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## Corporate Managers, Agency Costs, and the Rise of Double Taxation

Steven A. Bank

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# CORPORATE MANAGERS, AGENCY COSTS, AND THE RISE OF DOUBLE TAXATION

STEVEN A. BANK\*

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\* Visiting Professor, UCLA School of Law (2002-2003); Associate Professor, Florida State University College of Law. B.A. 1991, University of Pennsylvania; J.D. 1994, University of Chicago. Thanks to Barbara Banoff, Joseph Dodge, Christopher Hanna, Carolyn Jones, Peter Oh, and Daniel Schneider for their comments and suggestions. Previous versions of this paper were presented at the 2001 Annual Meeting of the Central States Law School Association at Michigan State University-Detroit College of Law and at a Florida State University College of Law Faculty Colloquium. Thanks to participants for all of their comments. Thanks also to Paul Berk (Ph.D. candidate, FSU History Department) and Michael Barry (J.D. 2001) for their research assistance and to the archivists at the Hoover Institution Library and Archives at Stanford University and the Center for American History at the University of Texas for their hospitality and help in locating documents. This project benefitted from a summer research grant from Florida State University College of Law.

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## INTRODUCTION

Corporate income is currently taxed twice—first to the corporation when earned and a second time to the shareholder when distributed as dividends.<sup>1</sup> This “double taxation” is a much reviled, but stubbornly persistent feature of our current system.<sup>2</sup> Few, if any, commentators suggest that we would consciously adopt it if we were working from a blank slate,<sup>3</sup> and most openly recommend double taxation’s demise.<sup>4</sup> Even the nineteenth-century movement to personify the corporation as a separate entity, which is often considered the foundation for the separate corporate income tax and, by implication, double taxation,<sup>5</sup> was followed by an income tax act carefully crafted to avoid imposing a second layer of tax on

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1. I.R.C. § 11 (2000) (imposing a tax on corporate income); *id.* §§ 301, 316 (imposing a shareholder-level tax on distributions in the form of dividends). This is sometimes referred to as the “classical” system because it still treats the corporation and shareholder as separate taxpayers rather than integrating the corporate and shareholder-level taxes. See Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 TAX NOTES 1767, 1768 (1999). As Graetz and Warren point out, the classical system does not always result in double taxation. For example, corporate income is not taxed twice when a shareholder is exempt from tax or when corporate income is paid out as deductible interest payments. In fact, it is not even taxed once when it is paid out as deductible interest to a foreign or other tax-exempt holder of corporate debt. *Id.* at 1768.

2. See, e.g., CHARLES E. McLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? 2-3 (1979); Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719, 720 (1981).

3. For one of the few defenses of double taxation, see Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613 (1990) (arguing that double taxation protects the progressivity of the income tax).

4. See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT – INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES – REPORTER’S STUDY OF CORPORATE TAX INTEGRATION (1993); U.S. DEPT OF TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992); Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Sharerholder Integration Proposal*, 50 TAX L. REV. 265 (1995); John K. McNulty, *Corporate Income Tax Reform in the United States: Proposals for Integration of the Corporate and Individual Income Taxes, and International Aspects*, 12 INT’L TAX & BUS. L. 161 (1994); George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431 (1992).

5. See, e.g., AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, TAXATION OF PRIVATE BUSINESS ENTERPRISES: REPORTER’S STUDY 35-36 (1999); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 136 (1990); cf. RICHARD GOODE, *THE CORPORATION INCOME TAX* 24-25 (1951) (“In the legal sense, of course, the corporate and individual income taxes do not result in double taxation. The corporation and its stockholders are different legal persons and have separate incomes.”).

corporate income.<sup>6</sup> Not until 1936 was corporate income fully subject to two layers of tax. Double taxation's origins, therefore, have remained a mystery for modern observers.

This Article seeks to resolve this mystery by examining the circumstances leading to the imposition of the full double tax in 1936. Although the corporate-level tax traces its roots to the nineteenth century,<sup>7</sup> and the corporate and shareholder-level taxes have coexisted since the first post-Sixteenth Amendment revenue act was adopted in 1913,<sup>8</sup> double taxation was at least partially or fully alleviated during the early years of the income tax. In the Revenue Act of 1936,<sup>9</sup> however, President Roosevelt introduced a radical plan to combat corporate "hoarding" of earnings by replacing the corporate income tax with an undistributed profits tax and a repeal of the exemption for dividends from the "normal" individual income tax.<sup>10</sup> If distributed as dividends, corporate income would only be subject to the individual income tax.<sup>11</sup> If retained, however, corporate income would be subject to a punitive undistributed profits tax and, upon distribution in later years, the individual income tax as well.<sup>12</sup> Managers bitterly fought the proposal, claiming that its coercive undistributed profits tax constituted a dangerous and unwarranted governmental interference with the operation of their businesses.<sup>13</sup> As part of an ill-fated compromise, Congress retained the corporate income tax, along with a more

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6. See Tariff Act of 1894, ch. 349, § 28, 28 Stat. 509, 554. For a more complete description of the circumstances giving rise to the adoption of the first separate corporate income tax, and a refutation of the traditional view that the separate corporate income tax arose because of developments in entity theory, see Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 462 (2001).

7. See Bank, *supra* note 6, at 462.

8. Tariff Act of 1913, ch. 16, 38 Stat. 114.

9. Revenue Act of 1936, Pub. L. No. 74-740, 49 Stat. 1648.

10. At the time, all individual income was subject to a "normal," or base flat rate tax. When income reached a certain point, an additional surtax was applied at progressive rates. Dividends were exempt from the normal tax, but not the surtax rates. See *infra* text accompanying notes 58-73.

11. See Revenue Act of 1936, Pub. L. No. 74-740, 49 Stat. 1648.

12. See *id.*

13. Corporations had been subject to an accumulated earnings tax since the first post-Sixteenth Amendment income tax in 1913, but it only applied in the event that a corporation retained income with the purpose of evading the high surtax rates. This intent requirement was difficult to prove. Under Roosevelt's proposal, by contrast, the undistributed profits tax applied regardless of the purpose for the retention. See *infra* text accompanying notes 170-71.

modest undistributed profits tax, but no effort was made to restore the dividend exemption.<sup>14</sup> Thus, for the first time corporate earnings were fully subject to both the corporate and individual income taxes. This tax on dividends survived the repeal of the undistributed profits tax a few years later.<sup>15</sup>

As several modern commentators have noted,<sup>16</sup> managers' vigorous opposition to the undistributed profits tax partly reflected the problem of agency costs, or the costs flowing from the delegation of authority to an agent—the manager—who is imbued with self-interest.<sup>17</sup> In this imperfect agency relationship, shareholders must monitor manager behavior to guard against projects that will result in an increase in manager compensation and prestige without a corresponding benefit to shareholders.<sup>18</sup> In large, publicly-traded corporations, however, existing shareholders tend to be much less vigilant than lenders and potential investors in this task.<sup>19</sup> Recognizing this, managers often seek to avoid the capital markets by financing their new ventures through "free cash flow," or internal cash flow in excess of that needed to fund existing operations and projects.<sup>20</sup> During the New Deal, various legal and extra-legal norms

14. § 25, 49 Stat. at 1661-62.

15. See *infra* Part II.C.4.

16. See, e.g., William G. Christie & Vikram Nanda, *Free Cash Flow, Shareholder Value, and the Undistributed Profits Tax of 1936 and 1937*, 49 J. FIN. 1727, 1728 (1994); Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1496-99 (1991). But see CHARLES W. CALOMIRIS & R. GLENN HUBBARD, INTERNAL FINANCE AND INVESTMENT: EVIDENCE FROM THE UNDISTRIBUTED PROFITS TAX OF 1936-1937, at 12-13 (Nat'l Bureau of Econ. Research, Working Paper No. 4288, 1993) (concluding that the difference in costs of external financing reflected capital market problems rather than the excesses of entrenched managers).

17. For a general discussion of the agency cost problem in the economics and finance literature, see Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

18. See Kevin J. Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis*, 7 J. ACCT. & ECON. 11, 11-12 (1985); James R. Repetti, *The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 698-99 (1997).

19. See Easterbrook, *supra* note 17, at 654 ("New investors are better than old ones at chiseling down agency costs.").

20. See Christie & Nanda, *supra* note 16, at 1728-29 (finding that firm value increased

of corporate behavior supported this form of financing both by affording managers virtually unlimited discretion on the decision to issue dividends and by considering the retention of between 30 and 50% of corporate profits to be good business practice.<sup>21</sup> The undistributed profits tax, by penalizing the retention of earnings, posed a substantial threat to managers' ability to rely on internal financing.<sup>22</sup>

This Article concludes that the threat posed to managers by the undistributed profits tax led to the retention of the corporate income tax and the repeal of the dividend exemption. Far from being a typical New Deal assault on big business or an inadvertent by-product of the compromise over Roosevelt's original proposal,<sup>23</sup> double taxation was a pro-manager measure adopted to blunt the force of the undistributed profits tax. Business leaders and their allies in Congress hoped that the repeal of the dividend exemption and the resulting imposition of double taxation would aid in aligning management-shareholder attitudes toward the retention of corporate earnings. Shareholders were willing to allow corporate managers to retain earnings so long as the high surtax rates on distributed income exceeded the corporate-level tax on retained income. At high rates, however, the undistributed profits tax would reverse shareholder incentives and cause shareholders to demand distributions. Opponents sought to counter such incentives by subjecting dividends to a tax rate equal to or higher than that on undistributed profits. These critics believed this would circumvent the pro-distribution policy of the undistributed profits tax and leave managers free to retain earnings for alternative uses. Double taxation thus became a tool in the campaign against the undistributed profits tax.

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after the announcement of the undistributed profits tax where the potential to abuse free cash flow was the greatest); Jensen, *supra* note 17, at 323 (defining "free cash flow").

21. See *infra* text accompanying notes 91-95.

22. See Roe, *supra* note 16, at 1496-97 (suggesting that manager dissatisfaction with the undistributed profits tax was due to the threat it posed to managers' ability to use retained earnings).

23. See Kwall, *supra* note 3, at 619-20 (suggesting that double taxation was the inadvertent result of the Senate's decision to retain the corporate income tax to go along with the undistributed profits tax proposal); Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1097-98 (2000) (same).

Double taxation's political origins demonstrate that the disincentive to distribute corporate earnings as dividends is not merely a by-product of the tax on dividends, but was indeed the underlying impetus for the provision. While others have attributed the persistence of double taxation to the problem of agency costs,<sup>24</sup> this Article is the first to suggest that double taxation actually arose as a political resolution to the problem of divergent manager/shareholder views toward dividend payout policies. Part I briefly describes the origins of the separate corporate income tax and its development immediately after the ratification of the Sixteenth Amendment. The absence of double taxation, or of any conscious attempt to design a system of double taxation, during this period is particularly emphasized. Part II outlines the economic and legal circumstances leading to Roosevelt's call for an undistributed profits tax. Part III explores the concerted campaigns by corporate management in 1936 and 1938 to defeat Roosevelt's proposal and, when this proved too difficult, to minimize its disruptive force through the use of the dividend tax. Part IV concludes by exploring the possible reasons why double taxation continued beyond the expiration of the undistributed profits tax.

## I. THE ORIGINS OF A SEPARATE CORPORATE INCOME TAX

### A. Civil War and Reconstruction

During this country's earliest experience with an income tax,<sup>25</sup> corporations were not directly taxed on account of their corporate

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24. See, e.g., Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 336 (1995); John K. McNulty, *Reform of the Individual Income Tax by Integration of the Corporate Income Tax*, 46 TAX NOTES 1445, 1446 (1990); James R. Repetti, *Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis*, 67 NOTRE DAME L. REV. 971, 1034-35 (1992); Repetti, *supra* note 18, at 716; Herwig J. Schlunk, *The Zen of Corporate Capital Structure Neutrality*, 99 MICH. L. REV. 410, 411 n.8 (2000); Lee A. Sheppard, *Corporate Tax Integration, The Proper Way to Eliminate the Corporate Tax*, 27 TAX NOTES 637, 638-39 (1985); Alvin C. Warren, Jr., *Three Versions of Tax Reform*, 39 WM. & MARY L. REV. 157, 173 (1997).

25. Although there was some antebellum experimentation with income-like taxes at the state and local level, a federal income tax was first employed in 1861 at the onset of the Civil War and remained a source of revenue until it was allowed to expire in 1872 at the end of Reconstruction. See Steven A. Bank, *Origins of a Flat Tax*, 73 DENV. U. L. REV. 329, 340-60 (1996).



status. Nevertheless, the seeds of a corporate income tax were planted during the Civil War and Reconstruction.<sup>26</sup> Individuals, in these early revenue acts, were taxed on the dividends received from corporations as well as the undistributed profits of corporations or partnerships in which an individual held an ownership interest.<sup>27</sup> When shareholders mounted a judicial challenge to the attempt to tax them on the undivided profits of a corporation, the Court upheld this conduit form of income taxation in *Collector v. Hubbard*.<sup>28</sup>

The focus on individual income does not mean that corporations were not subject to taxation under the new revenue measure. The 1864 Act taxed businesses in certain specified industries such as transportation, insurance, and banking on dividends or interest paid, and "undistributed sums, or sums made or added during the year to their surplus or contingent funds."<sup>29</sup> These taxes were technically based on the type of business, rather than the form of organization, but it was no accident that the corporate form of doing business dominated the selected industries.<sup>30</sup> The measure appeared to parallel efforts at the state and local levels to prevent erosion

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26. This section is but a brief description of the origins of a separate tax on corporations. For a more complete discussion of the early development of corporate income taxation, see Bank, *supra* note 6.

27. See Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 282 ("[T]he gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise.").

28. 79 U.S. (12 Wall.) 1 (1870).

29. §§ 120-22, 13 Stat. at 283-85. The taxes on dividends and interest paid were generally regarded as withholding taxes. See Joseph A. Hill, *The Civil War Income Tax*, Q. J. ECON. 416, 427 (1894). However, the tax on undistributed sums or sums added to surplus was effectively an entity-level tax on corporate earnings.

30. See JOHN W. CADMAN, JR., *THE CORPORATION IN NEW JERSEY: BUSINESS AND POLITICS 1791-1875*, at 389 (1945). According to Cadman:

[T]here were certain types of business corporations that were singled out during the first half of the nineteenth century for special treatment in the matter of taxation. The principal representatives of the groups to which special rules of taxation were applied were commercial banks, insurance companies, canal and railroad corporations, and a few early telegraph companies.

*Id.*; see also FRANK I. HERRIOTT, *AN INTRODUCTION TO THE HISTORY OF CORPORATION TAXES IN IOWA* 4a (1902) ("One class of corporations would receive attention and then another. One method of assessment would be taken with one class and another basis with another class."); JAMES WILLARD HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970*, at 17 (1970).

of the property tax base by targeting industries with a high concentration of corporations.<sup>31</sup>

Although these two taxes—the individual dividends/undivided profits tax and the industry-specific dividends/undistributed profits tax—overlapped considerably, Congress did not intend to use them to impose a double tax burden. As one Representative said on a related provision, “I do not think that the Government should derive double taxation from the same property for the same period of time. That is a proposition, the correctness of which I think every member will concede.”<sup>32</sup> To avoid this result with respect to business earnings, taxable businesses were permitted to deduct amounts previously taxed, such as undistributed sums, from the tax due on the payment of a dividend; investors were permitted to exclude dividends and interest received from taxable businesses.<sup>33</sup> This only achieved partial integration at best, however, because the business dividends tax was imposed at a flat rate while the individual income tax was imposed at graduated rates that sometimes exceeded the flat rate.<sup>34</sup> Nevertheless, this omission is more likely the result of

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31. See FREDERIC C. HOWE, *TAXATION AND TAXES IN THE UNITED STATES UNDER THE INTERNAL REVENUE SYSTEM 1791-1895*, at 103 (1896) (noting that the Civil War “legislation but followed the approved practices of the States in selecting such a method of reaching this form of property”); see also EDWIN R.A. SELIGMAN, *ESSAYS IN TAXATION* 143 (1895) [hereinafter SELIGMAN, *ESSAYS IN TAXATION*] (noting the development at the state level to combat the erosion of the property tax). The property tax’s decline in effectiveness was primarily attributed to the expansive operations, widely dispersed stock ownership, and vast intangible wealth associated with certain classes of corporations. See Henry C. Adams, *Suggestions for a System of Taxation*, *PUBLICATIONS OF THE MICH. POL. SCI. ASS’N* 65 (1894) (“The inadequacy, under existing economic conditions, of the general property tax, so called, and its utter failure, even under the most rigorous and effective administrative methods that have been devised, to reach for taxation property of a corporate and intangible character are recognized in all the States [studied].”); Edwin R.A. Seligman, *The Taxation of Corporations I*, 5 *POL. SCI. Q.* 269, 269 (1890) [hereinafter Seligman, *The Taxation of Corporations I*] (“In all ages and in all countries it has been found almost impossible to reach intangible personalty. What has always been a difficult task has become immensely complicated to-day through the growth of the corporation.”).

32. CONG. GLOBE, 37th Cong., 2d Sess. 1534 (1862) (statement of Rep. Edwards) (offering an amendment to a proposed inheritance tax that would relieve all property taxed during life from taxation at death).

33. §§ 117, 121, 13 Stat. 223, at 281, 284.

34. As originally introduced by the House Ways and Means Committee, the income tax portion of the 1864 Act proposed a flat 5% tax on all income, including dividends and interest. Graduated rates were later added to the individual income tax sections during the debates in Congress, but no similar change was made to the taxation of the specified businesses on

administrative difficulties than a decision to subject business income to double taxation.<sup>35</sup>

### *B. State Law Developments in the Taxation of Corporations*

The federal experiment with income taxation was allowed to expire at the end of Radical Reconstruction, but states continued to focus on the corporation in their effort to raise revenues. The industry-specific method of targeting corporations broke down, however, as corporations became the predominant form of doing business in nearly every industry.<sup>36</sup> Thus, states increasingly shifted their focus from taxing industries to taxing corporations.<sup>37</sup> Industry-specific taxes were not eliminated; instead, they were supplemented with a general system of corporate taxation intended to more fairly allocate the burden of taxation among the corporations.<sup>38</sup> The

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their dividends and interest. See EDWIN R.A. SELIGMAN, *THE INCOME TAX* 440-41 (1911) [hereinafter SELIGMAN, *THE INCOME TAX*].

35. *Id.* at 444 ("The graduated principle of the income tax could, however, obviously not be applied to the dividends and interest tax, and it was for this reason that the proportional rate of five per cent was imposed."); HAROLD Q. LANGENDERFER, 2 *THE FEDERAL INCOME TAX*, 1861-1872, at 475 (1980). Discussing the same provision under the 1865 Act, Langenderfer concluded:

Dividends, salaries, and interest were subject to a straight five per cent withholding tax on all amounts above \$600. In other words, the progressive feature did not apply to these sources of income even though Congress had had several years experience with the tax. The apparent reason seems to have been the problem of administration.

*Id.*

36. See Adams, *supra* note 31, at 65 (statement of Mr. Cutcheon as part of the discussion after delivery of Adams' main paper).

37. As noted by one historian:

By 1903 ... seventeen of the twenty states of the iron rectangle reached the capital stock of corporations under provisions of the general property tax as *specialy* administered for certain classes of corporations. Under special definitions of personal property, moreover, eight of the twenty states, including New York, Michigan, Indiana, and Illinois, levied taxation on corporate franchises. But the most impressive shift away from the policies of the preceding generation could be traced in the fact that seventeen states of the Northern tier had inaugurated extensive systems of distinct corporate taxation, some general, some special.

C.K. YEARLEY, *THE MONEY MACHINES: THE BREAKDOWN AND REFORM OF GOVERNMENTAL AND PARTY FINANCE IN THE NORTH, 1860-1920*, at 207 (1970).

38. In 1869, for example, New Jersey's Governor used his inaugural address to call for the adoption of a tax "based on the 'profits or dividends' of all the corporations chartered" by the

corporate tax became not merely a Band-Aid to cover the gaps in the traditional property tax's reach, but a separate form of taxation altogether.

Paralleling the advent of the general corporation tax was a growing recognition of the failings of property-based systems of corporation taxation, such as the capital stock tax. The problem was that a corporation's capital stock was not reliably correlated with its ability to pay. Where the tax was based on the amount of capital stock outstanding at the time of incorporation, corporations easily could reduce their burden by deliberately establishing a low capitalization.<sup>39</sup> Moreover, capital stock only measured equity, rather than debt, contributions to the corporation. As Edwin Seligman pointed out, "heavily bonded corporations, would ... entirely escape taxation; because in such cases—and they are the great majority—the capital stock alone would not represent the value of the property."<sup>40</sup> Because of such problems, in effect, the corporate income tax arose at the state level as a substitute for an individual property tax on corporate investments.<sup>41</sup> States increasingly resorted to corporation taxes based upon earnings, the

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state. CADMAN, *supra* note 30, at 409-10. According to the Governor, only a few corporations, and some of them neither rich nor profitable, contributed all of the expenses of the state. See Editorial, *Taxes on Corporations*, NEWARK DAILY ADVERTISER, Feb. 18, 1870, at 1. The New Jersey corporate tax was designed "to include all, or at least many more corporations in the operation of the law, thus increasing the sources of revenue and equalizing the burdens." *Id.* New Jersey's general corporate tax subsequently died for lack of enforcement, but it was revived in the 1880s at about the time that other states, such as New York and Iowa, were adopting or considering the adoption of similar general corporate taxes. CADMAN, *supra* note 30, at 414-16; HERRIOTT, *supra* note 30, at 24; Seligman, *The Taxation of Corporations I*, *supra* note 31, at 301-02.

39. In one typical example, an Indiana railroad whose stock was worth at least \$3 million set its capital stock at a mere \$50,000 because state law imposed a tax based on a percentage of the capital stock at the time of incorporation. See JACOB P. DUNN, *THE NEW TAX LAW OF INDIANA AND THE SCIENCE OF TAXATION* 51 (1892). As a local commentator noted in discussing the situation, "The law as framed admits of evasions ... but how can such a result be avoided under the law? You can not compel a corporation to have a certain amount of capital stock." *Id.*

40. SELIGMAN, *ESSAYS IN TAXATION*, *supra* note 31, at 193.

41. As one contemporary commentator explained, since it is "impossible to secure payment from [stocks, bonds, shares, and other forms of personal property] by tracing it to individual proprietors, the tax is levied upon the corporation, which from its nature must have a legal situs and maintain a current record of its property and earnings." Adams, *supra* note 31, at 441-42.

amount of business transacted, dividends, and profits or income.<sup>42</sup> The trend was away from the taxation of corporate property and toward the taxation of corporate income.

### *C. Federal Adoption of a Separate Corporate Income Tax*

The increasing state reliance on general, rather than industry-based, corporate income taxes during the latter half of the nineteenth century served as a model for Congress when it once again enacted an income tax in 1894.<sup>43</sup> Under the income tax provisions passed by the House, a 2% tax was first imposed on the "dividends" and "undistributed sums, or sums made or added during the year to [the] surplus or contingent funds" of certain banks and insurance companies.<sup>44</sup> This essentially mirrored the measure enacted in 1864 except that it followed Pennsylvania's innovation in extending this tax to cover all corporations or limited liability business enterprises.<sup>45</sup> Much like its Civil War predecessor, however, the measure was essentially a withholding tax with an undistributed profits tax designed to protect against schemes to avoid the dividends tax.<sup>46</sup>

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42. SELIGMAN, *THE INCOME TAX*, *supra* note 34, at 452.

43. Tariff Act of 1894, ch. 349, 28 Stat. 509.

44. Section 59 of the House Bill provided, in relevant part:

That there shall be levied and collected a tax of 2 per cent on all dividends in scrip or money thereafter declared due, wherever and whenever the same be declared payable to stockholders, policy holders, or depositors or parties whatsoever, including nonresidents, whether citizens or aliens, as part of the earnings, income, or gains of any bank, trust company, savings institution, and of any fire, marine, life, inland insurance company, either stock or mutual, under whatever name or style known or called in the United States or Territories, whether specially incorporated or existing under general laws, and on all undistributed sums, or sums made or added during the year to their surplus or contingent funds ....

26 CONG. REC. 6831 (1894).

45. *Id.*; *id.* at 6866 (statement of Sen. Vest) (explaining that the House bill "adopted the system as to its details which was in the old law of 1864 and which is found in the law of Pennsylvania to-day"). Pennsylvania's law was the first to impose a tax on corporations rather than industries and was the basis for later general corporation taxes such as the one enacted in New York in 1880. See Seligman, *The Taxation of Corporations I*, *supra* note 31, at 166 (discussing Pennsylvania's adoption of a general corporate tax in 1840, which provided that "banks and all corporations whatever" shall be subject to the tax); *id.* at 170 (describing New York's general corporation tax and noting that it "was based on the Pennsylvania act").

46. See Bank, *supra* note 6.

In the Senate, the corporate tax provision appeared to be dramatically changed, but this change was considered more form than substance. Rather than imposing a tax on dividends and undistributed profits, the Senate Finance Committee's version of the bill, which eventually prevailed in the final act, imposed a tax directly on the net income of corporations.<sup>47</sup> Under Section 32 of the 1894 Act, a 2% tax was imposed on all "corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, but not including partnerships."<sup>48</sup> Senator George Vest, the person responsible for the new language, explained:

Instead of making the corporation a collector simply for the Government, we have endeavored to simplify the bill and, in my judgment we have strengthened it, by putting the tax directly upon the corporation and then allowing the corporation to adjust its relations with its own stockholders as it sees proper.<sup>49</sup>

The intent was to combine the separate dividend and undistributed profits tax provisions into one step.<sup>50</sup> Since late nineteenth century corporations commonly distributed virtually all their profits to the stockholders as dividends,<sup>51</sup> it was reasonable to view the corporate

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47. See 26 CONG. REC. 6866 (1894).

48. § 32, 28 Stat. at 556. In full, the statute provided as follows:

That there shall be assessed, levied, and collected, except as herein otherwise provided, a tax of two per centum annually on the net profits or income above actual operating and business expenses, including expenses for materials purchased for manufacture or bought for resale, losses, and interest on bonded and other indebtedness of all banks, banking institutions, trust companies, savings institutions, fire, marine, life, and other insurance companies, railroad, canal, turnpike, canal navigation, slack water, telephone, telegraph, express, electric light, gas, water, street railway companies, and all other corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, but not including partnerships.

*Id.*

49. 26 CONG. REC. 6866 (1894) (statement of Sen. Vest).

50. *Id.* at 6880 (statement of Sen. Chandler) (claiming that Senator Vest "seems to have thought that he could roll all those sections into one" by imposing an income tax).

51. See *id.* at 6869 (statement of Sen. Allison). According to Senator Allison:

[The tax on the undistributed profits] will be an infinitesimal amount as respects all the great corporations and the little corporations of our country, because there is nothing carried to the surplus account except in the case of national banks, where they are obliged to carry a certain portion of their

income tax as the equivalent of a withholding tax, or a tax in lieu of the regular tax on shareholders.

Consistent with this withholding tax notion, Congress was careful to structure the corporate income tax to avoid double taxation. Section 28 of the Act excluded from income dividends received from entities already taxed under the Act.<sup>52</sup> As under the 1864 Act, however, this was only a partial solution because the entity-level tax could not be avoided by reason of the individual-level \$4,000 exemption.<sup>53</sup> Thus, for shareholders with incomes below the exemption level, the tax on corporate income imposed an indirect tax where none should have been imposed at all. Nevertheless, the intent was to avoid double taxation.<sup>54</sup>

Although the Court subsequently struck down the 1894 Act's income tax provisions as unconstitutional,<sup>55</sup> the corporate income tax continued to be used as a shareholder proxy tax when Congress adopted a federal excise tax on corporations that was measured by income in 1909.<sup>56</sup> The 1909 Act was never a threat to impose double taxation because, unlike under the 1894 Act, the corporate tax was not accompanied by an individual income tax. As President Taft admitted, the corporate excise tax was a second-best alternative or substitute for the individual income tax barred by the Court's decision on the 1894 Act.<sup>57</sup> Supporters of this proposal emphasized

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earnings to surplus from year to year and perhaps other banks and insurance companies. But as to the great body of the corporations of our country they make dividends covering practically [all] their earnings each year.

