CARTER FABRICS CORPORATION
SOUTH ELM STREET EXTENSION
GREENSBORO, N. C.

February 9, 1938.

Chairman Marriner S. Eccles,
Federal Reserve Board,
Washington, D. C.

Dear Marriner:

The writer has been giving intensive study to the proposed tax on closely held operating corporations. This proposal is known as Title 1-B of the new tax bill. As a result of these studies, I have finally prepared a memorandum on this subject which states the reasons for my opposition to the proposal. Thinking you might be interested in this memorandum, I am taking the liberty of sending you a copy herewith. I do not know whether the views I have expressed in this memorandum are in line with or opposed to yours. If you should find time to look this memorandum over I would certainly be grateful for any comments you might care to make to me in connection with it. This memorandum was just completed before I left New York last night, which accounts for the fact that I am sending it to you from Greensboro, North Carolina. If you do find time to comment upon it, I would appreciate your writing to me at my office which, as you know, is at 44 Leonard Street, New York City.

I was very sorry to miss seeing you two or three weeks ago when I stopped by your office. I had a pleasant visit with Larry and hope very much to have the pleasure of a visit with you in the not distant future.

With highest personal regards and thanking you in advance for any consideration you may give this memorandum, I am

Yours most sincerely,

Bob Stevens

RTS:RC
Enc.

- THE PROPOSED TAX ON CLOSELY HELD CORPORATIONS -

On January 14, 1938 there was submitted to the House Ways and Means Committee the report of its sub-committee on taxation. Embodied in that report was something brand new in connection with taxation of operating corporations; namely, a proposal for a 20% penalty tax on earnings of closely held operating corporations. The sub-committee undertook to define these closely held operating corporations in a section of its report. This section is known either as recommendation No. 17 or as Title 1-B. The press refers to this section as "The Third Basket". It defines closely held corporations as those in which one individual or family owns more than 50% of the outstanding stock and so on in a series of ten classifications up to those corporations in which ten or fewer individuals own more than 75% of the outstanding stock.

The purpose of this memorandum is to present the viewpoint of an average American businessman in opposition to the proposal referred to above. The opposition of the writer should not be construed as other than constructive, for he merely intends to point out some of the discriminatory characteristics of Title 1-B. He fully realizes the need for revenue through the medium of corporation taxes. He would not oppose a normal tax rate of whatever percentage necessary to raise the amount now raised by the normal, the undistributed profits, the capital stock and the excess profits taxes. He visualizes the simplicity of administration in using one base rate as compared with the complexity of administering the four taxes mentioned above. However high this base rate might appear, it would at least have the advantage of treating all operating corporations alike. Discrimination against certain operating corporations and as between competitors, the inevitable result of the proposed 1-B tax, would be eliminated. Simplicity of administration would take a forward step.

In advocating in the foregoing paragraph the same tax treatment for all operating corporations, the writer does not oppose graduated normal rates for the first $25,000 of earnings as an aid to the small businessman. On the contrary, he favors this policy.

While the writer feels strongly that Title 1-B is thoroughly unsound, he nevertheless respects and appreciates the earnest and intelligent effort at tax revision which is revealed in the report of the sub-committee. The problems are many and the solutions are difficult. It is almost impossible to impose tax burdens without creating some inequalities. Many times these inequalities develop later and cannot be forseen in advance. However, in the case of Title 1-B, the inequalities are clear now and can be avoided. Such a tax would prove a constant source of hardship and trouble and this can be avoided by action at this time.

In connection with Title 1-B, the report of the sub-committee contains the following observation:

"It is believed that operating companies with closely held stock ownership and net incomes of substantial size which retain a considerable portion of their incomes are commonly used to avoid individual surtaxes."

The writer cannot concur with this statement - particularly as to the use of the word "commonly". He is very familiar with a number of operating corporations which would be affected by Title 1-B and in not one instance has there been the slightest thought about the impact of dividend declarations upon any stockholder. These companies have adopted dividend policies based upon sound management of the business. They have not considered the position of any stockholder, so far as personal surtaxes were concerned, in any way, shape or form. The pressure has been all the other way - what was the largest dividend that could be safely paid! And yet, these very corporations are among those which will fall within the scope of Title 1-B and will be penalized.

