Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 17, 1936.

To Chairman Eccles

From Lauchlin Currie
L.C.

Subject: Amendments to Treasury's tax proposals.

GPO 16—852

I am enclosing a tentative draft of a statement of your proposed amendments. I have included an additional point concerning the calculation of undistributed earnings after preferred stock dividend requirements, which might be included if you think, as I do, that we won't get very far with a uniform rate.

I am also enclosing some estimates prepared by Miss Burr, which indicate that the adoption of your amendments would yield sufficient revenue. They assume that 80 percent of the amount available after taxes and exemptions is distributed to stockholders, which is perhaps high. If a less amount is distributed, the tax yield would be higher. The estimates for the Administration's proposal are the Treasury's. Miss Burr tells me that they are based in part on revised upward estimates of corporate income, so that the estimated additional yield is only in part attributable to the new tax proposals.

I hope you will secure an opportunity to go over this material with me, so that I can prepare a final statement. The Treasury, I feel, is handling the matter badly and the corporations are getting away with murder. There has been no effective presentation of the theory and purposes of the tax yet and as the matter is so important I think you should take a hand in it.

March 17, 1936.

SUGGESTED AMENDMENTS TO PROPOSED TAX ON UNDISTRIBUTED CORPORATE INCOME

The proposed amendments are as follows:

1. Retain a flat corporate tax of twelve percent.

2. Permit exemption for reasonable and contractual debt retirements and delinquent taxes.

3. Apply a 50 percent uniform rate to undivided profits after exemptions.

4. If a graduated rate on undivided profits is retained, make the graduation steeper and apply it to undistributed profits after preferred stock dividend requirements.

5. Exempt the undistributed income of banks and insurance companies but retain a corporate tax of twelve percent.

6. Interpret "undistributed" as meaning undistributed by March 1st of the succeeding year.

There are three main purposes which the proposed tax should serve:

1. It should raise some $600 million additional revenue.

2. It should close up a loophole through which the owners of property have escaped their fair share of taxation.

3. It should do this by actually forcing distribution of profits in order that the abuses associated with undistributed income may be lessened.

Since the tax is to be grafted onto an existing system, care must be taken as far as possible to avoid fortuitous gains and losses to individuals and to minimize hardship to financially weak corporations. In other words, the purposes of the tax should be accomplished, if possible, without changing people's incomes, including income actually received in the form of dividends and income left with corporations, and without causing bankruptcies and undue hardships to people whose corporations have entered into contractual obligations to make certain payments out of income. It is believed that the nearest approach to this ideal would be secured by the adoption of the amendments suggested above.

Retention of corporate income tax of twelve percent.

From a legalistic point of view the corporate income tax constitutes a deduction from the income of the people owning a corporation. It may be argued, therefore, that the remission of the corporate tax and the imposition of a tax on undivided profits does not constitute an increase in the income of stockholders but merely means that their income is taxed in a different way. The flaw in this argument is its legalistic bias. In actual fact, stockholders look up a corporation's earnings as the earnings after the deduction of taxes and assess the value of the stock accordingly. To remit the corporate income tax would, from the point of view of the stockholders, be on the same footing as a reduction of corporate expenses and an increase in corporate income. Per share earnings would be higher and stock prices would rise in reflection of this fact. This would be a clear windfall gain to the present holders of listed stocks. Even in the case of privately-owned corporations the remission of the corporate tax would enhance the sale value of the property. The windfall gain would be particularly noticeable in the case of public utility holding companies, where a small percentage increase in the per share earnings of operating companies is translated into a large percentage increase in the per share earnings of the top holding companies.

There appears to be no justification for granting this windfall gain, particularly in view of the fact that the recipients of the gain are already the wealthiest people in the community, and in view of the fact that profits have been rising more rapidly than wage rates and will doubtless continue to do so as recovery proceeds. Moreover, it is undesirable on other grounds that a further impetus be given to the rise in stock prices. The most that stockholders are entitlted to is a reduction in the corporate income tax to compensate for the removal of the exemption of dividends from the normal individual income tax.

