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MERITS AND DEMERITS OF THE STOP-
PAGE-AT-SOURCE SYSTEM IN THE
INCOME TAX ON CORPORATE
DIVIDENDS

INTRODUCTION

The suggestion has been made by some leading business men in our country that the lump sum system in the taxation of corporate dividends falling under Class C of the Income Tax Law be replaced by the stoppage-at-source system. With the increase in the prevailing business depression, the suggestion seems to have gathered force. The meaning of the suggestion, however, is not quite clear. We do not know whether it aims at raising the income tax rate in Class A for the corporation income as in the case of the system that existed prior to 1920 (for example, to raise the tax rate for the general income of corporations from five to seven and half percent), or at adopting the stoppage-at-source principle in the case of dividends along with interest

on debentures and bonds, the interest on bank deposits, and profits from entrusted money in Class B. It is conceivable that the business men advocating the above change do not care which of the two systems be adopted. They may be satisfied if the present system of lump sum progression on individuals is changed to a proportionate tax on corporation incomes. Each of the two systems of taxation of corporations has its own merits as well as demerits. From the standpoints of tax technique and financial revenue, however, the taxation of the corporation income in Class A of the Income Tax Law would seem more desirable than the other system, inasmuch as the tax would be also levied on the income which is not paid to the members of the corporation. Many scholars have voiced their opposition to the business men's suggestion for a return to the former system of corporation income tax. I myself would endorse their conclusion but cannot agree with them in their sweeping condemnation of the stoppage-at-source scheme, for it has some merits of its own which are not duly considered by these scholars. The stand taken by those advocating this principle must be more sympathetically considered. I intend in the following pages to deal both with the merits and the demerits of the system for the purpose of passing a cool and unbiassed judgment on it, in my firm belief that my study will have some academic significance and give some hint to the officials in charge of the task under consideration.

PART I THE MERITS OF THE STOPPAGE-AT-SOURCE SYSTEM

Although the taxation of corporation dividends under the stoppage-at-source principle has serious demerits, as I shall later point out, it must be admitted that the principle has merits some of which are quite important. Whether it should be adopted instead of the lump sum scheme would

in a large measure depend upon its practicability and particular merits on some definite points on which stress is to be made. At any rate, it is highly important to recognise that the system has some merits of its own. These merits are as follows:

(1). Economic advantages—The most important of the merits of the system are economic ones. They are:

(A). Promotes investments by corporations, for the following reasons:

(a). Alleviates the financial burden of wealthy persons. Under the present Japanese income tax system, the burden falls heavily upon wealthy persons and very lightly upon poorer persons who receive smaller dividends, because the former must pay the progressive lump sum income tax as natural persons after their corporation has paid its income tax. As the lump sum income tax is levied progressively with the exemption point, those who receive but a small dividend would not have to shoulder any tax burden in the least; but those whose dividend is large in amount would be called upon to pay a heavy tax. Under such a system, the poorer corporators would be encouraged to invest, but the wealthier ones would instead be discouraged. Moreover, the system inevitably results in a double taxation for the latter class of taxpayers, who must pay their income tax both as a corporation and as individuals. Not only would the tax on their dividend income from the corporation, but that on other sources of income as well would be of much higher rates than under the stoppage-at-source scheme. Because of this tax burden, big capitalists would invest their surplus funds in bonds, debentures, or would deposit them in banks and trusts rather than invest them in industrial enterprises, in order to escape the heavy taxation. (Investments in government bonds incur no tax and naturally investors prefer them to any other forms of investment). It is quite obvious that all this results in checking industrial investments by corporations.

If, on the other hand, only the stoppage-at-source

scheme is adopted, industrial investments by corporations may be rather encouraged than discouraged. It is contended by some that the reluctance on the part of big capitalists to invest because of the existing lump sum scheme of income taxation is amply made up for by the encouragement given by the same system to smaller corporators to invest. However, it must be noted that these smaller capitalists lack proper knowledge about industrial investments and are often unwilling to invest. Moreover, they are passive and inactive in their attitude. As powerful corporators assume the position of industrial leadership, the tendency under the lump sum scheme is to discourage industrial investments by corporations.