The first question that arises in connection with the 1-B tax is "What is the object of this tax?" Certainly it is not a tax for revenue only. The revenue aspect is clearly secondary and the reform aspect appears to be primary. "Who is it desired to reform?" Of course, this question can only be answered by those who have access to all corporation returns. Based upon their studies, they are sincere in their belief that there are cases of abuse or cases where the corporate form is being availed of for purposes of avoiding personal surtaxes. This memorandum holds no brief for those cases - it decries them in the strongest possible terms. Indeed, if Title 1-B would catch only these cases of abuse, the writer would definitely favor same. However, it is his firm conviction that Title 1-B would catch a minimum of five innocent operating corporations for every guilty one caught. Would not such a result be unsound, undesirable and un-American?

There are two methods that will take care of cases of abuse without bringing hardship upon any innocent operating corporation. Section 102 of the Revenue Act of 1936 can be further strengthened to provide the Department of Internal Revenue with a vantage point for immediate attack on cases of abuse. The majority of cases of abuse can be taken care of in this manner. Any offenders who successfully defend themselves will gain only a temporary advantage. The Treasury will lose nothing in the long run because estate or gift taxes will sooner or later make possible a full collection.

Having stated his opposition to the proposed penalty tax on closely held operating corporations, and having also stated his opinion as to the best method of imposing corporate taxes as well as touching upon methods of dealing with cases of abuse, the writer now proceeds to set forth the reasons why he believes the inclusion of Title 1-B in the forthcoming Revenue Act of 1938 would be a great mistake.

1. Promotes Monoply - the tax would definitely retard the efforts of the small and medium sized operating corporation to gain in stature. Thus the position of the large operating corporations would become more secure and monoply would be encoraged.

2. Promotes Absentee Ownership - closely held operating corporations are usually of that type where ownership and management are synonymous. Penalty taxes on these corporations would encourage

the sale of the control of the business. Absentee ownership would result. Many of the securities sold to the public would undoubtedly prove worthless once the ownership management equation was eliminated.

3. Encourages Peaks and Valleys of Employment - many closely held operating corporations set aside reserves in good years in order to carry them and their employees through bad years. Penalty taxes would make this procedure too costly and the result would be quicker impairment of working capital and quicker shutdown of plant in bad times with resultant hardship on employees and burden on the Treasury for relief.

4. Hinders Installation of New Machinery and Plant Expansion - the 20% penalty tax, adding substantially to the cost of new machinery and to the already high cost of building, would retard the sound economic maintenance and expansion of closely held operating corporations.

5. Advances New Theory of Taxation - not only are production and employment practically placed by Title 1-B in the same category as non-operating or holding companies but, further, the retention of earnings for the needs of this production and employment is regarded as "tax avoidance". In addition, the sound tax theory of "ability to pay" is disregarded in Title 1-B and many closely held operating corporations might have far less ability to pay than their publicly owned competitors.

6. Disturbs Competitive Situation - two operating corporations are the same size, in the same business and in the same financial position. 75% of the stock of one corporation is owned by 10 people and 75% of the stock of the other is owned by 11 people. The first company may be subject to the 20% tax under Title 1-B and the second would not be subject. The competitive disadvantage of the first company is apparent. Why should the arbitrary difference between 10 or 11 stockholders owning 75% of the stock of these two companies result in a serious disequilibrium in the competitive situation between the two corporations?

7. Discourages Working for Oneself - working for oneself produces the greatest effort and efficiency. It stimulates initiative, invention and improved methods because the owner shares directly in the benefits derived from his own efforts. Why penalize this type of effort?

8. Penalizes not only Stockholders but also Employees - many closely held operating corporations have profit sharing arrangements with their employees. Profits are always figured after taxes. The 20% penalty tax would reduce net profits partly at the expense of the employees, so that Title 1-B is not only a burden to the owners of a closely held operating corporation but also in many cases is a burden to all the corporation's employees.