*Id.*

52. § 28, 28 Stat. at 554.

53. *Id.* at 553.

54. See 26 CONG. REC. 6876 (1894) (recording the exchange between Sen. Dolph and Sen. Hill in which Sen. Hill points out that the structure is designed to avoid double taxation to the maximum extent possible).

55. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 572 (1895).

56. Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 11, 12.

57. 44 CONG. REC. 3344 (1909) (message from President Taft). He also spoke of "another merit" of the excise tax—"the federal supervision which must be exercised in order to make the law effective over the annual accounts and business transactions of all corporations." *Id.* Indeed, Taft suggested that such a tax was "an excise tax upon the privilege of doing business as an artificial entity and of freedom from a general partnership liability enjoyed by those who own the stock." *Id.* This, however, was merely an attempt to conform to the Court's statements regarding the ability to use an excise tax on the privilege of doing business in lieu of an income tax. See *Spreckels Sugar Ref. Co. v. McClain*, 192 U.S. 397, 413 (1904) (upholding a tax on the gross receipts of sugar refiners as a constitutional excise tax); *Pollock*, 158 U.S. at 635-37 (noting that its decision striking down the 1894 income tax as

its ability "to reach the great accumulated wealth of the country, or its earnings, engaged in corporate enterprise."<sup>58</sup>

Upon ratification of the Sixteenth Amendment,<sup>59</sup> a corporate income tax again was adopted in conjunction with the individual income tax imposed under the Revenue Act of 1913.<sup>60</sup> Congress minimized the risk of double taxation by excluding dividends from the normal individual income tax.<sup>61</sup> Originally, this exclusion avoided double taxation automatically because, under the 1913 Act, the corporate income tax rate was explicitly tied to the individual normal rate.<sup>62</sup> This link between the corporate and normal taxes was severed in the 1916 Act, so that separate provisions determined the rates of each, but the result was the same because the rates were both set at 2%.<sup>63</sup>

During World War I, the corporate and normal individual tax rates began to diverge. Under the War Revenue Act of 1917,<sup>64</sup> the second revenue measure enacted that year,<sup>65</sup> an additional 2% tax was added to the corporate income tax rate, but not to the individual normal tax rate.<sup>66</sup> According to Senate Finance Committee Chair F.M. Simmons, the corporate rate was increased both to raise

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unconstitutional did not mean that an excise tax on the privilege of doing business would be unconstitutional).

58. 44 CONG. REC. 3756 (1909) (statement of Sen. Newlands).

59. U.S. CONST. amend. XVI.

60. Tariff Act of 1913, ch. 16, 38 Stat. 114, 166-81.

61. *Id.* § II(B), 38 Stat. at 167-68.

62. From 1913 through 1915, both the maximum corporate income tax rate and the individual normal tax rate were 1%. *Id.* §§ II(B), (G), 38 Stat. at 166, 172. Rather than imposing a corporate income tax rate equivalent to the normal rate, the corporate provision specifically provided that the normal tax levied to individuals would also be levied to corporate income. *See id.* § II(G) ("[T]he normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income [of] ... every corporation[s]."). Corporate income was thus subject to both the corporate income tax rate and the individual surtax rate, if applicable, but not to the individual normal tax rate, while noncorporate business income was subject to the individual normal tax rate and the surtax rate, if applicable, but not the corporate income tax rate. Since the corporate rate and the normal rate were identical, both individual and corporate income were subject to a 1% tax plus any applicable surtax.

63. Revenue Act of 1916, §§ 1, 10, 39 Stat. at 756-57, 765-66 (1916).

64. War Revenue Act of 1917, 40 Stat. 300 (enacted Oct. 3, 1917).

65. The Revenue Act of 1917, enacted exactly seven months earlier on March 3, 1917, imposed the first excess profits tax on corporate and partnership income. *See* SIDNEY RATNER, *TAXATION AND DEMOCRACY IN AMERICA* 364 (photo. reprint 1980) (1967).

66. §§ 1, 4, 40 Stat. at 300-02.



revenue and to minimize the use of the corporation as a device to avoid the individual surtax rates.<sup>67</sup> The additional tax was called a "corporation surtax" because it would be difficult, if not unconstitutional, to tax corporate stockholders on the undistributed profits of a corporation, but it would also be inequitable to permit this "discrimination against partnerships and individuals in favor of corporations in respect to surtaxes on incomes" to continue.<sup>68</sup> Effectively, the higher corporate rate operated like an undistributed profits tax because it penalized attempts to use the corporation as a method of sheltering income from the high surtax rates on individual income.

Some believed this divergence further pushed the corporate income tax away from its original focus on shareholder wealth.<sup>69</sup> As Fred Taussig observed, because of the divergence "[t]he [corporate income] tax comes even more to be regarded not as one that serves to reach shareholders' income, but one that is to be assimilated to other taxes, to be shifted to the general public, and to leave the shareholder's income undiminished."<sup>70</sup> Notwithstanding this apparent theoretical shift, the Revenue Act of 1918 temporarily halted this trend by resetting the corporate and individual normal rates to their former identity, albeit at the higher rate of 12%.<sup>71</sup> The precedent was set, however, and subsequent revenue acts raised the corporate income tax rate without making corresponding increases in the individual normal rate.<sup>72</sup>

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67. See 55 CONG. REC. 5966 (1917) (statement of Sen. F.M. Simmons).

68. *Id.*

69. See, e.g., Roy G. Blakey, *The War Revenue Act of 1917*, 7 AM. ECON. REV. 791, 808-09 (1917); F.W. Taussig, *The War Tax Act of 1917*, Q. J. ECON. 1, 20 (1917).

70. Taussig, *supra* note 69, at 20.

71. See Revenue Act of 1918, §§ 210, 230, 40 Stat. 1057, 1062, 1075-76.

72. See, e.g., Revenue Act of 1921, §§ 210, 230, 42 Stat. 227, 233, 252 (imposing a normal tax of 8% and a maximum corporate income tax of 10%); Revenue Act of 1924, §§ 210, 230, 43 Stat. 253, 264, 282 (imposing a normal tax of 6% and a maximum corporate income tax of 12.5%); Revenue Act of 1926, §§ 210, 230, 44 Stat. 9, 21, 39 (imposing a normal tax of 5% and a maximum corporate income tax of 13% in 1925 and 13.5% starting in 1926); Revenue Act of 1928, §§ 11, 13, 45 Stat. 795, 797 (imposing a normal tax of 5% and a maximum corporate income tax of 12%); Joint Resolution Reducing Rates of Income Tax for 1929, 46 Stat. 47 (reducing, only for 1929, the normal tax to 4% and the corporate income tax to 11%); Revenue Act of 1932, §§ 11, 13, 47 Stat. 174, 177 (imposing a normal tax of 8% and a maximum corporate income tax of 13.75%); Revenue Act of 1934, §§ 11, 13, 48 Stat. 684, 686 (imposing a normal tax of 4% and a maximum corporate income tax of 13.75%); Revenue Act of 1935, § 102, 49 Stat. 1015 (raising the maximum corporate income tax to 15%).

Despite this divergence between the base corporate and individual income taxes, Congress maintained the exemption from the normal individual tax for dividends and the corporate income tax continued to be regarded, at least nominally, as a withholding tax.<sup>73</sup> This partial integration approach reduced the tax on corporate income to something less than the full corporate rate, although it still left corporate income subject to a higher pre-surtax rate burden than noncorporate income.<sup>74</sup> Thus, shareholders received some relief from the double taxation of corporate income and Congress at least paid homage to the original shareholder focus of the corporate income tax. It was not until 1936 that Congress deviated from this approach by repealing the exemption from the normal tax for dividends and thus, for the first time, subjecting corporate income to full double taxation. This change in the tax treatment of corporate income can be traced to the revival of an undistributed profits tax.

## II. THE ADOPTION OF AN UNDISTRIBUTED PROFITS TAX

### A. Campaign of 1932

Throughout the 1930s, commentators were consumed with the search for possible causes of the Depression and for methods of stabilizing the economy.<sup>75</sup> This was especially true as the Democratic candidate, Franklin Delano Roosevelt, prepared for the

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73. See COMMITTEE ON TAXATION OF THE TWENTIETH CENTURY FUND, STUDIES IN CURRENT TAX PROBLEMS 55 (1937) ("Until 1936 the federal government exempted dividends from the normal personal tax if they came from a corporation that was subject to the corporation net income tax. Obviously, the corporation income tax was to be regarded, at least in part, as a normal tax collected at the source.").

74. In both cases, the income was subject to a base tax and, if applicable, a graduated surtax, but this in itself was not double taxation. The surtax made the system more progressive and was thus really just a selective increase in rates.

75. See, e.g., LEONARD P. AYRES, *THE ECONOMICS OF RECOVERY* (1934); ELEANOR LANSING DULLES, *DEPRESSION AND RECONSTRUCTION: A STUDY OF CAUSES AND CONTROLS* (1936); PAUL EINZIG, *THE WORLD ECONOMIC CRISIS, 1929-1931* (1931); William W. Cumberland, *Factors Operating Toward Recovery from Depression*, 5 J. BUS. U. CHI. 114 (1932); Marriner S. Eccles, *Controlling Booms and Depressions*, in *ECONOMIC BALANCE AND A BALANCED BUDGET* 69 (Rudolph L. Weissman ed., 1940); R.T. Ely, *Real Estate in the Business Cycle*, 22 AM. ECON. REV. 137, 138 (1932).

1932 campaign for the presidency.<sup>76</sup> Although Roosevelt himself refused to either engage in a serious debate about the cause of the Depression or to provide many specific suggestions for economic recovery,<sup>77</sup> his small circle of policy advisers—later dubbed the “Brain Trust”—were hard at work on these issues.<sup>78</sup> Composed primarily of academics such as Raymond Moley, Rexford Tugwell, and Adolf Berle,<sup>79</sup> the Brain Trust outlined what became the foundation for the New Deal in a May 19, 1932 memorandum to then-Governor Roosevelt.<sup>80</sup>

While the May 19 memorandum identified many culprits for the Depression, one in particular eventually assumed great importance in the Revenue Act of 1936. In a section authored by Berle entitled “Corporate Surpluses,”<sup>81</sup> the memorandum assigned much of the blame for the stock market crash and subsequent Depression on the unreasonable accumulation of corporate profits. According to the memorandum, the prosperity of the twenties led to “a greater accumulation of surpluses than were ever before realized in economic history.”<sup>82</sup> Rather than distributing such excess profits to stockholders, “corporate administrators have assumed that they

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76. See William Starr Myers, *Looking Toward 1932*, 25 AM. POL. SCI. REV. 925, 930 (1931) (“Both parties will strive to place stress on economic questions. A serviceable and constructive plan for the stabilization of business and the mitigation or prevention of future unemployment would be a great asset to either party.”).

77. PAUL K. CONKIN, *THE NEW DEAL* 22 (2d ed. 1975).

78. See DANIEL R. FUSFELD, *THE ECONOMIC THOUGHT OF FRANKLIN D. ROOSEVELT AND THE ORIGINS OF THE NEW DEAL* 207 (1956); RAYMOND MOLEY, *AFTER SEVEN YEARS* 21-22 (1939).

79. Moley taught in political science, Tugwell in economics, and Berle in law, all at Columbia University. FUSFELD, *supra* note 78, at 209-10.

80. Memorandum from Raymond Moley and others, to Franklin Delano Roosevelt (May 19, 1932) (in Box 282, Folder 3, Raymond Moley Papers, Hoover Institution Library and Archives, Stanford University) [hereinafter Memorandum of May 19, 1932] (outlining national program for recovery). The May 19 memorandum was written in response to a request by Roosevelt to keep him updated during his pre-campaign vacation trip to Warm Springs. The memorandum provided the opportunity to prepare a series of specific recommendations for various aspects of the economic crisis and was the foundation of many of Roosevelt's campaign speeches and eventually his acceptance speech. See FUSFELD, *supra* note 78, at 219; MOLEY, *supra* note 78, at 21-22. Many, if not most, of the memorandum's recommendations were eventually enacted into law.

81. Although the memorandum was written as a group project under the direction of Moley, the individual authors of each section were identified in a handwritten note accompanying drafts of the memo in Moley's files. See Memorandum of May 19, 1932, *supra* note 80 (accompanying handwritten note regarding authors of individual sections). Berle was identified as the author of the section on corporate surplus. *Id.*

82. Memorandum of May 19, 1932, *supra* note 80, at 1.

were private funds, capable of being withdrawn from personal uses and used to satisfy unrestrained ambitions for expansion."<sup>83</sup> This practice of "corporate hoarding," the memorandum charged, "upset the balance of production and consumption" and contributed both to the stock market crash and the ensuing Depression.<sup>84</sup>

Although subsequent studies have questioned the memorandum's conclusions,<sup>85</sup> many at the time shared the view that the corporate accumulation of profits was a substantial problem.<sup>86</sup>

83. *Id.* at 4.

84. *Id.* at 2-3. The theory was that profits, which might have been distributed to shareholders or paid to employees and made available for consumption, were instead left idle. To combat the overcapacity problem, companies closed plants and prices rose (because the company had to spread the overhead costs over fewer products) while workers went unemployed and shareholders failed to see a return on their investment. Furthermore, managers' investment of liquid surplus in the market enhanced volatility as managers quickly withdrew money and parked it in short-term securities or in savings accounts. *Id.*

85. See SERGEI P. DOBROVOLSKY, *CORPORATE INCOME RETENTION 1915-1943*, at 26 (1951) (arguing that the rate of corporate savings did not increase substantially during the twenties, even though the absolute numbers grew); MAURICE LEVEN ET AL., *AMERICA'S CAPACITY TO CONSUME* 109-12 (1934) (concluding that corporate additions to surplus, while increasing in absolute numbers, did not substantially increase as a percentage of national income); Benjamin M. Anderson, *Eating the Seed Corn*, CHASE ECON. BULL. 3, 23 (May 12, 1936) (claiming that the argument that corporate oversaving caused the depression is an economic "fallacy"). According to John Martin:

While it is true that cash holdings of corporations increased 5.6 billions between 1926 and 1929, we cannot ignore the conclusions of the Brookings Institution that between 1900 and 1930 the unutilized margin of productive capacity in the United States *did not increase* in manufacturing, electric power utilities, agriculture, mining (except for the dislocation of the war), and probably also construction and merchandising.

John B. Martin, *Taxation of Undistributed Corporate Profits*, 35 MICH. L. REV. 44, 55 (1936). Some of the confusion about the extent of the problem may be due to the fact that corporate "savings" or surplus is itself an elusive concept to define. See J. Ellwood Amos, *The Economics of Corporate Saving*, 22 ILL. STUD. SOC. SCI. No. 2, at 12 (1937).

86. See, e.g., Memorandum from George Haas to Roswell Magill (Sept. 1937) (on file with the Office of Tax Analysis/Division of Tax Research; General Records of the Department of Treasury, Record Group 56, Box 63, National Archives, College Park, MD) (regarding Tax Revision Studies, 1937—General Statements, Revenue Estimates, Summaries and Recommendations), available at <http://www.tax.org/thp/civilization/Documents/Surveys/hst23732/23732-2.htm>. Haas noted:

[I]t has been argued by very respectable economic authorities, that among the causes of the depression was the starving of consumption through the withdrawal of too large a proportion of our national income for corporate capital expenditure. It is also held by many that one of the vicious influences contributing to the late stock market boom of the late Twenties was the piling up of liquid corporate resources through excessive retention of corporate earnings. Stock market speculation, which had already been stimulated by the

During a debate over the 1932 Revenue Act, Representative McFadden reported that "[t]hese corporation surpluses of \$60,000,000,000 represent hoarding upon a far greater scale than the comparatively tiny sums which are said to be locked in safe-deposit boxes or in family socks."<sup>87</sup> According to McFadden, this accumulated surplus

is the source of the funds that were designated by the Federal reserve bankers as bootleg money when it was invested in the stock market and in brokers' loans in 1928-29. This was independent money, not under the control of the Federal reserve, and the investment of which impeded the management of the Federal reserve to deal with the orgy of speculation in 1928 and 1929.<sup>88</sup>

Many economists agreed with this logic. Professor Donald Gilbert wrote in 1936:

The process of accumulating current assets therefore is an indirect method of hoarding and, furthermore, a method which is self-destructive for not only is consumption obstructed and a recession in the durable goods industries invited, but stock

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rapid growth in corporate earnings, was further stimulated by the volume of funds representing undistributed earnings that was poured into brokers' loans by corporations.

*Id.*; see also ALFRED G. BUEHLER, *THE UNDISTRIBUTED PROFITS TAX* 16 (1937) ("During the depression there was much criticism of corporate saving, which was popularly held to be an important cause of the depression."); MARK H. LEFF, *THE LIMITS OF SYMBOLIC REFORM: THE NEW DEAL AND TAXATION, 1933-1939*, at 172 (1984) (noting that the concern about excessive corporate surpluses was "pervasive" throughout the 1930s); *A Sound Tax*, 142 *NATION* 337, 337 ("Recent studies have shown that one of the primary causes of the depression is to be found in the tendency toward oversaving on the part of wealthy individuals and corporations."); *The Tax Debacle*, 142 *NATION* 265, 266 (1936) ("The studies of the Brookings Institution have shown that the tendency toward oversaving underlies many of our economic difficulties.").

87. 75 CONG. REC. 6341 (1932) (statement of Rep. McFadden) (quoting from U.S. TREASURY, *STATISTICS OF INCOME*, 25); see also *id.* at 6483 (statement of Rep. Blanton) ("Many corporations have gotten into the habit of refusing to distribute their annual profits, but have been setting aside each year a large proportion of such annual profits as surplus."); DAVID CUSHMAN COYLE, *BRASS TACKS* 22 (1935) ("The large corporations had accumulated surpluses before 1929 which made up a considerable item in the total of the nation's saving.").

88. 75 CONG. REC. 6482 (statement of Rep. McFadden).

values are pyramided to levels which cannot be maintained in the light of reasonable profits prospects.<sup>89</sup>

The result, according to Professor Gilbert, was the onset of the Depression as investors recognized that stock prices were artificially inflated.<sup>90</sup>

Contemporary practices among corporate boards and management bolstered the perception that corporations were hoarding money. One source reported that during the twenties "the notion was rather widespread that sound financial policy required retention in the enterprise of 50 cents out of every dollar of net income."<sup>91</sup> Treasury reports indicated that between 1923 and 1929 corporations reporting net income retained more than 45% of such income rather than distributing it to stockholders.<sup>92</sup> This was considered very high from the perspective of the late thirties, however, when the practice was to retain no more than 30% of net income.<sup>93</sup> Moreover, corporate savings far outpaced other sources of business financing. From 1927 to 1929, for instance, manufacturing corporations retained a total of \$5.6 billion in profits while at the same time raising only \$1.8 billion through issuances of common stock.<sup>94</sup> Even after the onset of the Depression and despite suffering huge operating losses, many large corporations increased their liquid positions rather than relying on debt or equity financing.<sup>95</sup>

Not surprisingly, Roosevelt's advisers blamed corporate management for these large surpluses. Soon before joining the Brain Trust, Berle completed his landmark study with economist Gardiner Means, *The Modern Corporation and Private Property*.<sup>96</sup> The study

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89. Donald W. Gilbert, *Should the Undistributed Profits Tax Be Repealed?*, 14 TAX MAG. 710, 755 (1936).

90. *Id.*

91. DOBROVOLSKY, *supra* note 85, at 13.

92. See Memorandum from George Haas to Rosswell Mogill, *supra* note 86, at 6 (noting that when all corporations are considered, including those corporations reporting no net income for the period, only 27% of net profits were retained); George Creel, *The Battle Cry of Business*, COLLIER'S, Jan. 8, 1938, at 16, 30.

93. DOBROVOLSKY, *supra* note 85, at 13.

94. FINAL REPORT OF THE COMMITTEE OF THE NATIONAL TAX ASSOCIATION ON FEDERAL TAXATION OF CORPORATIONS 9 n.5 (statement of Robert Murray Haig, Chairman 1939) (presented at the 32d National Tax Conference held in San Francisco, CA, Oct. 16-19, 1939).

95. See MARRINER S. ECCLES, *BECKONING FRONTIERS* 260 (1951).

96. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE*

documented the developing separation between the ownership and control of large corporations.<sup>97</sup> One consequence of this separation was a divergence between managers and stockholders concerning the direction and goals of the underlying business.<sup>98</sup> In what modern observers would describe as an agency cost problem,<sup>99</sup> managers increasingly became interested in "profits" that could not be distributed as dividends to stockholders, such as expansion plans and their own job security.<sup>100</sup> According to Berle and Means, this disintegration of the traditional notion of a profit motive suggested that the corporation and its stockholders had surrendered the right to operate free from outside regulation and any general obligation to society at large.<sup>101</sup>

In the May 19 memorandum, Roosevelt's advisors concluded that the key to stabilizing the economy and correcting the imbalance between a corporation and its stockholders was to find a mechanism to force undistributed corporate surplus into the market. "By forcing undistributed surplus into the general market for capital," Berle wrote, "we could prevent the piling up of individual surpluses which, as we now know, can only be used in ways which are disastrous to the general economic welfare."<sup>102</sup> To accomplish this, the memorandum suggested enacting a "tax on undistributed surplus income of corporations."<sup>103</sup> This sought to both discourage unreasonable accumulation of corporate surplus and simultaneously provide an incentive for corporate managers to increase dividend distributions to small investors, thereby breaking the cycle of overproduction and underconsumption.

There was no shortage of legislative precedent for the undistributed profits tax proposal. As discussed earlier,<sup>104</sup> Congress employed an undistributed profits tax during the Civil War and Reconstruction to supplement the dividends tax imposed on businesses in certain industries and the House revived such a

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PROPERTY (1932); FUSFELD, *supra* note 78, at 213.

97. See BERLE & MEANS, *supra* note 96, at 120-21.

98. *Id.* at 121-22.

99. See *supra* text accompanying notes 16-21.

100. BERLE & MEANS, *supra* note 96, at 349-50.

101. *Id.* at 353-54.

102. Memorandum of May 19, 1932, *supra* note 80, at 3.

103. *Id.* at 4.

104. See *supra* text accompanying notes 29-31 and 44-46.

measure as part of the dividend tax enacted in 1894. Under the modern income tax, Congress employed the undistributed profits tax concept, but only to penalize corporations that unreasonably accumulated profits for the purpose of evading the high surtax rates on individual income.<sup>105</sup> Because of the tax's burdensome intent requirement, however, the provision was hardly ever enforced in its early years.<sup>106</sup> Recognizing this problem, various sources forwarded proposals to impose an undistributed profits tax. In 1917, Senator Andrieus Jones of New Mexico proposed to tax corporations on a certain percentage of their undistributed profits regardless of the purpose for the retention.<sup>107</sup> A bill introduced by the Senate Finance Committee to adopt this proposal was rejected in 1917 and again in 1924, although the latter bill actually passed the Senate before being rejected by the House.<sup>108</sup> In 1928, the Staff of the Joint Committee on Internal Revenue Taxation revived the undistributed profits tax proposal, but Congress rejected it amid concerns about making such a radical change during a period of business expansion.<sup>109</sup>

At the same time Congress was toying with the idea, an undistributed profits tax began to receive support in other quarters. In 1920, Thomas S. Adams, a Yale economics professor and an advisor to the Treasury, advanced an undistributed profits tax as a method of equalizing the treatment of incorporated and unincorporated enterprises.<sup>110</sup> Testifying before the House Ways and Means Committee, Adams acknowledged some potential problems with the proposal, but nevertheless supported adopting such a tax should Congress repeal the excess profits tax.<sup>111</sup> Perhaps under

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105. See Tariff Act of 1913, ch. 16, § II(A)2, 38 Stat. 114, 166-67.

106. See 75 CONG. REC. 6478 (1932) (statement of Rep. Frear) (suggesting that no tax had ever been assessed against a corporation under the provision, although later conceding that recent efforts had produced some success); WALTER LAMBERT, *THE NEW DEAL REVENUE ACTS: THE POLITICS OF TAXATION* 273 (1970).

107. See LAMBERT, *supra* note 106, at 274; Martin, *supra* note 85, at 44.

108. LAMBERT, *supra* note 106, at 274; Note, *The Surtax on Undistributed Profits*, 50 HARV. L. REV. 332, 332 n.2 (1936).

109. ROY G. BLAKEY & GLADYS C. BLAKEY, *THE FEDERAL INCOME TAX* 405 (1940).

110. See Thomas S. Adams, *Immediate Future of the Excess Profits Tax*, 10 AM. ECON. REV. SUPP. 15 (1920). The theory was that the undistributed profits tax would ensure that both corporate and partnership income would be subject to the high surtax rates on individual income. *Id.*

111. See *Hearings on Revenue Revision, 1920-21, Before the House Comm. On Ways and*



Adams' influence, the Secretary of the Treasury recommended an undistributed profits tax as a substitute for the excess profits tax in his 1920 annual report.<sup>112</sup> Although never adopted, this recommendation was not without its supporters in the business and academic community. The National Association of Credit Men issued a pamphlet in 1920 urging Congress to replace the excess profits tax with an undistributed profits tax.<sup>113</sup> Professor Fred Fairchild, a Yale economist, also wrote in support of such a tax, but only if it was structured to equalize the treatment of businesses and not to penalize the reinvestment of earnings.<sup>114</sup>

Although the undistributed profits tax was previously supported as a way to equalize the taxation of businesses or to prevent tax avoidance, a larger goal appeared to motivate Roosevelt's advisers when they proposed the undistributed profits tax in the May 19 memorandum. This apparent goal was to promote the government planned economy outlined by Rex Tugwell in his 1933 book, *The Industrial Discipline and the Governmental Arts*.<sup>115</sup> According to Tugwell, both the Depression as well as the boom and bust of the business cycle were attributable to a misallocation of capital resources.<sup>116</sup> "[W]hy are prices so high or incomes so low that they cannot buy what they wish?" Tugwell asked. "This evidently cannot be answered completely, but even a partial explanation seems to involve reference to our inept allocation of capital. For this in itself involves high costs which must be covered in selling prices."<sup>117</sup> Under a system of self-allocation, managerial hoarding of corporate profits was inevitable as "[i]ndustries, because of their past and present successes, regardless of temporary luck, [grew] overconfident of the future and expand their own activities beyond all reason."<sup>118</sup>

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*Means*, Part I, 66th Cong. 17 (1920) (statement of Prof. Thomas S. Adams).

112. See BUEHLER, *supra* note 86, at 9-10; LAMBERT, *supra* note 106, at 274.

113. BUEHLER, *supra* note 86, at 10.

114. See Fred R. Fairchild, *Suggestions for Revision of the Federal Taxation of Income and Profits*, 10 AM. ECON. REV. 785, 789 (1920).

115. REXFORD G. TUGWELL, *THE INDUSTRIAL DISCIPLINE AND THE GOVERNMENTAL ARTS* (1933); see FUSFELD, *supra* note 78, at 210 ("All three [Moley, Tugwell, and Berle] were agreed that the federal government must take a more positive role in economic life. Of the three men, Tugwell has been most closely associated with that idea.").

116. TUGWELL, *supra* note 115, at 203.

117. *Id.* at 204.

118. *Id.* at 205.