If corporations elect to retain earnings subject to the undivided profits tax to an amount sufficient to cause their tax bill to equal the present taxes, and thus cause no change in per share earnings after taxes, the windfall objection is met, but even more serious objections arise. Two of the main purposes of the tax, the raising of additional revenue and the forcing of increased dividend disbursements, will have been defeated.

Under the low rates on undistributed income reported to have been approved by the House Sub-Committee, it is stated that corporations can retain as large a proportion of earnings as before and still pay no greater tax. If they retain 40 percent of their earnings the effective rate on the total net income is only 14½ percent. If this is so no more will be distributed to stockholders and the only additional revenue will come from the removal of the exemption of dividends from the normal tax. Additional revenue from higher dividends due to higher earnings accompanying business revival should not, of course, be attributed to the proposed tax, since they are presumably already included in the individual income tax estimates.

The problem of securing fair taxation on earnings attributable to stock held by foreigners would be solved in large part by retaining a corporate tax on net earnings. Since it has been proposed above that it be lowered to twelve percent because of the removal of dividends from the normal tax, and since foreigners are not subject to this tax, dividends paid on stock held by or on behalf of foreigners should be subject to a special four percent tax. This rate would offer less incentive to evasion than would the high rates mentioned in the press.

If corporations still paid a corporate tax on net income, managements could not fool the stockholders by justifying the payment of a tax on retained earnings by pointing out that the tax was no higher than formerly.

Still another reason for the retention of the corporate tax is that it will permit necessary exemptions from the undivided profits tax without entailing too great a loss of revenue. Unless grave injustice is to be done, exemptions should be allowed for income devoted to the repayment of debt and back taxes, in accordance with contractual and legal obligations. This exemption could be strictly limited by providing that (a) it be applied to funded debt outstanding on March 1, 1936, (b) it be applied to unfunded debt outstanding on March 1, 1934, regardless of renewals since that date, and (c) it is limited either to sinking fund requirements or to an annual amount sufficient to retire the debt at maturity. The same exemption should apply to sinking fund requirements for the retirement of preferred stock if agreements to this effect have been entered into before March 1, 1936. For the future it will be understood that debt retirements would have to be handled by issuing new stock for this purpose.

For the most part the exemptions would benefit corporations in straitened circumstances such as small corporations heavily in debt to banks, real estate corporations, and railroads and utilities. Most of the very large and profitable corporations are out of debt. Agitation for exemptions of "reasonable" reserves might be met by granting exemptions for the purposes mentioned above, and the opposition to a high rate on undistributed profits thus diminished. If a corporate income tax is retained and undistributed earnings taxed at a high rate, both of which courses are desirable, many small corporations heavily in debt will face bakruptcy owing to the difficulty of getting <u>all</u> the stockholders to agree to purchase new stock.

The tax should be applied after the deduction of the corporate tax exemptions and preferred dividend requirements. While preferred stock is called <u>stock</u>, it resembles a junior debenture much more closely than it does an equity. With few exceptions preferred stockholders do not share in increased earnings. Preferred stockholders, therefore, do not have income on which they evade taxation by leaving it with corporations. Common stockholders may point to a sixty percent distribution of their corporation earnings when actually only some thirty percent of their earnings (i.e., net available for common) is distributed. The Government should be concerned with the realities of situations and not allow itself to be circumvented in its objectives by the extent that both preferred and common are called stock. In this particular case the reality of the situation is the evasion of taxation by common stockholders. By imposing the tax on earnings available for the equity holders and undistributed to them, equality of treatment would be assured stockholders of corporations having preferred stock outstanding and those not having preferred stock outstanding. This amendment is suggested if a graduated rate is maintained. If a flat rate is substituted it would not be necessary.

A firm stand should be made against exemptions for "depression reserves". As much publicity as possible should be given to the fact that the so-called depression reserves were in actual fact not availed of to any extent in the worst depression on record. The holdings of cash and tax-exempt securities of non-financial corporations from December 1929 to December 1932 declined only from $10,859,000,000 to $9,070,000,000, or $1,789,000,000, while their holdings of other securities increased $5,594,000,000. The surplus of these corporations decreased by nearly $15,000,000,000, but this was due to charge-offs rather than out-of-pocket disbursements. It should be pointed out that corporations in general have more cash now than they have ever had in the past and that if they feel they need still more there is nothing to prevent them from issuing new stock for this purpose. The whole argument for "depression reserves" is a smokescreen to cover aversion to the payment of taxes and the weakening of despotic insider control that would be endangered by a prohibitive tax on undistributed earnings. The Administration should assume a vigorous offensive on this point and make the facts known.