9. Discriminates - the penalty tax is clearly discriminating against certain kinds of capital investment. Frequently the entire net worth of stockholders in a closely held operating corporation is tied up in that one corporation and is wholly and continously at the risk of the business. In many cases the public would be unwilling to invest in the enterprise, even if the opportunity were provided. Most of these companies as a matter of fact are not large enough to interest the capital market. Stockholders in this type of operating corporation, in the vast majority of cases, want all they can get in dividends, but conservative dividend policies must be maintained

10. Bottles up Some Managements - many operating corporations are not permitted by their creditors to pay dividends beyond a certain point. The RFC and Federal Reserve Banks exercise strong measures of dividend policy control over corporations to whom they have made loans. In these cases, debt retirement must be the immediate objective and it is a hardship to pay principal, interest and then an extra 20%. In some states there are laws which make impossible the payment of dividends under certain conditions. Why handicap a management which may be rebuilding a business but whose hands are tied on the subject of dividends?

11. Affects Minority Stockholders - many operating corporations which would fall under Title 1-B nevertheless have substantial minority stockholders. These minority stockholders, noting that their investment is in a corporation which may be liable to a 20% penalty tax, will be encouraged to withdraw their investment, if possible, and place it where the penalty tax cannot be applicable. Such a trend would limit still further the capital available to small or medium sized businesses of the closely held type and would tend, if forced sales occurred, to break down values to an unreasonable point.

12. Personal Taxes not Responsible for Earnings Retention - many of the operating corporations that would be affected by Title 1-B established their dividend policies many years before the first personal income tax law was passed in October 1913. They were plowing back earnings into their business long before there was any tax on their individual stockholders. Surely they were not guilty of "tax avoidance" then - why are those same companies guilty now in pursuing the same course they have always followed?

The textile industries, with which the writer is associated, are very largely made up of operating corporations which are of the closely held type. These corporations have had to be that way because the record of the textile industries has not been such that outside capital was attracted. These plants have been very largely founded and built up through earnings over the generations by families or small groups of men. The public in general was not interested. The number of textile securities listed on the exchanges or in any sense widely held, is very limited and probably 80% to 90% of textile operating corporations today would fall within the 1-B definition of a closely held corporation. It is possibly true that under the proposed exemption of earnings up to $50,000 a great many of these companies would not pay the penalty tax, but this does not alter the fact that the definition per se takes in almost all of one of the oldest and largest industries in America and, actually, many textile operating corporations would be affected by the penalty tax. The question is here raised as to whether or not it is sound procedure to single out a restricted group of closely held operating companies for penalty taxes when in the case of the vast majority of those corporations there is no desire, evidence or trace of tax avoidance.

In addition to the $50,000 exemption permitted under Title 1-B, it is proposed that $40,000 or 30% of earnings, whichever is higher, may be exempted from the tax. On this latter point the sub-committee says

"It is believed that this 30-percent allowance is ample to cover all reasonable needs of corporations for accumulation of income."

Is it inappropriate to ask how any formula can possibly be laid down on this point to cover all corporations, irrespective of the kind of business they are in or what their individual problems are? Some businesses are so cyclical in character that a 30% earnings exemption in good years might fail by far to take them through bad years. Strong corporations in some fields will not need to retain any earnings - weak ones in the same field may have to retain far more than 30%.

As a means of providing a method for keeping earnings within a closely held operating corporation, the sub-committee recommends a "consent" procedure under which the company may retain earnings provided the individual stockholders unanimously agree in writing to pay personal income taxes on their respective shares of the earnings so retained. This plan would have many disadvantages and in practical operation would be of assistance in relatively few cases. One trouble would be that many large blocks of stocks in this type of corporation are held in estates, trusts, etc., and it would be exceedingly difficult to get trustees to agree to the "consent" procedure, calling for substantial tax payments on income not actually received.

