Form F.R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Chairman Eccles

Subject:

From Lauchlin Currie
L.C.

GPO 16—852

Attached are statements of the proposed amendments, and the arguments against depression reserves. It is very difficult to estimate the revenue that would result from the adoption of these amendments, owing in large part to the uncertainty both as to the amount of debt that will be retired, and the amount of earnings that will be retained, but Miss Burr puts it very tentatively at between four and five hundred millions. I have modified the proposal to require joint returns from all husbands and wives by making it apply only to husbands and wives who are living together and are not maintaining separate establishments. Daiger pointed out to me that the whole proposal would be ridiculed if we made husbands and wives who are living apart and who are not on speaking terms get together to prepare their income tax.

By the way, I checked up on Class 1 railroads, and find that at the end of 1934 they comprised 93 percent of the total mileage,operated 97 percent of the total gross revenues, and 94 percent of the investment in railway property, although they were only 9 percent of the total number.

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SUGGESTED AMENDMENTS TO THE TAX PROGRAM

It should be clearly understood that the following proposals do not indicate any lack of sympathy with the objectives of the recent tax proposals. On the contrary, they are suggested as a means of strengthening the proposals against attack and of enabling them to achieve their objectives more surely. They have been designed to meet the major objections and difficulties that have arisen since the program was made public.

The broad objectives of the program are (a) to raise additional revenue, (b) to close up a loophole through which the wealthy have evaded surtaxes on the income left undistributed with corporations, and (c) to do this, so far as it is practicable and equitable, by forcing the distribution of corporate earnings and thus diminishing the monetary, social and economic abuses associated with the practice of withholding earnings.

The tax program, as modified to date by the House Sub-Committee, appears at present to be along the following lines:

1. Removal of the present corporate income, excess profits, and capital stock taxes.

2. The imposition of a tax on undistributed corporate earnings, graduated by percentages undistributed, and by the size of the net earnings.

3. Removal of the exemption of dividends from the normal individual income tax.

4. The imposition of a flat 15 percent tax on the income of fiduciary corporations, — banks, insurance companies, etc., — in place of a tax

on undivided earnings.

5. The imposition of a tax of 33 1/3 percent on dividends paid foreigners.

6. In cases where corporations are forbidden to pay dividends when their capital is impaired or when earnings fail to reach a certain percentage of bond interest requirements, or preferred dividend requirements, the exemption of earnings from the graduated scale and the imposition of a flat 22½ percent.

7. The imposition of taxes on a range of commodities.

8. The imposition of taxes on windfall profits resulting from the abolition of the processing taxes.

Suggested Amendments

1. Retain a corporate income tax but at a flat 12 percent on all corporations, including fiduciary corporations.

2. Exempt from taxation $15,000 of earnings after corporate income taxes and preferred stock dividends.

3. Allow a deduction for repayment of contractual obligations on the payment of a tax of 10 percent on the amount so deducted. Contractual obligations are to be understood as sinking fund requirements, annual amounts not more than sufficient to retire debt at maturity, legal requirements to retire preferred stock, and additions to surplus in cases where there are legal prohibitions on the payment of dividends under certain conditions.

4. Impose a steeply graduated tax on undistributed earnings after the above deductions and credits. It is suggested that the scale of graduation be along the following lines:

Percent of Earnings	Rate of Tax
Less than 50%	40%
More than 50%	60%

It is also suggested that, following British practice in levying estate taxes, the highest rate applicable shall apply to all the undistributed earnings. For example, if 55 percent of earnings were undistributed, the 60 percent tax would apply to all undistributed earnings rather than a rate of 40 percent on the first 50% undistributed and a rate of 60% only on the balance.

5. Exempt earnings of banks from a tax on undivided earnings, provided the capital and surplus together are less than 20 percent of deposits.

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

7. Abandon the proposal to levy further excise taxes and in its place require joint income tax returns by all husbands and wives, living together.

Retention of a flat corporate income tax of 12 percent.

The reasons for recommending the retention of the corporate income tax are the assurance of a source of revenue of upwards of a billion dollars, and the fact that business men and investors have adjusted themselves to this tax. The tax is treated as an expense and per share earnings are calculated _after_ taxes. Stock prices have become adjusted to this tax and to remove it now would constitute a windfall gain to holders of stocks. Already Wall Street statisticians are calculating the increase in the per share earnings of various corporations if the tax were removed. The increase will be particularly large in the case of holding companies with bonds and preferred stock outstanding. In such cases, due to the leverage factor, a small percentage increase in per share earnings of operating companies results in a very large percentage increase in the per share earnings of the top holding companies. Similarly, common stockholders in corporations having preferred stock outstanding will receive a larger windfall gain than stockholders in corporations with no preferred stock. This is true because in corporations with preferred stock outstanding the whole of any increase in net earnings (with certain exceptions) will go to the common stockholders who provide only part of the capital. Even in the case of privately owned companies the remission of the corporate income tax would increase the sale value of the property.

