5/11/36 Left with the President

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May 11, 1936

Memorandum for the President:

Taxation of undistributed earnings of corporations, which is the underlying principle of the pending tax bill, is in my judgment highly desirable from the fiscal, economic, social, and monetary points of view. Existing great accumulations of cash in the hands of large corporations are, in fact, one of the important obstacles to recovery, since they interrupt the flow to consumers of money created by Government spending. A tax that would effectively force large corporations to pay out their current earnings would greatly contribute to the progress of recovery. It is because I am confident that the tax in the form in which it passed the House would not accomplish this purpose that I wish strongly to urge upon you certain modifications in the pending bill.

In its present form the tax bill will not achieve the objective specified in your message to Congress of securing "equality of tax burden on all corporate income, whether distributed or withheld from the beneficial owners". The tax has also 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 will be understood by few and will engulf many small corporations in unnecessary and difficult tax procedure. Grave questions have also been raised as to the revenue it will yield.

It seems to me that by the adoption of a few changes the objectives originally laid down for the tax will become much more certain of achievement.

1. My first proposal is that the present corporate income tax be retained. The argument for repealing this tax rests on the belief that it taxes the rich and the poor stockholders on the same basis regardless of ability to pay. This argument disregards the fact that the investment made by stockholders represents a price for the stock which takes into account the corporate income tax. Only such present holders as bought their stocks before the present tax was imposed have been unfavorably affected by the tax. Prices paid for stocks reflect net earnings to stockholders and are based on current and expected future earnings <u>after</u> deduction of taxes. To remove this tax now would increase per share earnings for all stockholders anywhere from 15 percent, in the case of operating companies with no preferred stock, to a hundred percent or more in the case of certain holding companies. Unless other taxes offset this advantage the elimination of the tax now would result in an unearned increase in the value of the stocks. With corporate profits increasing more rapidly than wages there is no reason for this unexpected addition to the wealth of stockholders. The purpose of the law should be to cause earnings to be paid out wherever possible and then be subject to individual income taxes which are graduated in accordance with ability to pay.

The retention of the corporate income tax would assure the continuance of revenue of over a billion dollars from a tax which has been in operation for a long time and is thoroughly accepted, established, and understood. Revenue from a new tax on undistributed earnings and from income taxes on increased dividend disbursements would be over and above the existing tax and would be a net gain to the Treasury. Furthermore, the retention of the corporate income tax would make it possible to exempt small corporations and to apply the undistributed earnings tax exclusively to the small group of large corporations whose holdings of undistributed earnings is the difficulty that the law is designed to correct.

2. Adjusted net income up to $15,000 should be exempt from the tax on undistributed earnings. In levying a tax on undistributed earnings it is essential to distinguish between large and small corporations. Smaller corporations have no ready access to the capital market, and also have difficulty in obtaining capital loans from banks. It is to meet their needs that the Government has provided special facilities through the Reconstruction Finance Corporation and the Federal Reserve banks for loans for working capital purposes to smaller businesses. It would not be consistent now to impose heavy taxes on such funds as these corporations may acquire in the course of their business. Small corporations, in general, depend on earnings for the development of their business. It would be inequitable and economically undesirable to apply an undistributed earnings tax to these corporations in the same manner as to large corporations. On the other hand, it would not be equitable to exempt small corporations entirely from taxation on their income, since this would permit their owners to escape tax-free. Retention of the existing corporate tax makes it possible to exempt small corporations without injustice or loss of revenues.

The House bill recognizes that small corporations have far more need of the privilege of retaining earnings than large corporations. That's why it provides lower rate schedules for small corporations. This, however, requires many small corporations to adjust themselves unnecessarily to new and difficult tax procedure, makes the tax more difficult to administer, and endangers the good will and support of hundreds of thousands of small corporations. If the corporation income tax is retained, the serious difficulties which have arisen in adapting the undistributed earnings tax to the financial problems of small corporations could be met by exempting earnings up to $15,000 from the new tax, and thus altogether exempting from the tax the great numerical mass of corporations. The existing tax is adequate for these corporations, since it amounts to more than would the total personal income tax that would be paid by most of the stockholders if all the 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. Concentration of effort on these 10 percent would be a great help to the administration of the tax plan.

3. Much higher tax rates should apply to undistributed earnings. For the large corporations toward which the tax is directed the tax rates should be high enough to force distribution of earnings. The proposed rates would not accomplish this. From 1923 to 1929 non-financial corporations reporting income paid dividends amounting to

57 percent of their income and retained $25,000,000,000. Under the House schedules for large corporate incomes corporations could continue to disburse no larger percentage of their earnings as before in dividends and yet pay a tax of only 14 1/2 percent of adjusted net income. It would still be profitable for wealthy stockholders to have the corporations retain a large part of their earnings. Where this was done the purpose of the bill would be defeated.

The tax on undistributed earnings, after equitable deductions, should be high enough to <u>force</u> the distribution of earnings and to make it necessary for corporations to depend for expansion on borrowing or on the issuance of stock in the capital market. For big corporations this presents no difficulty. This proposal would be the most effective way of checking uneconomic bigness and of preventing important evasion of surtaxes.

In essence, my suggestions are that a heavy earnings tax be imposed on a few thousand big corporations if they did not distribute their earnings in dividends. This tax would be more effective than the tax in the House bill in closing up a loophole in the present law; it would greatly simplify the form and administration of the proposed tax; and could be easily explained and defended. It would also make the tax more popular and the number of its opponents much less numerous, because the large number of small companies would be relieved of the tax.

A detailed discussion of these and other changes is contained in the accompanying memorandum.