In conclusion, it can be stated that there is undeniably a very widespread feeling that the undistributed profits tax should be eliminated or drastically modified. The sub-committee, working with the Treasury, has recognized this feeling in its report by recommending a very drastic revision of this tax. Every reason brought forth in opposition to the undistributed profits tax applies with equal force to the proposed 1-B tax. In the latter case, however, there will be such a small percentage of corporations affected that the clamor against it will be but a faint echo of the rising storm of criticism against the undistributed profits tax. It is interesting to note, however, that the recommendations submitted to the President on February 4, 1938 by the conference of small businessmen included opposition to any "surtax on small business closely held corporations". The 1-B tax is a blow at the backbone of American business - a blow at the type of enterprise which started and helped this country on the way to its present position of industrial development. It strikes at the heart of many an American community where ownership management corporations have built up and have maintained something that is the lifeblood of the community. This type of ownership management should be encouraged - not discouraged. Not only to hamper it, but to bring it into disrepute by singling it out for discriminatory taxation is a mistake which, in the writer's judgement, the Congress will not make.

February 8, 1938

February 19, 1938.

Mr. Robert Stevens,
44 Leonard Street,
New York, New York.

Dear Bob:

Your letter has been held for several days because I wanted an opportunity of reading carefully your statement regarding Title 1-B of the new tax bill. In addition to reading your memorandum myself, I turned it over for study to a member of our staff. The attached comments, which I think will interest you, are the result; and I notice that a number of your points regarding the proposed "third basket" are treated with a good deal of sympathy.

As you know, I have been favorable to the principle of the undistributed profits tax. A point not emphasized in the enclosed notes is one that appeals to me very much. I refer to the fact that to maintain the economic system in operation we must keep funds flowing through the economy. When they pile up as idle balances, we tend to get a deflationary effect that sends the whole economic system into a tailspin. It has been my view that the undistributed profits tax is one of the important weapons of government in combatting such developments and in causing companies to pay out earnings rather than to pile them up in cash or idle bank balances, pay off debts, and otherwise pursue the objective of excessive liquidity. When all or most companies are pursuing liquidity the result is a serious deflation for the economy as a whole.

I was glad you stopped by the office when you were in town some time ago and am sorry things did not work out so that we could see each other. It would be nice to have time in which we could talk out these problems together. With highest regards.

Very sincerely yours,

M. S. Eccles
Chairman

MSE:rhs

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Mr. Stevens Statement on Title 1-B

The memorandum by Mr. Stevens seems to me to make several perfectly valid points. I feel he is correct in saying that the proposed "third basket tax" on closely-held operating corporations will result in somewhat arbitrary and capricious distinctions between the tax treatment of corporations (or their stockholders) whose circumstances are essentially identical. This fact will almost necessarily result from the definition of a closely-held corporation in accordance with percentages of stock held by one or more individuals, for the definition, in order to achieve exactness, is itself arbitrary. It thus seems entirely pertinent for Mr. Stevens to point out that a corporation in which <u>ten</u> individuals own 75 percent of the stock will be subject to a penalty tax on retained earnings, while a corporation in which <u>eleven</u> individuals own the same amount of stock will not be subject to the tax.

In addition, Mr. Stevens implies that the definition of a closely-held operating company in Title 1-B rests upon a presumed motive of tax avoidance. He is thus able to observe correctly that closely-held operating companies may in fact retain earnings for any number of reasons connected with a company's especial circumstances or business opportunities and not at all based on a motive of tax avoidance. The presumption of motive does not nicely fit the truth of the situation in all cases. On the other hand, if the tax is levied on the <u>fact</u> of retained earnings, then there seems little reason to distinguish between closely-held and non-closely-held companies, for the <u>fact</u> of retention may be the same in both cases.

It is possible, of course, to argue against Mr. Stevens' memorandum in the foregoing regard. It can be pointed out that closely-held corporations are exempted from the penalty tax on 30 percent of retained earnings. That allows such corporations to retain, without penalty, a percentage of earnings approximating the customary practice of American corporations; for closely-held corporations to retain, on the average more than that amount does, indeed, offer some basis for presuming that their policy of retention is motivated by something more than the ordinary practices of prudent management. The new law allows consent dividends, which Mr. Stevens notices. Furthermore, it will be possible in many instances to make dividend distributions in stock taxable to the recipient, so that earnings are retained in the corporate treasury for such purposes as may appear appropriate to the enterprise; and, with corporations as closely-held as those defined in the proposed law, it will even be possible in many cases to distribute cash and, by means of arrangement with the leading stockholders, to effect a return of the disbursed cash in the form of new capital subscriptions sufficient for operating needs or reasonable expansion. Despite these rejoinders, however, the idea that the tax will result in many arbitrary differences of treatment and of inconvenience, does not entirely disappear. In this connection, though, I have not had time to explore the facts and implications, the statement that small, closely-held companies are typical of the textile industry is interesting.