Tugwell's prescription for the problem was to "drive corporate surpluses into the open investment market" and out of the hands of managers through "a tax ... imposed on funds, over and above replacement, which are kept for expansion purposes."<sup>119</sup> If such a tax "forced these funds into distribution as dividends, they would have to seek reinvestment through the regular channels, and a concern's plans for expansion would be subject to check in the investment market."<sup>120</sup> Under Tugwell's larger vision for the economy, this move to increase market control of the allocation of capital would fall short of the more formal system of national planning he advocated.<sup>121</sup> Nevertheless, Tugwell suggested that an undistributed profits tax, when combined with the substitution of federal for state incorporation, would be an "eminently practical" way to address the nation's economic problems.<sup>122</sup>

Despite the historical precedent and strong intellectual backing for an undistributed profits tax in 1932, there was no rush to action after Roosevelt took office. This was partly because Roosevelt was worried that such a program might arouse business opposition in the event of an economic slowdown and lead to a counterattack on his other New Deal policies.<sup>123</sup> The May 19 memorandum, however, clearly did make an impact on Roosevelt. In his July 1932 acceptance speech at the Democratic National Convention in Chicago, for example, he attributed the Depression to heavy "corporate surpluses" used to finance "unnecessary plants" and rampant pre-crash stock market speculation.<sup>124</sup> After taking office, Roosevelt continued to discuss the undistributed profits tax concept with his advisers. He even favorably reviewed Tugwell's more radical suggestion that the government create a bank in which all

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119. *Id.* at 206.

120. *Id.*

121. *See id.* at 205 ("Capital allocation would depend on knowledge, from some planning agency, of how much for a measured future period ought to be put to one use rather than to another. Given this information, the first step in control would be to limit self-allocation."); *see also* FUSFELD, *supra* note 78, at 211 ("Planning was the solution to the problem, and Tugwell advocated creation of a national economic council to act as a planning agency.").

122. FUSFELD, *supra* note 78, at 207.

123. W. Elliot Brownlee, *Historical Perspective on U.S. Tax Policy Toward the Rich*, in *DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH* 29, 51 (2000).

124. Franklin D. Roosevelt, Speech Accepting the 1932 Democratic Presidential Nomination (July 2, 1932), in 1 *THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT* 651 (Samuel I. Rosenman ed., 1938); *see* BUEHLER, *supra* note 86, at 18.

undistributed profits would be deposited and either lent out for expansion projects deemed to be nationally important or returned to the depositing business on the payment of a significant tax.<sup>125</sup> By 1935, perhaps influenced by Treasury's backing of the undistributed profits tax in the December 1934 tax package,<sup>126</sup> Roosevelt appeared to be pushing toward an attack on corporate surplus. In his message to Congress on June 19, Roosevelt declared that ultimately we might need to use taxation to "discourage unwieldy and unnecessary corporate surpluses."<sup>127</sup> Despite such rhetoric, Roosevelt did not publicly propose that Congress adopt the undistributed profits tax in either its radical or mild forms until a budgetary crisis arose toward the end of his first term in office.<sup>128</sup>

### *B. 1936 and the Revival of the Undistributed Profits Tax*

On January 3, 1936, Roosevelt announced in his annual message to Congress that "it is my belief based on existing laws that no new taxes, over and above the present taxes, are either advisable or necessary."<sup>129</sup> Thus, he recommended few changes to the existing tax structure in submitting his budget to Congress.<sup>130</sup> Shortly thereafter, however, developments on both the judicial and legislative fronts opened two gaping holes in his proposed budget and forced him to revisit the tax question.

Three days after Roosevelt's message to Congress, the Supreme Court opened the first big hole in the President's budget. In *United States v. Butler*,<sup>131</sup> the Court struck down the Agricultural Adjustment Act and thus invalidated the processing taxes Roosevelt had counted on to finance the Act's operations.<sup>132</sup> Under the Act, the

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125. See LEFF, *supra* note 86, at 172.

126. See *id.* at 173; ECCLES, *supra* note 95, at 256.

127. BUEHLER, *supra* note 86, at 19 n.1.

128. Ellis Hawley suggested that by the end of 1935 it seemed likely that Roosevelt would postpone consideration of the undistributed profits tax indefinitely. See ELLIS W. HAWLEY, *THE NEW DEAL AND THE PROBLEM OF MONOPOLY* 352 (1966).

129. Franklin D. Roosevelt, Annual Message to Congress (Jan. 3, 1936), in 5 *THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT* 17 (Samuel I. Rosenman ed., 1938).

130. See BUEHLER, *supra* note 86, at 20.

131. 297 U.S. 1 (1936).

132. This decision was one of many attacks led by the Supreme Court on New Deal policies that forced Roosevelt to reconsider his ill-fated court-packing scheme. See ECCLES, *supra* note 95, at 257.

Secretary of Agriculture was empowered to pay farmers not to produce a particular commodity when prices for that commodity fell to dangerously low levels.<sup>133</sup> To finance such payments, the Act authorized the levying of a processing tax on the particular commodity at issue.<sup>134</sup> Applying a fairly narrow reading of the taxing and spending clauses, the Court struck down the Act and its processing taxes as unconstitutional.<sup>135</sup> This outcome was not entirely unanticipated. Roosevelt had warned during his 1936 Annual Budget Message that “[i]f 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.”<sup>136</sup> As a result, Roosevelt needed to replace the \$500 million from the processing taxes by tapping other sources.<sup>137</sup>

Congress opened a second big hole in Roosevelt’s budget by overriding a presidential veto to pass the Adjusted Compensation Payment Act of 1936.<sup>138</sup> Originally, Congress gave World War I veterans a bonus payable in 1945.<sup>139</sup> The 1936 Act accelerated payment on the veterans’ bonuses to provide for an immediate cash settlement in 1936 of almost \$2 billion.<sup>140</sup> Financing this payment added an annual carrying charge of \$120 million to the budget over

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133. *Butler*, 297 U.S. at 54-55.

134. *Id.* at 55. As the Court pointed out, effectively the plan was “to take money from the processor and bestow it upon farmers who will reduce their acreage for the accomplishment of the proposed end.” *Id.* at 58-59.

135. *Id.* at 111. According to the Court:

[The Act] invades the reserved rights of the states. It is a statutory plan to regulate and control agricultural production, a matter beyond the powers delegated to the federal government. The tax, the appropriation of the funds raised, and the direction for their disbursement, are but parts of the plan. They are but means to an unconstitutional end.

*Id.*

136. Franklin D. Roosevelt, Annual Budget Message (Jan. 3, 1936), in 5 *THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT* 18, 28 (Samuel I. Rosenman ed., 1938) (quoting from the Summation of the 1936 Budget).

137. See LAMBERT, *supra* note 106, at 267.

138. See *Revenue Act, 1936: Hearings on H.R. 12395 Before the S. Comm. on Fin.*, 74th Cong. (1936) [hereinafter *1936 Senate Hearings*] (statement of Henry Morgenthau, Jr., Secretary of the Treasury), reprinted in 16 *U.S. REVENUE ACTS, 1909-1950; THE LAWS, LEGISLATIVE HISTORIES, AND ADMINISTRATIVE DOCUMENTS* 2 (Bernard D. Reams, Jr. ed., 1979).

139. See LEFF, *supra* note 86, at 170.

140. See *id.*; BLAKEY & BLAKEY, *supra* note 109, at 401.

the next nine years.<sup>141</sup> Combined with the \$500 million shortfall caused by the Court's decision on processing taxes, Roosevelt needed to come up with \$620 million in additional annual revenue in order to avoid cutting any of his New Deal programs or incurring a deficit.

To address this budgetary crisis, Roosevelt and his advisers once again explored the possibility of an undistributed profits tax.<sup>142</sup> They first ruled out any effort to obtain the necessary revenues by increasing income taxes or taxes on commodities during an election year.<sup>143</sup> Instead, Roosevelt and his advisers began to focus on raising revenue by closing significant avenues of tax evasion and avoidance.<sup>144</sup> In the eyes of Treasury Secretary Henry Morgenthau, the previously shelved undistributed profits tax proposal was ideal for this task.<sup>145</sup> Treasury estimated that approximately \$4.5 billion in corporate profits would go undistributed in 1936.<sup>146</sup> Given the large spread between the corporate and individual income tax rates and the accumulated earning tax's apparent failure to guard against abuses of the corporate form to take advantage of this spread, Morgenthau considered the undistributed profits tax to be a valuable tool against tax avoidance.<sup>147</sup> If those funds were either taxed as undistributed profits or distributed as dividends taxable to the individual shareholders under the personal income tax, the government stood to gain as much as \$1.3 billion in additional revenue.<sup>148</sup>

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141. See LEFF, *supra* note 86, at 170; RATNER, *supra* note 65, at 472.

142. See JOHN MORTON BLUM, *FROM THE MORGENTHAU DIARIES: YEARS OF CRISIS, 1928-1938*, at 306 (1959).

143. *Id.* at 305; HAWLEY, *supra* note 129, at 352; see also *Revenue Act, 1936: Hearings on H.R. 12395 Before the House Comm. on Ways and Means*, 74th Cong., 2d Sess. 18 (1936) [hereinafter *1936 House Hearings*] (statement of Guy T. Helvering, Commissioner of Internal Revenue, Treasury Department) (explaining that 61% of Federal revenues were already derived from consumption taxes and income taxes could not be increased without first addressing tax evasion), reprinted in 15 U.S. REVENUE ACTS 1909-1950; THE LAWS, LEGISLATIVE HISTORIES, AND ADMINISTRATIVE DOCUMENTS 18 (Bernard D. Reams, Jr. ed., 1979).

144. BUEHLER, *supra* note 86, at 20.

145. See 1936 *Senate Hearings*, *supra* note 138, at 4-5 (statement of Henry Morgenthau, Jr., Secretary of the Treasury).

146. BLUM, *supra* note 142, at 307.

147. See 1936 *Senate Hearings*, *supra* note 138, at 4-5 (statement of Henry Morgenthau, Jr., Secretary of the Treasury); Brownlee, *supra* note 123, at 53-54.

148. BLUM, *supra* note 142, at 307.

Although Roosevelt was likely unconvinced by the national planning angle Tugwell emphasized in his earlier advocacy of the undistributed profits tax,<sup>149</sup> the tax was deemed attractive for more than just its ability to offset the shortfall in revenue or guard against tax avoidance. First, as Tugwell and Berle had pointed out in 1932, many expected the tax would aid the economy while preventing any recurrence of the conditions leading up to the crash and ensuing Depression.<sup>150</sup> Herman Oliphant, Treasury's general counsel and one of the undistributed profits tax's biggest supporters at the time,<sup>151</sup> believed increasing dividends would stimulate the economy by increasing consumer spending.<sup>152</sup> Federal Reserve Board Chairman Marriner Eccles also favored adopting the tax as a method of stabilizing the economy, suggesting that the existence of large corporate surpluses "tended to nullify any attempts at monetary and credit controls by the Reserve System."<sup>153</sup> Second, the undistributed profits tax was viewed as an antitrust device. According to the proponents of this view, large corporate surpluses encouraged monopoly and concentration by providing the capital for acquisitions and by preventing stockholders from reinvesting amounts received as dividends in smaller ventures.<sup>154</sup> For instance, Robert Jackson, then an assistant attorney general in charge of the Tax Division in the Department of Justice, complained that the "antiquated tax laws" permitted corporate managers to use surpluses "to finance monopolistic practices."<sup>155</sup> Although this antitrust argument was often considered less important,<sup>156</sup> there was a general belief that the undistributed profits tax could

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149. See LEFF, *supra* note 86, at 173 ("By the time the tax received approval at the top levels of the Treasury, Tugwell's notion of government supervision of the investment process seems to have played a smaller role.").

150. See *supra* text accompanying notes 102-03.

151. See Max Lerner, *The Corporate Tax Battle*, 144 NATION 669 (1936).

152. See BLUM, *supra* note 142, at 307.

153. ECCLES, *supra* note 95, at 260.

154. See BLUM, *supra* note 142, at 307; W. ELLIOT BROWNLEE, *FEDERAL TAXATION IN AMERICA: A SHORT HISTORY* 77-78 (1996); LEFF, *supra* note 86, at 173; Brownlee, *supra* note 123, at 54.

155. Robert H. Jackson, *The Proposed Revision of Corporation Taxes*, 2 VITAL SPEECHES 431, 432 (1936).

156. See LEFF, *supra* note 86, at 173-74.

"democratize corporate finance" by transferring power to small stockholders.<sup>157</sup>

By mid-February, Roosevelt approved the idea of an undistributed profits tax and directed Treasury officials to work out some of the details of the proposal.<sup>158</sup> In 1932, the undistributed profits tax sketched out for then-candidate Roosevelt would have effected only "a modification of taxes on corporate income."<sup>159</sup> In 1936, however, Oliphant persuaded Treasury to devise a more radical solution to the problem of taxing corporate income.<sup>160</sup> Under this new proposal, the undistributed profits tax would not merely supplement the corporate income tax, but would replace it entirely.<sup>161</sup> Treasury believed this would force most income to be distributed as dividends and therefore be subject to personal income taxation, including the high surtaxes on individual income.<sup>162</sup> This pass-through design was consistent with the prevailing view among economists that corporate income should neither be subject to double taxation nor free from personal taxation.<sup>163</sup>

On March 3, Roosevelt addressed Congress in a supplemental budget message.<sup>164</sup> Ostensibly, the message was merely to announce the need for an additional \$620 million in revenue to replace the processing taxes and fund the veterans' bonuses. Indeed, Roosevelt made a point of acknowledging Congress's discretion to determine the appropriate means to raise such revenue.<sup>165</sup> His true aim, however, was to push his proposal for an undistributed profits tax.<sup>166</sup> In advocating for the undistributed profits tax, Roosevelt did

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157. LAMBERT, *supra* note 106, at 270; see LEFF, *supra* note 86, at 173 ("Although the theme of dispersing power to the stockholders cropped up frequently, the allied antimonopoly thrust was secondary.").

158. See BLUM, *supra* note 142, at 307.

159. Memorandum of May 19, 1932, *supra* note 80, at 3.

160. See BLUM, *supra* note 142, at 308 (crediting Oliphant with influencing Treasury to make the change to its proposal).

161. *Id.*

162. *Id.*

163. See LEFF, *supra* note 86, at 175.

164. See Franklin D. Roosevelt, A Supplemental Budget Message to the Congress (Mar. 3, 1936), in 5 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 102 (Samuel I. Rosenman ed., 1938).

165. *Id.* at 104-05 ("I leave, of course, to the discretion of the Congress the formulation of the appropriate taxes for the needed permanent revenue.").

166. *Id.* at 105.

not mention its positive effect on the economy or its incidental use in antitrust enforcement. Roosevelt instead emphasized the tax's two more politically saleable features:<sup>167</sup> (1) the ability to equalize the treatment of all business owners, and (2) the promise to "stop 'leaks' in present surtaxes."<sup>168</sup> As to the former, Roosevelt noted the present inequity whereby businesses utilizing the corporate form could accumulate profits without penalty, while businesses operating as partnerships or sole proprietors were subject to tax regardless of whether any profits were withdrawn from the business.<sup>169</sup> As to the latter, Roosevelt observed that "[r]epeated attempts by the Congress to prevent [the evasion of high surtaxes through the unnecessary retention of corporate earnings] have not been successful."<sup>170</sup> According to Roosevelt, "[a] proper tax on corporate income ... which is not distributed as earned, would correct the serious twofold inequality in our taxes on business profits" by forcing corporations to distribute profits to their shareholders and thereby taxing those profits at the shareholders' individual rates as is done for partnerships and sole proprietorships.<sup>171</sup> Treasury estimated the tax's combined effect on undistributed earnings and the increased distribution of taxable dividends would be to increase revenues by at least the \$620 million dollars necessary to make up the budget shortfall.<sup>172</sup>

Notably, Roosevelt's proposal was not designed to subject corporate income to double taxation. Roosevelt stated that the undistributed profits tax would accomplish its goals only "if accompanied by a repeal of the present corporate income tax, the capital stock tax, the related excess profits tax and the present exemption of dividends from the normal tax on individual incomes."<sup>173</sup> While undistributed corporate income would be subject to double taxation through the application of the undistributed profits tax and, when distributed in later years, the individual normal tax, distributed corporate income would avoid the partial

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167. See LEFF, *supra* note 86, at 175-77.

168. Franklin D. Roosevelt, A Supplemental Budget Message to Congress (Mar. 3, 1936), in 5 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT, *supra* note 164, at 105.

169. *Id.*

170. *Id.*

171. *Id.* at 106.

172. *Id.*

173. *Id.*



double taxation imposed under the existing spread between the corporate and individual normal rates. Thus, not only was Roosevelt's original plan not intended to result in double taxation, it was designed to provide corporations with a means to integrate the corporate and shareholder-level taxes with respect to their own income.

### III. DOUBLE TAXATION AS A TOOL IN THE ATTACK ON THE UNDISTRIBUTED PROFITS TAX

#### *A. Prelude to the Revenue Act of 1936*

Initial reaction to Roosevelt's March 3 message was quite positive.<sup>174</sup> Many of his supporters in Congress and the press hailed the undistributed profits tax idea as a "master political stroke," a "natural," and "politically painless" because of its ability to raise the necessary revenues by imposing a tax on a small, generally wealthy, segment of the population.<sup>175</sup> A *New York Times* editorial noted that the proposal already had "strengthened public confidence in the integrity of the Government's credit" as evidenced by "the prompt oversubscription in a single day of the enormous issue of bonds and notes offered by the Treasury ...."<sup>176</sup> *The Nation* boldly concluded that "[n]o tax could be devised which would be less likely to alienate the voters."<sup>177</sup>

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174. Such positive reaction was not confined to political commentators. See, e.g., *Sprague Likes Tax Plan*, N.Y. TIMES, Mar. 4, 1936, at 3 (reporting that Professor O.M.W. Sprague of the Harvard Business School, a former fiscal adviser to the Treasury and the Bank of England, indicated that the tax was "a step in the right direction").

175. BUEHLER, *supra* note 86, at 23; George B. Bryant, Jr., *Reform Motive in Tax Program*, BARRON'S, Mar. 30, 1936, at 13; Arthur Krock, *House Is Finding New Problems as Tax Bill Is Studied*, N.Y. TIMES, Mar. 18, 1936, at 22; see also *A Sound Tax*, *supra* note 86, at 337 ("[T]he President's proposed tax on-undivided corporation profits represents masterly strategy.... [H]e has saved Congress from the painful necessity of imposing an income or sales impost on the eve of a national election."); *Taxing Corporate Surplus*, 86 NEW REPUBLIC 153 (1936) ("[The undistributed profits tax proposal] is thought by many commentators to be merely an ingenious way of escaping the wrath that would follow an increase of income-tax rates in an election year.").

176. Editorial, *The President's Message*, N.Y. TIMES, Mar. 4, 1936, at 20.

177. *A Sound Tax*, *supra* note 86, at 337; see also *Robinson Urges Speed on Tax Bill*, N.Y. TIMES, Mar. 4, 1936, at 3 (quoting the reaction of numerous members of Congress, including that of the Speaker of the House, who said that "it will meet with the approval of the majority of people"). As one commentator pointed out in describing the political virtues of the tax, "[i]t

Notwithstanding the glowing appraisals of the President's strategy, observers did recognize that the proposal was likely to arouse "deep opposition" on the part of corporate managers.<sup>178</sup> Alfred Buehler reported that "[t]he business world ... was aghast at the proposal and shuddered at the consequences if it were adopted."<sup>179</sup> Under then-prevailing dividend practices, the tax could not possibly raise the required \$620 million in revenue.<sup>180</sup> Thus, the rates would have to be set high enough to "compel[] corporations radically to alter their present dividend policy" in order to reach its revenue goals.<sup>181</sup> This would force many corporations to rely more heavily on expensive and intrusive external financing sources, something managers are generally disinclined to do especially when the alternative is simply to dip into retained earnings.<sup>182</sup> Perhaps more offensive to managers, a forced change in dividend policy would effectively substitute "the blanket judgment of Congress and the Treasury Department, based on a general theory" for the "individual judgment of business managers, based on their direct knowledge of the needs of their particular company."<sup>183</sup>

For a number of reasons, observers discounted the political force of such opposition. First, corporate managers were not expected to favor Roosevelt's re-election in any event.<sup>184</sup> As Herman Oliphant remarked, "[i]f we have to fight, we might as well fight the people who are our enemies anyway."<sup>185</sup> Second, stockholders would support anything that forced managers to disgorge corporate profits and thus would not join the corporate managers' campaign against the tax. Writing soon after Roosevelt's speech, *New York Times*

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seems to avoid any tax upon 99 per cent of the voters. It raises the tax upon the remaining 1 per cent, who in the opinion of the aforementioned 99 per cent should pay higher taxes anyway." Joseph Stagg Lawrence, *A Death Sentence for Thrift*, 93 REV. REVS. 40, 41 (1936).

178. Arthur Krock, *Opposition is Divided Over President's Tax Proposal*, N.Y. TIMES, Mar. 4, 1936, at 20.

179. BUEHLER, *supra* note 86, at 23.

180. See *The New Tax Schedule*, N.Y. TIMES, Mar. 17, 1936, at 20.

181. *Id.*

182. See Jensen, *supra* note 17, at 323 ("Financing projects internally avoids this monitoring and the possibility the funds will be unavailable or available only at high explicit prices.").

183. *Punishing Prudence*, N.Y. TIMES, Mar. 13, 1936, at 22.

184. See Krock, *supra* note 178, at 22.

185. BLUM, *supra* note 142, at 308 (quoting Herman Oliphant).

columnist Arthur Krock argued that stockholders' support of the undistributed profits tax had deep-seated roots:

The President is fortunate in choosing a battleground between two split wings of the opposing forces. For a long time Washington has received complaints against managers of large corporations who, exercising minority control, decided to pile up large surpluses instead of passing them out in the form of dividends. This was done without consulting the scattered stockholding majorities, under powers granted by the charters of the corporation. But, however legal, and, in numerous instances, however wise, the policy has irritated many stockholders with the need or the wish for accessions to income.<sup>186</sup>

The immediate rise in the stock market after Roosevelt's speech appeared to bolster the view that stockholders supported the undistributed profits tax in spite of its promise to subject dividends to the normal tax.<sup>187</sup> As Krock observed, stockholders "seem for the present to be thinking only of the dividends, now piled up for reserves and other purposes, which they hope will be released by the new law."<sup>188</sup> Finally, some speculated that the proposal's bias in favor of existing surpluses would convince managers in larger corporations to remain silent while the tax hampered the financing efforts of their younger competitors.<sup>189</sup> Although contrary to Roosevelt's stated goal of equalizing the treatment of businesses,<sup>190</sup>

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186. Krock, *supra* note 178, at 22; see also W.R. Draper, Letter to the Editor, *Salaries, Taxes, and Dividends*, WALL ST. J., Apr. 30, 1936, at 4 (complaining about "the flippant and often insulting replies made by corporation presidents to stockholders who ask why they do not receive dividends when the aforesaid officials are drawing down enormous salaries" and suggesting that "[t]hese 'brass collars' are riding for a fall just the same as the old time railroad man").

187. *A Sound Tax*, *supra* note 86, at 337; *What's News*, WALL ST. J., Mar. 4, 1936, at 1 ("The stock market bullishly construed this move [the announcement of the undistributed profits tax recommendation] to turn a greater share of earnings into dividend channels. Industrial shares gained sharply."); *Abreast of the Market*, WALL ST. J., Mar. 4, 1936, at 17 ("Traders yesterday took a little time to assimilate the President's message to Congress advocating a radical change in corporate taxation methods. When they did, a wave of buying occurred that sent most of the list strongly upward and the industrial averages into new high ground.").

188. Krock, *supra* note 178, at 22.

189. *Id.*

190. See *supra* text accompanying notes 169-72.

this unintended bias nonetheless suggested that the proposal would find little serious opposition in Congress.

Such appraisals clearly underestimated the political force of the opposition. While business leaders remained relatively quiet as a House subcommittee feverishly worked to turn the proposal into a bill for Congress's consideration,<sup>191</sup> this was hardly because they had accepted defeat on the matter. During this period, corporate managers and their lobbyists in the various national and local trade groups quietly started what later became a very open and public attack on the proposed tax.<sup>192</sup> The strategy primarily involved two tactics. The first and clearly preferred tactic was to oppose the undistributed profits tax in any form.<sup>193</sup> When that tactic failed and enactment of some form of undistributed profits tax appeared inevitable, opponents used a second tactic. They supported measures that would minimize the burden at the corporate level and transfer it to the individual level so as to neutralize the effect of any remaining undistributed profits tax.<sup>194</sup> Double taxation, because of its ability to counteract any shareholder calls for

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191. According to an article in *Barron's* magazine:

The remarkable lack of visible opposition to the proposal to date can be explained easily. It does not necessarily mean that business and industry will accept it without question and opposition. The scheme, thus far, has been in a purely formulative stage, and its effects upon the interests most vitally concerned cannot be definitely appraised.

George B. Bryant, Jr., *Reform Motive in Tax Program*, BARRON'S, Mar. 30, 1936, at 13. According to an article in the *New York Times*:

Organized business groups are reserving any public criticism of the President's plan for taxing corporate surpluses until later, it developed in a canvas of association offices yesterday. Advices received by some of the associations from Washington offices are to the effect that opposition to the measure will develop within the coming ten days ....

*Trade Groups Study Tax Plan*, N.Y. TIMES, Mar. 6, 1936, at 30.

192. See Turner Catledge, *Public Opinion Wins a Victory in Tax Debate*, N.Y. TIMES, May 10, 1936, § IV, at 3.

In preparing the ground [for their attack on the tax proposal] not a single insidious lobbyist's methods has [sic] been employed. No letters have gone out from the national headquarters of this or that organization directing a mass protest on Washington as to the corporate tax. Senators' mail on the subject has been singularly light.

*Id.*

193. See *infra* Part III.B.1. (discussing business testimony against the bill in the House Ways and Means Committee Hearings).

194. See *infra* Part III.B.2. (discussing business testimony against the bill in the Senate Finance Committee Hearings).

increased dividends in response to the undistributed profits tax, eventually became a significant weapon in this second prong of the attack on the undistributed profits tax.

Perhaps most significant about this campaign against the undistributed profits tax was the involvement of large corporations, both directly and through lobbying organizations that they effectively controlled during the period, including, the National Association of Manufacturers and the U.S. Chamber of Commerce.<sup>195</sup> While the small, undercapitalized businesses, which were most likely to be affected by the tax, also were active opponents of the bill, corporations with professional managers led the charge. Despite retaining a lower percentage of profits and possessing a larger accumulated surplus than their smaller competitors,<sup>196</sup> big business dominated the testimony over the bills

195. See LEFF, *supra* note 86, at 244 ("To some extent, this unity [of the business community in opposition to the tax] reflected the dominance of giant corporations in industrial associations."). For instance, while the National Association of Manufacturers nominally represented a broad cross-section of industry, large corporations dominated its decision-making body throughout the New Deal and the World War II period. See Philip H. Burch, Jr., *The NAM as an Interest Group*, 4 POL. & SOC'Y 97, 103 (1973).

Throughout the New Deal-World War II years an average of about sixty-five to seventy percent of the membership of the executive committee was composed of representatives of big industrial concerns, and in some years eighty percent or more of these important figures was drawn from such select business circles.

*Id.*; see also Alfred S. Cleveland, *NAM: Spokesman for Industry?*, 26 HARV. BUS. REV. 353, 365 (1948) ("[T]he identity of the inner policy-making group indicates that active leadership within the NAM comes primarily from among the very largest manufacturing corporations ...."); Richard W. Gable, *NAM: Influential Lobby or Kiss of Death?*, 15 J. POL. 254, 259-60 (1953).

In practice, therefore, the board has constitutionally unlimited power in making all policy decisions. This group has been heavily weighted in favor of an active minority which represents conservative, big businesses and which is an unrepresentative sample of NAM members in terms of size, wealth, and number of employees.

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... Between 1933 and 1937 a total of almost \$4 million was collected. A group of 262 companies—among the largest and most powerful in the nation—supplied almost 50 per cent of that total.