There is very little in the much-touted point of the maintenance of dividends in a depression. For all non-financial corporations in the years 1930-1932 the payment of unearned dividends less undistributed earnings amounted only to $2,734,000,000 -- which is inconsiderable in comparison with the decline of $41,000,000,000 in the national income between 1929 and 1932.

Under the low scale of graduation provided for by the House Sub-Committee, corporation managements and wealthy stockholders will still find it advantageous to hold back earnings, paying, if necessary, up to 33% on undistributed earnings. They will still be evading high surtax rates and strengthening their control, and the small stockholders will be victimized. It is doubtful, however, if the smaller stockholders would make an effective protest since the corporation managements will talk about "depression reserves", "sound corporate practice", etc., and put the blame on the Government. If the tax is uniform and high it will no longer pay to retain earnings and there will be no talk of "depression reserves", and stockholders will pay taxes according to their ability to pay and not according to the tax calculations of wealthy stockholders or of managements desirous of increasing their power.

It is assumed that banks and insurance companies will be exempted from the tax on undistributed earnings and will continue to pay the present corporate income tax. It is suggested that, in view of the removal of the exemption of dividends from the normal tax, the corporate tax on such institutions should be reduced to twelve percent. The larger the capital and surplus of banks, the less danger there is of loss to depositors and to the Federal Deposit Insurance Corporation. Interest rates are low and may remain low for a considerable period. Banks' earnings, therefore, are also low and many banks experience difficulty in raising new capital, although the rapid increase in deposits makes this desirable. In these circumstances it may prove to the best interests of the country to encourage banks to strengthen the proprietors' interest by reinvesting earnings. It might be well to limit this exemption in the case of banks to such undistributed earnings as will not cause the combined capital and surplus to exceed twenty percent of deposits. It might be well also to require that present capital plus future subscribed capital should be at least equal to surplus in order that advantage may be taken of this exemption.

For the purposes of the proposed tax, undistributed income should be income undistributed by March 1st of the succeeding year. Corporations do not know what their earnings have been until after the end of the year. Adequate time should be allowed for the declaration of a final dividend after the result of the year's operations is known.

Tentative

March 17, 1936

DETAILS OF TAX ON UNDISTRIBUTED EARNINGS OF CORPORATIONS, ADMINISTRATION PROPOSAL AND CHAIRMAN ECCLES' SUGGESTED MODIFICATION ON BASIS OF 1936 INCOMES

	Administration proposal	Chairman Eccles
	(Millions of dollars)	
Statutory net income	7,200	7,200
Add: capital stock tax, no longer deductible	108	108
dividends received	1,000	1,000
	8,308	8,308
Deduct dividends paid, on basis of present law	3,540	3,540
	4,768	4,768
Other deductions		
Income taxes paid	none	1/ 877
Exemption of banks and insurance companies	100	100
For amortization of funded debt, incurred prior to Jan. 1, 1936	none	1,000 (-1,200)
Payment of current debt incurred prior to January 1, 1935	none	900 (-1,300)
Delinquent taxes paid	none	100 (-200)
Total, other deductions	100	2,977-(3,677)
Undistributed earnings subject to tax, if no further distribution of dividends	4,668	1,791 (-1,091)
Net tax rate percent	33 1/3-35 2/	36 3/ - 50 (maximum)
Tax	1,556-1,634	654-895 4/

1/ Computed at flat 12 percent rate.
2/ Average rate of tax on further dividend distributions and undistributed earnings. Press reports indicate 33 1/3 percent; anticipated revenue results, 35 percent.
3/ Average rate assuming 1/2 of corporation earnings distributed.
4/ On basis of higher figure for undistributed earnings. For lower figure the revenue yield is 395-545 million dollars.

