

CORPORATIONS AND THE TAX LAWS*

BY RALPH R. NEUHOFF

Taxes exert a marked influence upon corporations in their formation and in the conduct of their business. The extent of this influence is probably not fully perceived, even by those intimately connected with corporations themselves, and even less by the public in general.

There are several reasons why the effects of taxes often go unnoticed. One of these is that the pressure exerted by a tax is gradual and constant and does not force itself upon one's consciousness as an extraordinary pressure would. Furthermore, the reaction of a corporation to a condition created by tax laws is not ordinarily announced as such, but the action taken by the corporation is likely to be kept quiet and purposely made as inconspicuous as possible. Indeed, in some cases, great pains may be taken by the corporation to conceal the fact that consideration of taxes has any relation to the act in question.

THE SIZE OF THE TAX LOAD

In the aggregate the burden of taxation upon corporations is surprisingly great. It has been stated by railroad corporations that of each dollar of their gross income 8 cents is paid for taxes of one kind or another, and that 35 cents of each dollar of the net income, before deducting taxes, is paid for taxes. Another authority has stated that thirty per cent of corporate net income was devoted to taxes of various kinds. The burden of the tax on incomes alone is very considerable. The present rate on corporations is twelve per cent of the net income for the Federal income tax and under the new income tax law in Missouri, the corporate rate is two per cent, making a total of fourteen per cent for income taxes alone on local corporations, and to this must be added the franchise tax, the property tax, and various registration fees; so that on the whole, a large part of the income of the corporation must be devoted to payment of governmental exactions.

* An address delivered at the Washington University Law School, May 1, 1931.

Taxes on individuals, except the wealthy, are not so high. But in spite of the fact that corporations are discriminated against as compared with individuals and partnerships, the advantages of the corporate form of doing business are so great that there is no apparent inclination to avoid it at the present time. Some years ago there was a fad for the trust form, and numerous so-called "Massachusetts Trusts" were formed to engage in ordinary active business. A trust of this kind which engages in an active business is now generally classified as a corporation for taxing purposes, and for this reason the movement from the corporate form to the trust form has practically died out.

The advantages of the corporate form of doing business are familiar. For instance, the corporation is the only practical method at the present time for the mobilization of capital. If one has \$30.00 and desires to go into the automobile business, it is simply out of the question and it would also be out of the question for one to go around among one's friends and talk up a plan whereby one could obtain enough contributions of capital to embark upon the automobile business; but there is by virtue of the market for stock of automobile companies a perfectly practicable method for one to enter one's capital in the automobile business, even if it consists only of \$30.00, namely, by the purchase on the New York Stock Exchange of one or more shares of stock of a large motor company. In this way, instead of going into the automobile business on the smallest scale possible, one's \$30.00 will go into the automobile business in one of the largest aggregations of capital in the business and therefore with the good auspices which come from large enterprises, which ordinarily are well managed.

Another advantage of the corporate form of organization is the marketability of corporate securities. The incidents of the corporate form of organization are well understood and well defined by law. The result is that in New York and in other large cities there are maintained markets where the securities of corporations are dealt with in large volume. Accordingly, it is quite easy if one should decide to take his capital out of the automobile business to put his resolution into effect within fifteen minutes. An order to a broker to sell a share of stock, followed by its delivery to the broker, can be executed immediately upon the exchange dealing in the security in question.

Another very important feature of the corporation is that its continued existence is not affected by the death of particular individuals. A partnership terminates with the death of a partner. A partnership composed of a large number of individuals would be frequently beset with the complications caused by the death of a partner. A corporation avoids all this. The stock changes hands, but the existence of the corporation is undisturbed.

In the case of a small business man, perhaps the most important advantage of the corporate form is the limitation of liability which the laws grant. An individual or a partnership engaged in a business may become liable through an accident for a personal injury claim which will wipe out everything the proprietors own, but if the business is incorporated, the usual case will be that only the corporation is liable and the proprietors' private savings and other capital are not at the hazard of the business.