*Id.*; Richard Walter Gable, *A Political Analysis of an Employers' Association: The National Association of Manufacturers 242-43* (1950) (unpublished Ph.D dissertation, University of Chicago) (on file with The University of Chicago library) ("[I]n terms of corporate size and number of employees, the leadership of the Association since 1933 has not been, on the whole, reflective of NAM members, much less of American industry.").

196. See CALOMIRIS & HUBBARD, *supra* note 16, at 23 (stating that small corporations in growing industries bore the brunt of the burden of the undistributed profits tax); John W. Lee,

in the House and Senate and waged an active campaign against the tax in the press.<sup>197</sup> Their effect on the ultimate result cannot be understated. According to Mark Leff, "The U.S. Chamber of Commerce, overseeing the details of tax legislation, served as a prime information source for many congressmen, even drafting major Republican amendments."<sup>198</sup> As Treasury Secretary Henry Morgenthau later recalled, "The opposition from the conservative press and big business, and their influence in both parties on the Hill, made a terrific impact."<sup>199</sup>

The involvement of large corporations and their professional managers should not be surprising given Berle and Means' evidence of the growing problem of agency costs.<sup>200</sup> In their study, they found that shareholders were becoming increasingly distant and separated from the professional managers who controlled the business enterprise.<sup>201</sup> As a consequence, it was no longer possible to automatically assume that "those in control of a modern corporation will also choose to operate it in the interests of the owners."<sup>202</sup> On the issue of the undistributed profits tax, this agency cost problem was readily apparent. While many investors apparently welcomed the prospect of receiving increased dividend distributions as a result of the tax,<sup>203</sup> corporate managers felt quite differently. Managers "feared government intervention into a politically vulnerable, faltering investment process" and waged a full-scale counter-offensive to protect their control over corporate profits.<sup>204</sup>

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*A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do,"* 78 TEX. L. REV. 885, 951-52 (2000) (noting most public corporations distributed 70% or more of their earnings). But see Turner Catledge, *Senators Fail to Agree on a Corporate Tax Bill; Fight May Go to Floor*, N.Y. TIMES, May 15, 1936, at 1 (reporting figures submitted by Treasury Department officials that indicated many large corporations would indeed pay higher taxes under the House bill).

197. See BLUM, *supra* note 142.

198. LEFF, *supra* note 86, at 275.

199. See BLUM, *supra* note 142, at 319.

200. See *supra* text accompanying notes 96-101.

201. See BERLE & MEANS, *supra* note 96, at 113 ("The position of the owner has been reduced to that of having a set of legal and factual interests in the enterprise while the group which we have called control, are in the position of having legal and factual powers over it.").

202. *Id.* at 121.

203. See *supra* text accompanying notes 187-88 (describing the rise in the stock market in response to Roosevelt's speech proposing the adoption of an undistributed profits tax).

204. LEFF, *supra* note 86, at 247.

*B. The Campaign to Defeat the Tax in the Revenue Act of 1936**1. House*

At the end of March, the House Ways and Means Committee conducted Hearings to consider the undistributed profits tax.<sup>205</sup> After working for three weeks to turn the undistributed profits tax idea into a workable tax bill, a Ways and Means subcommittee delivered its final version on March 30.<sup>206</sup> Under the bill, the corporate income tax would be replaced by an undistributed profits tax graduated according to the percentage of net income retained.<sup>207</sup> For corporations with an annual net income of \$10,000 or less, the rates ranged from 1% on the first 10% of undistributed net income to 29.7% on undistributed net income of 70.3% or more.<sup>208</sup> For corporations with annual income in excess of \$10,000, the bill proposed rates ranging from 4% on the first 10% of undistributed net income to a maximum of 42.5% on undistributed net income of 57.5% or more.<sup>209</sup> The definition of "undistributed net income" included adjusted net income less taxable dividends and the undistributed profits tax itself.<sup>210</sup> The bill exempted or provided special treatment for banks, insurance companies, corporations in receivership, foreign corporations and corporations that were contractually or legally prohibited from paying dividends.<sup>211</sup> Finally, the bill subjected dividends received to the normal tax on individuals.<sup>212</sup>

Guy Helvering, the Commissioner of Internal Revenue, opened the hearings on behalf of the Treasury Department by explaining

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205. 1936 *House Hearings*, *supra* note 143, at 1. A Ways and Means subcommittee opened the hearings with a detailed recommendation in favor of an undistributed profits tax similar to the one Roosevelt recommended to Congress. *Id.* at 4-13.

206. See BUEHLER, *supra* note 86, at 25.

207. 1936 *House Hearings*, *supra* note 143, at 5.

208. *Id.* at 5-6.

209. *Id.* at 6.

210. *Id.* at 5.

211. *Id.* at 6-11. Banks and insurance companies were required to keep a certain amount of surplus income on hand under state and federal regulations, while the latter three types of corporations were either unable to pay out all of their income as dividends or, in the case of foreign corporations, were subject to the dividend rules of other countries. *Id.*

212. *Id.* at 9.

the benefits of the proposed tax.<sup>213</sup> "The primary purposes of the proposal," according to Helvering, were:

[F]irst, to eliminate the present inequalities in our taxation of business profits as between incorporated and unincorporated business; second, to remove a very important source of tax avoidance that inheres in our present income-tax laws; and third, as a consequence of the elimination of inequalities and sources of tax avoidance, to increase the Federal revenues to the extent necessary to balance the regular Budget of the Federal Government.<sup>214</sup>

This essentially reiterated the benefits outlined by Roosevelt when he recommended the undistributed profits tax in his message to Congress.<sup>215</sup>

More revealing than Helvering's reasons for Treasury's support of the proposal was his response to the concerns already expressed by corporate managers. "There is no intention or desire whatever to interfere with the internal management of business enterprises," Helvering declared.<sup>216</sup>

The object of the proposed revenue measure is not to tell corporate management what proportion of earnings they shall distribute and what proportion they shall retain. The object is, rather, to see that, whatever the decisions of corporate managements, the Federal Government shall not be unreasonably and inequitably deprived of necessary revenues.<sup>217</sup>

Moreover, Helvering contended that the proposal would not threaten a corporate manager's ability to retain "a substantial portion of its current earnings" as surplus.<sup>218</sup>

Legislators were dubious of the claim that the tax was not intended to interfere with corporate management and several representatives attacked that point during the question-and-answer

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213. *Id.* at 14.

214. *Id.* at 19.

215. See *supra* text accompanying notes 167-71.

216. 1936 *House Hearings*, *supra* note 143, at 22.

217. *Id.*

218. *Id.*



period following Helvering's prepared statement. Representative Frank Crowther of New York charitably called Helvering's statement on the matter "naïve," asking, "is it not a fact that under what might be well termed 'pressure rates', we are, in a sense, compelling corporations to distribute?"<sup>219</sup> While Crowther's question only evoked a feeble response from Helvering,<sup>220</sup> a fellow New Yorker, Representative Daniel Reed, made the more shrewd charge. Reed suggested the undistributed profits tax proposal could be traced to Rex Tugwell's earlier writings on a nationally planned economy.<sup>221</sup> Quoting from Tugwell's book, *Industrial Discipline*, in which Tugwell wrote that "[t]he first step in control would be to ... drive corporate surpluses into the open investment market," Reed apparently hoped to stain the tax with the imprimatur of Tugwell's radical attack on corporate management.<sup>222</sup>

The perceived threat the undistributed profits tax posed to the independence of corporate managers permeated the testimony in opposition to the bill. Most of the business leaders and their representatives before the Ways and Means Committee raised various essentially neutral arguments about the value of surplus and planning and the uncertain revenue prospects of any change in the corporate tax. Implicit in their testimony, however, was the view that corporate managers and their boards of directors were much better equipped to decide such issues than were Congress or Treasury. One of the principal criticisms of the tax was that it incorrectly blamed the existence of large corporate surpluses for the economy's ills. Noel Sargent, secretary of the National Association of Manufacturers, argued that retaining corporate profits produced benefits ranging from increased stockholder value and industrial employment from the expansion of plant operations to preserving working capital and protecting against depression.<sup>223</sup> Moreover, because of its positive effect on a corporation's balance sheet, it was

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219. *Id.* at 38.

220. *Id.* (statement of Guy Helvering, Commissioner, Internal Revenue Service) ("Well, of course, Mr. Crowther, that statement was occasioned to a certain extent by the continued attack made as to the inability to create reserves.").

221. *Id.* at 42 (statement of Rep. Reed).

222. *Id.* After quoting liberally from the *Industrial Discipline*, Reed noted that "evidently he [Tugwell] is quite in harmony with this recommendation." *Id.*

223. *Id.* at 206-10 (statement of Noel Sargent, Secretary, National Association of Manufacturers).

called a necessity for securing alternative forms of financing such as bond or equity issuances.<sup>224</sup> Leslie Johnston, Pittsburgh's Director of Public Works, even went so far as to suggest that corporate surplus was a necessary hedge against natural disasters such as the flood that had recently struck his city.<sup>225</sup>

A related concern was that the undistributed profits tax would damage smaller corporations. According to the argument, the lack of an accumulated surplus and an inability to secure reasonable financing through the debt or equity markets forced small corporations to "plow back" their earnings into the company. As the president of a small bridge corporation testified, "[t]he smaller companies have only grown by using their earned surplus in the building of larger facilities and in increasing their working capital the necessary amount to take care of the increased capacity."<sup>226</sup> By taxing each year's undistributed profits, the chairman of the tax committee of the Illinois Manufacturing Association warned of the "grave danger that the present highly capitalized organizations will have a continuing advantage over these small corporations."<sup>227</sup> Even representatives of the larger corporations acknowledged this complaint's validity. Sargent noted that one "pretty good sized" member of the National Association of Manufacturers expressed its approval for the tax because "it would tend to drive out their weak competitors."<sup>228</sup> Notwithstanding the plausibility of such complaints, the fact that most large corporations publicly opposed the tax despite its apparent advantages left some congressmen suspicious of their true motives.<sup>229</sup>

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224. *Id.* at 266.

225. *Id.* at 111 (statement of Leslie M. Johnston, Director of Public Works, City of Pittsburgh, Pa.).

226. *Id.* at 146 (statement of Clyde G. Conley, President, Mount Vernon Bridge Company). According to Conley, the company had an annual income of less than \$24,000. *Id.* at 144.

227. *Id.* at 352 (statement of G.L. Walters, Illinois Manufacturing Association).

228. *Id.* at 251 (statement of Noel Sargent, Secretary, National Association of Manufacturers).

229. *Id.* at 814 (statement of Rep. Hill). Representative Hill stated:

It strikes me as rather an unusual attitude for the large corporations to take—out of purely altruistic motives, I assume—that this will work to the detriment of the small corporations and that it will tend toward monopoly. I cannot conceive that these strong corporations who like to monopolize the field as far as they can are solicitous for the small corporations through the imposition of a tax which they claim, or which it is claimed here, will work to

As these congressmen probably surmised, businesses' underlying concern was that the tax would interfere with the decisions of corporate managers and boards of directors. G.L. Walters of the Illinois Manufacturing Association explained that "[b]usiness corporation management must decide, with reference to the particular situation of the particular business corporation at the particular time, how much of its net income is required to be retained for corporate purposes."<sup>230</sup> Enacting an undistributed profits tax, Walters complained, would "take from business management one of the most essential matters of management involved in business. Government would just as well take away from all those who have the responsibility of driving automobiles their control over the brakes, the clutch, the throttle, or the steering wheel."<sup>231</sup> Fred Clausen of the United States Chamber of Commerce echoed these concerns, arguing that "[t]his proposal would cause corporate management to be controlled, in its decisions on fiscal policy, by fear of Government exactions rather than by good business judgment."<sup>232</sup> Representative Fred Vinson concluded that this was "the major objection that has been presented in these hearings."<sup>233</sup>

What appeared to scare corporate management the most, even more than the prospect of government interference, was the possibility such interference would pit managers against their stockholders and creditors. Under the Revenue Act of 1935, individual surtax rates ranged from 27 to 75% while the corporate income tax topped out at 15%.<sup>234</sup> This rate differential helped align management-stockholder interests toward the retention of corporate profits. Since dividends would subject wealthy stockholders to the high surtax rates, while a policy of non-distribution would allow the profits to grow subject to substantially lower rates, stockholders

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their advantage.

*Id.*

230. *Id.* at 338 (statement of G.L. Walters, Illinois Manufacturing Association).

231. *Id.* at 339.

232. *Id.* at 737 (statement of Fred H. Clausen, Chairman of the Committee on Federal Finance, United States Chamber of Commerce).

233. *Id.* at 822 (statement of Rep. Vinson). E.C. Alvord of the United States Chamber of Commerce agreed with Representative Vinson's statement. *Id.* (statement of E.C. Alvord, United States Chamber of Commerce).

234. See Revenue Act of 1935, §§ 101-02, 49 Stat. at 1014-15.

were more than happy to let managers retain corporate profits for reinvestment in the business. The proposed tax, by contrast, promised to narrow or eliminate this gap for most stockholders by setting the maximum rate on undistributed profits at 42.5%.<sup>235</sup> Fred Clausen predicted:

[The tax] would engender such uncertainties concerning the sound course to pursue as to subject the management to grave difficulties with shareholders and creditors.... You can well imagine the difficulties facing managers and the board of directors in a company as to how to meet a situation which would exist if this proposal becomes the law of the land.<sup>236</sup>

According to Clausen, "[i]t presents the danger that corporate management would be subject to serious criticism and even law suits if liberal dividend policies were followed to escape taxes and gave rise to charges of dissipation of assets."<sup>237</sup> Probably more frightening to managers was the corresponding danger that stockholders would no longer permit them to pursue conservative dividend policies geared toward building up cash for capital expansion.

During their testimony, Treasury representatives attempted to allay corporate managers' fears. Herman Oliphant emphasized:

[I]t is not for anybody in Washington to tell business executives how much of their earnings they shall keep back and how much they shall distribute. That is not the Government's business.... But it is the Government's business to see to it that those administering the affairs of a corporation shall not use it, nor permit it to be used, for avoiding the surtaxes which everybody else has to pay. That is what this does.<sup>238</sup>

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235. See *supra* text accompanying note 209.

236. 1936 *House Hearings*, *supra* note 143, at 739-40 (statement of Fred H. Clausen, Chairman of the Committee on Federal Finance, United States Chamber of Commerce).

237. *Id.* at 740.

238. *Id.* at 607 (statement of Herman Oliphant, General Counsel, Treasury Department). The *New York Times* was clearly dubious of Oliphant's statement, asking:

If the proposed tax is not a tax designed to control the dividend policy of corporations, one would like to know what it is.... Mr. Oliphant is saying to the corporations in effect: "We are not trying in the slightest to influence your dividend policy, but we will put a thumping tax on you if you don't pay out

Officials backed up their claims by identifying two principal mitigating factors. First, they pointed out that the tax would still permit accumulation of a fairly significant surplus. Arthur Kent, Acting Chief Counsel of the Bureau of Internal Revenue, noted that it "is continually overlooked that the measure will permit retention of a substantial fraction ... without a corporate tax burden equal to or in excess of the burden imposed by the present law."<sup>239</sup> According to Oliphant, corporations might be able to retain 20 and 30% of their earnings without incurring a tax liability under the undistributed profits tax in excess of their liability under the corporate income tax.<sup>240</sup> Second, Treasury officials suggested corporations could satisfy their capital needs through other means. While debt and equity financing were likely sources for the large corporations, opponents complained that they were less accessible to the smaller corporation.<sup>241</sup> In response to such concerns, Kent cited a number of alternative "financing" vehicles such as stock rights, taxable stock dividends, and interest-bearing dividend script.<sup>242</sup> Of these vehicles, members of the committee were most interested in taxable stock dividends. Kent explained that recent judicial decisions had confirmed the possibility that a corporation could issue a type of stock dividend that would be considered taxable to the stockholder, but would permit the corporation to retain the underlying funds.<sup>243</sup> Concerning one case, *Koshland v. Helvering*,<sup>244</sup> which was then

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everything, and let you off scot free from taxes if you do."

Editorial, *The Ship and the Rats*, N.Y. TIMES, Apr. 8, 1936, at 22.

239. 1936 House Hearings, *supra* note 143, at 581 (statement of Arthur H. Kent, Acting Chief Counsel, Bureau of Internal Revenue).

240. *Id.* at 649 (statement of Herman Oliphant, General Counsel, Treasury Department); *see also id.* at 582 (estimating that a corporation might be able to retain as high as 40% of earnings without exceeding its previous income tax liability).

241. *See, e.g., id.* at 761 (statement of Roy Osgood, United States Chamber of Commerce).

242. *Id.* at 582. In the case of some of these, such as stock dividends, they were not truly financing vehicles in the sense of raising cash from outside investors or lenders. Kent was suggesting that if a company viewed undistributed profits, or, in modern parlance, free cash flow, as its only viable means of financing expansion or a new venture, then the company could achieve the same result by keeping the profits and distributing taxable stock dividends. *See id.*

243. *Id.* at 593. In 1935, for instance, the Sixth Circuit held that a dividend of common stock to preferred stockholders constituted a taxable stock dividend because it meaningfully changed the preferred stockholders' interest in the corporation. *See Commissioner v. Tillotson Mfg. Co.*, 76 F.2d 189, 190 (6th Cir. 1935).

244. 298 U.S. 441 (1936).

pending at the Supreme Court, Kent predicted the decision likely would recognize the possibility that a common stock dividend issued to preferred stockholders could be found taxable.<sup>245</sup> Furthermore, Kent noted that a stock dividend with a cash option was already considered taxable under *Eisner v. Macomber*<sup>246</sup> because it effectively operated as a cash dividend followed by a purchase of the distributing corporation's stock.<sup>247</sup> Representative Vinson called the taxable stock dividend idea "very interesting" and suggested that "it will allay a major portion of the fear that some folks have that ... the capital structure of a corporation would be in danger, or that thereby it would not have the money for the rainy day."<sup>248</sup>

Treasury's responses appeared sufficient to placate members of the Ways and Means Committee as well as most other members of the House. Despite opponents' urgings to proceed slowly before pursuing such a "radical change" in the system of taxing corporate income,<sup>249</sup> the undistributed profits tax emerged from the Committee and quickly passed in the House with surprisingly little dissent.<sup>250</sup> Republicans did raise many of the same objections made during the hearings before the Ways and Means Committee,<sup>251</sup> going

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245. 1936 *House Hearings*, *supra* note 143, at 593 (statement of Arthur H. Kent, Acting Chief Counsel, Bureau of Internal Revenue).

246. 252 U.S. 189 (1920).

247. 1936 *House Hearings*, *supra* note 143, at 593-94. In *Eisner*, the Court held that stock dividends are not taxable, but conceded that "an actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend ...." *Eisner*, 252 U.S. at 215 (1920).

248. 1936 *House Hearings*, *supra* note 143, at 592 (statement of Rep. Vinson).

249. *Id.* at 857 (statement of John W. O'Leary, President, Machinery and Allied Products Institute); *see also id.* at 841 (statement of Raymond H. Berry, Detroit Board of Commerce) ("I believe a tried system of taxation is much better than a new system of taxation, which to me presents many difficulties.").

250. *See \$803,000,000 Tax Bill Wins by Vote of 267-93 in House; Business Attacks New Deal*, N.Y. TIMES, Apr. 30, 1936, at 1; *House Gets New Tax Bill, But Yield is Still in Doubt; Quick Passage is Forecast*, N.Y. TIMES, Apr. 22, 1936, at 1 (noting that House Ways and Means Committee voted fifteen to eight in favor of reporting the bill to the full House).

251. *See, e.g.*, 80 CONG. REC. 6081 (1936) (statement of Rep. Reed) (arguing for surplus to repair "impaired capital" and rebuild businesses); *id.* at 6083 (statement of Rep. Reed) (describing the tax as "a plan of industrial control contemporaneous with the inauguration of the present administration and to be carried forward into capital allocation itself"); *id.* at 6085 (statement of Rep. Lamneck) (suggesting that the principle of the bill is to "attempt by taxing methods to compel business institutions to follow our bidding"); *id.* at 6094 (statement of Rep. Plumley) ("[T]he small struggling corporation is strangled in its infancy; the growing and thrifty young business is anesthetized; the healthy and prosperous industry seeking to expand and to develop is put to death by the lethal weapon concealed in this plan for its

so far as to bombastically characterize the bill as "but a further effort to regiment business under the Federal taxing power along the lines proposed by that revolutionary-minded college professor, 'brain truster' extraordinary, exponent of planned economy, and enemy of American ideals and institutions—Rexford G. Tugwell,"<sup>252</sup> but their opposition was considered "perfunctory" and the chamber called "indifferent" to their pleas.<sup>253</sup> At times, fewer than 10% of the Representatives were present for the debates over the bill, and, according to the *New York Times*, "not more than half [of those present] were listening to the discussion."<sup>254</sup> Those debates about the bill that did take place involved no more than a handful of congressmen.<sup>255</sup>

Much of this apparent lack of interest was due to the Republicans' decision to oppose the bill without offering any alternatives. During a party caucus held while the bill was still under consideration in the House, Republican leaders chose to make "campaign material" out of the tax bill rather than attempt to lessen its impact on business.<sup>256</sup> According to the Minority Leader, Representative Snell, "[t]here is only one amendment the Republican side could offer and that would be to strike out the enacting clause. The measure is not a question of raising taxes, but a question of changing the policy that has been in vogue for the last twenty years."<sup>257</sup> The Republicans did nominally support a proposal from Ohio Representative Arthur P. Lamneck, the lone Democrat opponent of the bill on the Ways and Means Committee, to replace the undistributed profits tax with a flat tax on corporate income at a rate of 22.5%.<sup>258</sup> Otherwise, the Republicans limited themselves to

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economic murder.").

252. 80 CONG. REC. 6300 (1936) (statement of Rep. Treadway).

253. See Turner Catledge, *House Democrats Wind Up Tax Bill; Final Vote Today*, N.Y. TIMES, Apr. 29, 1936, at 1 (calling the proceedings "the most perfunctory witnessed in the House on an important measure in many years"); Editorial, *On the Senate's Lap*, N.Y. TIMES, Apr. 30, 1936, at 18 ("After little debate worthy of the name, conducted for the most part before an indifferent chamber whose seats were less than one-quarter filled [the House passed the measure].").

254. Turner Catledge, *Democrat Lines up with Tax Bill Foes in Attack in House*, N.Y. TIMES, Apr. 25, 1936, at 1; 80 CONG. REC. 6009 (1936) (statement of Rep. Rich).

255. See LAMBERT, *supra* note 106, at 306.

256. See *Republicans Bar Tax Amendments*, N.Y. TIMES, Apr. 28, 1936, at 12.

257. *Id.*

258. *Id.*

voting against the bill as it emerged from Committee and avoided a prolonged battle over amendments.

## 2. Senate

The Republican strategy in the House may have been prompted in part by the belief that the Senate would provide a more receptive audience for an attack on the bill.<sup>259</sup> Opponents were initially emboldened by reports that even the pro-Administration members of the Senate Finance Committee were dissatisfied with the House bill.<sup>260</sup> Although the overwhelming approval of the bill in the House caused such optimism to waver,<sup>261</sup> most observers considered the bill a likely target for revision if for no other reason than its enormous complexity.<sup>262</sup> Nevertheless, the business community's outrage over the House bill's passage may have led opponents to reconsider whether they could afford to let the undistributed profits tax pass in the Senate without amendment.<sup>263</sup> While they still hoped to persuade the majority that the entire idea should be scrapped, opponents began a campaign to reduce the undistributed profits tax's impact. By minimizing the bill's reliance on the tax, they believed the rate could be reduced to an amount sufficient to force

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259. See LAMBERT, *supra* note 106, at 307-08.

Most observers were convinced that the critical decisions would be made in the Senate.... Senators practiced freer debate, listened to the public criticism, and had an open mind. The House, on the other hand, disposed of public business in a great rush and left it to the Senate to improve a measure.

*Id.*

260. See Alfred F. Flynn, *Finance Committee Questions Tax Bill on Two Grounds*, WALL ST. J., Apr. 24, 1936, at 1.

261. See George B. Bryant, Jr., *Tax Bill Speeded as Opposition Wanes in Senate*, WALL ST. J., Apr. 29, 1936, at 1; *\$803,000,000 Tax Bill Wins By Vote of 267-93 in House; Business Attacks New Deal*, *supra* note 250, at 1.

Because of the tremendous House majority in today's vote and the ease with which the bill was shoved through the amending stages in that body yesterday, prospective opposition in the Senate was felt to be cooling perceptibly.

Republican Senators indicated they might follow the lead of their House colleagues and merely make their record against the whole new tax proposal, without attempting to amend it.

*Id.*

262. See *Muddle Over "Simplified" Tax Bill*, 121 LITERARY DIG. 39 (1936).

263. See, e.g., Turner Catledge, *Small Companies Fight Profit Tax; King Has New Plan*, N.Y. TIMES, May 2, 1936, at 1; *Chamber Speakers Assail Profits Tax*, N.Y. TIMES, Apr. 30, 1936, at 10; *Thrust at Tax Bill Winds Up Chamber*, N.Y. TIMES, May 1, 1936, at 1.



corporate managers to increase dividend distributions. This, in effect, would render it impotent as a method for government to exert its control over corporations.

To reduce the bill's exclusive reliance on the undistributed profits tax, opponents questioned its revenue-raising ability and harped on its lack of a track record of success.<sup>264</sup> Early in the process, a majority of the Senate Finance Committee clearly was sympathetic to both these concerns. According to the *Wall Street Journal*, during the Committee's private deliberations on the bill, "both Democratic and Republican members of the committee ... bombarded treasury tax experts with questions regarding the revenue feature."<sup>265</sup> Such concerns spilled over into the public hearings concerning the bill, as both Morgenthau and Helvering continually fielded questions regarding Treasury's revenue projections.<sup>266</sup> Senator King, for example, asked Helvering: "[H]ow 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" of the individual stockholders?<sup>267</sup>

Several witnesses emphasized the revenue issue in their testimony. R.C. Fulbright of the Southern Pine Association pointed out 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."<sup>268</sup> Thus, according to Fulbright, they could not be counted on for the necessary increase in revenues.<sup>269</sup> This uncertainty captured the essence of the problem for several witnesses. James Emery, general counsel for the National Association of Manufacturers, said "[i]t is not ... a reliable source of revenue, for it is subject to the

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264. *See id.*

265. Flynn, *supra* note 260, at 1. Another concern was that several of the provisions, most notably relating to the separate classifications for debt-laden corporations, were unconstitutional. *See Senators Seek Ruling on Constitutionality of Profits Tax Bill*, WALL ST. J., Apr. 25, 1936, at 1.

266. *See 1936 Senate Hearings, supra* note 138, at 1-28 (statements of Henry Morgenthau Jr., Secretary of the Treasury, and Guy T. Helvering, Commissioner, Internal Revenue Service).

267. *Id.* at 18.

268. *Id.* at 147 (statement of R. C. Fulbright, Southern Pine Association).

269. *Id.*

variations of business policy rather than the net income of the business itself."<sup>270</sup> M.L. Seidman of the New York Board of Trade summarized these concerns:

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?<sup>271</sup>

The attacks on the bill's revenue estimates caused a significant internal rift among Treasury officials. Morgenthau supported the undistributed profits tax idea primarily because of its ability to raise the necessary revenue. When that ability encountered critical scrutiny, he made a quick retreat. On May 5, Morgenthau reportedly told Oliphant:

You assumed the responsibility of the tax bill ... and I am willing to rely on your judgment that you have it in hand. I place my reputation in your hands. You have not abused it yet. However, as people call various things to my attention, I will bring them to you. We are gambling to the extent of \$1,250,000,000 in revenue and you fellows must be triply sure that you are right. I leave it entirely to you and Haas.<sup>272</sup>

Treasury's technical staff was hardly up to the task set forth by Morgenthau. In fact, George Haas, the head of Treasury's Division

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270. *Id.* at 682 (statement of James A. Emery, General Counsel, National Association of Manufacturers); *see also id.* at 221 (statement of Fred H. Clausen, United States Chamber of Commerce) ("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.").