It may be said that it is only the investment in corporations' shares that is checked and discouraged under the lump sum system of taxation and that the investment in debentures would rather be placed in a more advantageous position as a consequence; and thus what is lost under the scheme is amply made up. This contention loses sight of the fact that primarily the investment in debentures is conditioned by that in shares, and thus the former is secondary in importance. Its advantage, therefore, is smaller than the advantage which the investment in shares possesses under the stoppage-at-source system. In short, we may safely say that under the lump sum system the industrial development of corporations is prevented to a greater degree than under the stoppage-at-source scheme. It is clear that a replacement of the former principle by the latter would promote the growth of corporation enterprises. We may say that the adoption of the stoppage-at-source principle would place a nation in an advantageous position for its industrial growth inasmuch as modern large-scale enterprises must be undertaken by corporations and large-scale enterprises must be promoted in connection with the rationalisation of industry.

(b). To encourage re-investments of dividends. The dividend which small investors enjoy under the lump sum scheme is mostly used as part of their living expenses and

only an insignificant portion of it is re-invested in corporation enterprises. On the contrary, the larger dividend big investors receive is usually re-invested for the most part under the stoppage-at-source system. In this respect, too, this system of taxation tends to promote a greater tendency to reinvestment in corporation enterprises.

(c). Individual burden becomes indirect. Not only does the tax burden of large investors become lighter under the stoppage-at-source system than under the lump sum system, but the same burden would be more endurable at it becomes indirect under the former scheme, whereas the burden falls directly under the latter system. From this standpoint, also, the stoppage-at-source system stimulates re-investment by corporations and encourages their industrial enterprises.

(d). No enquiry made into the economic conditions of the members of corporations. Under the lump sum system, an enquiry is made into the economic conditions of the members of corporations, but there is no necessity for such an enquiry in the case of the stoppage-at-source scheme. Thus, investors would have greater tranquillity under the latter system of taxation, and this would encourage them to make more and greater investments in industrial enterprises than under the former scheme.

(e). The calculation of the rate of yield becomes more definite. Under the stoppage-at-source system, yielding rates are quite definite and people would know readily whether corporation investment is profitable or not. For this reason more people are urged to invest in the industrial enterprises of corporations than under the other scheme in which there are large differences in the amount of the tax burden according to the differences in the amount of income, and under which it is difficult to calculate the yielding rates of the stocks or to make exact valuation of them, thereby making people hesitate to invest.

(B). Better suits the nature of stocks. The stoppage-at-source system better suits the nature of stocks than the lump sum scheme. Many stocks are sold to registered

holders, it is true. But stocks after all are negotiable instruments like debentures, and no one knows how long the registered holders will continue to possess them. Stockholders usually do not insist on having a certain particular kind of stocks, but invest their money now on one kind of stocks and then on another kind, after making a comparative study of risks and profits involved in them. One may more appropriately say that stockholders invest, not in certain stocks, but in group of stocks or more broadly, in these or those negotiable securities. The tax on such objects, therefore, should be a real and objective tax instead of a personal and subjective one. By such a tax arrangement, the negotiability of the securities would be much more expanded. This is then another merit of the stoppage-at-source system over the lump sum scheme.

(2). From Tax Technique.

(A). Easy to grasp and difficult to evade. Although it is not impossible to tax the income under the lump sum system, in the case of stocks the majority of which are possessed by registered holders, there is some room for evasion, especially in the case of bearer-stocks which however are not numerous. Under the stoppage-at-source system, it would be easy to mark the taxable income and difficult to evade its imposition.

(B). Cost of tax collection small. Under the lump sum system, the collection of the tax is quite expensive. This obviously is a demerit of the system, even though every possessor of stocks, being registered, is reached. Greater cost will be involved in reaching bearer-stocks. But under the stoppage-at-source scheme, the expense of tax collection is insignificant.

(C). Scope of tax objects is expanded. Whereas under the lump sum system, only the dividends paid to individuals are taxed, under the stoppage-at-source scheme, the income reserved to a corporation also is taxed. Moreover, where under the stoppage-at-source system, the income, which non-resident aliens receive from this country, may be taxed,

under the other system, it may escape taxation, unless some special arrangement is made. This point may not require special mention if the income of foreigners is taxed under such a special tax as provided by Class B of the income tax law. The income which is below the exemption point under the lump sum system may also be made taxable under the stoppage-at-source scheme; however, this can hardly be called an advantage, inasmuch as the taxation of such an income may be objected to from the standpoint of social policy as well as justice in taxation, although it may be held as an advantage from the financial point of view; and this last named advantage is related to the advantage mentioned in A.

