

January 1936

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Recommended Citation

William D. Morrison, Phases of the Revenue Act of 1936, 14 Dicta 27 (1936).

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Phases of the Revenue Act of 1936

PHASES OF THE REVENUE ACT OF 1936

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BECAUSE of the extensive subject to be considered, I shall attempt to cover only a few of what I believe to be the more important phases in connection with the Revenue Act of 1936 as compared with the Act of 1934, as it affects: Individual Normal Tax and Surtax; Corporation Excess-Profits Tax, Normal Income Tax, and Surtax on Undistributed Profits, and the Surtax on Corporations Improperly Accumulating Surplus. I shall, with a few exceptions, omit any reference to the Revenue Act of 1935. So far as the theory of the Act is concerned, no change has taken place; however, there is a pronounced change in the procedure and the method of calculating the tax, and a material change in the rates particularly with respect to corporations. Regardless of many opinions and views expressed with reference to the Act of 1936, it was approved June 22, 1936; and it is necessary to proceed under its provisions, as it is effective for the 1936 calendar year and any fiscal year beginning after January 1, this year.

INDIVIDUALS—NORMAL INCOME TAX

The normal income tax rates, applicable to individuals under the Laws of 1934 and 1936, are unchanged. The personal exemption remains the same; that is, a single person has an exemption of \$1,000.00, the head of a family or married person has a personal exemption of \$2,500.00, and no change has been made with reference to the credit of \$400.00 for each dependent person. The earned income credit, minimum and maximum, continues as under the prior Act. While the rate remains the same, the provision in the Act of 1936 as to the taxable income has been altered. Under the 1934, and prior acts, dividends were not subject to normal income tax to the shareholder on the theory that they had been taxed while in the hands of the corporation, and to impose a tax thereon would constitute double taxation.

The 1936 Law imposes a tax on dividends of certain types received during the taxable year by shareholders, and, when so paid, constitute taxable income to the recipient and a credit to the corporation for dividends paid.

Further treatment of dividends will be considered under the provisions of Corporation Credit for Dividends Paid and Distributions by Corporations.

INDIVIDUALS—SURTAX

The surtax, under the 1934 and 1936 Acts, is based on the net income in excess of the personal exemption, and the credit for dependents. The rate remained the same for net incomes up to \$50,000.00. In the 1934 Act the rate ranged from 4% upward to 59%, whereas the 1936 Act rate is from 4% to a maximum of 75%.

CORPORATION—EXCESS-PROFITS TAX

The excess-profits tax now in force was imposed by the Act of 1935 as amended by the 1936 Act. Under the 1934 Law an excess-profits tax of 5% was imposed on the corporate net income in excess of 12½% of the adjusted declared value of entire capital stock as shown in the 1935 Return of Capital Stock Tax for the year ended June 30, 1935. In computing the excess-profits tax under the 1936 Act, definite items of deductions are provided; for example, dividends received by corporations are deductible as a credit for the purpose of this tax to the extent of 85% of their amount. There is no tax on interest received on obligations of a State, Territory, Municipality, the District of Columbia, or United States Possessions. The normal income tax is not deductible in computing net income subject to excess-profits tax for taxable years beginning after January 1, 1936.

After applying the items above mentioned, we arrive at the figure subject to excess-profits tax. The rates provided for the computation of this tax are 6% of such portion of the net income as is in excess of 10% and not in excess of 15% of the declared value of entire capital stock as shown by

the 1936 Return of Capital Stock Tax, and 12% of such portion of the corporation's income as is in excess of 15% of the declared value of the entire capital stock. As an example, assume a corporation with no dividends from corporations or interest on obligations of states, municipalities, etc., which had declared its entire capital stock as \$50,000.00 and had an income subject to this tax of \$44,602.27. The first 10% of the declared value of \$50,000.00 or \$5,000.00 would be deducted and not subject to tax. The amount of the declared value between 10% and 15%, or 5% of \$50,000.00, or \$2,500.00 would be at the rate of 6%. The tax on this amount would, therefore, be \$150.00. The two items of \$5,000.00 and \$2,500.00 would constitute 15% of the declared value. The remainder, deducting these two items in the aggregate sum of \$7,500.00 from the net income of \$44,602.27, would leave \$37,102.27. The excess-profits tax on this amount at the rate of 12% is \$4,452.27. The total excess-profits tax under this example would be the sum of \$150.00, 6% of \$2,500.00, and 12% of \$37,102.27 or \$4,452.27, a total excess-profits tax of \$4,602.27.