271. *Id.* at 93 (statement of M.L. Seidman, Chairman, Tax Committee, New York Board of Trade). This theme was also emphasized in the popular press:

Nobody knows how much revenue the bill would actually produce; it might be less than the billion dollars obtainable by the present taxes, which the bill would recklessly abolish.... If the things nobody knows about this bill were laid end to end, they would constitute an aggregate of ignorance as enormous and formidable as American statesmanship has ever been able to boast.

*Taxing and Destroying*, *BUS. WEEK*, May 9, 1936, at 48.

272. *BLUM*, *supra* note 142, at 311.

of Research and Statistics, was said to be "virtually in tears at the prospects of defending his estimates ... before the Finance Committee."<sup>273</sup> As Mark Leff recounted, Treasury's statistical knowledge was "rudimentary" at best and Treasury witnesses were "uninformed" about other countries' experiences with an undistributed profits tax.<sup>274</sup>

By far the most staggering blow to Treasury came in the form of testimony from former Treasury official George May, a senior partner in the accounting firm of Price Waterhouse Company. May found an error in the figures Treasury Secretary Morgenthau used in his opening testimony before the Committee.<sup>275</sup> Morgenthau had claimed that more than \$4.5 billion of corporate income would be withheld from stockholders under existing law.<sup>276</sup> According to Morgenthau, if distributed this income would translate into an additional \$1.3 billion in income taxes from individual stockholders.<sup>277</sup> May pointed out, however, that the \$4.5 billion would only be available for distribution if the current corporate taxes were repealed.<sup>278</sup> More than a billion dollars of that figure would go directly to the Federal coffers under existing law, leading May to suggest that this and other aspects of the Treasury projections "artificially inflate[d] the estimate of increase of yield from the new law" by ignoring the revenue already available under the current corporate tax.<sup>279</sup> May's testimony, which "administration spokesman admitted was perhaps the most rational indictment yet laid against the proposed undistributed corporate profits tax,"<sup>280</sup> only highlighted the perils of pursuing a radical change in the system of taxation. The *New York Times* responded by reprinting the entire text of May's prepared statement and calling the undistributed profits tax "a huge gamble."<sup>281</sup>

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273. *Id.* at 314; LEFF, *supra* note 86, at 180.

274. LEFF, *supra* note 86, at 180.

275. 1936 *Senate Hearings*, *supra* note 138, at 538 (statement of George O. May, Price Waterhouse Company).

276. *Id.* at 4 (statement of Henry Morgenthau, Secretary of the Treasury).

277. *Id.*

278. *Id.* at 538.

279. *Id.* at 539.

280. Turner Catledge, *Tax Bill Unsound and Not Needed, Expert Testifies*, N.Y. TIMES, May 7, 1936, at 1.

281. *Statement on Taxes by George O. May Before Senate Finance Committee*, N.Y. TIMES, May 7, 1936, at 5; Editorial, *A Huge Gamble*, N.Y. TIMES, May 8, 1936, at 22.

These attacks served to reinforce the criticism that the tax was just a thinly-veiled attempt to control corporate governance. A *New York Times* editorial observed that “[i]t has become increasingly obvious that in the eyes of most of its sponsors the proposed tax on corporation surpluses is not primarily a revenue measure, but a new economic ‘reform.’”<sup>282</sup> While this may not have been entirely accurate,<sup>283</sup> corporate managers at least thought that the bill was more about theories of proper corporate governance than about raising revenue. Businessmen registered loud approval, for instance, when the U.S. Chamber of Commerce adopted a resolution at its annual meeting calling the undistributed profits tax an attempt “to regulate the management of American corporations.”<sup>284</sup> As in the House, corporate managers were concerned that the tax was intended to drive a wedge between themselves and their stockholders. Herman Lind of the National Machine-Tool Builders Association warned:

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.<sup>285</sup>

The result, H.W. Storey, the vice-president of the Allis Chalmers Manufacturing Company, candidly admitted, is that “the normal pressure on management by stockholders for the payment of larger dividends” would grow, making it “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.”<sup>286</sup>

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282. Editorial, *Punishing Prudence*, N.Y. TIMES, Mar. 13, 1936, at 22.

283. See BLUM, *supra* note 142, at 307 (Morgenthau interested in same); LAMBERT, *supra* note 106, at 277 (suggesting that FDR was primarily interested in raising revenue by combating tax avoidance).

284. Felix Belair, Jr., *Business and the New Deal Still Far Apart*, N.Y. TIMES, May 3, 1936, § IV, at 3; *Thrust at Tax Bill Winds Up Chamber*, N.Y. TIMES, May 1, 1936, at 1.

285. 1936 Senate Hearings, *supra* note 138, at 520 (statement of Herman H. Lind, National Machine-Tool Builders Association).

286. *Id.* at 724 (statement of H.W. Storey, Allis Chalmers Manufacturing Company).

In effect, corporate managers would be precluded from pursuing the policy of capital expansion that many favored.

With the momentum from May's testimony, a group of nine Democrats on the Committee joined the Republican minority to announce an alternate revenue proposal.<sup>287</sup> Under the proposal, which was prepared with the substantial assistance of the U.S. Chamber of Commerce and its representatives,<sup>288</sup> the undistributed profits tax would assume a greatly reduced role. In its place, the Senators planned to raise the corporate income tax from its current top rate of 15% to rates ranging from 17.5 to 20% and to eliminate the exemption from the normal tax for dividends.<sup>289</sup> The undistributed profits tax would remain a part of the bill only as a "temporary" tax for three years.<sup>290</sup> According to the *Wall Street Journal*, the plan was an "outgrowth" of testimony "that the bill in its present form will jeopardize assured revenue for an experiment which may or may not produce more revenue than the existing law provides."<sup>291</sup> Although the Senate Finance Committee was rumored to have discussed such a proposal before formally considering the bill,<sup>292</sup> May's testimony appeared to be the final straw that led to the announcement of the compromise plan.

Perhaps seeing the writing on the wall (or in the newspapers),<sup>293</sup> Roosevelt announced that he was open to the Senate Finance Committee's proposed changes to the original plan approved by the House.<sup>294</sup> According to the *New York Times*, "The President was

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287. See *Senate Group Plans Complete Tax Bill Revision*, WALL ST. J., May 9, 1936, at 1.

288. *Id.*

289. *Id.*

290. *Id.*

291. *Id.*

292. See, e.g., Flynn, *supra* note 260, at 1-2 ("Members of the [Senate Finance] committee advanced suggestions that the bill might be changed so that the present corporation tax structure would be retained, but supplemented with some taxes on excess profits or undivided earnings."); *Senate Will Modify Tax Bill*, BUS. WEEK, May 2, 1936, at 26 ("[S]uch retention [of the corporate income tax] is still the best guess on Senate prospects.").

293. See, e.g., Turner Catledge, *Senate Backers Waver on Roosevelt Tax Plan; Hard Fight in Prospect*, N.Y. TIMES, May 8, 1936, at 1; Bernard Kilgore, *White House Lash Necessary to Stop Tax Bill Revisions*, WALL ST. J., May 8, 1936, at 1 ("As public hearings on the Administration's 1936 tax program draw to a close, it is becoming increasingly evident that President Roosevelt will have to 'turn on the heat' again to avoid drastic revision of the House bill by the Senate.").

294. See Alfred F. Flynn, *Roosevelt Held Willing to Have Tax Bill Changed*, WALL ST. J., May 12, 1936, at 1 ("President Roosevelt is open to suggestions for changes in the House tax

reported to have told [Senate Finance Committee Chairman] Senator Harrison that he would approve this or any other similar proposal if it promised to produce the needed revenue and, at the same time, carried out the general philosophy of an impost on undistributed corporate earnings.<sup>295</sup> Roosevelt's willingness to compromise was not surprising considering that both Treasury Secretary Morgenthau and Bureau of Internal Revenue Commissioner Helvering came to similar conclusions after listening to the Senate Finance Committee Hearings.<sup>296</sup> Announcing to his staff his decision to pursue a compromise proposal, Morgenthau stated that there were "too many dangers surrounding the possibilities."<sup>297</sup> The most important purpose of the measure, he reminded Oliphant, was to raise the necessary revenue.<sup>298</sup> Mindful of the election year, Roosevelt could not afford to ignore Morgenthau's warnings.

Despite the general agreement that the tax bill's exclusive reliance on the undistributed profits tax was untenable, there was no consensus on what role, if any, the undistributed profits tax should still play in any compromise bill. In addition to the proposal to make the undistributed profits tax a mere temporary measure in the revenue bill, one other proposal had garnered support from members of the Senate Finance Committee. This proposal, which a *New York Times* editorial first described and substantially resembled proposals forwarded by the American Institute of Accountants and the New York State Society of Certified Public Accountants,<sup>299</sup> sought to raise the necessary revenue while

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bill, sources close to the White House made known Monday.").

295. Turner Catledge, *Revised Tax Plan Offered With Roosevelt's Approval*, N.Y. TIMES, May 13, 1936, at 1; see also Catledge, *supra* note 293, at 1.

Some Senators said they had it on good authority that if a plan were evolved which would promise the desired additional revenue and at the same time maintain a vestige of the proposed levy on undistributed corporate profits, the President would accept it gladly, rather than hazard a long session-end fight with Congress in an election year.

*Id.*

296. See Turner Catledge, *Senators Draw Up Compromise Plan on Profit Tax Bill*, N.Y. TIMES, May 9, 1936, at 1.

297. LAMBERT, *supra* note 106, at 325.

298. *Id.*

299. See 1936 Senate Hearings, *supra* note 138, at 602 (statement of Victor H. Stempf, Committee on Federal Taxation, American Institute of Accountants); Catledge, *supra* note

appeasing Roosevelt's need for a symbolic undistributed profits tax. Under the *Times* plan, the existing tax on corporate incomes would be retained, but at a flat rate of 15% rather than the graduated rates ranging from 12.5 to 15%.<sup>300</sup> In addition, the proposed bill would eliminate the exemption from the 4% normal tax on dividends paid to individuals and would impose a 4% undistributed profits tax.<sup>301</sup>

The identity of rates between the dividend tax and the undistributed profits tax was no mere coincidence. As the *New York Times* acknowledged, "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."<sup>302</sup> Although it was true that undistributed profits would be subject to the individual normal and surtax rates if distributed in a subsequent year, a company that never or rarely issued dividends would avoid shareholder pressure to do so now. The *Times* also suggested raising the 4% undistributed profits tax for retentions above a threshold "normal" dividend policy, with a notable exception for retentions ear-marked for "the purchase of new machinery, the building of added plants or the creation of tangible facilities," as a method of limiting tax avoidance.<sup>303</sup> Senator King was so favorably impressed by the plan that he had the editorial entered into the record during the Hearings.<sup>304</sup>

The *Times* proposal pushed Roosevelt to the limits of his willingness to compromise, and beyond. His principal complaint—that the proposal would not force a corporation to increase its dividend distributions because the undistributed profits tax was identical to the dividend tax on distributions—was the greatest

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196, at 1; Editorial, *A Compromise Tax Bill*, N.Y. TIMES, May 4, 1936, at 18; *Long Tie-Up Looms on Tax Bill*, N.Y. TIMES, May 10, 1936, at 1, 32.

300. *A Compromise Tax Bill*, *supra* note 299, at 18.

301. *Id.* The American Institute of Accountants simply suggested that the undistributed profits tax be applied at a "low rate." *1936 Senate Hearings*, *supra* note 138, at 603.

302. *A Compromise Tax Bill*, *supra* note 299, at 18.

303. *Id.*

304. See *1936 Senate Hearings*, *supra* note 138, at 352 (statement of Sen. King) ("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.").

virtue in the eyes of the proposal's supporters.<sup>305</sup> He did not have the requisite Committee support, however, to dictate the terms of a compromise. Even after Senator Harrison appeared to steer the Committee toward a proposal that would raise the normal tax from 4 to 5% and set the undistributed profits tax at a modestly higher 7%,<sup>306</sup> corporate managers protested. The U.S. Chamber of Commerce issued a statement denouncing Harrison's proposed alternative.<sup>307</sup> According to the Chamber, even "[t]he introduction of that principle [the undistributed profits tax] into our tax system in any form whatever is opposed by business on the justifiable ground, among others, that it would inject government into the management of private enterprise."<sup>308</sup> Another Democrat on the Committee, Senator George, countered with a plan to remove any pressure on management to distribute profits by tying the normal and undistributed profits taxes at an identical rate of 5%.<sup>309</sup> Although a majority of the members of the Committee expressed approval for George's plan to tie the undistributed profits tax to the normal tax rate,<sup>310</sup> Harrison eventually engineered a compromise that kept the normal tax on dividends at 4% while levying a 7% undistributed profits tax.<sup>311</sup>

Notwithstanding the re-emergence of an undistributed profits tax that exceeded the normal tax on dividends, conservative forces claimed victory. The spread between the undistributed profits tax rate and the normal tax rate on dividends was too small to influence the distribution of dividends. As the *Wall Street Journal* observed, "the Senate committee has all but eliminated the tax pressure calculated to force corporations to pay out earnings liberally in

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305. See LAMBERT, *supra* note 106, at 327.

306. 18% Corporate, 5% Normal Tax New Senate Plan, WALL ST. J., May 16, 1936, at 1; see Turner Catledge, *Rise in Income Tax to 5%, 18% rate on Corporations, Now Favored By Senators*, N.Y. TIMES, May 16, 1936, at 1.

307. See Turner Catledge, *New Tax Program is Held Adequate by the Treasury*, N.Y. TIMES, May 17, 1936, at 1.

308. *Id.* The primary risk of accepting the principle, even with rates too low to force the distribution of profits, was that those rates could be adjusted in future years to accomplish that very thing. *Id.*

309. *Retained Profit Tax May Be Cut to Five Per Cent*, WALL ST. J., May 19, 1936, at 3.

310. 12 of Senate Group Oppose Supertax Above Normal Rate, WALL ST. J., May 20, 1936, at 2.

311. See Turner Catledge, *18% Corporate Income Tax and 7% on Undivided Profit Agreed on by Senate Group*, N.Y. TIMES, May 22, 1936, at 1.



dividends by trimming the pressure rate down to a flat 7 per cent on all retained income.<sup>312</sup> The *New York Times* concluded that the compromise "struck from the original plan the elements of economic reform which at the outset were its main prop."<sup>313</sup> The *Nation* called for "some stronger dynamite than a straight 7 per cent tax ... to blast" out the undistributed profits.<sup>314</sup> During a conference with Democrats on the Senate Finance Committee, Roosevelt expressed his displeasure with the proposed bill.<sup>315</sup> He urged them to set a much higher tax on undistributed profits, with rates ranging from as low as 25% to as high as 45%,<sup>316</sup> but to no avail.<sup>317</sup> The decision was made to quickly push the bill through the Senate so that it could go to the Conference Committee, where the administration's prospects for success were brighter.<sup>318</sup>

The price corporate managers paid for gutting the bill of its coercive power over dividend policy was the introduction of full double taxation of corporate profits. Because of Roosevelt's demands for increased revenue, the Finance Committee could not effect a

312. Editorial, *Taxes Must Be Disguised*, WALL ST. J., May 26, 1936, at 6.

313. Catledge, *supra* note 311, at 6; see also Editorial, *Taxes Must Be Disguised*, WALL ST. J., May 26, 1936, at 6 ("The committee recognizes the grave danger of such an enactment but feels compelled by party loyalty to accord the President a minor fraction of the project of social reform through taxation which he espoused.")

314. *The Shape of Things*, 144 NATION 725 (1936).

315. Roosevelt's displeasure was in part due to the realization that the Senate Finance Committee compromise proposal might come up short in raising the necessary revenue. See Arthur Krock, *Shortage of Revenue Upset Senators' Tax Program*, N.Y. TIMES, May 28, 1936, at 22.

316. See Turner Catledge, *Roosevelt Demands Return to His Original Tax Plan; Rejects Senate Revisions*, N.Y. TIMES, May 27, 1936, at 1; Alfred F. Flynn, *Finance Members Fight Roosevelt Tax Suggestions*, WALL ST. J., May 28, 1936, at 2; Editorial, *Going to the Mat?*, WALL ST. J., May 28, 1936, at 4.

317. See Turner Catledge, *Tax Plan Revision Barred in Senate to Wind Up Session*, N.Y. TIMES, May 29, 1936, at 1.

In a desperate attempt to save their plan for adjournment of Congress by June 6, Democratic leaders decided today to rush the Finance Committee's compromise revenue bill to the Senate floor, despite the objections of President Roosevelt to its failure to meet demands for revenue and corporate tax reform outlined by him in his message of March 3.

*Id.*

318. See BLUM, *supra* note 142, at 317; *Senate Group Rushes Action on Tax Bill; To Vote Own Plan*, WALL ST. J., May 29, 1936, at 1 (reporting that Vice President John Nance Garner was the principal proponent of this move among administration officials). Garner reportedly believed "that tax bills are always written in conference anyway and that it is just so much waste of time for one or the other bodies of Congress to get worked up over principles." *Id.*

drastic reduction of the undistributed profits tax without retaining the corporate income tax. Although business leaders advocated a program of slashing expenditures rather than raising taxes, most recognized that this was unlikely, especially all at once during an election year.<sup>319</sup> By coupling a corporate income tax with a dividend tax to negate the undistributed profits tax, corporate profits would be subject to double taxation even if they were immediately distributed. Far from being an unintentional consequence of legislative maneuvering,<sup>320</sup> double taxation emerged as part of a trade off for corporate managers.

Despite nominal protests about this introduction of double taxation,<sup>321</sup> business representatives appeared willing to accept it if the alternative was government interference with corporate management. Many of the corporate managers testifying before the Senate Finance Committee agreed that retaining the corporate income tax, even at a higher rate, was preferable to the undistributed profits tax as long as individuals bore some of the burden as well. The secretary and comptroller of one company, when asked to opine on a variant of the *New York Times*' plan favored by

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319. See Editorial, *A Compromise Tax Bill*, *supra* note 299, at 18.

320. See Kwall, *supra* note 3, at 619-20 (describing the origins of double taxation as "inadvertent"). Kwall is probably correct in his assessment when viewed from Roosevelt's perspective since the original bill in the House would not have imposed full double taxation. For opponents of the bill, both in the Senate and in business, double taxation was adopted with eyes wide open.

On the other hand, one contemporary observer suggested that it was to some extent inadvertent on the part of business as well.

With what may be regarded as an excess of zeal, the critics insisted both that the new tax would cripple corporations and that it would bring in a disappointingly small revenue. Hence they argued the Government could not afford to give up the time-tried corporation tax for this new experiment. Congress, being impressed by the latter argument, compromised by retaining the old taxes, imposing the new one as well, and abolishing the time-honored exemption of dividends from normal tax. In this case business seems to have talked itself into a higher tax bill.

Benjamin Graham, *The Undistributed Profits Tax and the Investor*, 46 YALE L.J. 1, 4 (1936). This argument ignores the opponents' two-part strategy against the tax. While the result might be viewed as ironic from the perspective of their strategy to oppose the undistributed profits tax altogether, it was consistent with their alternative strategy to minimize the reliance on the undistributed profits tax as much as possible.

321. See Catledge, *supra* note 307, at 1 (describing a United States Chamber of Commerce statement in which it listed fourteenth among its sixteen objections to the Senate Finance Committee proposal that "[i]t would subject corporate earnings to double taxation").

Senator King, stated, "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."<sup>322</sup> Arthur Ballantine, Under Secretary of the Treasury in the Hoover Administration and the representative of the Merchants Association of New York, similarly stated:

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.<sup>323</sup>

When pressed by Senator Connally to consider the possibility of a 20% tax on corporate income plus a 10 to 15% levy on undistributed profits, Noel Sargent of the National Association of Manufacturers responded by saying "the better procedure would be to increase the present corporation income tax and not to levy any superimposed tax on undistributed profits."<sup>324</sup> Business leaders and their representatives clearly advocated doing whatever was necessary to reduce the impact of the undistributed profits tax on corporate management. They believed that introducing double taxation through the retention of the corporate income tax and removing the exemption from the normal tax for dividends was a reasonable price to pay for accomplishing that objective.

Through a minority report on the Finance Committee's compromise plan, Senators Hugo Black and Robert La Follette, Jr., fired the last arrows in defense of a large undistributed profits tax.<sup>325</sup> The report's principal complaint was that the compromise proposal

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322. 1936 *Senate Hearings*, *supra* note 138, at 143 (statement of Paul Wilson, Graton & Knight Company).

323. *Id.* at 429 (statement of Arthur A. Ballantine, Merchants Association of New York).

324. *Id.* at 675 (statement of Noel Sargent, Economist, National Association of Manufacturers).

325. See *Committee Minority Report Opposing Tax Bill*, N.Y. TIMES, June 2, 1936, at 22 (reprinting the minority report in its entirety).

would do nothing for the problem of unnecessary retention of earnings:

While the corporation would be subject to an increased tax of 7 per cent on undistributed profits, it is also true that the committee's bill adds 4 per cent on the normal tax of the individual where these dividends are distributed to the individual stockholders. This means that if all the corporate profits should be distributed the corporation would not pay the 7 per cent penalty but the individual would pay a 4 per cent tax on the dividends.

The net incentive, therefore, is a 3 per cent tax on undistributed profits. Such a penalty will not cause the controlling group in the higher income tax brackets to declare dividends ....<sup>326</sup>

The report suggested retaining the corporate income tax while imposing rates as high as 30% on undistributed profits in excess of a certain amount, with generous exemptions for smaller businesses and for normal retentions.<sup>327</sup> As the minority report explained, "the committee's bill perpetuates the evils of a tax system under which the largest income beneficiaries in America avoid their fair proportion of tax."<sup>328</sup>

While the Senate considered the bill, members of the Finance Committee made clear that their intent was to use the tax on dividends to nullify the effects of the undistributed profits tax. According to Senator Walter George, the committee vote was twelve to four in favor of setting the undistributed profits tax at a rate no higher than the normal rate on dividends.<sup>329</sup> Only "after an earnest appeal by the chairman"<sup>330</sup> did the committee agree to raise the undistributed profits to the rate of 7% and even then it was "to arrive at an agreement" rather than to risk having the entire matter decided on the Senate floor.<sup>331</sup> Thus, the proponents of the compromise bill did not hide from, but instead embraced the fact

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326. *Id.*

327. *Id.*

328. *Id.*

329. 80 CONG. REC. 8809 (1936) (statement of Sen. George).

330. *Id.*

331. *Id.* at 8803.

that the dividends tax was being used as a foil for the undistributed profits tax's push to distribute excess profits. In their eyes, double taxation was a necessary tool in the fight to protect the retention of profits where, "as a matter of judgment and of sound business, it is of actual profit in the administration of the corporations to do so."<sup>332</sup> By reporting their desire to link the dividends tax to the undistributed profits tax, the Finance Committee members signaled their opposition to governmental interference with the management of corporate enterprises. Although business groups continued to protest the adoption of the undistributed profits tax in any form,<sup>333</sup> they acknowledged the Senate bill's superiority to the House bill.<sup>334</sup>

### 3. Conference

After passing the Senate,<sup>335</sup> the bill proceeded to the conference committee where it was deadlocked between the radically different House and Senate versions. House conferees refused to budge from their demands for a graduated undistributed profits tax and Senate conferees insisted on retaining the corporate income tax.<sup>336</sup> During this impasse, corporate managers took their case directly to their shareholders. Alfred Sloan, President of General Motors, sent a letter to shareholders with the regular quarterly dividend warning that it "would be little short of a catastrophe" for the government to interfere with "the employment of accumulated profits by aggressive and intelligent management."<sup>337</sup> Most proponents of the Senate bill, however, recognized that a compromise was likely and could only

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332. *Id.* at 8804.

333. The National Association of Manufacturers issued a statement declaring:

Both the Senate Finance Committee and House bills accept the principle of taxation of undistributed profits. Such a proposal is economically unsound, since it repudiates the policy of industrial reinvestment of earnings upon which expansion and employment have been based for over 100 years, and because it seeks to substitute government judgment as to the desirable amount of corporate reserves for that of directors elected by corporation stockholders.

*Heated Debate on Taxes Forces Recess in Senate; Rise in Surtaxes Voted*, N.Y. TIMES, June 4, 1936, at 1 (quoting the National Association of Manufacturers).

334. *Id.*

335. *See Tax Bill is Passed by Senate, 38 to 24; Conference to Act*, N.Y. TIMES, June 6, 1936, at 1.

336. *See LAMBERT, supra* note 106, at 343.

337. *Decreed Dividends Opposed By Sloan*, N.Y. TIMES, June 12, 1936, at 33.

result in a higher undistributed profits tax.<sup>338</sup> These proponents, nevertheless, sought to persuade the Senate conferees to mitigate the damage. A *New York Times* editorial, for example, suggested that any concessions toward a higher rate should include an exemption for "all profits retained for the explicit purpose of buying new machinery, making extensions of plant or otherwise adding to the facilities."<sup>339</sup> Such an exemption would effectively leave businesses with the freedom to do most of what they had done before with retained surplus.

With the assistance of Morgenthau,<sup>340</sup> the deadlock was resolved. He convinced Ways and Means Chair Robert Doughton that they had to retain the corporate income tax in the bill, telling him "I feel that at this stage that we can't just throw all that overboard."<sup>341</sup> With that compromise, the Senate conferees were more amenable to a higher undistributed profits tax. This should not have been surprising given that the harshest critics of the House bill among the senators originally chosen for the conference committee—Senators Couzens and Keyes—declined the appointments because they would be unable to recommend any possible compromise.<sup>342</sup> The only hard-line opponents of the undistributed profits tax on the Senate conference committee were Senators Walsh and George, and they dissented from the final agreement.<sup>343</sup> Despite the pro-Administration slant of the Senate conferees, the graduated undistributed profits tax rates eventually agreed upon, with rates ranging from 7 to 27%,<sup>344</sup> still were considered "less severe" than the rates proposed by Treasury or the House bill.<sup>345</sup> The top rate on the

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338. See Editorial, *Tax Bill Compromise*, N.Y. TIMES, June 9, 1936, at 22 ("Undoubtedly the Senate conference committee will now be under great pressure, not merely from the House committee but from some of its own members, to compromise with the House measure.").

339. *Id.*

340. See BLUM, *supra* note 142, at 318.

341. *Id.*

342. See *Tax Bill is Passed by Senate*, 38 to 24, *supra* note 335, at 1.

343. See 80 CONG. REC. 10163 (1936) (reprinting minority report filed by Senators George and Walsh); *Congress Ready To Enact the Compromise Tax Bill and Adjourn Tomorrow*, N.Y. TIMES, June 19, 1936, at 1.

344. Revenue Act of 1936, 49 Stat. 1648.

345. See Brownlee, *supra* note 123, at 54. In their minority report to the House conference report on the bill, Senators Treadway, Crowther, and Woodruff acknowledged that the primary difference between the final bill and the House bill was "in the degree of 'pressure' exerted" by the undistributed profits tax rates. 80 CONG. REC. 10,263 (1936) (reprinting

undistributed profits tax was identical to the lowest surtax rate for incomes in excess of \$44,000.<sup>346</sup> This may have been designed to subject corporate income to the same tax—whether it was retained or distributed—assuming the shareholder's income fell within this surtax bracket. Application of the 4% dividend tax, therefore, ensured that it was still logical for those shareholders to permit the corporation to retain profits rather than subject them to an additional tax.<sup>347</sup> Only those shareholders not subject to any surtax—who were presumably the least powerful equity holders—were still likely to clamor for distributions as a result of the ultimately enacted undistributed profits tax.