In view of the fact that earnings available for common stock have been increasing rapidly (Standard Statistics gives a compilation showing an increase of 55 percent for a large number of companies in 1935), and are expected to increase substantially in 1936, and in view of the fact that although common stockholders have lost money in the depression they are still as a class the wealthiest in the community, there appears to be no possible justification for conferring upon this class at this time a substantial windfall gain. The fact that some persons would pay higher taxes by reason of the windfall is no justification for conferring a windfall. The purpose of the proposed tax is not to increase incomes but to make the present individual income tax rates effective in reaching existing incomes. The most they are entitled to is a reduction in the rate of the tax and the abolition of the excess profits and capital stock taxes in compensation for the removal of the present exemption of dividends from the normal income tax.

Since the removal of the present exemption of dividends from the 4 percent normal tax applies also to dividends of fiduciary corporations, it appears only fair to make the corporate income tax levied on their net earnings 12 percent instead of the proposed 15 percent. Unless this is done, bank stockholders will be penalized in comparison with stockholders of other types of corporations.

Exemptions

1. It is suggested that net earnings up to $15,000, calculated after the payment of the corporate income tax and preferred dividends, be exempt from the tax on undivided profits. There are two main reasons for this recommendation. In the first place, it is equitable, and, in the second, it would greatly weaken the opposition to the proposed tax without diminishing the effectiveness of the tax.

A corporation with earnings as low as $15,000 available for common is at a serious disadvantage in contrast with large corporations in raising money for expansion. The small corporation has no access to the capital market and local banks are naturally reluctant to make capital loans. It relies, therefore, mainly on retaining earnings for the purpose of expansion. Moreover, it is, generally speaking, the small corporations as a class whose position has been severely strained by the depression and which are most in need of financial rehabilitation. Finally, if the corporate income tax of 12 percent is retained, the small corporation will pay as much in taxes as its owners would if this tax were removed and all earnings were disbursed in dividends. It appears equitable, therefore, to exempt undivided profits of small corporations from the proposed tax.

This exemption would remove most of the opposition, since it would exempt over ninety percent of all corporations. In 1933 only 10,000 corporate returns out of 450,000 showed statutory net incomes of over $25,000. At present the financial press and the campaign organized by the large corporations is playing up the injustice involved to the smaller corporations. It is constantly said that the present proposals will favor the large corporations with large surpluses and easy access to the capital markets and will prevent the development of small corporations. If small corporations are exempted this effective argument will not be able to be used. The advantages of the corporate form of enterprise will not be weakened for the small business man. Finally, the purposes of the tax will not be impaired. Little, if any, revenue will be lost. It is really the enormous undistributed earnings of the few thousand big corporations around which abuses have centered and which it is desired to force out in dividends. Around 90 percent of corporate net income is earned by 10 percent of the corporations.

2. It is recommended that corporations be permitted to devote earnings in excess of $15,000 to the payment of contractual obligations upon the payment of a 10 percent tax. In view of the fact that up to this time there has been no tax on undivided profits, many corporations have either entered into contractual obligations to retire debt out of earnings or have contracted debt upon the obvious and reasonable assumption that it could be retired out of earnings. Creditors have lent on this basis, even to the extent, in some cases, of requiring that the debt be retired before any dividends are declared. This has been done to some extent even by Government lending agencies. In other cases there are legal prohibitions against the payment of dividends when capital is impaired, or when earnings fail to exceed interest payments or preferred stock dividends by a certain amount. If such contractual obligations or legitimate assumptions are disregarded, not only will grave injustices be done, resulting in certain cases in bankruptcy, but in addition the opposition to the principle of the tax will be strengthened. The plight of the railroads, in particular, will be mentioned. The citation of a few hard cases may

sometimes wreck a good bill.

The purpose of the 10 percent tax is to prevent abuse of this exemption. The tax is high enough to prevent most corporations from taking advantage of the exemption unless they really have to, and yet is not too high to impose a burden on those to whom the exemption is a practical necessity. With this rate most corporations would find it more economical to issue stock to retire debt if they can, rather than retain earnings. This is not true in the case of large corporations dominated by wealthy individuals, but in most cases such corporations have no contractual obligations which would permit them to take advantage of the exemption.

The 10 percent tax is equitable, since the net worth of the corporation is increased by the repayment of debt out of earnings and th equity of the common stockholders is correspondingly increased. Moreover, if th earnings were disbursed in dividends most of these dividends would be subject to at least a 10 percent income tax.

The calculation of earnings undistributed after preferred stock dividends.

While preferred stock is called stock, 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 60 percent distribution of their corporation earnings when actually only some 50 percent of their earnings (i.e., net available for common) is distributed. The Government should, of course, direct its tax toward the realities of the situation and not allow itself to be circumvented in its objectives by the legal usage which confers the name stock on both preferred and common. 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. If a corporation has participating preferred stock outstanding, undistributed earnings could be interpreted as earnings undistributed before preferred stock dividends.

