income has different results for different stockholders. But any reduction in the combined tax rate must operate to make common stocks more attractive and thus more valuable.

Tax relief to the shareholder is not so logical as equivalent relief to the corporation, but it is likely to have more of a personal or voter appeal. This probably explains why expectations always run in this direction. Even here a strong case could be made for reducing the burden by equalizing the rates on dividends and on capital gains, instead of merely granting a limited exemption of dividends from the regular tax.