

May 7, 1936

Dear Mr. President:

I am keenly interested in and heartily sympathetic to the underlying philosophy of your recently proposed tax on undistributed earnings. One of the main obstacles to effective monetary control is offered by the big accumulations of cash in the hands of corporations. In the past few years the chief check on the recovery movement has been the increase in corporations' cash holdings, which has operated to restrain the flow of purchasing power brought into being by the Government's spending program. I am, therefore, most desirous on monetary grounds that the proposed tax be really effective in forcing corporations to pass along cash as rapidly as it is received. I feel confident, however, that the form in which the proposed tax has been passed by the House will not accomplish this end.

Neither do I feel that the present form of the proposal will secure "equality of tax burden on all corporate income, whether distributed or withheld from the beneficial owners", which you stated as one of its principal objectives. Moreover, the tax has become so complicated that instead of effecting "great simplification in tax procedure, in corporate accounting, and in the understanding of the whole subject by the citizens of the Nation", it does the opposite. Finally, there is grave question whether the yield from the tax will be adequate.

By a few simple changes I think that the desirable objectives you originally laid down can still be effectively achieved.

1. It is, I think, absolutely essential that the present corporate income tax be retained. The argument for its removal rests on the belief that it constitutes a deduction from the income of existing stockholders. But this only applies to stockholders who bought their stocks years ago before the tax was imposed. Stock prices since the tax has been in force have been adjusted to current and expected future earnings after taxes. To remove the tax now would be equivalent to increasing earnings per share of all corporations anywhere from 15 percent, in the case of operating companies with no preferred stock, to a hundred percent or more in the case of holding companies that can benefit from the leverage factor. It would constitute an unexpected gain for all stockholders. The fact that, of earnings available after taxes, a substantial portion escapes the payment of surtaxes, is a separate and distinct abuse that can be handled as a separate problem.

The retention of the corporate income tax would mean the retention of an assured source of revenue of over a billion dollars. The yield of the tax on undistributed earnings or the additional income taxes paid on higher dividends would then become a net gain to the Treasury. Moreover, the retention of the corporate income tax would permit various desirable exemptions to be made, of which the most important would be the exemption of small corporations from the tax on undistributed earnings.

2. The exemption of adjusted net earnings of \$15,000 from the tax on undistributed earnings. The House Bill recognizes that small corporations have far more need of the privilege of retaining earnings than large corporations. They have no access to the capital market and banks are reluctant to make capital loans to small concerns. If, however, the corporate income tax is repealed it is not equitable to exempt small corporations entirely from the tax on undistributed earnings, as in this case their owners could escape all taxation. The House, therefore, tried to meet this problem by providing lower rate schedules for small corporations. This has complicated the tax; would make it more difficult to administer; loses the goodwill and support of hundreds of thousands of small corporations; and would yield a minor amount of revenue.

If the corporate income tax is retained it would be equitable to exempt the 400,000-odd small corporations from the tax on undistributed earnings, since the corporate income tax amounts to more than the personal income tax most of the owners would pay if all earnings were distributed. No revenue would be lost and the administration of the tax could be concentrated on the few thousand big corporations around which center the abuses of withheld earnings. Over 90 percent of all net income is earned by less than 10 percent of the corporations.

3. Much higher rates should apply to the amount of earnings undistributed after preferred dividend requirements. From 1923 to 1929 non-financial corporations reporting income disbursed 57 percent in dividends and retained \$25 billion. Under the House schedules they could continue to disburse the same amount and yet pay a tax of only  $14\frac{1}{4}$  percent of adjusted net income. In other words, it would still pay all wealthy stockholders to leave a substantial portion of their earnings with corporations. This defeats the whole purpose of the bill. The rate should be high enough to force the distribution of earnings and compel corporations to borrow or issue new stock for expansion. This would be the most effective way of checking uneconomic bigness and would have the incidental benefit of restricting the rise in stock prices.

4. The retention of the corporate income tax will permit a lowering of the rate of  $22\frac{1}{2}$  percent applied to earnings devoted to the retirement of debt outstanding on March 3, 1936, or earnings prohibited from being paid by legal considerations. It is suggested that the rate be 8 percent. It is also suggested that the privilege of retiring debt on the payment of this rate be made to apply to all debt in annual amounts equal to sinking fund requirements or amounts sufficient to retire the debt at maturity. No account should be taken of the amount of accumulated earnings, as in the

House Bill, since accumulated earnings is only a bookkeeping concept and may represent property now worthless. It has no bearing on current and future earnings.

In essence, my proposals would mean adding a heavy undistributed earnings tax to a few thousand big corporations. They would yield adequate revenue by closing up a loophole in the present law; would greatly simplify the form and administration of the proposed tax; and could be easily explained and defended. A detailed discussion of these and other changes is contained in the accompanying memorandum.

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