Tentative
March 17, 1936

COMPARISON OF REVENUE EFFECT OF TAX CHANGES,
ADMINISTRATION PROPOSALS AND CHAIRMAN ECCLES' SUGGESTED MODIFICATIONS

	Administration	Chairman Eccles
	(In millions of dollars)	
New taxes		
Tax on undistributed earnings (including tax on further distribution of dividends)	1,556-1,634	681-895 1/
Normal tax on dividends	120	120
Total revenue from new taxes	1,676-1,754	801-1,015 2/
Taxes repealed or revised		
Corporation income tax	950	73 3/
Capital stock and excess profits	168	168
Total revenue eliminated	1,118	241
Additional revenue	558-646	560-774 4/

1/ Figures on basis of lower estimate of undistributed earnings are 393-545 million dollars.
2/ On basis of lower estimate 513-665 million dollars.
3/ Revision in rate from graduated to flat 12 percent.
4/ Figure on basis of lower estimate of undistributed earnings is 272-424 million dollars.

EXAMPLES OF OPERATION OF DIFFERENT TYPES OF TAXES

A. Before the imposition of the proposed tax.

Statutary net earnings	$1,000,000
Present tax (16%)	160,000
Net (after taxes).	$ 840,000
Preferred dividend requirements	300,000
Net available for common	$ 540,000
Dividends on common stock	270,000
Undivided profits	$ 270,000

Of net after taxes 67.9% is distributed.

Of net available for common 50.0% is distributed.

B. After the imposition of the proposed tax.

Statutary net earnings	$1,000,000
Preferred Dividend requirements	300,000
Net available for common	$ 700,000
Common dividends.	270,000
Amount undistributed (which is 43% of statutary net earnings	$ 430,000
Proposed tax (approx. 36%).	154,800
Net available for common (after payment of tax) . .	545,200

Of statutary net income 57% is distributed in dividends.

Of net available for common 38.6% is distributed in dividends.

Net result:

Treasury receives $154,800 as contrasted with $160,000 at present from the corporations and a possible $10,000 additional from individuals due to the removal of the exemption of dividends from the normal tax.

Common stockholders' equity $700,000 - $154,800 =545,200 as contrasted with $540,000 at present.

C. Corporation disburses all income under proposed tax.

Common stockholders receive $700,000, which is $160,000 more than their equity earnings at present.

D. A corporate tax of 12% and a tax of 50% on net after deduction of preferred dividend requirements.

Statutary net income.	$1,000,000	
Corporate tax 12%.	120,000	
	$ 880,000	
Preferred dividend requirements	$ 300,000	
Net available for common.	$ 580,000	(as contrasted with $540,000 now)
Dividend on Common.	$ 270,000	
Undivided profits	$ 310,000	(which is 53% of net available for common)
Tax 50% of $310,000	$ 155,000	

Treasury receives from the corporation
$120,000 + $155,000 = $275,000 (as contrasted with $160,000 now)

Stockholders' equity after payment of taxes = $425,000 (as contrasted with $540,000 now)

There will be a distinct inducement to distribute more earnings.

E. Same as D. except that all earnings are distributed.

Treasury would receive $120,000 from the corporation and individual normal and surtax yields on $310,000 additional dividends.

Stockholders' equity is $580,000 instead of $540,000.

F - Before imposition of proposed tax -- Holding company case

(a) operating company

Net	$1,000,000
Taxes	160,000
	$ 840,000
Preferred dividend	400,000
Net available for common	$ 440,000
Common dividend	$ 440,000
Undistributed	—

(b) holding company

Net	$ 220,000
Taxes	35,200
Net	$ 184,800
Preferred dividend	80,000
Net available for common	$ 84,800
Common dividend	84,800
Undistributed profits	84,800

G - After imposition of proposed tax

Holding company tax.

(a) operating company

Net	$1,000,000
Preferred dividend	400,000
Net available for common	$ 600,000
Common dividend	600,000
	—

(b) holding company

Net	$ 300,000
Preferred dividend	80,000
Net for common	$ 220,000
Common dividend	$ 220,000
	—

On the assumptions of remission of present corporate tax and full distribution of earnings the net available for the common stock of the holding company increases from $84,800 to $220,000, or by 159%.