Of the other points made by Mr. Stevens in his memorandum, several are general considerations that from time to time have been advanced against the whole principle of undistributed profits taxation, and those particularly directed toward the proposed Title 1-B are hard to evaluate. Thus, Mr. Stevens remarks that the new penalty tax would promote absentee ownership because the present owners, often owners-managers, would tend to divest themselves of stock control in order to avoid the tax. In much the same vein he suggests that the tax will discourage "working for one's self".

Mr. Stevens is probably correct in believing that there will be many cases of border-line character in which a certain amount of stock will be sold in order to bring the corporation outside of the closely-held definition established in law. It is my own suspicion, moreover, that there will be ways by which the owners of closely-held corporations will often be able to divest themselves of legal control without in fact losing control of dividend policy. (Likewise, there are going to be numerous cases in which actual control of a company will rest on far smaller stock ownership than the statutory percentages.) However, considering the limited number of corporations that will be affected and the ways of avoidance, it does not appear that the encouragement of absentee control can be pressed too far in arguing the undesirability of the proposed tax on such social grounds. In fact, I have the impression that Mr. Stevens himself would not press the argument especially far, for he says in another connection that most closely-held corporations are not large enough to interest the capital market and do not have an investment outlet for their security issues.

In addition to the foregoing criticisms that I find hard to evaluate but am inclined to minimize, Mr. Stevens makes two especial attacks against Title 1-B that seem to me largely in error. For instance, he suggests that it advances "a new theory of taxation" in disregard of "ability to pay" because many closely-held operating companies have "less ability to pay than their publicly owned competitors." This statement puzzles me because the ability-to-pay doctrine applies to the taxation of individuals and but slightly if at all to American corporate taxes. The latter do not make any distinction concerning whether the corporate stockholder is a man of large income or small income; even the slight favor now granted to small corporations is based on another theory, and the intention of the undistributed profits tax, or the new Title 1-B as proposed, is not to tax the corporation as such but, by levying a penalty, to compel distribution of dividends and thus, indeed, to compel the taxation of individuals in accordance with ability as measured by the receipt of income. In consequence, I am inclined to feel that Mr. Stevens' comment in this regard goes a little wide of the mark, but it could be rephrased to have real content. The merit of what he has to say in this connection is contained in the thought that the levy of the tax on closely-held corporations and its non-levy on publicly-held corporations creates a marked disparity in the treatment of individual stockholders, depending on whether they have their securities in closely-held or publicly-held corporations. The point as thus phrased is closely related to another made by Mr. Stevens. He says that Title 1-B will discriminate against investment in a closely-held corporation in comparison with investment in a non-closely-held corporation, and I believe this is a correct view of the situation that will be created by the proposed tax.

Again, Mr. Stevens seems to feel that the tax will create a disequillibrium in competitive conditions between taxed and non-taxed corporations. This may be true in the long run but must be most carefully stated.

The tax is laid, after all, on the net profit; and the net profit is not a price-determining cost. Such competitive disturbance as may be created, therefore, will not be an immediate price factor but will be the result of long-run factors — perhaps a greater difficulty in obtaining funds for expansion, working capital, and so on.

Finally, Mr. Stevens' feeling that the provision against the improper accumulation of surplus can be developed to meet the retained earnings problem is one that needs careful exposition. That provision has been one of the most disappointing ever enacted into the Federal revenue system, for no satisfactory test for "improper" has ever been hit upon despite long and serious study by the Treasury. To leave the word "improper" without close objective definition necessarily vests in the revenue officials a degree of administrative discretion almost wholly at variance with American practice in such matters; and, as a result, the provision against improper accumulation of surplus has remained, in the absence of satisfactory definition, almost completely a dead letter. If a good method of strengthening the provision can be discovered, a first-rate contribution will have been made.