As finally adopted, the Revenue Act of 1936 imposed a surtax on the "undistributed net income" of corporations at rates ranging from 7 to 27%.<sup>348</sup> "Undistributed net income" was determined by deducting from the adjusted net income<sup>349</sup> dividends paid during the taxable year and amounts due to contracts that restricted the payment of dividends.<sup>350</sup> An additional deduction was provided for corporations with an adjusted net income below \$50,000.<sup>351</sup> Moreover, a number of corporations—most notably banks, insurance corporations, foreign corporations, and corporations in bankruptcy—were exempt from the tax altogether.<sup>352</sup> In addition to imposing this surtax on undistributed profits, the 1936 Act retained the normal corporate income tax, with rates ranging from 8 to 15%,<sup>353</sup> and removed the exemption from the 4% normal individual tax for dividends received.<sup>354</sup> Thus, for the first time in the history of the income tax, corporate income was fully subject to double taxation.

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minority report of Republican House conferees).

346. See Revenue Act of 1935, § 101, 49 Stat. 1014 (1935) (both were set at 27%).

347. Of course, if the corporation retained the profits and became subject to the tax, the shareholder would eventually be subject to a heavy tax upon distribution. If no distribution was ever made, however, the shareholder could recoup his profits in the form of capital gains upon sale of the stock.

348. Revenue Act of 1936, § 14(b), 49 Stat. 1648, 1656.

349. *Id.* § 14(a)(1), 49 Stat. at 1655. "Adjusted net income" was further defined as the net income less the normal corporation tax and interest on U.S. obligations. *Id.*

350. *Id.* §§ 26(c), 27, 49 Stat. at 1664-65.

351. *Id.* § 14(c), 49 Stat. at 1656.

352. *Id.* § 14(d), 49 Stat. at 1656.

353. *Id.* § 13(b), 49 Stat. at 1655.

354. *Id.* § 11, 49 Stat. at 1653.

*C. The Rise and Fall of the Undistributed Profits Tax**1. The Aftermath of the Revenue Act of 1936*

While legal scholars hurried to analyze the technical details of the Revenue Act of 1936 and its "hastily drawn" undistributed profits tax,<sup>355</sup> business opposition to the undistributed profits tax did not subside. According to Alfred Buehler, national and regional business associations "continued to direct broadsides of criticism against the measure because of its alleged complexities, inequalities, and unfortunate effects on corporations."<sup>356</sup> John Morton Blum recounted that "[b]ecause that tax tended to return to stockholders the decision about how to spend or invest their money, it challenged the power of professional managers of large corporations. These managers, their lawyers, and accountants, in all an able, articulate, and influential group, were aggressive opponents of the tax."<sup>357</sup> Republicans also helped sustain opposition by highlighting it during the 1936 election campaign as an example of the administration's anti-business stance.<sup>358</sup> Alf Landon, the Republican candidate for president, vowed to eliminate "this vicious method of taxation," calling the undistributed profits tax "the most cockeyed piece of tax legislation ever imposed in a modern country."<sup>359</sup>

While continuing their public attack on the undistributed profits tax, corporate managers were also attempting to learn to live with

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355. Homer Hendricks, *The Surtax on Undistributed Profits of Corporations*, 46 YALE L.J. 19, 19 (1936); see Graham, *supra* note 320, at 1; Martin, *supra* note 85, at 44; Note, *The Corporate Undistributed Profits Tax*, 36 COLUM. L. REV. 1321 (1936); Note, *The Surtax on Undistributed Profits*, 50 HARV. L. REV. 332 (1936).

356. BUEHLER, *supra* note 86, at 35; see LAMBERT, *supra* note 106, at 409 ("Business representatives continued to complain that the law impaired the financial strength of corporations, imposed unreasonable penalties upon expansion, and retarded economic recovery. Business executives, lawyers, and economists gloomily predicted that the levy on undivided corporate surpluses would lead to industrial stagnation, increased unemployment, and a financial collapse."). For a typical expression of such sentiments, see *Executives Sound Confident Keynote*, N.Y. TIMES, Jan. 4, 1937, at 55 (year-end statement of W.G. Carey, President of Yale & Towne Manufacturing Company, assailing undistributed profit tax).

357. BLUM, *supra* note 142, at 321.

358. *Id.* at 319; HAWLEY, *supra* note 128, at 356.

359. Alf M. Landon, *Federal and Family Finances*, in 2 VITAL SPEECHES OF THE DAY 763, 764 (1936).



it. One significant change attributed to the enactment of the new tax was a noticeable increase in dividend distributions as businesses attempted to take advantage of the dividends-paid credit.<sup>360</sup> This was particularly evident during year-end when companies were beginning to adjust to the new tax. Dividend payments in October were the largest for that month since 1931 and dividends in November set a record for any one month period, beating the old record set in December of 1930 by almost \$250 million.<sup>361</sup> The year-end surge in dividend declarations was so great that it threatened to overwhelm the New York Stock Exchange's ability to register the payments.<sup>362</sup> Even after the turn of the year, however, dividend listings continued to rise. In February 1937, for instance, dividends increased by almost one-third over the previous year, with many of the announcements labeling the distributions as "interim" or "irregular" to indicate that they were prompted by the undistributed profits tax.<sup>363</sup> Although some observers later claimed that these merely represented accelerated distributions or were the result of a prosperous year,<sup>364</sup> most commentators agreed that the

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360. See GEORGE E. LENT, *THE IMPACT OF THE UNDISTRIBUTED PROFITS TAX 1936-1937*, at 33 (1948) (concluding that the undistributed profits tax was responsible for an increase of dividends by one-third); E.J.H., Jr., *Some Economic Aspects of the Surtax on Undistributed Profits of Corporations*, 25 GEO. L.J. 423, 435 (1937).

During the last few weeks of 1936 announcements have been made of extra dividends, of bonuses, and of wage increases, running into millions of dollars. Each day brings announcement of further actions of this character, and when the statistics are finally compiled for the calendar year 1936, the total of these disbursements will probably reach, if not pass, the half billion mark.

*Id.*

361. *Month's Dividends Put At \$800,000,000*, N.Y. TIMES, Nov. 29, 1936, § 3, at 1 (noting that dividends were \$800 million versus \$567 million in December of 1930); *October Dividends Largest Since 1931*, N.Y. TIMES, Nov. 1, 1936, § 3, at 1; *\$7,500,000 is Added to Dividend Total*, N.Y. TIMES, Nov. 22, 1936, § 3, at 1.

362. *Exchange Eases Transfer Rules*, N.Y. TIMES, Nov. 21, 1936, at 25.

363. *Dividend Listings Rose in February*, N.Y. TIMES, Feb. 28, 1937, § 3, at 6. This may have been due in part to the desire to manage investor expectations and rebut labor demands for higher wages. See *A.F. of L. Demands Large Wage Rises on Recurring Basis*, N.Y. TIMES, Nov. 30, 1936, at 1 (demonstrating the ability to pay the wage increases by "pointing to what it said were record dividend payments this month").

364. See Francis McIntyre, *The Effect of the Undistributed Profits Tax Upon the Distribution of Corporate Earnings - A Statistical Appraisal*, 7 ECONOMETRICA 336, 347-48 (1939). The dividends were accelerated because the Treasury took the position that the dividends-paid credit would only be available if the dividend checks were actually received by shareholders before the end of the taxable year. See T.D. 4674, Art. 27-1(b), 33 Treas. Dec. Int. Rev. 480, 492 (1936). For a contrary view, see Harry G. Guthmann, *The Effect of the*

undistributed profits tax played a significant role. According to a *New York Times* editorial:

The unparalleled distribution of dividends at the end of last year was only in part the result of returning prosperity; the distribution would never have been as large as it was had it not been for the pressure on corporations to escape a heavy tax penalty for the retention of earnings.<sup>365</sup>

In a study of 360 corporation executives by the National Industrial Conference Board, 61% of respondents indicated that their company's dividend policies were affected by the undistributed profits tax.<sup>366</sup>

Even the change in dividend policies was simply another opportunity for corporate managers to assail the tax publicly. The National Association of Manufacturers spearheaded a campaign to send letters to shareholders explaining that a desire to avoid the undistributed profits tax, and not the exercise of business judgment, forced the extra dividends.<sup>367</sup> In one example, a prominent oil company declared a special dividend with an accompanying explanation stating:

This special dividend declaration is made in order to reduce the company's liability for the new Federal tax on undistributed earnings. Because of the company's needs for capital expenditures and debt payments, the directors would prefer to retain in the business the cash represented by this special dividend. In any event, they would not ordinarily declare any dividend at this time with respect to earnings for the present calendar year, as such earnings cannot be known with sufficient exactness in the usual course of business for some time after year's end.<sup>368</sup>

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*Undistributed Profits Tax upon the Distribution of Corporate Earnings: A Note*, 8 *ECONOMETRICA* 354, 356 (1940).

365. Editorial, *The Surplus Tax*, N.Y. TIMES, Jan. 5, 1937, at 22.

366. Lewis H. Kimmel, *Experience Under the Undistributed Profits Tax*, 11 CONF. BOARD BULL. 105, 106 (1937).

367. See LEFF, *supra* note 86, at 249 (noting the advent of "NAM sponsored shareholder letters in 1936").

368. M.L. Seidman, *The Stockholder Holds the Bag*, 59 MAG. WALL ST. 156, 157 (1936). For other examples, see *Profits-Tax Levy Avoided By Trust*, N.Y. TIMES, Jan. 15, 1937, at 31 ("Distribution of extra and special dividends before the end of 1936 enabled Supervised Shares, Inc., to avoid liabilities under the tax on undistributed profits, Merrill Griswold,

Similar statements accompanied announcements of other changes necessitated by the undistributed profits tax. For example, the president of a public electric company explained that the directors voted in favor of a stock split with a reduction in stated par value because the tax would potentially interfere with plans for capital expenditures,<sup>369</sup> and a steel corporation executive sent a letter to stockholders blaming the undistributed profits tax "for abandoning its old policy of financing expansion and improvements out of earnings."<sup>370</sup>

Some managers sought to avoid distributing profits by resorting to taxable stock dividends. Under the 1936 Act, corporations were entitled to a credit for distributions of taxable dividends, even if they were paid in the form of stock rather than cash.<sup>371</sup> A taxable dividend consisted of a distribution that effected a meaningful change in the shareholders' ownership of the corporation. A Dun & Bradstreet Survey indicated that while 86% of the dividends declared in 1936 were paid in cash,<sup>372</sup> an increasing number of managers, especially in small and medium-sized corporations, were strongly considering using alternatives to cash dividends in 1937.<sup>373</sup>

Despite their appeal to managers, taxable stock dividends never became a widely used solution to the undistributed profits tax problem. Less than 1/3 of 1% of all corporations subject to the tax decided to issue taxable stock dividends.<sup>374</sup> Part of the problem was the legal uncertainty surrounding the taxation of stock dividends.<sup>375</sup> As Arthur Kent had predicted during the House Ways and Means Committee hearings on the 1936 Act,<sup>376</sup> the Supreme Court eventually ruled in *Koshland* that common stock dividends issued to preferred stockholders were taxable.<sup>377</sup> Nevertheless, the taxability of other types of stock dividends was still an open

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Chairman, and Mahlon E. Traylor, President, said in a quarterly report issued yesterday.").

369. See *Will Balance Effect of Federal Surtax*, N.Y. TIMES, Aug. 6, 1937, at 23.

370. *Financing Planned by Ludlum Steel*, N.Y. TIMES, Aug. 26, 1937, at 31.

371. Revenue Act of 1936, § 27(e), 49 Stat. 1665.

372. See Willard L. Thorp & Edwin B. George, *An Appraisal of the Undistributed Profits Tax*, DUN'S REV., Sept. 1937, at 5, 11.

373. *Id.* at 10 (Table I), 12.

374. Christie & Nanda, *supra* note 16, at 1753 n.19.

375. See Godfrey N. Nelson, *Law Still is Hazy on Stock Dividends*, N.Y. TIMES, Nov. 1, 1936, § 3, at 1.

376. See *supra* text accompanying notes 244-45.

377. *Koshland*, 298 U.S. at 447.

question. A recent Board of Tax Appeals opinion added to the uncertainty by ruling that a dividend in preferred stock on common stock would not be taxable.<sup>378</sup> Moreover, with the simplicity of many corporations' capital structures, there were few available avenues other than the cash option dividend.<sup>379</sup> This, however, would have charged shareholders rather than managers with the reinvestment decision, a result clearly unacceptable to business leaders.<sup>380</sup>

A significant percentage of corporate managers chose to incur the undistributed profits tax rather than increase their dividend distributions.<sup>381</sup> According to one recent study, between 17 and 23% of small to medium-sized corporations paid marginal rates under the undistributed profits tax of 22% or more and the total collections under the tax reached \$176 million in 1936 and \$176 million in 1937.<sup>382</sup> The study concluded: "While it is true that the vast majority of firms increased dividend payout rates in 1936 to limit their tax liability under the new law, a substantial number of firms paid high marginal SUP [Surtax on Undistributed Profits] rates, and the revenue from the new tax was large."<sup>383</sup> Not surprisingly, those corporations that had retained the largest percentage of earnings prior to the enactment of the undistributed profits tax continued to retain the most—almost 50% of their free cash flow by one

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378. See J.S. Seidman, *Corporate Dividend Policies During the Rest of 1936 Under the New Tax Law*, 48 ANNALIST 671, 672 (1936).

379. COMMITTEE ON TAXATION OF THE TWENTIETH CENTURY FUND, INC., *FACING THE TAX PROBLEM* 175-76 (1937); LENT, *supra* note 360, at 180. Even the taxability of the cash option dividend was potentially called into question if all of the stockholders elected to take stock rather than cash. See Norman L. McLaren, *Management of Capital Distributions Under the Revenue Act of 1936*, 62 J. ACCT. 334, 347.

380. This fear was expressed during the hearings before the Senate Finance Committee, and Treasury's George Haas responded that the argument against cash-option dividends assumes that corporate managements may justly reinvest earnings in a particular enterprise against the desire of the stockholders .... 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.

1936 Senate Hearings, *supra* note 138, at 52 (statement of Mr. Haas).

381. See, e.g., *Many Companies Will Pay Surtax to Conserve Cash*, WALL ST. J., Nov. 10, 1937, at 1 (citing companies such as American Gas & Electric, Distillers Corporation-Seagrams Limited, Schenley Distillers Corporation, Chrysler Corporation, Douglas Aircraft, and Skelly Oil Company).

382. CALOMIRIS & HUBBARD, *supra* note 16, at 6-7.

383. *Id.*

estimate—notwithstanding their increase in dividends.<sup>384</sup> Moreover, those corporations in growing industries with the highest external finance costs—and thus the greatest need to retain earnings to fund expansion projects and other needs—paid the highest rates under the tax.<sup>385</sup>

## 2. 1937 Economic Downturn

In the spring of 1937, business leaders recognized they had little hope of outright repeal of the undistributed profits tax,<sup>386</sup> so they focused on the more realistic goal of revising the undistributed profits tax to remedy obvious inequities and inefficiencies.<sup>387</sup> Coincidentally, the movement for revision lost steam when it became clear that Treasury faced a revenue shortfall of \$300 million or more for the fiscal year.<sup>388</sup> Spurred on in part by the revelations in the government's long-running audit of former Treasury

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384. See Christie & Nanda, *supra* note 16, at 1744.

385. See CALOMIRIS & HUBBARD, *supra* note 16, at 23.

386. See *Seeks Data on Profits Tax*, N.Y. TIMES, Mar. 17, 1937, at 8 ("While there appears to be little likelihood of the immediate elimination of the surtax on undistributed corporate earnings," the [United States Chamber of Commerce] wrote, "there apparently is a growing interest in official quarters in illustrations of substantial hardships and inequities attributable to the tax.").

387. See *7 Changes Urged in Tax on Surplus*, N.Y. TIMES, Apr. 12, 1937, at 6 (report of a committee of the Boston Chamber of Commerce); *Sibley Asks Slash in Tax on Business*, N.Y. TIMES, Apr. 19, 1937, at 16 (United States Chamber of Commerce President urges exemption for retentions of 30% or less.). Many members of Congress shared this sentiment:

Doughton noted that, as with any new tax law, it is usually necessary to amend a tax law after the problems of administration have been determined. There is some demand to revise the corporate surplus tax to take care of weak companies and those with heavy indebtedness. It's a little early yet to talk about that, but you can say that the road has not been closed by the committee.

*New Tax Unlikely, Doughton Asserts*, N.Y. TIMES, Mar. 17, 1937, at 8; see also *Excess Profits Tax Revision Favored by Rep. Doughton*, WALL ST. J., Apr. 10, 1937, at 3 (reporting that Chair of Ways and Means expresses "[h]ope that the undistributed profits tax will be revised 'in the near future' to give relief to corporations with little or no surplus, and those that are heavily in debt ...."); Godfrey N. Nelson, *New Levy As Cause of Tax-Receipt Lag*, N.Y. TIMES, Apr. 18, 1937, § 3, at 1 (reporting on a bill introduced by Representative Bullwinkle to sunset the undistributed profits tax after a year and reenact the provisions previously in effect); *Taxes High Enough, Harrison Asserts*, N.Y. TIMES, Mar. 19, 1937, at 7 (saying that "a possible modification of the undistributed corporate earnings tax ... is a matter of study by the committee").

388. See *President Hoping to Avoid New Taxes*, N.Y. TIMES, Apr. 10, 1937, at 1.

Secretary Andrew Mellon,<sup>389</sup> Roosevelt attempted to deflect the blame away from the undistributed profits tax by focusing on rampant tax evasion.<sup>390</sup> In his message to Congress in June 1937, Roosevelt described a Treasury report that revealed "efforts at avoidance and evasion of tax liability, so widespread and so amazing both in their boldness and their ingenuity, that further action without delay seems imperative."<sup>391</sup> The legislation resulting from such appeals—the Revenue Act of 1937—has been derisively called "an apple-pie issue."<sup>392</sup> No one wanted to oppose the legislation and be seen as a defender of tax dodgers, but no one was willing to make it a meaningful weapon against abuse.<sup>393</sup>

By the late summer of 1937, an economic slowdown changed the political climate on the issue of taxation. Just when many Americans believed they had weathered the worst of the Depression,<sup>394</sup> the country experienced one of its quickest downturns in history.<sup>395</sup> According to Marriner Eccles, Chairman of the Federal Reserve Board, the Federal Reserve Index of Production (which averaged 100 between 1923 and 1925) dropped from 117 in August 1937 to 83 in December of the same year.<sup>396</sup> "Before the economy picked up in the late spring of 1938," Mark Leff observed, "industrial production fell by a third, durable-goods production and stock prices slipped by half, and profits skidded to one-fifth their 1937 highs. Unemployment, always a tragic embarrassment to the

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389. See BLUM, *supra* note 142, at 324-25.

390. See LEFF, *supra* note 86, at 194-95.

391. *The President Urges Legislation to Prevent Tax Evasion* (June 1, 1937), in 1937 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 238 (Samuel I. Rosenman ed., 1941).

392. LEFF, *supra* note 86, at 201.

393. *Id.* at 201-02. It did make inroads against the personal holding company device, but preferred to focus on the more high profile abuses such as the incorporated yacht instead of tackling more serious problems. *Id.* at 202; BLUM, *supra* note 142, at 330-37.

394. See LEFF, *supra* note 86, at 205-06 ("In a May 1937 radio address, South Carolina's James Byrnes eagerly justified the postponement of reform by declaring: 'The emergency has passed.' Americans polled in April 1937 apparently agreed, with only one-fifth denying that the Depression was even partly over and over a quarter affirming its end.").

395. *Id.* at 209.

396. *Testimony Before the Senate Special Committee to Investigate Unemployment Relief, January 4, 1938*, in ECONOMIC BALANCE AND A BALANCED BUDGET: PAPERS OF MARRINER S. ECCLES 89, 91 (Rudolph L. Weissman ed., 1940). Eccles called it "the sharpest rate of decline in production on record." *Id.* at 92.

New Deal, shot up by nearly 4 million.<sup>397</sup> Such an abrupt plunge in the economy sent administration friends and foes alike scurrying for targets of blame.

The recession created the window of opportunity corporate managers were waiting for in their attack on the undistributed profits tax. Critics blamed the tax either partially or completely for a variety of economic ills,<sup>398</sup> including the decline of retail credit,<sup>399</sup> delay and termination of expansion plans,<sup>400</sup> lagging employment,<sup>401</sup> the onset and aggravation of stock market volatility,<sup>402</sup> and what the president of General Tire and Rubber Company called, "strikes by capital," where a lull in business confidence caused both large and small-time capitalists as well as corporate financiers to keep their money on the sidelines rather than to invest in business.<sup>403</sup> Horace Stoneham, President of the New York Giants professional baseball team, even went so far as to blame the undistributed profits tax for his team's inability to sign a high profile star like Joe "Ducky Wucky" Medwick of the St. Louis Cardinals.<sup>404</sup> According to Stoneham:

If you wanted to spend your surplus on ball players, the government would step in and stop you. That sort of thing is inimical to baseball. If you make a lot of money you want to make more by strengthening your club. But you cannot do what

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397. See LEFF, *supra* note 86, at 209.

398. Another tax provision cited as a cause of the economic downturn was the capital gains tax. *Tax Modification Asked as Trade Aid*, N.Y. TIMES, Aug. 4, 1937, at 28.

399. See *Profits Tax Slows Recovery, He Says*, N.Y. TIMES, Aug. 28, 1937, at 20.

400. See *Levy on Profits Halts Expansion*, N.Y. TIMES, Aug. 27, 1937, at 24.

401. *15 Criticisms Made of the Profit Tax*, N.Y. TIMES, Sept. 26, 1937, at 24 (United States Chamber of Commerce study); *Surplus Tax Repeal Held Labor Benefit*, N.Y. TIMES, Oct. 31, 1937, § 3, at 8 (National Association of Manufacturers Study).

402. *Ballantine Finds New Deal Harmful*, N.Y. TIMES, Oct. 20, 1937, at 10 (highlighting the undistributed profits tax among New Deal programs "as responsible for the current stock market slump"); Editorial, *A Tax Theory Demolished*, WALL ST. J., Oct. 22, 1937, at 4; *Our Taxes Too High, Periling Business, Tremaine Asserts*, N.Y. TIMES, Oct. 1, 1937, at 1 ("[New York State Controller] Tremaine blamed the stock market slump directly upon the Federal Capital Gains and Losses Tax, and the Undistributed Profits Tax.").

403. *Capital 'Strikes' Laid to Tax Laws*, N.Y. TIMES, Oct. 23, 1937, at 25; *Profits Tax Held Bar to Confidence*, N.Y. TIMES, Nov. 8, 1937, at 33.

404. *Unfair to Baseball*, BUS. WEEK, Dec. 11, 1937, at 44. Thanks to my colleague, Larry Garvin, for pointing out that, while modern commentators refer to him as Joe "Ducky" Medwick, his real nickname was "Ducky Wucky." For further support, see *Nicknames*, in THE NEW BILL JAMES HISTORICAL BASEBALL ABSTRACT 157, 158 (2001).

you please. You've got to distribute a large part of your profits to stockholders.<sup>405</sup>

Although economists refuted claims that the undistributed profits tax was responsible for the recession,<sup>406</sup> it was not enough to shake the tag in many people's minds.

These attacks began to have effect as a loosely formed coalition of conservative Democrats joined Republicans and corporate managers in demanding repeal of the undistributed profits tax.<sup>407</sup> While a number of members of this conservative coalition were already opposed to almost all New Deal reforms, the arrival of a true "Roosevelt recession" had caused many Democrats to reconsider their blind allegiance to the Administration on tax matters.<sup>408</sup> Several congressmen openly advocated repealing the undistributed profits tax even while the House Ways and Means Committee began hearings on possible measures to soften the tax's impact.<sup>409</sup> Both current and former members of the Administration, including former Securities and Exchange Commission Chair Joseph Kennedy and Interstate Commerce Commission member Joseph Eastman, joined these converts.<sup>410</sup> Senator Josiah Bailey of North Carolina, one of the leaders of the coalition, asked the Senate to pass a resolution "giving notice that it intended to vote for repeal of the undistributed profits tax when a revenue bill reached the Senate."<sup>411</sup>

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405. *Unfair to Baseball*, *supra* note 404, at 44.

406. *See Eased Income Tax Urged By Tremaine*, N.Y. TIMES, Dec. 15, 1937, at 12 ("Dr. Willard L. Thorp, director of economic research for Dun & Bradstreet, said there was 'danger in saying that the undistributed profits tax was responsible for the recession.' He declared there would have been a slump if there had been no such tax.").

407. *See LAMBERT*, *supra* note 106, at 423.

408. *See* John Robert Moore, *Senator Josiah W. Bailey and the "Conservative Manifesto" of 1937*, 31 J. S. HIST. 21, 21 (1965); James T. Patterson, *A Conservative Coalition Forms in Congress, 1933-1939*, 52 J. AM. HIST. 757, 765 (1966); *see also* Creel, *supra* note 92, at 16 ("[W]hat gives an unexpected uncertainty to the outcome is that New Dealers will not present a solid front against repeals or revisions. Many defections have taken place ....").

409. *See Byrnes For Tax Revision*, N.Y. TIMES, Nov. 6, 1937, at 4 ("I am in favor of modifying, or repealing, the undistributed profits tax," [Senator Byrnes] said after talking taxes with President Roosevelt."); *see also* Turner Catledge, *Tax Revision Data to be Heard Today as Congress Move*, N.Y. TIMES, Nov. 4, 1937, at 1 (describing the purpose of the House hearings); *Glass Would Annul Surplus Profits Tax*, N.Y. TIMES, Nov. 3, 1937, at 38 (referencing Sen. Glass); *Treasury to Give New Tax Program to House Group*, WALL ST. J., Nov. 4, 1937, at 1 (referencing Sen. Van Nuys).

410. *See LAMBERT*, *supra* note 106, at 421.

411. *See* Turner Catledge, *Move to Repeal Profit Tax Makes Headway in Senate; Roosevelt*



Although this repeal movement still lacked a majority in Congress, support for the undistributed profits tax was clearly wavering.

At the same time, a subtle shift was taking place in opponents' criticism of the undistributed profits tax. Rather than emphasizing the tax's direct effect on the economic slowdown, opponents began to focus more on the undistributed profits tax's effect on business confidence. Walter Lambert noted that "[b]usiness spokesmen were almost unanimous in the belief that the levy on corporate surpluses had created a climate of fear and uncertainty which, in turn, had discouraged capital investment and contributed to the economic recession."<sup>412</sup> The problem, according to Arthur Ballantine, was that the tax "robs industry of reassuring reserves," or the surpluses that allowed corporate executives to invest and expand without fear of bankrupting their companies.<sup>413</sup> Prominent business leaders such as the president of Chemical Bank advocated repeal "as a means of restoring confidence among business men."<sup>414</sup> The American Institute of Accountants issued a report declaring that in order for business "to face the future confidently" Congress must return to "fixed principles of ... taxation" and abandon the failed undistributed profits tax.<sup>415</sup>

This change in approach appeared calculated to win over moderate Democrats. While there were some who doubted that repeal would restore business confidence,<sup>416</sup> the consensus appeared to be that the undistributed profits tax was one element in the fear gripping Wall Street. One contemporary commentator concluded that moderate Democrats "are convinced that the situation is dominated by a psychological factor that cannot be ignored."<sup>417</sup>

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*Program Lags*, N.Y. TIMES, Nov. 18, 1937, at 1.

412. LAMBERT, *supra* note 106, at 414; see Kimmel, *supra* note 366, at 105-15 (noting that survey of 360 corporate executives revealed that many corporate expansion plans were delayed by fear of the tax's effect on surpluses); Godfrey N. Nelson, *Loss of Confidence Laid to Tax of 1936*, N.Y. TIMES, Feb. 20, 1938, § 3, at 1 ("[T]he results of research show that the undistributed-profits tax is one of the major causes of the loss of business confidence.").

413. *Ballantine Finds New Deal Harmful*, N.Y. TIMES, Oct. 20, 1937, at 10.

