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May 15, 1936.

THE PROPOSED TAX ON UNDISTRIBUTED EARNINGS

Now that there is apparently a disposition to retain a flat fifteen percent corporate income tax, which gives assurance against any loss of revenue, it is important to return to the original objectives of the tax on undistributed earnings. While the primary purpose is, of course, to raise additional revenue, the special objectives of this particular tax can only be attained if the practice of the few thousand big corporations of retaining enormous amounts of undistributed earnings is effectively checked.

From 1923 to 1929 non-financial corporations reporting net earnings retained \$24,657,000,000. Since over 90 percent of corporate income is earned by less than 10 percent of the corporations, the overwhelming bulk of this figure of retained earnings is represented by a few thousand big corporations. Various consequences flow from this fact.

In the first place, it points to a glaring inequality in our tax laws by means of which billions of dollars of the income of the wealthiest in the community escape personal income taxes. Only a small amount of these retained earnings was paid out in dividends during the depression. From 1926 to 1929, three Mellon corporations paid out only \$27,000,000 out of \$178,000,000 reported available for common. In the depression years they paid out only \$15,000,000 in common dividends that were unearned. For various reasons the amount retained was undoubtedly much greater than these figures show. From 1926 to 1935 the Great Atlantic and Pacific Tea Company, dominated by a single family, retained \$84,478,000. This loophole

in the law should be closed before higher income tax rates are imposed on those who cannot evade payment.

Secondly, it is doubtful whether any other factor has contributed more to the growth of uneconomic bigness, to the lessening of competition, to the continued absorption of small concerns, to excessive plant investment, and to the skyrocketing of stock prices, than the ease with which big corporations have obtained new money by withholding earnings. Our tax laws have actually encouraged these developments by offering inducements to retain earnings.

Thirdly, withheld earnings by the few thousand big corporations not only impede recovery now but make the problem of securing a tolerable measure of business stability in the future more difficult of solution. Of the increase in adjusted demand deposits in member banks from June 30, 1933, to June 30, 1935, of \$5,389,000,000, some \$3,901,000,000, or 72 percent occurred in cities with a population over 150,000. The bulk of the increase was undoubtedly in business rather than personal accounts. A special study of large deposits indicates that from October 25, 1933 to November 1, 1935 some 5,558 identical accounts increased \$832,000,000. The indications now are that business deposits are in excess of 1929, although both production and prices are lower. Industry has been disbursing less to the factors of production than it has been receiving in the sale of products to those factors and this has impeded recovery. Moreover, this piling up of idle business deposits represents a source of danger in the future if there should be a concerted move to utilize them.

It appears, therefore, that the objectives of the proposed tax will

be lost unless the rates proposed are high enough to force the distribution of the earnings of the large corporations. The tentative schedule of rates proposed in the Senate Finance Committee will not achieve this. Personal incomes in excess of \$74,000 are subject to surtax rates ranging from 47 to 75 percent. The highest rate in the proposed schedule is 45 percent. Since it is a fair assumption that individuals dominating large corporations have incomes in excess of \$74,000, it follows that they will continue to find it personally advantageous to leave earnings undistributed.

The exemption of 50 percent of earnings from an undistributed earnings tax was doubtless proposed as a means of permitting small corporations to expand. This method of seeking to equalize the competitive position of large and small corporations fails completely in its purpose. It does not constitute sufficient exemption for small corporations who have no access to the capital markets, and it is excessive for large corporations that have such access. Undistributed earnings of non-financial corporations from 1925 to 1929 amounted to 43 percent of net profits. It is apparent, therefore, that an exemption of 50 percent and the proposed low rates applicable to undistributed earnings of from 30 to 40 percent would be completely ineffective in forcing out in dividends any appreciably higher proportion of earnings than occurred in the past.

In order to equalize the competitive position of large and small corporations with respect to securing funds for expansion it is desirable, on the one hand, to exempt small corporations entirely by providing that earnings up to \$15,000 be exempt from the undistributed earnings tax and, on the other hand, to subject all the undistributed earnings of large corporations (except those devoted to debt retirement, when a special rate should

apply) to rates sufficiently high to make it no longer profitable to retain earnings.

By making provision for the retention of earnings on the payment of an 8 percent tax in cases where there are legal prohibitions on the payment of dividends, or on earnings devoted to amortizing debt outstanding on March 3, 1936, the only legitimate claim for exemption on the part of large corporations will be met. This will, in particular, meet the requirements of financially hard-pressed railroads. In all other cases large corporations should resort to new stock issues in raising funds for expansion.

It is not necessary for large corporations to retain earnings. The opposition has nowhere met the contention that large corporations can obtain all the funds necessary for legitimate expansion from new stock issues. Even Mr. May, who made the most closely reasoned statement against the tax, could only say with respect to this point that it seemed academic and unrealistic, which is remarkably weak considering the cogency of the rest of his argument. It did not appear unrealistic when the U. S. Steel Corporation retired its bonded indebtedness through new stock issues in 1929. Corporations do not need a surplus in time of depression. What they do need are comfortable ratios between their net quick assets and current liabilities and between their net worth and their indebtedness. They can obtain such ratios as well by stock issues as by withholding earnings.

An effective and just method of raising the rates applicable to undistributed earnings after the exemptions just noted would be to make the rates higher and then apply them to the percentage of earnings available for common stockholders, and undistributed to them. Another way would be to make the rate applicable to, say, 50 percent undistributed earnings apply to the whole 50 percent, rather than just to the difference between 40 and 50 percent of undistributed earnings. A precedent for this method is offered by British practice in levying estate taxes.

It is only by making the rates in effect prohibitive that sufficient revenue will be raised to permit desirable exemptions; that tax evasion will be stopped; that smaller stockholders will cease to be penalized; and that the other monetary, economic and social objectives of the tax will be achieved.