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THE PROPOSED TAX ON UNDISTRIBUTED EARNINGS

Now that there is apparently a disposition to retain a flat fifteen percent corporate income tax, which gives assurance against any loss of revenue, it is important to return to the original objectives of the tax on undistributed earnings. While the primary purpose is, of course, to raise additional revenue, the special objectives of this particular tax can only be attained if the practice of the few thousand big corporations of retaining enormous amounts of undistributed earnings is effectively checked.

From 1923 to 1929 non-financial corporations reporting net earnings retained \$24,657,000,000. Since over 90 percent of corporate income is earned by less than 10 percent of the corporations, the overwhelming bulk of this figure of retained earnings is represented by a few thousand big corporations. Various consequences flow from this fact.

In the first place, it points to a glaring inequality in our tax laws by means of which billions of dollars of the income of the wealthiest in the community escape personal income taxes. Only a small amount of these retained earnings was paid out in dividends during the depression, non-financial corporations reporting deficits paying out only \$3,769,000,000 in the years 1930-33, while non-financial corporations reporting net income actually retained \$1,034,000,000 of their earnings in these years. From 1926 to 1929, three Mellon corporations paid out only \$27,000,000 out of \$178,000,000 reported available for common. In the depression years they paid out only \$15,000,000 in common dividends that were unearned. For various reasons the amount retained was undoubtedly much greater than these figures show. This loophole in the law should be closed before

higher income tax rates are imposed on those who cannot evade payment.

Secondly, it is doubtful whether any other factor has contributed more to the growth of uneconomic bigness, to the lessening of competition, to the continued absorption of small concerns, to excessive plant investment, and to the skyrocketing of stock prices, than the ease with which big corporations have obtained new money by withholding earnings. Our tax laws have actually encouraged these developments by offering inducements to retain earnings.

Thirdly, withheld earnings by the few thousand big corporations not only impede recovery now but make the problem of securing a tolerable measure of business stability in the future more difficult of solution. Of the increase in adjusted demand deposits in member banks from June 30, 1933, to June 30, 1935, of \$5,389,000,000, some \$3,901,000,000, or 72 percent occurred in cities with a population over 150,000. They represented presumably mainly large corporate accounts. A special study of large deposits indicates that from October 25, 1933 to November 1, 1935 some 5,558 accounts increased \$882,000,000. The indications now are that business deposits are in excess of 1929, although both production and prices are lower. Industry has been disbursing less to the factors of production than it has been receiving in the sale of products to those factors. This piling up of idle deposits represents a source of danger in the future if there should be a concerted move to utilize them.

It appears, therefore, that the objectives of the proposed tax will be lost unless the rates proposed are high enough to force the distribution

of the earnings of the large corporations. The tentative schedule of rates proposed in the Senate Finance Committee will not achieve this. Personal incomes in excess of \$74,000 are subject to surtax rates ranging from 47 to 75 percent. The highest rate in the proposed schedule is 45 percent. Since it is a fair assumption that individuals dominating large corporations have incomes in excess of \$74,000, it follows that they will continue to find it personally advantageous to leave earnings undistributed.

The lowness of the proposed rates is doubtless attributable to the desire not to make it too difficult for small corporations to grow. Since, however, it is proposed to retain a corporate income tax, this objective can best be obtained by exempting earnings up to \$15,000 of corporations other than personal holding companies from the undistributed earnings tax. The tax would then apply only to some 15,000 to 20,000 corporations and high rates could be applied. Spokesmen for big corporations have maintained that the proposed tax would penalize the small corporations; that big corporations by and large are not only in excellent financial condition but that in addition they have ready access to the capital markets. Why not take them at their word? Exemption of earnings up to \$15,000 would deprive the opposition of its most effective argument; would entail practically no loss of revenue; and would greatly facilitate the administration of the tax.

Another partial exemption that appears equitable is the application of a special rate of 8 percent on earnings withheld because of statutory or charter prohibitions, and earnings devoted to the amortization of debt outstanding on March 3, 1936. This rate is not too high to be a burden on corporations to whom the exemption is a practical necessity, and

yet is sufficiently high to encourage the use of other means of debt retirement if they are available.

An effective and just method of raising the rates applicable to undistributed earnings after the exemptions just noted would be to make the rates higher and then apply them to the percentage of earnings available for common stockholders, and undistributed to them. Another way would be to make the rate applicable to, say, 50 percent undistributed earnings apply to the whole 50 percent, rather than just to the difference between 40 and 50 percent of undistributed earnings. A precedent for this method is offered by British practice in levying estate taxes.

It is only by making the rates in effect prohibitive that sufficient revenue will be raised to permit desirable exemptions; that tax evasion will be stopped; that smaller stockholders will cease to be penalized; and that the other monetary, economic and social objectives of the tax will be achieved. It is not necessary for large corporations to retain earnings. The opposition has nowhere met the contention that large corporations can obtain all the funds necessary for legitimate expansion from new stock issues. Even Mr. May, who made the most closely reasoned statement against the tax, could only say with respect to this point that it seemed academic and unrealistic, which is remarkably weak considering the cogency of the rest of his argument. Corporations do not need a surplus in time of depression. What they do need are comfortable ratios between their net quick assets and current liabilities and between their net worth and their indebtedness. They can obtain such ratios as well by stock issues as by withholding earnings.