414. *F.K. Houston Urges Repeal of Two Taxes*, N.Y. TIMES, Oct. 22, 1937, at 33.

415. *Taxation Found 'Bugaboo' of Corporations; Accountants Advocate Nonpartisan Study*, N.Y. TIMES, Sept. 23, 1937, at 41.

416. See LAMBERT, *supra* note 106, at 425 (citing an editorial in the *New York Post* debunking the theory that business confidence was directly related to high taxes).

417. Creel, *supra* note 92, at 30.

Although skeptical that many of the accusations regarding the tax were accurate, moderates held the view that

capital does believe implicitly and unchangeably that the policy is restrictive, punitive and paralyzing and has taken to the storm cellar. The immediate importance is to bring business out of its tailspin, and since finance and industry refuse to budge until changes have been made, then the intelligent course is to make them.<sup>418</sup>

### 3. Revenue Act of 1938

The combination of the recession and business' steady campaign against the tax changed the fulcrum of the debate that had begun in 1936. Whereas previously moderate Democrats had supported the undistributed profits tax originally proposed by Roosevelt, the most that they were willing to do by 1938 was to preserve the principle in substantially reduced form. This meant Republicans and Democrats generally agreed about the tax's fate. The only question was whether it would be repealed outright or merely nullified by reducing the rate to the dividend tax rate of 4% or below. In this context, double taxation became a tool of moderate Democrats seeking to appease both Roosevelt and corporate managers.

#### a. Subcommittee Plan

Nowhere was the transformation among moderate Democrats more evident than in the revision plan introduced by a subcommittee of the House Ways and Means Committee.<sup>419</sup> The

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418. *Id.*

The psychological objection to the undistributed-profits tax proved the most penetrating one. Given the economic and political expectations that the business community invested in repeal, and given a corporate fetish for stability that had frozen out industrial expansion, even those who rejected the business analysis saw the need for concessions.

LEFF, *supra* note 86, at 258.

419. In August, when the 1937 Act was passed, the House also passed a resolution from Representative Doughton to allow the Ways and Means Committee to conduct an intersession study of the revenue laws, with special attention to the undistributed profits tax. A subcommittee was formed which delayed consideration of the issue until November when Treasury completed its own investigation of the subject. See LEFF, *supra* note 86, at 255-56.

subcommittee proposed to merge the undistributed profits and corporate income taxes by making the corporate income tax rate dependent on the percentage of net profits distributed. The proposed corporate income tax would have rates ranging from 16 to 20% for corporations with net incomes exceeding \$25,000 per year.<sup>420</sup> A corporation could reduce its tax by 4/10 of 1% for each 10% of net profits distributed, with a maximum credit of 4% if a corporation distributed all its profits as dividends.<sup>421</sup> Dividends received still would be subject to the individual normal tax of 4%.<sup>422</sup> Rather than extolling the proposal's virtues as a tool against tax avoidance, Vinson emphasized the proposal's revenue-neutral nature.<sup>423</sup>

Styled as a revision, the House proposal effectively nullified the undistributed profits tax. In stark contrast to its proposal two years earlier, when Chairman Fred Vinson pushed through an undistributed profits tax with rates reaching as high as 42.5%,<sup>424</sup> the proposal reduced the effective undistributed profits tax rate from a high of 27% to a high of 4%. Like the Senate Finance Committee proposal in 1936, this effective rate equaled the normal individual tax on dividends, thus eliminating any effect the bill would have on forcing the distribution of profits.<sup>425</sup> As a *Wall Street Journal* editorial concluded, the proposal's "net effect if enacted would be virtually to do away with the present levy."<sup>426</sup> In apparent deference to Roosevelt, the subcommittee sought to retain the principle of the undistributed profits tax.<sup>427</sup> This did not indicate, however, a desire to continue to use the tax as a lever to force the distribution of

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420. See *President Seen Agreed to Altering Profits, Gains Taxes*, WALL ST. J., Nov. 24, 1937, at 1.

421. *Id.* at 3.

422. *Id.*

423. *Id.* Treasury experts questioned this conclusion. See *Profits Tax Change Means Loss, Treasury Experts Warn Capitol*, N.Y. TIMES, Nov. 25, 1937, at 1.

424. See 1936 House Hearings, *supra* note 143, at 6.

425. See Editorial, *The Proposed Tax Bill*, N.Y. TIMES, Jan. 18, 1938, at 22 ("This allowance of 4 per cent for dividends was presumably chosen because that is the normal income tax, and the security holder will pay it in personal income tax on the dividends when he receives them.").

426. Editorial, *A Ray of Tax Hope*, WALL ST. J., Nov. 24, 1937, at 4.

427. See *Proposed Revision of the Revenue Laws, 1938: Report of a Subcomm. of the House Comm. on Ways & Means*, 75th Cong. § 8 (1938) ("On the basis of the facts, your subcommittee believes that the principle of the undistributed profits tax is sound and should be retained. However, it is believed that it should be substantially modified.").

corporate profits. The subcommittee later explained in its official report, "[i]t is believed that the basic tax rate should not be so high as to create undue hardship when for any reason dividend distributions are impractical."<sup>428</sup> By reducing the tax to a rate equal to that on dividend distributions, the subcommittee not only eliminated the "undue" hardships, but all the hardships accompanying a corporate manager's decisions to retain profits.

While Roosevelt seemed amenable to revising the tax,<sup>429</sup> the House proposal, like the Senate proposal in 1936, went too far toward a de facto repeal. It retained the principle of undistributed profits taxation, but not the effect. According to Bernard Kilgore of the *Wall Street Journal*, administration officials worked behind the scenes "to try to preserve far more of the so-called 'principle' of the undistributed profits tax" than the proposal forwarded by the House Ways and Means subcommittee.<sup>430</sup> One of Roosevelt's principal concerns was the possibility that the watered-down undistributed profits tax would permit wealthy families to organize corporations to retain income and thereby avoid the high surtax rates on individual income.<sup>431</sup> Thus, he conditioned his approval of the subcommittee proposal on the strengthening of the penalty on unreasonable accumulation of corporate surpluses.<sup>432</sup> The problem was that this penalty had never proven very effective.<sup>433</sup> Unlike the personal holding company provision, which had been fairly successful in containing evasion among the limited number of corporations subject to it, convincing courts that corporate managers' decisions to retain corporate profits were "unreasonable" was difficult.<sup>434</sup>

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428. *Id.*

429. See *Roosevelt For Tax Revision 'When Congress is Ready'; Prepares Housing Message*, N.Y. TIMES, Nov. 27, 1937, at 1; *President Seen Agreed to Altering Profits, Gains Taxes*, WALL ST. J., Nov. 24, 1937, at 1. Roosevelt had earlier sent signals that he would be open to a possible revision. See Arthur Krock, *Business Takes Heart Despite Roosevelt Talk*, N.Y. TIMES, Oct. 31, 1937, § 4, at 3.

430. Bernard Kilgore, *Administration "Left-Wingers" Stall For Time to Block Changes in Laws*, WALL ST. J., Dec. 3, 1937, at 1.

431. See BLUM, *supra* note 142, at 412; LAMBERT, *supra* note 106, at 433.

432. *House Tax Plan Gets Roosevelt's Tentative Approval*, WALL ST. J., Dec. 11, 1937, at 1. This is essentially the modern accumulated earnings tax. See I.R.C. § 531 (2002).

433. See Joseph Alsop & Robert Kintner, *Tax Revision Hits on "Third Basket"*, N.Y. TIMES, Dec. 28, 1937, at 4.

434. The difficulty coming up with a method to strengthen the penalty led to a delay in the

The solution, devised by Representative Vinson, was to blend the bright line definitions in the personal holding company provisions with the principle underlying the penalty for unreasonable accumulations of corporate profits.<sup>435</sup> He proposed imposing an additional 20% rate on certain closely held corporations that retained 40% or more of their earnings.<sup>436</sup> Coupled with the regular corporate tax imposed under the subcommittee plan, the maximum effective rate would be 32%, or approximately the same maximum rate imposed under the existing undistributed profits tax.<sup>437</sup> Although this "third basket tax," as it came to be called,<sup>438</sup> was expected to apply to fewer than 1,000 corporations, this group potentially included notable corporations such as the Ford Motor Company.<sup>439</sup> This appeared sufficient to garner Roosevelt's blessing and become part of the subcommittee's final report.<sup>440</sup>

*b. House*

During the January 1938 hearings before the House Ways and Means Committee, Treasury officials quickly reassured business that the subcommittee's proposal substantially freed corporate

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release of the subcommittee's final recommendations. See *Tax Revision Delayed as Committee Disbands*, WALL ST. J., Dec. 21, 1937, at 1.

435. See *Tax Draft Covers Private Companies*, N.Y. TIMES, Jan. 7, 1938, at 5 ("The proposed legislation seeks to give a definition that would avert litigation as to actual status.").

436. See *Tax Plan Calls For Closely Held Firms To Pay Special 20%*, WALL ST. J., Jan. 7, 1938, at 1. A corporation was considered "closely held" for these purposes if it was held by one family or primarily by a group of not more than ten unrelated individuals. *Id.* at 7. Such closely held corporations were considered to be a significant source of abuse by wealthy taxpayers. *Id.*

437. *Id.*

438. It was called the "third basket" to signify that it was the third of three classifications. The first two classifications were for corporations with incomes less than \$25,000 annually and for all other corporations, whether publicly or closely held.

439. See *Tax Draft Covers Private Companies*, *supra* note 435, at 5. In response to the media speculation that the third basket tax was aimed at Ford, Ways and Means Chair Doughton and subcommittee Chair Vinson issued a joint statement that not only was Ford not the target of the tax, but it would not even be subject to the tax because Ford routinely distributed almost 70% of its earnings. See *Hold Tax Revision Not Aimed at Ford*, N.Y. TIMES, Jan. 8, 1938, at 2. Despite such responses, opponents insisted that the tax was designed to target "a 'couple or maybe three' corporations which the administration is said to be determined to punish ...." Henry N. Dorris, *Foes of 'Third Basket' Tax Count Committee Majority to Kill It*, N.Y. TIMES, Feb. 4, 1938, at 1, 7.

440. See BLUM, *supra* note 142, at 442.

managers from the perceived shackles imposed by the undistributed profits tax. Roswell Magill, the Under Secretary of the Treasury and former Columbia law professor who testified first on behalf of the subcommittee's proposal, noted several times that the bill imposed only a "somewhat" lower burden for corporations that distributed, rather than retained earnings.<sup>441</sup> In response to a question from Representative Vinson, Magill emphasized that once a corporation had paid the maximum 20% tax, it was "entirely free" to spend its earnings in whatever manner it wished.<sup>442</sup> Although Magill disputed charges that the bill merely was a "face-saving" policy,<sup>443</sup> he was clearly walking a tightrope between reassuring business and defending the continued need for an undistributed profits tax.

Opponents, emboldened by the popular outrage against the tax, argued that maintaining even the nominal undistributed profits tax proposed in the subcommittee report was unacceptable. The United States Chamber of Commerce recommended "[r]epeal[ing] the thoroughly discredited undistributed-profits tax and openly abandon[ing] the 'principle.'"<sup>444</sup> As one railroad executive noted, nothing short of repeal would be sufficient:

The continuation of this tax, even in the modified form proposed, will continue to hamper business and destroy the confidence of business management in its ability to look ahead and to plan and enter into long-time commitments, which constitutes the very essence of recovery. This tax should be repealed in its entirety.<sup>445</sup>

While corporate managers spoke of the hardships still imposed under the revised tax, the principal concern appeared to be that

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441. *Revision of Revenue Laws 1938: Hearings Before the House Comm. on Ways and Means*, 75th Cong. § 104, at 136 (1938) (statement of Roswell Magill, Under Secretary of the Treasury).

442. *Id.* at 133.

443. *Id.* at 136 (responding to a statement from Rep. Crowther).

444. *Id.* at 468 (prepared statement of Ellsworth C. Alvord, United States Chamber of Commerce); see also *id.* at 155 (statement of M.L. Seidman, New York Board of Trade) ("The undistributed profits tax stands before the country today thoroughly convicted as an undesirable tax and as harmful to business and to confidence. It has earned its execution. Let it die.").

445. *Id.* at 401 (statement of George Houston, President of Baldwin Locomotive Works).

retaining the principle would invite the reintroduction of more meaningful rates in subsequent years.<sup>446</sup>

Somewhat surprising was business leaders' criticism of the third basket tax. It was expected that the closely held corporations most likely to be affected by the penalty provision would be vocal in their opposition,<sup>447</sup> but managers of large corporations presumably would have been willing to accept this provision in exchange for the nullification of the undistributed profits tax. Nevertheless, they also bitterly complained about the third basket tax. For instance, Ellsworth Alvord of the United States Chamber of Commerce called the tax a threat to the pioneers in American industry.<sup>448</sup> While the Chamber may have been speaking on behalf of its members that would be subject to the tax, Alvord made clear that the Chamber's objections mirrored those raised against the undistributed profits tax.<sup>449</sup> According to Alvord, ending all penalties against managers for exercising their sound discretion in the operation of their businesses was critical to restore "confidence ... [and] start the wheels of business."<sup>450</sup> Opposition to the third basket tax, thus, was part of a general campaign to remove all traces of the undistributed profits principle from the Act.

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446. See, e.g., *Tax Bill Sent to Conference, House Not Yielding on Changes*, N.Y. TIMES, Apr. 13, 1938, at 1 (Rep. Lamneck of Ohio "declared that the business interests were absolutely opposed to the undistributed profits tax theory, as retained in the House bill, 'not because it is going to levy a high tax on them, but because they fear we may use the principle to raise the rates and change the schedule.'").

447. *Revision of Revenue Laws 1938: Hearings Before the House Comm. on Ways and Means*, 75th Cong. §§ 1005, 1006 (1938) (statement of Benjamin H. Namm, President of A.I. Namm & Son) ("[T]he framers of the proposed penalty tax have not fully considered the implications as to whether we continue as a family-owned, family-run, and independent store or not. They would make it difficult and perhaps impossible for us to compete with our publicly-owned competitors."); *id.* at 562 (statement of Albert D. Hutzler, President of Hutzler Brothers Company) ("If this law were passed, our competitors could amortize their mortgages—and they also have them—and build up their working capital with no penalty, while we and the other local stores would be competitively penalized."); *id.* at 619 (statement of Edward H. Lane, Lane Cedar Chest Company) ("We do not see why you single us out and make us pay 50 percent more in taxes than you do these big monopolistic corporations that have access to the general capital markets."); *id.* at 403 (statement of Thomas E. Donnelly, President of Donnelly & Sons) (calling the third basket tax "a tax upon owner management" because it targets corporations which, by their very nature, are run by the owners of the corporation).

448. *Id.* at 470 (statement of Ellsworth Alvord, United States Chamber of Commerce).

449. *Id.* at 488-89.

450. *Id.* at 471.

In an unexpected turn of events,<sup>451</sup> the House retained at least a nominal undistributed profits tax, but heeded opponents' calls to remove the third basket tax.<sup>452</sup> Acceptance of the former provision was greased by the operation of the dividend tax. As Representative Vinson noted, "[t]he only undistributed-profits tax we have until we get to I-B [the third basket tax] is a 4-percent rate, the same rate that an individual pays, as a normal tax upon any dividend that would be paid out."<sup>453</sup> In the subcommittee's view, Representative Vinson explained, "it is just as fair for the Federal Government to get a 4-percent tax on money retained as it is to collect it from the shareholder as a normal tax when distributed."<sup>454</sup> This was a substantial admission that the undistributed profits tax was no longer a pressure tax at all because of the operation of the dividend tax.

According to the Minority report on the Ways and Means Committee, removing the third basket tax provision may have been due to "a widespread feeling ... that another purpose of the proposed penalty tax is to provide the administration with a means of retaliation against certain corporations controlled by a few individuals who differ politically with the administration and who have resisted certain New Deal policies with which they do not agree."<sup>455</sup> More likely, however, especially in an election year,<sup>456</sup> the third basket tax simply ran afoul of the political symbolism

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451. See *House Set to Pass Tax Bill Without Major Amendment*, WALL ST. J., Mar. 2, 1938, at 2 (reporting prior to the debates on the floor that "[t]he leadership is confident, however, that it can muster sufficient strength to protect the measure against important revisions").

452. See *House Appears Indifferent as Tax Bill Debate Begins*, WALL ST. J., Mar. 4, 1938, at 2.

453. 83 CONG. REC. 2996 (1938) (statement of Rep. Vinson).

454. *Id.*

455. 83 CONG. REC. 2776 (1938) (views of the Minority to the House Ways and Means Committee Report, entered into the record by Rep. Treadway). Representative William McFarlane even accused the Ways and Means Committee of delaying consideration of the third basket tax "in order to give big business sufficient time to crystallize sentiment even against the third basket which is the only part of the shell left concerning the undistributed profits tax." W.D. McFarlane, *Capitol Newsletter*, WICHITA BANNER (Feb. 11, 1938), in William Doddridge McFarlane Papers, 1919-1981, Box No. 3U265, Center for American History, Univ. of Texas.

456. See Arthur Krock, *In the Nation: Congressional Progress Since Tax Fight of '35*, N.Y. TIMES, Mar. 11, 1938, at 1 (stating that the rejection of the third basket tax "is especially worth the notice of students of political trends when it is recalled that 1938, unlike 1935, is for all members of the House a re-election year").



associated with the family-owned business.<sup>457</sup> This defeat was considered a crushing blow to Roosevelt, with the *Wall Street Journal* reporting that some believed it signaled "that the peak of President Roosevelt's influence over the national legislature may have passed."<sup>458</sup> Treasury Secretary Morgenthau considered the House's vote to remove the third basket tax from the bill "the worst slap the President had to take during his entire administration."<sup>459</sup>

### c. Senate

As the House completed its consideration of the revenue bill, it was clear that the Senate would be less charitable toward Roosevelt's plea for preserving the principle of the undistributed profits tax. The chair of the committee, Senator Pat Harrison, issued a statement announcing his intent to secure the tax's repeal: "While the House retained only the skeleton of the undistributed profits tax ... the remains will haunt business, and its complete removal and return to a sufficient flat corporation tax is preferable."<sup>460</sup> Even before hearing the complaints of business leaders, the Finance Committee privately grilled Treasury officials about projected revenue yields under the House bill and possible alternatives.<sup>461</sup> Essentially, the Finance Committee concentrated on replacing the tax rather than neutralizing it through double taxation.

In light of the Senate Finance Committee's predisposition for a quick recommendation of repeal,<sup>462</sup> business leaders kept their

457. See LEFF, *supra* note 86, at 260. Newspaper corporations, typically family-owned and therefore subject to the tax, perpetuated this rhetoric with a constant barrage of attacks. *Profit Tax Repeal Beaten in House; '3d Basket' Fought*, N.Y. TIMES, Mar. 8, 1938, at 1.

458. See *House Tax Bill Revolt Bares Weakened Roosevelt Control*, WALL ST. J., Mar. 10, 1938, at 2; see also Editorial, *An Independent Congress*, N.Y. TIMES, Mar. 12, 1938, at 16 ("It is increasingly evident that the era of 'rubber-stamp' legislation has ended in Washington and that Congress intends to assert its own prerogatives in the matter of ... national policies.").

459. BLUM, *supra* note 142, at 444.

460. *Harrison Demands End of Profits Tax to Help Business*, N.Y. TIMES, Mar. 13, 1938, at 1.

461. See generally *Revenue Act of 1938: Hearing on H.R. 9682 Before the Sen. Comm. on Finance*, 75th Cong. (1938) [hereinafter *1938 Senate Hearings*] (statement of Roswell Magill, Under Secretary of the Treasury).

462. See *Senators to Start Tax Hearing Today*, N.Y. TIMES, Mar. 17, 1938, at 13 ("Senator Harrison, chairman of the committee, said tonight that he hoped to ... report a bill within two weeks .... Fifteen of the committee of twenty-one members have said[] they favor[] elimination of the undistributed profits tax principle ....").

comments regarding the undistributed profits tax relatively brief.<sup>463</sup> Nevertheless, the testimony contained two recurring themes: (1) The undistributed profits tax was having a deleterious effect on business confidence; and (2) only repeal could bolster business confidence. To the extent they addressed other concerns with the income tax portion of the House bill, the testimony focused on the capital gains tax, rather than the continued double taxation of corporate income.

Although the undistributed profits tax's negative impact on business confidence was by this time a common refrain, witnesses suggested the matter had become more urgent. The general counsel for the Illinois Manufacturers' Association wrote that, "[u]nless Congress will act now, at this time, to dispel the all-enveloping cloud over the future of business and industry, the outlook is calamitous."<sup>464</sup> Business leaders conceded that the current economic problems were largely "a matter of psychology,"<sup>465</sup> but the undistributed profits tax's contribution to these problems arguably were significant "whether it is a real anxiety or a psychological anxiety of businessmen as to the effects of existing laws on their operations."<sup>466</sup> The National Association of Manufacturers filed a report stating:

The psychological effect of this tax has been even more serious [than the direct effect of eliminating a source of industrial capital]. It has been universally condemned by businessmen large and small and has created a fear on their part that the purpose of government through its tax laws is to make impossible the earning of a sufficient rate of return to induce investment of new capital ....<sup>467</sup>

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463. See *1938 Senate Hearings*, *supra* note 461, at 460 (statement of Ellsworth C. Alvord, United States Chamber of Commerce) ("I do not think it is necessary for me to repeat my views with respect to the undistributed-profits tax .... They are all a matter of record and readily available.").

464. *Id.* at 660 (statement of David R. Clarke, General Counsel, Illinois Manufacturers' Association).

465. *Id.* at 468 (statement of Ellsworth Alvord, United States Chamber of Commerce).

466. *Id.* at 178 (statement of H.B. Spalding, Committee on Government Finances, National Association of Manufacturers).

467. *Id.* at 180.

Joseph Klein of the New York State Society of Certified Public Accountants suggested the situation had reached such crisis proportions that the committee should "make public" any "early determinations of the kind which business pleads for with respect to the undistributed-profits tax ..." so as "to calm existing fears and uncertainty."<sup>468</sup>

Business leaders emphasized that the only way to ease the crisis of business confidence was to repeal the undistributed profits tax altogether. These individuals first repeated their earlier argument that retaining the principle would not alleviate concerns that punitive rates would not someday re-emerge. A representative of the Brooklyn Chamber of Commerce warned that retaining the principle would make it "an ever-constant threat,"<sup>469</sup> while M.L. Seidman of the New York Board of Trade predicted that "it would remain to haunt business, not only for what it is, but also for what it may eventually grow into if permitted to remain as a permanent part of our tax structure."<sup>470</sup> Ellsworth Alvord of the United States Chamber of Commerce asked "if you impose 3 1/3 percent this year ... what is there to assure a businessman that you will not boost that penalty to 42½ percent, as was proposed two years ago?"<sup>471</sup> More importantly, perhaps, business leaders suggested that the complete repeal of the undistributed profits tax would actually increase revenues, and obviate the need for a rate increase by releasing the economy's pent-up energy. The Secretary of the American Mining Congress reported that "[w]e believe the repeal of the undistributed-profits tax would stimulate business and increase the tax base from which the Government obtains revenue to such an extent that it

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468. *Id.* at 399 (statement of Dr. Joseph J. Klein, Chairman of the Committee on Federal Taxation, New York State Society of Certified Public Accountants).

469. *See 1938 Senate Hearings, supra* note 461, at 183 (statement of J.W. Hooper, Chairman of the Federal Tax Committee, Brooklyn Chamber of Commerce).

470. *Id.* at 257 (statement of M.L. Seidman, Chairman of Taxation Committee, New York Board of Trade).

471. *Id.* at 469 (statement of Ellsworth Alvord, United States Chamber of Commerce). Henry Heimann of the National Association of Credit Men echoed these sentiments, stating:

We think that the present undistributed-profits tax will not constitute the menace, the penalty that it has in the past, but nevertheless we still believe the principle of the tax is dangerous, and there is no assurance at any time that the law may not be changed with respect to rates so that the same danger that was inherent in the 1936 bill will again become included in the bill.

*Id.* at 19 (statement of Henry H. Heimann, National Association of Credit Men).

would far more than offset the apparent loss of revenue from elimination of this tax."<sup>472</sup> Alvord agreed, stating, "you can make much more money by telling investors, by telling business, by telling labor, all three, that the principle of the undistributed-profits tax is abandoned completely and forever and they no longer have to worry about the penalties."<sup>473</sup> Based on an assumption that repealing the undistributed profits tax would increase business by 6%, Alvord concluded that the Senate could adopt a flat 15% tax on corporate income and still raise as much revenue as the House bill.<sup>474</sup>

Despite speaking before a relatively sympathetic Senate Finance Committee, and despite a startlingly forthright concession by Treasury official Roswell Magill that the double taxation of corporate income was unfair,<sup>475</sup> business leaders did not seek to use this forum to advocate for the revival of a dividend exemption for individuals. While this might have been due to a desire not to be greedy or to confuse the issues, no such concerns prevented them from seeking a reduction in the tax on capital gains and other amendments designed to aid business.<sup>476</sup> Alvord of the United States

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472. *Id.* at 477-78 (statement of Julian D. Conover, Secretary, American Mining Congress); *see also id.* at 397 (statement of Dr. Joseph J. Klein, Chairman of the Committee on Federal Taxation, New York State Society of Certified Public Accountants) ("[I]f the undistributed profits tax remnant were completely eliminated the psychological effect on business might be what you wish it to be, and that the taxable income that would flow consequent upon such elimination would more than make up for the slight loss of revenue.").

473. *Id.* at 467 (statement of Ellsworth Alvord, United States Chamber of Commerce). The call to "tell ... labor" may have been reference to the American Federation of Labor's recent demand for a repeal or modification of the undistributed profits tax as a method of restoring public confidence in the economy. Louis Stark, *Profit Tax Repeal Demanded by A.F.L.*, N.Y. TIMES, Feb. 9, 1938, at 6.

474. 1938 Senate Hearings, *supra* note 461, at 467 (statement of Ellsworth Alvord, U.S. Chamber of Commerce).

475. *See id.* at 680-81 (statement of Roswell Magill, Under Secretary of the Treasury). In contrasting the treatment of distributed and undistributed corporate income, Magill pointed out:

[T]he distributed corporation income is somewhat more heavily taxed, since the corporation has paid a normal tax of 8 to 15 percent on it before distribution, and the stockholder is subject to a second normal tax of 4 percent, as well as to any applicable surtaxes, when he receives the dividend. In fairness, he might properly be given a credit against his own normal tax for the normal tax already paid by the corporation.

*Id.* When Senator King asked Professor Magill if such a shareholder credit system was not already the practice in England, Magill responded that it was "and we did it here until 1936." *Id.* at 681.

476. *See, e.g., id.* at 167-68 (statement of Victor H. Stempf, Committee on Taxation,

Chamber of Commerce acknowledged that repealing the undistributed profits tax was his highest priority, but reducing the capital gains tax was a close second.<sup>477</sup> H.B. Spalding of the National Association of Manufacturers echoed this point, noting that his group had "consistently opposed the inclusion in net income of capital gains and losses, believing that taxation of capital gains and losses has no place in an income tax."<sup>478</sup>

In reality, capital gains taxation may have been a higher concern for business leaders.<sup>479</sup> *The Nation* suggested that business' number one priority was the repeal of the capital gains tax, but the undistributed profits tax simply proved an easier target.<sup>480</sup> This would be consistent with corporate managers' preference for retained earnings. As long as dividends are taxed, but capital gains from sales of stock are not taxed or are subject to taxation at greatly reduced rates, most stockholders are likely to encourage retention of earnings. This permits them to recoup their share of the corporate earnings through the more tax-advantaged method of a sale of the stock.