(3). From Financial revenue.

(A). Revenue is larger. The Government is able to secure a greater revenue under the operation of the stoppage-at-source scheme than under that of the other system, although much depends upon the rates as well as the particular method of taxation employed. A considerable amount of revenue could be secured under the system even if the rates are low, as there is only little tax evasion, the reserved income of corporations as well as the income below the exemption point (in case of the other system) are also taxed. The revenue will be much greater than that which a progressive lump sum tax would secure. Suppose the present individual lump sum tax on dividends is replaced by a corporation tax whose rate is seven and a half percent of the ordinary income (the ordinary rate at present being 5 percent). Taking the figures for 1928, the following will be the results of such a change: the total amount of the ordinary income tax on domestic corporations for that year which was estimated at Yen 56,639,718 would be increased by Yen 28,319,859. On the other hand, the revenue from Class B and Class C will be decreased by Yen 14,430,404. Thus, there would be an increase of something like Yen 14,000,000 in the total revenue. Moreover, as I have already pointed out, the cost of collecting the tax under the stoppage-

at-source is much cheaper than under the lump sum scheme. Thus, from the standpoint of state revenue, the former principle is far superior to the latter one.

(B). Certainty of revenue. Under the lump sum system, taxpayers will make attempts to evade the tax or to pay the least possible amount. As the result of all this, there is no certainty of state revenue. So long as no such efforts are made by taxpayers under the stoppage-at-source system, it has a higher degree of certainty of revenue.

(4). From justice in taxation. Viewed from this standpoint, on the whole, the inferiority of the stoppage-at-source system to the lump sum system is undisputed. However, the former has some points worth noting. They are:

(A). Omission of tax objects is scant. The stoppage-at-source principle keeps the omission of tax objects much smaller than under the lump sum scheme, and thus it is conducive to justice. To be more concrete, the former principle enables the reaching of the reserve income of corporations. Failure to reach this income is highly regrettable inasmuch as it elevates the economic position of shareholders as much as the dividends which are paid to them. Secondly, the stoppage-at-source is able to reach the dividends more effectively than is the other system, which often fails to reach them at all.

(B). Ability to avoid double taxation. Under the lump sum scheme now in force, the tax on dividends is levied on both corporations and individuals composing them, at the same time. Thus, the tax is levied twice on the same object. It may be contended in support of such a system that corporations and individuals composing them are different persons. This argument may have some force in case there are two different kinds of taxes imposed on the same object. But it is absolutely imperative in the case of the same tax that it should not be levied twice on the same object. Double taxation should be avoided to the utmost extent possible. It is because of this need that the income-tax law avoids double taxation between Class A income and

Class B income and also between Class B income and Class C income. It is regrettable that double taxation is still possible between Class A income and Class C income in the present system. The only way to eliminate this double taxation would be either to tax dividends as Class C income only, and abolish the taxation of dividends in Class A income, or to abolish the taxation of Class C income all together, so that dividends will be taxed only as Class A income. At any rate, the stoppage-at-source system would be more effective in eliminating double taxation. The argument that the double taxation under consideration would be justified if corporations and individuals composing them are treated as different persons, loses its weight because of the fact that the income tax law of our country is not very strict in discriminating between them. Thus, if importance is attached to differentiation between corporations and their members, progressive rates should be adopted for the corporate incomes of different sizes; but as a matter of fact a proportionate rate is adopted, because of the realisation that corporate income is nothing but the income of the individuals composing a corporation, and that all investors irrespective of wealth are equally capable of earning such an income: hence an intermediate tax rate that falls alike on both big and small capitalists. Thus, our income tax law regards a corporation as an instrument of investment by individuals. Secondly; the income tax law permits a deduction of 40 percent for corporate dividends in the individual income on which a lump sum tax is levied, the intention being to alleviate the tax burden of individuals; the law realizes that the income of a corporation is after all the income of the individuals composing it. This realization includes a consideration for debts also, but at any rate evinces the fact that the lawmakers recognize the double taxation involved in the system.

