

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM**Office Correspondence**Date May 27, 1936.To Chairman EcclesSubject: A suggestion for amending
Section 102.From Lauchlin Currie
L.C.

Attached is a suggestion for putting teeth into Section 102. It is the only way I have been able to think of to distinguish "reasonable needs". It is dictated more by monetary considerations than social considerations. If one were confronted with the choice between an amendment something like the attached and a flat tax on undistributed earnings, even though small and ineffective I think I should choose the latter. The principle of a flat rate is better and its application can always be improved. If, however, we could put teeth into 102 in addition to the tax on undistributed earnings, it might be worthwhile.

A SUGGESTION FOR AMENDING SECTION 102

"Reasonable needs" of a corporation is to be interpreted as being evidenced by plant or inventory expenditures, or debt and preferred stock retirements. For an ordinary corporation the tax will apply to an amount of earnings after the corporate income tax, dividends and the undistributed earnings tax, which is equal to 90 percent of the increase in the holdings of cash, marketable securities and loans. In the case of personal holding companies the tax will apply to retained earnings equal to 100 percent of the increase in the assets. "Marketable security" is to be defined as any security listed on the stock exchange. A tax of 25 percent shall apply to "unreasonably" retained earnings in excess of \$15,000 but not in excess of \$100,000; 35 percent shall apply to retained earnings in excess of \$100,000.

1. This amendment would be effective in the case of most personal holding companies.

2. Operating companies could avoid the tax by using earnings to retire debt or to extend plant, but at least they would not impound a lot of cash or increase their holdings of marketable securities. It would be a stimulus to recovery and prevent a downturn that might arise from excessive increases in holdings of cash by big corporations.

3. It would prevent the growth of holding companies through retained earnings.

4. By phrasing the amendment to read "equal to" rather than "used for", a loophole would be closed up.

5. Ten percent of retained earnings is permitted to take the form of cash or marketable securities, thus meeting the claim for "reasonable needs" for tax provision purposes, etc.

6. If it is objected that cash may be increased because of deferred maintenance, collection of past debts, bond sales, etc., it can be retorted that the fact that cash has increased for these reasons shows that it is not necessary to retain earnings. This would prevent the sale of bonds for the sole purpose of using earnings to retire the bonds to evade the tax.

7. An increase in cash, marketable securities or loans was cited above as evidence of "unreasonable" retention of earnings. These items could be defined more carefully.

8. This amendment would make a definite start toward putting teeth in Section 102. It would then be easier to plug up various loopholes as they appear.