In one sense it might be thought that the state, having granted the valuable privilege of doing business as a corporation, is charging a price for it. The writer does not favor this view, because it does not aid in solving the questions which arise in the taxation of corporations. Possibly there may be a justification for looking upon the privilege of doing business as something for which a price is charged by the state, but it fits the situation more closely to describe the discrimination against corporations as a case of "ease of collection."

EASE OF COLLECTION

There are certain reasons to be noticed why it is easier to collect a given amount in taxes from corporations than from individuals.

At the outset, all taxation of corporations is, in one sense, indirect. The corporation is an artificial entity, which has no actual existence, and the real owners are, of course, the stockholders. However, the corporation has its own bank account and its own officials and many times the stockholders are totally unaware of what taxes, if any, the corporation is paying. Certainly they are unaware of the taxes at the time they are being paid and only learn about them later, if at all, by the summary

in a report at the end of the year, which gives the total amount of taxes paid, without any details. So, generally speaking, the stockholder is in blissful ignorance of the extent to which he is indirectly paying taxes through the corporation.

Another reason why it is easier to collect taxes from corporations than from individuals is that corporations find it harder to conceal their assets and income than individuals do. The very fact that numerous stockholders have an interest in the corporation causes records to be required which an individual might, and usually does, dispense with, especially if his business is small. Again, the stockholders have the right to inspect the books and there must be adequate books to inspect. Another factor is the large size of the corporation, which in itself enforces accurate and more detailed records for controlling the corporation's activities than would be necessary or even desirable in the case of a smaller business.

Most corporations consider it likely that at some time they will call upon the public for more capital. A certain public utility does this on the average of once every two years. They desire to keep in the good graces of the investing public so that they can easily obtain more capital if necessary. This also induces corporations to keep accurate records and to make them available to the public. Naturally, if the records are kept, and they show a tax liability, the tax cannot be avoided.

The corporations, furthermore, are often heavy borrowers at the bank and from the public by the issuance of bonds. Here too it is necessary to have accurate records in order to inspire confidence in the corporation's credit. This is further exemplified by the almost universal custom of having certified public accountants as independent auditors examine the books of corporations and make up their own version of assets, liabilities, and profits for the period covered.

There is no doubt, of course, that some inaccuracy and understatement in the corporation's books as a matter of policy is still possible. For instance, inventory can be figured consistently low, and the value of capital assets can be consistently understated or, for that matter, overstated. However, the various taxes affect the corporation in different ways, so that, while one tax may be reduced by an understatement, another tax may be

increased. Too great understatement may affect the corporation's credit. Wherefore, the managers of a corporation are likely to conclude that after all, honesty is the best policy and only adhere to a mild amount of understatement which in the long run, and if it is uniform, does no great amount of harm.

According to the writer's personal observation, the "ease of collection" theory is the only practical criterion that has any weight in the levying of taxes. The "ability to pay" which is popular in certain academic circles is only pertinent so far as it will affect the ease of collection. Authorities are likely to be interested in extracting the taxes as painlessly as possible, and beyond that they do not care.

The flexibility of taxes on corporations as compared with taxes on individuals is also an advantage. This is due to the indirectness of the tax referred to above. A rate which is up one year and down another as applied to individuals who happen to be voters may be unpopular, but the up and down fluctuations of a tax on corporations will be much more readily borne.

EFFECTS OF TAXATION

Coming now to particular ways in which the activities of corporations are affected by the taxes, we consider first the subject of expenditures by the corporation.

OFFICERS' SALARIES

A large item of expense for any corporation, of course, is the compensation of the officers. It might be thought that this is a matter entirely between the corporation and the officers and perhaps the stockholders, but this is not so. Under the federal income tax, the salaries of the officers may be deducted in determining the net income of the corporation, *but only if they are "reasonable compensation."* They are not deductible to the extent that they are unreasonable. Therefore, the Federal Government undertakes to say to the corporation whether the compensation which the corporation determines and pays to the officers is "reasonable" or not, and there is quite a tendency for a corporation not to pay salaries which the government would deem unreasonable and would refuse to allow as a deduction from the income tax return.