(C). Differential taxation of different incomes is more easily carried out. Although under the stoppage-at-source, system progressive taxation by income size is difficult of

realization, it has the merit in differential taxation by income quality, i.e. heavy taxation on property, is easy of accomplishment. True, such a differential taxation is actually carried out under the lump sum scheme, being embodied in the Class C income tax. Thus, such taxation is not the exclusive merit of the stoppage-at-source system. Moreover, if a stoppage-at-source tax should levy a four or five percent rate on the pure property income in Class B income and seven and half percent on corporate income, the tax would be opposed to the object of taxing the property element heavily. One may, however, justify the heavy taxation of corporations in view of their special nature.

(5). From tax burden.

(A). Alleviation of tax burden. I have already made it clear that the tax burden on individuals is lighter under the stoppage-at-source system than under the lump sum tax plan.

(B). More conveniently borne. Under the stoppage-at-source scheme, the tax burden is more conveniently borne by individual taxpayers, although it is not so with corporations. But as it is convenient to the mass, the inconvenience of the few must be endured. Thus, the adoption of the principle under consideration is desirable also from this point.

(6). From the moral standpoint. The stoppage-at-source is conducive to the people's morality as it does not encourage tax evasion as does the other system.

PART II

DEMERITS OF THE STOPPAGE-AT-SOURCE SYSTEM

We have seen above that the stoppage-at-source taxation of corporate dividends has a considerable number of merits of its own. However, the system has some demerits which I shall point out in the following pages.

(1). From the nature of income and the income tax. Primarily, income is a concept referring to a property of

natural persons only, and in consequence the income tax may be defined as a tax on the lump sum of their incomes. Seen from this logical standpoint, the taxation of corporate income in Class A of the income tax law must be held as unjustifiable, for it is not united with the business tax as it should be. But greater objection should be made against any attempt as proposed to abolish the lump sum tax on corporate dividends in Class C of the income tax law and to raise the rate of the tax on corporate incomes in Class A of the income tax law. However, if importance is attached to differentiation between corporations and the individuals composing them, the separate taxation of the two may be held as permissible. And under such a system, the lump sum tax on the corporate income in Class C in the income tax law should be maintained, and progression should be profitably adopted for corporate income in Class A in the income tax law. Such a scheme seems highly logical.

(2). From justice in taxation.

(A). Difficulty of consideration.

(a). If a proportionate taxation is adopted under the stoppage-at-source system, it would be impossible to utilize the important facilities and arrangements now used under the lump sum scheme in order to assure justice in the tax burden, namely, progression, consideration of personal circumstances, and the exemption point. Progression, if adopted under the stoppage-at-source system—for it is not impossible to adopt it under this system—it would not be so efficient as under the other system. It would be too weak to serve its purpose. We have already observed that it is possible also under the stoppage-at-source system to adopt measures for the heavy taxation on property. But the personal lump sum tax on individuals is the cream of the income tax, and if this is jeopardised by the stoppage-at-source system, the value of the income tax would be reduced by a half. This, in fact, is the greatest defect of the stoppage-at-source principle. It may be said, however, that since this principle is actually adopted at present in Class B of the income tax

law or income from interest, it should not be limited to this class of income but adopted also in the case of corporate dividend as well. But Class B of the income tax law is an exception. It is highly desirable to abolish this exceptional provision and include the income from interest in the lump sum tax. This exception is made because of the fear of tax evasion; a great many of bonds and debentures coming under this provision are unregistered and in consequence there is a persistent fear that the bearers of these securities may evade the tax.

However, it is the ideal of the income tax to keep tax evasion as restricted as possible by promoting moral ideas and by improving tax technique, so that the enforcement of a lump sum system may be continued or rather extended despite the possibility of tax evasion. Many of bonds and debentures coming under Class B of the income tax law are unregistered and hence there is a great possibility of tax evasion. In the case of interests on bank deposits and trusted money, it is not impossible to apply the lump sum scheme to them, for banks and companies may be required to make reports on the owners of such deposits. The evasion of interest on bonds and debentures is a fact much to be regretted, but it should not stand in the way of adopting a lump sum scheme. If a nation keeps up the stoppage-at-source system of income taxation because it is unable to replace it by a lump sum scheme, that nation would be confessing she is unable to adopt the right income tax system because of the imperfection of her tax technique and the degeneration of her national morality.