For the purposes of the proposed tax, undistributed income should be income of the calendar year undistributed between February 28th of that year and 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.

If these amendments are adopted, the objections to the new tax proposals will be greatly lessened and the purposes of the proposals more surely achieved. Additional revenue will be raised; windfall gains will be minimized; there will be more assurance that the wealthy will pay their share of taxation than under the present proposals; and, finally, there will be more assurance that money will actually be forced out of corporations, either in the form of debt repayment, or in dividends, or in taxes.

A proposal to require joint tax returns for husbands and wives not actually separated and maintaining separate establishments.

If husbands and wives were required to file joint individual income tax returns, between $150,000,000 and $200,000,000 of additional revenue might be raised in the calendar year 1937. This revenue would come almost entirely from individuals with net incomes in excess of $10,000, and the bulk of it would come from individuals with net incomes of $50,000 and over. The more effective the tax on undivided profits is in forcing out dividends, the more will this proposal yield in revenue.

This increase in revenues would not require an upward revision in normal and surtax rates applied to individual incomes nor a change in personal exemptions and credits. Unless there are special legal difficulties, this could be accomplished by an appropriate change in the law affecting the administration of returns, either by eliminating the option now given husbands and wives of filing separate returns, or by making use of the privilege subject to special penalty tax rates.

From the point of view of ability to pay taxes, there is no reason why this change should not be made. The ability of married individuals living together to pay taxes depends on their combined net income rather than on the fact that income may come from sources belonging legally to two individuals.

To raise additional revenue by means of this proposed additional charge would impose little restraining effect on recovery since it would affect mainly the wealthy whose incomes, at the present time, are not all spent on consumers' goods or the making of producers' goods. To cut down savings at the present time, in other words, is no impediment to recovery since there is a superabundance of idle funds seeking investment.

There appears to be much more to be said for this proposal on the grounds of recovery, equity, and popularity, than for new or additional taxes on commodities.

BALANCE SHEET ITEMS, ALL NON-FINANCIAL CORPORATIONS, DECEMBER 1929-DECEMBER 1933

(In Millions of Dollars)

Year	Cash	Tax Exempts	Other Investments	Surplus
1929	7,901	2,958	21,824	40,003
1930	7,806	2,616	29,286	38,722
1931	6,495	2,607	24,755	32,136
1932	6,337	2,733	27,418	25,461
1933	5,984	2,840	24,687	25,131
1929 - 1933	-1,917	- 118	+2,863	-14,872

Year	Notes and Accts. Receivable less Notes and Accts. Payable	Bonded Debt and Mortgages	Inventory
1929	1,883	36,507	20,990
1930	1,287	39,203	18,310
1931	1,175	37,101	14,891
1932	-21	37,916	12,222
1933	64	37,230	13,437
1929 - 1933	-1,819	+ 723	-7,553

ITEMS FROM INCOME STATEMENTS, ALL NON-FINANCIAL CORPORATIONS, 1930 - 1933.

Year	Bad Debts	Depreciation and Depletion	Loss, Sale of Capital Assets
1930	650	4,108	353
1931	695	3,916	614
1932	752	3,637	601
1933	720	3,449	616
1930 - 1933	2,817	15,110	2,184

Source: United States Statistics of Income.

INCOME AND DIVIDENDS OF NON-FINANCIAL CORPORATIONS REPORTING NET INCOME

1923-1933

(In Millions of Dollars)

Year	Total Income less Taxes	Dividends	Income Undistributed	Percentage Undistributed
1923	7,306	3,315	3,991	55
1924	6,489	3,406	3,084	48
1925	7,944	4,059	3,885	51
			3,834	
1926	8,325	4,690	3,684	44
1927	7,552	4,859	2,692	36
1928	8,975	5,427	3,848	40
1929	10,145	6,322	6,823	38
1930	6,135	5,756	379	6
1931	3,515	3,371	144	4
1932	1,997	2,068	-71	-4
1933	2,740	2,158	582	21
Total for years 1923 to 1929, inclusive.	56,736	32,079	24,657	43
Total for years 1930 to 1933, inclusive.	14,387	13,354	1,034	7
Total for the period 1923 to 1933, inclusive.	71,123	45,433	25,691	36

Unearned Dividends Paid (Non-financial Corporations Reporting No Net Income 1923-1933) (In Millions of Dollars)

1923 - 221	1926 - 276	1929 - 271	1932- 1051
1924 - 239	1927 - 495	1930 - 799	1933- 394
1925 - 234	1928 - 333	1931 -1524	

Total for the years 1923 - 1929, inclusive. . . 2,068
Total for the years 1930 - 1933, inclusive. . . 3,769
Total for the period 1923-1933, inclusive . . . 5,837