From the newspapers, it has appeared that in several notable cases the corporations have paid salaries and bonuses which are now claimed to be highly unreasonable, from which we infer that the corporation's policy is not always dictated by the principle of reasonableness, and yet the present writer has had many cases in his own experience where the corporations which were fixing salaries of officers gave very earnest thought and took advice as to just how large a salary could be paid and still have the total amount of the salary deductible as an expense item for the corporation.

EMPLOYEES' SALARIES

The amount of compensation paid to employees who are not stockholders is also subject to the test of "reasonableness." But inasmuch as the relations between these employees and the management of the corporation are not so close, there is a greater presumption in favor of the good faith of the action which happens to be taken.

Still, when the tax rate is very high, as for instance under our war-time excess profits taxes, when the higher brackets were such that in particular cases the government would collect 82.4 per cent of profits that were not given to employees as bonuses, there was a great temptation to reward employees toward whom the management felt kindly, realizing that out of every dollar of bonus the corporation's stockholders would contribute but 17.6 cents and the government would contribute 82.4 cents.

ADVERTISING CAMPAIGNS

Another favorite way of spending money during the high tax years was on great advertising campaigns. The corporations subject to the high rates felt that if they made money according to their books the government would take practically all of it. Therefore, the corporations felt that if they could spend money for advertising, which was entirely deductible, the government would be footing the bill to the extent of a maximum of 82.4 per cent and the corporation only to the extent of 17.6 per cent. Then in better days when the tax rate was lower, the good will thus created would be productive of further income to the corporation. The most popular national weekly grew as it has not grown before or since, because of the large increase in

the amount of corporate advertising, evidently brought on by this artificial stimulation.

DONATIONS

In the matter of donations also, the policy of corporations is greatly influenced by tax considerations. There is a great reluctance on the part of the managers of corporations to give donations to charities on account of the fact that the amount donated is not at present deductible in the Federal corporation income tax return. On the other hand, certain business organizations of perhaps less real merit but more direct connection with corporate activities have secured rulings that donations to them are deductible as "necessary business expenses," and the result is that the managers of corporations are willing to make donations of this kind. The question is frequently asked whether a donation to a chamber of commerce or business league or what not is deductible in calculating the income of the corporation for tax purposes, and the decision of this question frequently determines whether the corporation will or will not make the contribution.

One way of getting around the non-deductibility of contributions to a charity was exemplified by the famous Red Cross Dividend which the United States Steel Corporation declared in 1917. The dividend was declared and the request was made that the stockholders endorse his check back to the corporation to turn over to the Red Cross. Probably in almost all instances this was done. The stockholder could deduct the amount of the contribution as a deduction in his income tax return, whereas if the contribution had been made directly by the corporation, it would not have been deductible from income on the corporation's income tax return.

SALE OF PROPERTY

Another respect in which the policy of corporations is greatly influenced by tax considerations is in the sale or disposition of property. The ownership of a capital asset which goes up in value does not result in taxable income to the corporation, but if the corporation "cashes in" on this income by a sale, then the amount of the appreciation which took place after February 28, 1913, is subject to the income tax.

A particular instance in the writer's experience will demonstrate this effect of taxation upon sales. During the boom in agricultural land in the South a certain plantation could be sold for \$80,000.00. It happened that the land had cost very little. It was ascertained that approximately \$30,000.00 of the \$80,000.00 would go to the government as a tax in the event that the sale took place. The down payment was about \$15,000.00, which meant that twice the down payment would be required to pay the tax. The sale did not take place and the corporation did not cash in on the \$80,000.00 that might have been realized. One may see what a strong deterrent a heavy tax rate on capital gain may be in a case of this kind.