The remaining points set forth by Mr. Stevens represent a competent outline of the more general arguments that have been made against the undistributed profits tax principle, and as Mr. Stevens notices by implication, they would be of much the same effect as arguments against a uniformly applicable undistributed profits tax as against the proposed especial tax on closely-held operating companies. None of the points made is entirely without merit. But a full discussion being beyond the scope of these comments, only a few concluding remarks on the general question are here set forth.

By far the most effective arguments in behalf of the undistributed profits tax, I believe, rest fundamentally on the question of tax equity. In the absence of the undistributed profits tax, or a better substitute, a considerable total of income, whether with or without intention, annually avoids the individual tax rates collected when income, for whatever reason, can not be placed in the form of corporate, retained savings. Because of the high rates now charged on individually-received incomes, the power to avoid individual surtaxes has become an exceedingly valuable privilege; and, because all income can not take advantage of this privilege by being secured in the form of retained, corporate savings, because the privilege is immensely more valuable to those in the high income brackets than to those in the low income brackets, and because other taxes do not, as is sometimes contended, eventually even out the inequities created by the foregoing facts, the non-taxation of undistributed profits creates gross discrepancies in the Federal tax system. This is, as was said, simply a matter of fact and not a matter of motive or intention; but it is fair to add that in view of the existing level of individual taxes there exists the most powerful incentive for larger income receivers to have corporate income retained as a means of avoiding individual taxes and to advocate that the revenue needs of the Federal Government, insofar as they are covered at all from income taxation, should be met by increases in the normal tax rate, which effects a relative increase of the tax burden for the lower bracket of dividend receivers.

It is not generally appreciated that the operation of the American tax system with a loophole for retained, corporate earnings has been (and, in increased measure, would be again) a powerful engine for distorting the economy. The non-uniform application of income taxation of such magnitude as now obtains in the United States is a tremendous force for inducing corporate savings. The relative advantage between funds retained as corporate savings and funds paid out as received, individual income unavoidably induces a considerable corporate investment expansion in disregard of whether other economic factors, if tax pressure were eliminated, would justify such a ratio of corporate investment to the total national income. We have become so accustomed in our thinking about corporate development and dividend policy to a situation so long existent that we often fail to notice what has been, in effect, a considerable susidy granted corporate savings by the American tax system. Thus, an engineer might call the undistributed profits tax a compensating pressure.

J. P. Stevens & Co., Inc.

Commission Merchants

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PLEASE REPLY TO 44 LEONARD STREET

February 23rd, 1938.

Chairman Marriner S. Eccles,
Board of Governors,
Federal Reserve Bank,
Washington, D. C.

Dear Marriner:

Thank you kindly for your recent letter regarding Title 1-B of the new tax bill. At this time I would also like to acknowledge receipt of the observations of one of your staff in connection with my memorandum. As yet, I have not had an opportunity of digesting these observations thoroughly, although I did note with pleasure on Page #5 the following statement: "None of the points made is entirely without merit."

Your opinion with respect to the principle of the undistributed profits tax, is entirely clear to me, and I am appreciative of your point of view. The fact that my own views on the undistributed profits tax do not entirely coincide with yours, is simply a matter of an honest difference of opinion. However, in the case of Title 1-B, I am really not primarily concerned with the pros and cons of the undistributed profits tax. My main contention in connection with Title 1-B is that it is arbitrary and discriminatory and singles out a particular group of operating corporations for punitive taxation. In other words, if the undistributed profits tax is to be drasctically modified, as proposed in the House bill, it seems grossly unfair to me that Title 1-B should be included, thereby failing to give the same undistributed profits tax relief to closely held corporations that it is proposed to give to the vast majority of operating companies.

Sometime when I am in Washington and happen to find you available, I would certainly like the opportunity of discussing the matter further. In the meantime I am most appreciative of your letter on this subject and also of the extent of your interest which has been shown through the medium of the memorandum prepared by a member of your staff.

With highest personal regards and hoping to have the pleasure of seeing you before long, I am

Yours sincerely,

Bob

RTS-B