

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

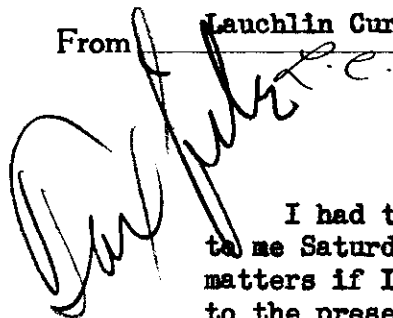
Office Correspondence

Date April 27, 1936.

To Chairman Eccles

Subject: Objections to the proposed
method of taxing undistributed
earnings.

From Lauchlin Currie



I had the impression that you did not complete your instructions to me Saturday on the telephone, but I thought it might expedite matters if I jotted down briefly my understanding of your main objections to the present form of the tax proposal. If you would let me know my omissions and what you would like expanded and what omitted, I shall be able to start work on a memorandum.

4/27/31

OBJECTIONS TO THE PROPOSED METHOD OF TAXING UNDISTRIBUTED EARNINGS

1. It will not succeed in forcing the distribution of a significantly larger proportion of corporate earnings. Under the schedules adopted by the House Committee, the larger corporations could retain fifty percent of their earnings and pay a tax equal to only seventeen and a half percent of their net income. Wealthy stockholders, whose personal income would be subject to surtax rates ranging up to seventy percent, will still find it advantageous to leave the bulk of the earnings of their corporations undistributed. Thus, the primary purpose of the bill will be defeated.

2. Although the abuses associated with retained earnings center around some ten thousand large corporations which earn ninety percent of total corporate net income, the proposed tax needlessly and unjustly applies to hundreds of thousands of very small corporations. Small corporations must rely mainly on retained earnings for plant expansion. When a small corporation has more than one or two stockholders, it is difficult to get all the stockholders to put money in the business. Larger corporations can have new stock issues underwritten, but this course is not open to small corporations. Little revenue would be lost and much goodwill would be created by exempting from the tax all corporations whose net earnings are less than \$15,000.

3. The complete removal of the present corporate income tax means giving up a certain and large source of revenue to which business men and investors have become adjusted. This surrender has various consequences. In the first place, it means that there is little revenue to spare for the purpose of granting necessary exemptions. In the second place, it

means that the stockholders of certain corporations that are able and willing to disburse all earnings receive a windfall gain, both in the form of higher dividends and in the form of appreciation of stock in reflection of higher per share earnings.

4. The problem of making proper exemptions for debt retirement purposes has not been satisfactorily solved. At present the exemption is made to depend on such an arbitrary and fortuitous thing as the relation of accumulated earnings to debt. A corporation that has had large earnings in the past but whose earnings are now low may find it much more difficult to pay off its debts than one whose earnings have been low in the past but are now rapidly increasing. Although apparently an attempt was made to make the exemption depend on inability to repay debt, this has not been done. Moreover, for those corporations that can qualify, the minimum time in which they can repay debt is so short that they can arrange to devote all their earnings to this purpose for the next five years. It would be much better to lay down a general rule permitting debt redemption at an annual rate sufficient to retire the debt at maturity, provided a tax was paid which was low enough not to cause undue hardship in necessitous cases and yet high enough to discourage the use of earnings for this purpose if funds could be raised in other ways.

5. Because of failure to retain a reduced corporate income tax and to apply broad exemptions, the tax proposal has become extraordinarily complicated. Besides being a source of irritation to all corporations

subject to the tax, a complicated tax invites ridicule and is difficult to explain and defend to the general public. The essential simplicity and justice of the idea has been lost sight of in the growing complication of the tax.