During the bull market in corporate stocks which culminated in 1929 there was the same tendency to refrain from "cashing in" on gains because of the tax. This applied more to individuals than to corporations. However, there are many corporations owning capital stock listed on the New York Stock Exchange, and doubtless the income tax discouraged the sale by corporate holders of their securities. Of course, events have now proved that the corporations would have done better to take their profits and pay the tax rather than suffer the severe deflation in value which has now taken place on account of the present bear market.

DIVIDENDS

Another matter in which the policy of corporations is practically controlled by the provisions of the income tax laws is the declaration of dividends.

Early in the history of our present series of Federal income taxes, it was discovered that there was a tendency for wealthy individuals to cause the corporations in which they were interested to accumulate their profits rather than distribute them so that the individuals would in this way avoid paying a surtax on the profits. As the individuals merely desired to accumulate this money, it was just as well saved by the corporation as in the hands of the individual. It was therefore necessary for the Federal Government to enact provisions designed to prevent, as was quaintly expressed, a corporation's being "formed or availed of for the purpose of preventing the imposition of the surtax on its shareholders through the medium of permitting its gains

and profits to accumulate instead of being divided or distributed.”

Some of these provisions have been so drastic that their imposition, which is happily rare, would be a real calamity to some corporations. It has been necessary to give earnest thought sometimes to situations where, for particular reasons, it was desired not to pay dividends, in order to ascertain whether there was any real danger of the corporation's suffering the penalty which was provided for improper accumulation of profits.

It has also been necessary to advise corporations to declare dividends which otherwise would not have been declared, because it appeared that it would be dangerous to continue to pile up surplus and incur a liability for the tax on this account.

FORMATION OF CORPORATIONS

Another way in which corporations have been affected by taxation is in their formation. The corporate structure itself is to some extent determined by considerations of taxation. For instance, the question might arise whether a corporation should acquire certain capital by an issue of bonds or of stock. If it issued bonds, the amount of interest would be an allowable deduction from the income of the corporation. On the other hand, there have been times, particularly during the late war and in the period immediately following, when it was an advantage to a corporation to have a large amount of so-called “invested capital,” because it was allowed to earn a certain amount of return on its “invested capital” before getting into the higher brackets of the tax. The amount of capital acquired by an issue of bonds would not be included in the “invested capital,” whereas the amount of capital acquired by an issuance of stock would be. The holders of bonds would be subject not only to the surtax but also to the normal tax on the interest received from the bonds, whereas dividends paid on stock would be subject only to the surtax. A balancing of these various considerations might determine the form of the new capital issue.

NUMBER OF CORPORATIONS

Another question which sometimes arises is whether to have one corporation or many. If a corporation's activities extend

through various states, even if each state levies similar taxes, it has happened that on account of different rules applying in different states one state would not defer to the rule adopted by another, and each state, having jurisdiction, would claim the tax. Therefore it has been a settled policy with certain executives to have a separate corporation in each state in all cases where the enterprise is large enough. Sometimes an enterprise which is really conducted as a unit is composed of as high as nine different corporations. A certain railroad comprises something like 450 separate corporations, the result of a reduction from the original group of over 1000.

On the other hand, it is sometimes advantageous to join several corporations together in a "consolidation" or "merger," and it is always a question whether the particular consolidation will result in taxable income to the stockholders. It has sometimes been necessary to advise the deferment of a consolidation which business policy dictated, simply to avoid an income tax on the stockholders. Later when the law was changed, permitting the desired consolidation to be effected without tax liability, the merger could proceed. In corporate reorganizations it has been absolutely necessary to keep one eye on the tax books or the result might be disastrous. Some years ago three large banks decided to merge. The stockholders of the three original banks were to turn in their stock and receive stock in the merged bank, which, according to the National Banking Law, was to be a continuation of all three banks under the charter of one. The par value of the stock received was greater than the par value of the stock turned in. The attorneys who handled the merger concluded that it was in effect a stock dividend not subject to income tax. The government thought differently, and for many years various phases of the question have been in the courts. The matter is not yet definitely settled.