The reason for discussing this tax first is, that the 1936 Act provides that the amount of the excess-profits tax paid or accrued under the Revenue Act of 1935 (as amended) is deductible in computing the net income of a corporation for the purpose of both normal tax and surtax on undistributed profits, and both excess-profits tax and normal tax are deductible before making the computation of the surtax on undistributed profits. No complications will result in computing the excess-profits tax first, because the net income for that purpose is computed without deduction of either the income or surtax on undistributed profits. Apparently excess-profits tax will be deductible from normal tax and surtax at the end of the calendar year, 1936, for those corporations only that are on the accrual basis, as corporations on the cash basis would not be in a position to determine the amount of said tax so as to pay it prior to the close of the calendar year. This applies also to fiscal years ending in 1937 and subsequent taxable years.

CORPORATIONS—NORMAL TAX

Section 13 of the 1936 Act imposes a normal tax on corporations with the exception of exempt corporations which come within Section 101; and banks and trust companies, under Section 104, wherein the rate is 15% instead of the rate provided by Section 13. Although the normal tax rate is higher on net taxable incomes up to \$40,000.00, this class of corporations is not subject to the surtax imposed by Section 14 of the Act. The normal tax, under the 1934 Act, was calculated on a straight line basis of 13 $\frac{3}{4}$ % of the taxable net income. Under the 1936 Act, a graduated scale of taxation is imposed upon the net taxable income; the first \$2,000.00 at the rate of 8%, the next \$13,000.00 at the rate of 11%, the next \$25,000.00 at the rate of 13%. This brings us to a total net income of \$40,000.00, and all income over that figure is subject to a tax at the rate of 15%.

Let us assume that a corporation had the same income as was mentioned under the excess-profits tax which is subject to tax under this section; namely, \$44,602.27, with no interest on United States bonds, dividends from corporations, or interest on obligations of states, municipalities, etc. The accrued excess-profits tax, it appears, may be deducted providing, as heretofore stated, that the corporation was making its return on the accrual basis. For example, from the net income heretofore used, of \$44,602.27, the accrued excess-profits tax of \$4,602.27 may be deducted leaving a net income subject to normal tax of \$40,000.00. Applying the rates of 8% for the first \$2,000.00, 11% for the next \$13,000.00, and 13% for the following \$25,000.00, the tax would amount to \$4,840.00. In this example the highest bracket of the normal tax was not reached, namely the maximum rate of 15%. Here, as in the excess-profits tax section, corporations may deduct as a credit 85% of dividends received from corporations subject to income tax. One of the interesting facts in connection with this tax is that where no excess-profits tax is applicable as a deduction before calculating the corporation's normal tax, the normal tax would be less under Section 13 of the 1936 Act than under the 1934 Act on corporations having a net income up to \$92,800.00. The

normal tax on a net income of \$92,800.00 amounts to \$12,760.00 under either Act.

CORPORATIONS—SURTAX ON UNDISTRIBUTED PROFITS

Authorities on taxation have, for some time, considered the imposition of a tax on the undistributed profits of a corporation. This part of the Act of 1936 is unique and the first Act to specifically impose a tax on the undistributed profits in this country. Some authorities doubt its constitutionality, while others point out the fact that the Sixteenth Amendment gives Congress the power to lay and collect taxes on incomes from whatever source derived. Under its administration many difficult problems will arise which will, of necessity, have to be clarified by judicial determination. This tax in principle represents a penalty tax upon the profits of any year in which the corporation does not distribute its profits to its shareholders. Such a procedure is rather drastic in that, through the depression period, many corporations sustained deficits of large amounts, and the law makes no provision for restoration of these deficits before determining the tax imposed, and causes the corporations to suffer the penalty for not making distribution of the taxable years' earnings. The undistributed profits of a corporation, as a general rule, are not represented by cash. They may be represented by an increase in assets or a decrease in liabilities, such as: (1) Notes or Accounts Receivable, (2) Inventories, (3) Capital Expenditures for the betterment of the plant or equipment, or (4) The Liquidation of Indebtedness.