This failure to raise the double taxation issue was not because of the ignorance of the issue generally. The United States Chamber of Commerce specifically protested a House proposal to limit the credit corporations received for dividends from subsidiaries. In defense of its position, the Chamber noted that "[t]he existing tax burdens upon corporate dividends are extremely heavy. The earnings and profits, out of which the dividends are paid, have already been subjected to taxation in the hands of the corporation

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American Institute of Accountants) (advocating, among other things, repeal of the undistributed profits tax, reduction in the capital gains tax, and restoration of consolidated returns); *id.* at 182 (statement of J.W. Hooper, Chairman of the Federal Tax Committee, Brooklyn Chamber of Commerce) (reporting the results of a survey of business executives in which the first two priorities were repeal of the undistributed profits tax and the tax on capital gains).

477. *Id.* at 468; *see also id.* at 138 (statement of William J. Kelly, Machinery and Allied Products Institute) (advocating a reduction in the capital gains rate after replacing the undistributed profits tax with a flat corporate income tax).

478. *Id.* at 178 (statement of H.B. Spalding, Committee on Government Finances, National Association of Manufacturers).

479. *Id.* at 258 (statement of M.L. Seidman, Chairman of Taxation Committee, New York Board of Trade) ("But, by far the most important single item in this bill is its provision for the treatment of capital gains and losses.").

480. *See Notes*, NATION, Nov. 27, 1937, at 574.

paying the dividend." It concluded that this "double and multiple taxation ... should be eliminated."<sup>481</sup> Despite the similarity between the double tax burden imposed on intercorporate dividends and that on dividends to shareholders, the Chamber and other business representatives did not expand their arguments.<sup>482</sup> Apparently, only the intercorporate double tax burden affected corporate managers' ability to operate their companies. The double taxation from distributions to shareholders was simply too far down on the managers' list of concerns.<sup>483</sup>

As expected, both the Senate Finance Committee and the Senate heeded business' complaints and overwhelmingly voted to repeal the undistributed profits tax altogether.<sup>484</sup> In a Senate floor debate that took only two and a half hours—less time than was afforded to the discussion of a proposed excise tax on pork<sup>485</sup>—Senator Harrison justified a 2% increase in the lowest corporate normal tax by suggesting it would "encourage private business" if it were free of the undistributed profits tax.<sup>486</sup> Robert La Follette, the lone senator who publicly challenged the repeal, discounted Harrison's claims, stating "this tax has been the object of one of the most widely organized and most successful propaganda campaigns in the history

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481. 1938 *Senate Hearings*, *supra* note 461, at 475 (Brief of Ellsworth Alvord, United States Chamber of Commerce).

482. *See, e.g., id.* at 183 (statement of J.W. Hooper, Chairman of the Federal Tax Committee, Brooklyn Chamber of Commerce) ("The proposed bill does not eliminate the inequitable feature found in the present law in the duplication of taxation by way of taxing intercompany dividends.").

483. Even those business leaders who complained about high individual surtax rates justified a reduction primarily by reference to the needs of managers. One trade group representative, for example, stated: "It is my belief that with a reduction to a maximum of not more than 50 percent tax rate on individuals, that a very substantial amount of capital will be redirected into business enterprise, which we urgently need there ...." *Id.* at 110 (statement of Claude W. Dudley, Millers National Federation).

484. *See* Lauren D. Lyman, *Profits Tax Eliminated, Gains Levy is Modified by Senate Finance Group*, N.Y. TIMES, Mar. 25, 1938, at 1 (reporting a vote of seventeen to four); *Senate Approves Most of Tax Bill*, N.Y. TIMES, Apr. 8, 1938, at 13 (noting that on the voice vote apparently only four senators opposed eliminating the undistributed profits tax).

485. Alfred F. Flynn, *Senate Drives Tax Bill Toward Final Vote; Foes Yield*, WALL ST. J., Apr. 8, 1938, at 1 ("In an amazing burst of speed, which naturally left some confusion in its wake, the Senate agreed to more than 250 pages of controversial legislation in about 30 minutes."); *Senate Approves Most of Tax Bill*, N.Y. TIMES, Apr. 8, 1938, at 13.

486. 83 CONG. REC. 4928 (1938) (statement of Sen. Harrison) (noting that under the House bill, a corporation would only pay a 16% income tax if it distributed all of its profits while the Senate bill imposed a flat 18% income tax).

of tax legislation."<sup>487</sup> According to Senator La Follette, "The repeal of the undistributed-profits tax will reestablish huge tax favors in behalf of retained corporate income."<sup>488</sup> His pleas, however, fell on deaf ears as Senators appeared to be primarily concerned with restoring business confidence. On this front, they were by all accounts successful. The *New York Times* called the repeal "the most reassuring single piece of news that has come out of Washington in many months."<sup>489</sup>

#### *d. Conference*

Almost immediately after the Senate vote, Roosevelt went on the offensive to try to force the conference committee to retain what was left of the undistributed profits tax principle.<sup>490</sup> In a letter to House Ways and Means Committee Chair Robert Doughton and Senate Finance Committee Chair Pat Harrison,<sup>491</sup> Roosevelt attempted to position the undistributed profits tax as an ally of the small corporation:

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487. *Id.* at 4932 (statement of Sen. La Follette). La Follette's Investigating Committee in the Senate found that the National Association of Manufacturers had spent almost \$1 million a year fighting the undistributed profits tax since its passage. In conjunction with the efforts of other groups such as the U.S. Chamber of Commerce:

[E]very known medium of reaching the public with their propaganda has been used, including advertising in the daily and weekly newspapers, and colored news articles. The [La Follette Investigating Committee] records show they have also used direct mail, booklets, leaflets, bulletin board posters, 24 sheet posters for outdoor boards, pay envelope slips, sound slide films, moving picture slides, plant publications and house organ service, nation-wide radio programs, including the "American Family Robinson" cartoon service and the "Uncle Abner" series and under many other names.

W.D. McFarlane, *Weekly Newsletter*, WICHITA BANNER (Mar. 11, 1938), in William Doddridge McFarlane Papers, 1919-1981, *supra* note 455.

488. 83 CONG. REC. 4933 (1938) (statement of Sen. La Follette).

489. Editorial, *For Complete Repeal*, N.Y. TIMES, Mar. 25, 1938, at 18; *see also* Editorial, *A Reassuring Tax Bill*, N.Y. TIMES, Apr. 11, 1938, at 14 ("When the business community begins to recover from its bad case of jitters (and there are signs that it is on the verge of doing so), it will see in this Tax Bill a remarkably reassuring sign.").

490. *See Roosevelt May Ask Retention of Surtax in Revenue Measure*, WALL ST. J., Apr. 11, 1938, at 1 ("President Roosevelt is still firmly wedded to the undistributed profits tax idea ....").

491. The letter was actually drafted by Roswell Magill after Roosevelt asked Treasury Secretary Henry Morgenthau "to prepare a letter for the conference committee which the 'man in the street' could understand." BLUM, *supra* note 142, at 444.

It would be particularly undesirable to eliminate the undistributed profits tax at this time, in favor of a flat rate of tax, representing an increase in the tax burden on many small corporations, and on all corporations which follow established American practices of dividend distribution; and a decrease in the tax burden of many large corporations, which have hoarded their earnings in the past, and would be encouraged to resume the practice in the future.<sup>492</sup>

"[R]epeal," Roosevelt wrote, would "strike at the root of fundamental principles of taxation. Business will be helped, not hurt, by these suggestions."<sup>493</sup> While this "unusual if not unprecedented attempt to dictate the terms of the conference agreement" served to publicly reaffirm his commitment to the undistributed profits tax principle,<sup>494</sup> Roosevelt privately told advisers to cut the best deal they could under the circumstances.<sup>495</sup>

Roosevelt's letter appeared to achieve its desired effect. When the conference began, many thought the House managers were "in a mood to compromise."<sup>496</sup> After the letter was made public, however, House conferees began to dig in their heels on retaining at least the principle of the undistributed profits tax.<sup>497</sup> Senate conferees "resented" Roosevelt's intrusion into the conference process,<sup>498</sup> but managed only to orchestrate a stalemate that lasted nearly a month.<sup>499</sup> Faced with the possibility that this would result

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492. *The President Discusses the Pending Tax Bill, April 13, 1938*, in 1938 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 214, 216-17 (Samuel I. Rosenman ed., 1941).

493. *Id.* at 217.

494. Editorial, *The President Intervenes*, N.Y. TIMES, Apr. 14, 1938, at 22; *Roosevelt Letter on Profits and Gains Taxes Irks Congress*, WALL ST. J., Apr. 14, 1938, at 3.

495. BLUM, *supra* note 142, at 445; LAMBERT, *supra* note 106, at 486. One reassuring fact for Roosevelt may have been the government's success in using the accumulated earnings tax against a company it accused of purposely avoiding the distribution of dividends. See *Helvering v. Nat'l Grocery Co.*, 304 U.S. 282, 289 (1938); *High Court Backs Profits Tax Basis*, N.Y. TIMES, May 17, 1938, at 1.

496. Arthur Krock, *Political Perils of Tax Conference Failure*, N.Y. TIMES, Apr. 19, 1938, at 20.

497. See *Conferees Deadlocked on Capital Gains and Surtax Issues*, WALL ST. J., Apr. 19, 1938, at 2; *House Conferees Seek to Retain Surtax Principle*, WALL ST. J., Apr. 20, 1938, at 1.

498. *Senators Revolt as Roosevelt Acts to Save Surplus, Capital Gains Taxes*, N.Y. TIMES, Apr. 14, 1938, at 1.

499. See LAMBERT, *supra* note 106, at 486; *Conferees on Tax Reach a Deadlock*, N.Y. TIMES, Apr. 15, 1938, at 15.



in no bill to reform the undistributed profits tax,<sup>500</sup> the Senate conferees finally agreed to impose a 19% corporate income tax with a maximum 2.5% credit for distribution of all of a corporation's net earnings.<sup>501</sup> Perhaps most significantly, conferees agreed the undistributed profits tax would expire after 1939.<sup>502</sup> The *New York Times* reported:

[t]he Senate conferees, in explaining their surrender on the undistributed profits tax principle, asserted that the reduction of the super tax rate to 2½ per cent and its limitation to two years, plus the modifications to help corporations with debts or impaired capital, met most of the objections to the undistributed profits tax.<sup>503</sup>

This "face-saving compromise," as one Republican Senate conferee described it,<sup>504</sup> did not appear to save enough face for Roosevelt. Despite Republican complaints that he had tainted the conference process in order to secure the compromise,<sup>505</sup> Roosevelt publicly expressed his dissatisfaction with the outcome. The bill, which passed both the House and Senate with little debate,<sup>506</sup> sat for several weeks awaiting the President's signature. Finally, in a speech delivered during the commencement exercises of a rural high school in West Virginia, Roosevelt announced that he would allow the bill to become law without signing it.<sup>507</sup> While he chose to refrain

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500. *Profits Tax Looms as Election Issue*, N.Y. TIMES, Apr. 24, 1938, at 4.

While the compromise was not all that certain groups had hoped for, it was regarded here as removing a potential threat to the Administration's recovery program by ending fears that a continued deadlock of the Senate and House conferees on the Tax Bill might leave in force the present revenue legislation, which many regard as definitely worse than the proposed law ....

*Id.*

501. *Business Tax Aids Retained in New Compromise Bill*, WALL ST. J., Apr. 23, 1938, at 1; Lauren D. Lyman, *Conferees Agree on Revenue Bill*, N.Y. TIMES, Apr. 27, 1938, at 2.

502. *Modified Surplus Tax for Two Years Retained in Senate-House Compromise*, N.Y. TIMES, Apr. 23, 1938, at 1.

503. *Id.*

504. *Profits Tax Looms as Election Issue*, *supra* note 500, at 4.

505. *See, e.g.*, 83 CONG. REC. 6691 (1938) (statement of Rep. Treadway).

506. *See House Passes Tax Bill Expected to Aid Business; Goes to Roosevelt Today*, N.Y. TIMES, May 12, 1938, at 1 ("The debate lasted little more than an hour ...."); *Senate Approves Modified Tax Bill*, N.Y. TIMES, May 10, 1938, at 33 ("Using little more than five minutes, the Senate approved today the conference report on the \$5,330,000,000 Tax Revision Bill.").

507. Felix Belair, Jr., *Roosevelt Scores Tax Bill, Asks Revamping Next Year; It Becomes Law*

from vetoing the legislation because of the “many good features” he saw in the bill, he wanted to emphasize his disagreement with its treatment of certain items such as undistributed profits taxes.<sup>508</sup> “By taking that course,” he said:

I am calling the definite attention of the American people to those unwise parts of the bill that I have been talking to you about today—one of them which may restore in the future certain forms of tax avoidance of the past, and of continued concentrated investment power, which we in Washington had begun to end ....<sup>509</sup>

Thus, for the first time in Roosevelt’s career he permitted a bill to become law without his signature.<sup>510</sup>

#### 4. Revenue Act of 1939

Although Roosevelt still hoped the undistributed profits tax principle could be maintained beyond its scheduled expiration,<sup>511</sup> he was left with few allies in this cause. Treasury now openly rejected continuing the undistributed profits tax principle. Testifying before the House Ways and Means Committee, Treasury Secretary Morgenthau classified the undistributed profits tax as one of the system’s “tax irritants.”<sup>512</sup> According to Morgenthau, “In its

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*Unsigned*, N.Y. TIMES, May 28, 1938, at 1.

508. *Id.* (citing favorably the strengthening of the accumulated earnings tax and the lessening of taxes on smaller corporations).

509. Franklin D. Roosevelt, Address at Arthurdale, West Virginia (May 27, 1938), in 1938 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 355, 365 (Samuel I. Rosenman ed., 1941).

510. Franklin D. Roosevelt, *The President Discusses the Pending Tax Bill* (Apr. 13, 1938), in 1938 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 214, 218 (Samuel I. Rosenman ed., 1941). Indeed, it was the first time since the ratification of the Sixteenth Amendment that a revenue bill was allowed to become law without the President’s approval. See Godfrey N. Nelson, *Disputes President on Some Tax Ideas*, N.Y. TIMES, May 29, 1938, § 3, at 1.

511. See LEFF, *supra* note 86, at 269; Turner Catledge, *Morgenthau Says Tax Plan Remains Open to Congress*, N.Y. TIMES, May 12, 1939, at 1 (“[T]he President’s spokesmen in Congress continued their efforts to arrange a plan whereby the disputed corporate tax structure, which expires automatically Dec. 31, might be extended temporarily, pending a more thorough study by Congressional committees of possible tax deterrents to business.”).

512. *Revenue Revision—1939: Hearing Before the House Committee on Ways & Means*, 76th Cong. § 5 (1939) [hereinafter 1939 House Hearings] (statement of Henry Morgenthau, Jr.,

present form this tax is unimportant and does not accomplish the objectives of the original proposal. The tax produces little revenue and has little effect on business."<sup>513</sup> He did not object to a proposal to eliminate the remaining 2.5% tax.<sup>514</sup> Administration officials also were reported to favor repealing the undistributed profits tax.<sup>515</sup>

With Treasury and the Administration all but conceding defeat on the undistributed profits tax, business leaders not surprisingly attempted for the first time to highlight the double taxation of corporate income in their testimony. In prepared statements for the Ways and Means Committee, members of the United States Chamber of Commerce,<sup>516</sup> the American Mining Congress,<sup>517</sup> the National Association of Manufacturers,<sup>518</sup> and the New York Board of Trade<sup>519</sup> advocated removing dividends from the individual normal tax and thus relieving corporate income from double taxation. The National Association of Manufacturers wrote:

[W]e seriously object to the principle of double taxation involved in taxing dividends as earned by a corporation, and then again when received by the individual. Tax equity is violated in such a case, particularly as concerns the normal tax rates, or, indeed, any tax rate which does not exempt the percentage of income tax paid by the corporation first receiving the income.<sup>520</sup>

Apparently, the demise of the undistributed profits tax helped to realign manager-shareholder interests on the question of double taxation. Once double taxation was no longer necessary to offset the pressure to distribute profits, corporate managers acknowledged double taxation's negative effect on a decision to invest in a business operating in corporate form. As one executive wrote in a letter to the Ways and Means Committee, "since in recent years all corporate

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Secretary of the Treasury).

513. *Id.*

514. *Id.* at 11 (colloquy between Sec'y Morgenthau and Rep. McCormack).

515. See Alfred F. Flynn, *Four Point Plan for Tax Revision Being Considered*, WALL ST. J., May 13, 1939, at 1.

516. 1939 *House Hearings*, *supra* note 512, at 105 (statement of Ellsworth C. Alvord, United States Chamber of Commerce).

517. *Id.* at 135 (statement of Julian D. Conover, American Mining Congress).

518. *Id.* at 146 (statement of Noel Sargent, National Association of Manufacturers).

519. *Id.* at 177 (statement of M.L. Seidman, New York Board of Trade).

520. *Id.* at 149 (statement of Noel Sargent, National Association of Manufacturers).

dividends were made subject not only to the graduated surtax but also to normal tax upon the stockholder receiving the dividend the corporation tax on income has been nothing but a penalty tax upon the corporate form of doing business."<sup>521</sup> Such attacks were not made with the same energy applied to the undistributed profits tax itself, but corporate managers nonetheless appeared to elevate the issue on their list of priorities.

Notwithstanding the reemergence of business leaders' opposition to double taxation, they never made it an issue in the hearings due to more pressing concerns. The main focus was to expedite a business tax assistance program negotiated by congressional leaders and officials from Treasury and the Administration.<sup>522</sup> Under this program, business would receive four major tax benefits. The program would (1) replace the undistributed profits tax and corporate income tax at rates ranging from 16.5 to 19% with a flat 18% corporate income tax, (2) permit an annual revaluation of capital stock for purposes of the capital stock tax, (3) eliminate the limit on capital loss deductions for corporations, and (4) permit corporations to carryforward losses for two or three years.<sup>523</sup> Unlike the relief of double taxation, these measures were designed to increase managers' flexibility and independence. As the *Wall Street Journal* pointed out with respect to the capital loss provision, "[r]emoval ... of the \$2,000 limitation on the deduction of capital losses from taxable income would do something to encourage corporation managements to venture more freely for the development of new lines of business, greater volume in old lines and wider employment in both."<sup>524</sup> A similar view was expressed with respect to the loss carryforward provision, with one expert opining that "the provision might also encourage some corporate investment, inasmuch as a considerable portion of entrepreneur investing in the past has been done by corporations."<sup>525</sup>

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521. *Id.* at 190-91 (statement of D.P. Larsen, Shevlin, Carpenter & Clarke Company).

522. See *Congress Leaders Plan to Expedite Tax Aid Legislation*, WALL ST. J., May 17, 1939, at 1; *Leaders to Push Business Tax Aid at Present Session*, WALL ST. J., May 16, 1939, at 1.

523. Flynn, *supra* note 515, at 1. The latter provision was eventually extended to individuals and partnerships in the final House bill. See *House Passes Tax Revision Bill; Approval by Senate Likely*, WALL ST. J., June 20, 1939, at 2; *Two New Concessions to Business Included in House Tax Bill*, WALL ST. J., June 17, 1939, at 1.

524. Editorial, *Promising Changes in Tax Laws*, WALL ST. J., May 26, 1939, at 4.

525. William J. Enright, *Losses Provision in Tax Bill Hailed*, N.Y. TIMES, June 25, 1939,

Because of concerns that delay might allow Roosevelt to sabotage the business tax aid program,<sup>526</sup> congressional leaders pressed to exclude the public debate of issues, such as the double taxation of corporate income, that were less important to business leaders. During executive session, Representative Doughton secured approval for a motion to limit discussion "to the subject of corporation taxes."<sup>527</sup> This move was not uncontroversial. One representative proposed that the committee "give public consideration to all taxes which are business deterrents (whether corporate, partnership or individual)" his motion on the matter failed.<sup>528</sup> Representative Doughton announced that witnesses desiring to make statements on other issues "may file briefs which will be considered by the subcommittee and the full committee, when they get down to the work of writing the bill."<sup>529</sup> Thus, when Noel Sargent of the National Association of Manufacturers tried to raise the double taxation issue in his testimony, he was permitted only to submit his remarks for the record.<sup>530</sup> The result was that, although business leaders favored eliminating double taxation, there apparently was not sufficient support to get it on the agenda for consideration.

As agency cost theory would predict,<sup>531</sup> double taxation thus survived the repeal of the undistributed profits tax because other issues were of more immediate concern to corporate managers and their allies. The tax bill sailed through the House and the Senate Finance Committees without consideration of the double taxation

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§ 3, at 7 (quoting J.M. Finke, of Klein, Hind & Finke, CPA).

526. *See Roosevelt Speech Not Likely to Alter Tax Revision Plans*, WALL ST. J., May 24, 1939, at 1 ("[I]t was revealed in Senatorial quarters that pressure was being brought to bear on the House ways and means committee to speed up consideration of the tax agenda in the belief that further delay might prove disastrous.").

527. *1939 House Hearings*, *supra* note 516, at 249 (statement of Rep. Doughton); *id.* at 146 (colloquy between Chairman Doughton and Noel Sargent). In hearing that Sargent was going to discuss, among other things, the "exemption of corporate dividends paid to individuals from normal income tax since this involves double taxation," Doughton remarked, "I hope you understood my first informal statement. Those are not corporation taxes ... I hope you will not discuss income taxes on individuals and excise taxes in this hearing." *Id.*

528. *Id.* at 249 (statement of Rep. Jenkins); *see Effort Proposed to Broaden Scope of Tax Hearings*, WALL ST. J., June 5, 1939, at 1.

529. *1939 House Hearings*, *supra* note 516, at 249 (statement of Rep. Doughton).

530. *Id.* at 148-49 (statement of Noel Sargent, National Association of Manufacturers).

531. *See supra* text accompanying notes 16-20.

question.<sup>532</sup> Only a last minute amendment by Senator La Follette on an unrelated matter delayed the bill on the Senate floor, but this effort was quashed and the bill resumed course.<sup>533</sup> While it is possible that Congress intended to address the double taxation of corporate income as part of a planned general study of the corporate tax structure,<sup>534</sup> the issue never garnered the same kind of attention or interest as did the undistributed profits tax. This may be because the double tax burden was relatively small compared to the impact of high individual surtax rates;<sup>535</sup> this, however, tells only part of the story. With the undistributed profits tax out of the way, corporate managers could avoid or defer the double tax by retaining earnings and focusing on other measures, such as preferential capital gains rates, that would provide equal or higher value to stockholders.

### CONCLUSION

The rise of double taxation is a story about one interest group's purchase of legislation at the potential expense of a diffuse larger group. Business leaders believed the undistributed profits tax would infringe upon their ability to run a corporation free from governmental intrusion. Congressional allies sought to eliminate that component of the tax, and thus allay the fears of corporate managers, by subjecting dividends to the individual normal tax and setting the undistributed profits tax at an equivalent or slightly higher rate. The cost was the retention of a corporate income tax, but this was a cost business was willing to incur. In effect, managers traded double taxation for control over the use of corporate profits.

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532. See Turner Catledge, *Rushing Tax Bill to Senate Floor*, N.Y. TIMES, June 21, 1939, at 5; *Tax Bill Passed in House; Ends Profits Levy, Extends "Nuisance" Imposts 2 Years*, N.Y. TIMES, June 20, 1939, at 1.

533. *Bill to Ease Taxes Passed By Senate*, N.Y. TIMES, June 23, 1939, at 1 (describing Senator La Follette's amendment to increase surtax rates on incomes between \$6,000 and \$100,000).

534. See *Congress Leaders Plan to Expedite Tax Aid Legislation*, WALL ST. J., May 17, 1939, at 8 ("The staff of the joint congressional committee on internal revenue taxation is analyzing many suggestions which have been advanced concerning changes in the corporation income tax structure.").

535. See Kwall, *supra* note 3, at 621 n.39 (table setting forth the effective tax rates on corporate income distributed as a dividend).

This story comports with modern efforts to explain why double taxation persists.<sup>536</sup> According to several studies, most notably one by Professors Jennifer Arlen and Deborah Weiss, managers actively lobby for incentives for new investment, such as investment tax credits and accelerated depreciation, or for tax cuts targeted to a specific business or industry.<sup>537</sup> By contrast, managers are either opposed to, or are less likely to actively lobby for, windfalls for existing equity such as rate cuts, or, to a certain extent, integration of the corporate and shareholder taxes.<sup>538</sup> In the former case, the tax incentives help to stimulate new investment, which satisfies a manager's desire both to diversify the corporation's investments, and thus safeguard her undiversified investment in the company, and to secure and enhance her position with the company.<sup>539</sup> In the latter case, however, the windfalls do little to improve the manager or her investment in the corporation. Moreover, depending upon the relative marginal rates, integration would threaten the "retained earnings trap," or double taxation's tendency to trap earnings within the corporation, by increasing shareholder pressure to distribute dividends.<sup>540</sup> While the current differential between the highest individual marginal rate (39.6%) and the highest corporate rate (35%) may be too small to induce shareholders to leave earnings inside the corporation,<sup>541</sup> business tax preferences often help reduce the top corporate rate for individual corporations.<sup>542</sup> Furthermore, from 1939 to 1986, the differentials were much greater.<sup>543</sup> Because of the uneven distribution of corporate tax

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536. See *supra* note 24 (collecting sources exploring the persistence of double taxation).

537. RONALD F. KING, *MONEY, TIME & POLITICS: INVESTMENT TAX SUBSIDIES AND AMERICAN DEMOCRACY* 285-86 (1993); Arlen & Weiss, *supra* note 24, at 341-42.

538. Arlen & Weiss, *supra* note 24, at 338-41.

539. *Id.* at 334-36.

540. See, e.g., *id.* at 348, 356; AMERICAN LAW INSTITUTE, *supra* note 4, at 28-33, 39; Eric Zolt, *Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839, 843-44 (1988).

541. Compare I.R.C. §§ 1(a) (highest marginal rate for individuals is 39.6%) and 11(b) (highest marginal rate for corporations is 35%). Under the Economic Growth and Reconciliation Act of 2001, the retained earnings incentive will disappear completely by 2005 and will actually reverse by 2006 when the highest marginal individual rate is reduced to 33%. See Economic Growth and Tax Relief Reconciliation Act of 2001, H.R. 1836 at 4, tbl. 3 (May 21, 2001).

542. Arlen & Weiss, *supra* note 24, at 357.

543. *Id.* at 356-57.

preferences, even after the broadening of the base and the reduction in rates in 1986, the retained earnings trap remained for many corporations.<sup>544</sup> Thus, it is not surprising that managers have not been very inclined to actively lobby for the passage of one of the many integration proposals that have arisen over the years.<sup>545</sup>

The distinction between double taxation's rise and its persistence is the role of managers. As the history surrounding the rise of double taxation demonstrates, corporate managers actively supported double taxation only in the context of a direct challenge to their ability to retain earnings. While some may oppose integration today, most managers publicly support it even while actively pursuing other goals.<sup>546</sup> The implication is that corporate managers are likely to actively lobby for integration only when repealing double taxation is a potential solution to a direct challenge to their interests. Just as corporate managers played a significant role in the rise of double taxation, so too must they play a role in its fall for integration efforts to succeed.

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544. *Id.* at 358.

545. *Id.* at 348. Over the years, at least five integration methods have received serious consideration: (1) the shareholder allocation method in which each shareholder is allocated his or her pro rata share of the corporation's tax items for the year; (2) the shareholder imputation credit which involves giving shareholders a credit for taxes paid by the corporation; (3) the dividend deduction method which involves giving the corporation a deduction for dividends paid; (4) the dividend exclusion method in which shareholders are entitled to exclude dividends from income; and (5) the partial or complete mark-to-market method in which all shareholders, or shareholders only in public corporations, are taxed on the annual rise in value of their stock and the corporate tax is eliminated entirely or limited to public corporations. See AMERICAN LAW INSTITUTE, *supra* note 4, at 3-4; Graetz & Warren, *supra* note 1, at 1769.

546. See Arlen & Weiss, *supra* note 24, at 368.