(b). Supplementary measures. Thus, considered from the principle of justice in taxation, the maintenance of the lump sum tax on individuals for their corporate dividends is highly desirable. If the corporation is regarded as an instrument of profit-making by individuals, the tax on the principal incomes coming under Class A in the income tax law should be at once abolished. But the tax on such things as reserved income, income of foreign corporations,

dividends that are to be sent abroad, excess profit income and clearance income, should be left intact. Thus, it is not necessary to abolish every income in Class A. In the case of the lump sum tax on individuals, the deduction of 40 percent on corporate dividends should be either abolished or replaced by the deduction of actual interest. But if importance is attached to the independent personality of corporations, a lump sum tax should be levied on individuals for their corporate dividends and a progressive tax rather than a proportionate tax should be levied at the same time on corporations in their dividend income.

(B). Possibility of shifting of tax burden big. Under the lump sum scheme, it is difficult to shift the tax burden from the tax payer to someone else, and thus the income tax can fulfil its function as a direct tax. Under the stoppage-at-source system, there is a possibility of stockholders shifting their tax burdens on to corporations which, in turn, tend to shift theirs on to consumers or other individuals by inserting it in the business expenses. Thus, there may be discrepancy in the tax burden against the intention of the income tax, the result being injustice in taxation.

(3). From financial revenue. The stoppage-at-source system has a demerit in that it has a slight flexibility of financial revenue for the State. Under the lump sum system, changes in the rates and in consequence the amount of revenue may be made easily, since all incomes from various sources are taken together. But changes in tax rates under the stoppage-at-source system would immediately affect the stock market and thus prove either detrimental or beneficial to stockholders. For this reason, changes in the tax rates under this latter system are difficult of accomplishment.

(4). From the economic standpoint. Under the stoppage-at-source system, the amount of the tax is added to the business expenses of the corporation whose business is thus oppressed by the system. The corporation could be free

from such an oppression if a lump sum is levied on the individual members composing a corporation. I have pointed out the economic advantages of the former system, but it must be noted that it has this economic disadvantage. However, it is possible that this defect may be made up by the willingness of big shareholders to invest in less yielding enterprises, so that there would be no economic oppression on industry as a whole. Moreover, an increase in the business expenses may encourage rationalisation of business management.

(5). From tax technique. It has been pointed out that under the stoppage-at-source system, tax evasion is difficult and reaching of the taxable object is easy. However, this merit is not so very important. As many stocks are registered, it is not a very difficult task to reach them all. Thus, this advantage in tax technique is not so important as in the case of bonds and debentures which are not usually registered. Thus, in this respect the lump sum system may be held as tolerable.

(6). From social policy. It may be said that the stoppage-at-source system as a whole places corporations and wealthy property holders at an economic advantage, and the people of the middle and lower classes at an economic disadvantage. However, it may be said that this objection is not so great in view of the possibility that the increased advantage of big capitalists might result in the economic improvement of the people of these lower classes, giving them chances of employment.

(7). From tax burden. The stoppage-at-source system may prove convenient to the Government from the standpoint of tax technique and economically advantageous to individuals. But it is bound to prove otherwise to corporations. No such inconvenience would be felt under the lump sum scheme. True, this inconvenience would be eradicated, if the rate of the tax on corporate incomes in the Class A income in the income tax law is raised, as previously advocated.

CONCLUSION

To summarise: the proper method of taxing the dividends of corporations is one of the most difficult problems of the income tax. The stoppage-at-source system has advantages economic, financial and technical, but its defect is found in its lack of justice. It is not harmonious with the very nature of the income tax. It also has some demerits in its financial and economic aspects. The technical advantages of this system are not so overwhelming as to compel a change in its favour, although these advantages cannot be ignored. One may indeed advocate the adoption of the stoppage-at-source scheme in the corporate dividend, but then the adoption of the same system in wage income also, then at last it may result in the abandonment of the income tax. Whether such an outcome is progress or retrogression will depend upon the judgments of different persons.

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