Many state laws prohibit the making of distribution of earnings while a deficit exists. Consider for a moment, Section 34, Chapter 41, "Corporations," 1935 Colorado Statutes Annotated, which reads as follows:

"If the directors, trustees or other officers or agents of any corporation shall declare and pay any dividend when such corporation is insolvent, or any dividend the payment of which would render it insolvent or would diminish the amount of its capital stock, all directors, trustees, agents or officers assenting thereto shall be jointly and severally liable for all debts of such corporation then existing, and for all that shall thereafter be contracted while the capital remains so diminished."

Under the provisions of this Section, it would be an exceedingly bad policy for a corporation having a deficit to pay dividends out of possible or actual profits until the deficit was eliminated.

The estimated amount of adjusted net income will, when circumstances permit, be a strong influencing factor in determining the amount which the corporation will distribute in dividends. For example, consider a corporation with a net income subject to normal tax of \$40,000.00, that is, after deducting the excess-profits tax, the normal tax thereon would amount to \$4,840.00, leaving the adjusted net income, subject to surtax, \$35,160.00, with no paid dividend credit. The computation of the surtax on undistributed profits would be as follows:

Surtax thereon:

		At Rate Of	Amount of Surtax
First 10% of adjusted net income			
\$3,516.00 increased under specific credit provision to....\$	5,000.00	7%	\$ 350.00
Next 10% of adjusted net income	3,516.00	12%	421.92
Next 20% of adjusted net income	7,032.00	17%	1,195.44
Next 20% of adjusted net income	7,032.00	22%	1,547.04
Balance of undistributed net in- come	12,580.00	27%	3,396.60
Total undistributed net in- come	\$35,160.00		Surtax \$6,911.00

The surtax under this example is equal to 19.65% of the undistributed net income, whereas, if a dividend of \$30,000.00 had been paid so as to leave the undistributed net income at \$5,160.00, the surtax would have amounted to \$369.20.

Inasmuch as the amount of the surtax on undistributed profits is directly predicated upon the amount of dividends paid, and upon the effect of restrictions on certain classes of dividends, let us turn to a discussion of the new phases it brings about. In connection with this tax, the government apparently does not care who pays it so long as it is paid. If the corporation does not distribute its profits to its shareholders, then it must pay the tax. If the corporation makes distribution of its profits to the shareholders, then the share-

holders must pay the tax. In either event additional revenue is received directly from corporate profits. The decision as to who shall pay the tax, therefore, lies with the corporation.

Section 115-A. "Definition of Dividend," eliminating the exceptions, in substance states: "The term, dividend, when used in this title means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year, without regard to the amount of earnings and profits at the time the distribution was made."

The regulations, Article 27, 1 (b), reads in part, "When Dividends are Considered Paid.—A dividend will be considered as paid when it is received by the shareholder. A dividends paid credit cannot be allowed unless the shareholder receives the dividend during the taxable year for which the credit is claimed.

If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mails, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the dividend would be received by the shareholder within the taxable year, a presumption arises that the dividend was paid to the shareholder in such year."

With reference to corporation credit for dividends paid, Section 27 divides this subject into the following subdivisions:

- (a) Dividends Paid Credit in General.
- (b) Dividend Carry-Over.
- (c) Dividends in Kind.
- (d) Dividends in Obligations of the Corporation.
- (e) Taxable Stock Dividends.
- (f) Distribution in Liquidation.
- (g) Preferential Dividends.
- (h) Non-taxable Distributions.

Time will not permit a discussion of each of these subdivisions although there are some items that justify specific attention.

If the corporation makes a distribution in the form of non-taxable stock dividends, it receives no credit for dividends paid, and of course the stockholders pay no tax on dividends so received. In the case of *Koshland v. Helvering*, 80 Law. Ed. 845, which was decided during the month of May this year, the court held that, "Where a stock dividend gives a stockholder an interest different from that which his former stockholdings represented he receives income." It would appear, from this decision, that stock dividends received in shares different from those held by the stockholder constitute taxable income under the Sixteenth Amendment, and should, therefore, be deductible by the corporation. Under Section 115 (F) (2), where the corporation gives the shareholder the election as to the medium of payment, that is, either in cash or stock, and he takes stock, it is a taxable dividend to the recipient, and the corporation may take credit for the distribution in arriving at its undistributed profits surtax.

