

BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

## Office Correspondence

Date December 23, 1936.To Chairman EcclesSubject: The Undistributed EarningsFrom Lauchlin CurrieTax.

*L.C.*

Mr. Bryan and I have gone over the proposed amendments and, in addition, Mr. Bryan has conferred with the head of the technical staff of the Bureau of Internal Revenue, a personal friend, and we both feel, for the reasons set forth in the accompanying memorandum, that any relaxation of the law in respect to debt-burdened corporations, or corporations with impaired capital, should be carefully safeguarded.

If I might make a suggestion concerning tactics, it is this. I think it is safer for us to appear to be prepared to make concessions rather than appear to advocate amendments. We can rely on the opponents of the tax to do the advocating.

Mr. Bryan is prepared to attend the meeting if this is satisfactory to you.

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Date December 23, 1936.

To Chairman Eccles

Subject: The Undistributed Earnings Tax.

From Malcolm Bryan and Lauchlin Currie

*M. B.*

*L. C.*

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The problems arising from (1) the present necessity of guessing at earnings before the taxable year is closed, (2) of additional income arising because of Bureau assessments, (3) small corporations, and (4) losses, seem to be fairly satisfactorily adjustable. The present notations deal simply with the problem of debt and capital impairment, on which the whole structure and purpose of the law may be defeated.

It is suggested that for the following reasons exemption of earnings from the undistributed earnings tax in the case of debt-burdened corporations and corporations with impaired capital should be approached most cautiously:

1. It should be appreciated that the payment of debt or the reduction of capital impairment through earnings operates to increase the assets behind ownership shares quite as much as if new funds were subscribed by the owners.

a. No general case in equity can at the moment be made for permitting the tax-free payment of debt, since in thousands of instances the present owners have secured control of corporations, or the ownership of corporation stock, at prices that discount the capital position of the companies involved. If owners who have held properties all through the depression are permitted to repair their capital position free of the undistributed earnings tax, other owners who have no claim on tax relief would secure it; and the balance of equities involved is certainly not clear on this score.

b. There seems no equitable ground for permitting the payment of debt in cases in which, through bankruptcy or negotiations, the indebtedness has been pared down. In such instances, the lender has already taken the rap.

c. An exemption of earnings for the purpose of debt repayment would result in injustice between corporations having a debt and those that are unindebted. Owners of indebted corporations would be allowed to increase capital from tax-free earnings; owners of corporations unencumbered by debt would be penalized for increasing capital from earnings. This would be at one with an exemption from the personal income tax in order that the taxpayer could reduce the mortgage on his house.

2. In addition to the foregoing points, exemption of earnings because of capital impairment would, according to expert opinion secured from the Bureau of Internal Revenue, seriously embarrass the administration of the tax. It is pointed out that book values would be unacceptable, and that the appraisal of assets by professional appraising companies would harrass the Bureau. All of the capital-determination problems that are to be expected in an excess profits tax would immediately arise.

3. The rapid upturn in business activity and in profits improves the position of indebted corporations by permitting them to strengthen their current position through the issue of stock or bank borrowing. If the payment of debt were permitted as a credit against adjusted net income for the purposes of the undistributed earnings tax, a premium would be placed on the improvement of the corporations' position through the retention of earnings rather than through resort to the capital markets, which is contrary to the non-fiscal purposes of the law.

#### Conclusion

In view of these considerations, it is believed that any alteration of the law in regard to debt and capital impairment should be narrowly restricted. Probably some liberalization of law or rulings is indicated in cases in which bond indentures, other covenants, or state laws compel the debt payments before dividends. Even so, an optional tax in lieu of the undistributed earnings tax should be provided for such an increase of owners' assets through earnings. Probably arrearages of interest could properly be freed from the tax.