In addition to the credit allowed in computing the amount subject to the undistributed profits surtax, for dividends actually paid out within the year, under Section 27, an additional credit is allowed by Section 26 (C) (1), consisting of amounts applied to obligations, covered by a contract entered into in writing before May 1, 1936, out of current year earnings, to the extent that the surplus at the beginning of the year was insufficient to pay such obligations, and of a credit allowed by Section 26 (C) (2), of amounts paid or set aside out of earnings of the taxable year for the discharge of a debt, provided the requirement to make such an allocation is contained in a written contract executed before May 1, 1936, which contract expressly requires the earnings of the taxable year be used for the discharge of, or appropriation for, such debt. If duplicate credits result from these two subsections, 26 (C) (1) and 26 (C) (2), only one, the larger of such credits, is allowed as a deduction in computing the undistributed profits surtax. The principle difference is that under subsection 26 (C) (1), the earning and profits at the beginning of the taxable year are taken into consideration, whereas, under 26 (C) (2), only the profits of the taxable year are applicable.

This tax has caused a considerable amount of discussion as to its alleged unjustness and unfairness. Looking at it from another angle, let us assume that Congress had imposed a normal tax at rates sufficiently high to obtain the revenue which this tax is expected to yield. No material difference would have resulted so far as the government is concerned. There is, of course, the argument that a higher normal tax and no surtax, even though it produces the same revenue, would have been less complicated than under the present Act. This is true to a certain extent, although under the surtax provision there are definite advantages which accrue to the corporations as they are in a position to satisfy their stockholders by making a distribution of their earnings and the tax burden falls to the stockholder. Most stockholders anxiously await dividends from their stock investments; and where their incomes are small, their tax burden, as individuals, is of little, if any, consequence.

Corporations on the fiscal year basis, whose year ends during the year 1936, make their income tax returns pursuant to the Revenue Act of 1934, therefore, a corporation filing its return on a fiscal year basis ending November 30, 1936, will not be subject to the surtax on undistributed profits until it files its return for the next fiscal year, beginning December 1, 1936. Inasmuch as corporations in this category are not subject to the surtax, any distribution of dividends made prior to the close of its fiscal year ending in 1936, will not be available as a credit for the undistributed profits tax. No doubt, between now and the close of the year, December 31, 1936, many corporations on the calendar year basis, will make a survey of their earnings to the present time as accurately as possible, and estimate their expected earnings for the remainder of the year, to determine the most expedient policy to adopt in declaring and paying dividends during the current year, so as to obtain the maximum benefit from the dividends paid as a credit on their undistributed profits tax.

Although surtax on undistributed profits as a general rule applies to every corporation subject to tax, there are certain special exemptions, which come under seven separate classifications as provided in Section 14 (D). The outstand-

ing exceptions are, banks, insurance companies, and bankrupt and insolvent corporations.

For the purpose of showing in recapitulated form the taxes imposed on corporate income under the three subdivisions, that is, the Excess-Profits Tax, Normal Tax, and the Surtax on the Undistributed Profits (using the examples heretofore discussed which yield the greatest amount of tax) the following tabulation is presented:

Net Income as adjusted subject to Excess-Profits Tax.....	\$44,602.27
Excess-Profits Tax thereon.....	4,602.27
	<hr/>
Net Income subject to Normal Tax.....	\$40,000.00
Normal Tax thereon.....	4,840.00
	<hr/>
Adjusted Net Income subject to Surtax on Undistributed Profits	\$35,160.00
Surtax on Undistributed Profits.....	6,911.00
	<hr/>
Remainder after tax.....	\$28,249.00

These three distinct taxes, calculated on the examples given, total \$16,353.27, and when based on the Net Income as adjusted, of \$44,602.27, are equivalent to a composite per cent of 36.66% of said income.

SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS

With reference to this tax, which is imposed by Section 102 of the Revenue Acts of both 1934 and 1936, there appears to be a general impression that all corporations with an accumulated surplus are subject to tax under this section, which is not the case unless the surplus is permitted to accumulate beyond the reasonable requirements of the business for the purpose of preventing the imposition of a tax upon the shareholders.

I wish to call particular attention to one of the new features of the 1936 Act, Section 23 (Q), which provides that corporations, under certain circumstances, may deduct contributions, in an amount which does not exceed 5% of the taxpayer's net income computed without the benefit of said Section.