Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 27, 1937

To Chairman Eccles

Subject:

From Malcolm H. Bryan

MHB

This memorandum limits itself to two general points:

1. Arguments for the modification of the undistributed profits tax on small corporations and, temporarily, on all corporations. These notes ignore considerations <u>against</u> such a procedure, because the opposing considerations have already been presented in a separate memorandum by Mr. Currie.

2. Comments against attempting to modify the capital gains tax for the purpose of securing an immediate improvement of the business or market outlook.

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The proposals to stimulate private expenditure for plant and equipment by modification in the undistributed profits tax at this time are two in number:

1. A more liberal exemption designed to assist the bulk of small corporations by allowing the exclusion of, say, $15,000 from earnings subject to the tax.

2. A provision that companies in the year 1938 may make plant and equipment expenditures (in excess of depreciation allowances) and may distribute such expenditures as a deduction from income subject to the tax in the years 1938-39-40.

In brief, the reasons that could be brought forward in support of the foregoing changes (aside from other slight revisions unrelated to the present business outlook) are as follows:

1. The tax places a premium on corporate financing by means of capital issues and other credit facilities and, in comparison, a penalty on financing by the retention of earnings. Small corporations usually find the use of the capital market either expensive or impossible; and their other credit facilities (and means of avoiding the tax through stock dividends) are often inadequate. A revision of the tax in favor of small corporations is thus indicated in any event, and whatever stimulation of expenditures as might be secured by revision at this particular time would be to the good in view of current business prospects.

2. Corporations in general, as was originally argued in support of the tax, are probably less reluctant to finance expenditures for expansion by money taken from earnings than by money obtained through the capital market. Generally speaking, a corporation would probably need to foresee a greater profit margin before financing through the capital market than before expanding from earnings. A relaxation of the tax would probably result in some plant and equipment expenditure that would not otherwise be made.

(a) If the relaxation of the tax were temporary, say for projects undertaken within six months or one year, a premium would be placed upon more or less immediate expansion expenditures by those companies that foresee a probable near-term necessity for expansion. With business receding, a stimulation of private expenditure in this direction would, if achieved, be helpful to the economy and to the Government.

3. A tax that tends to compel the use of the capital market, whatever may be the long-run outcome, is questionable in a period when the capital market is uncertain and erratic. The decline in security prices, over and beyond other direct and important effects, has practically precluded stock issues for financing purposes; and the bond market is disturbed. In such a situation a tax penalty on expansion from earnings is in a measure simply a penalty against expansion.

4. The rapid increase of business in the last quarter of 1936 and the first quarter of 1937 seemed to reveal a real lack of effective capacity in many phases of the economy. The result was the accumulation of big backlogs of orders and a rapid upsurge of prices, which tended to choke down demand and produce a fluctuating operation of the economy. Unless business utilizes the present and prospective lull to expand capacity at those points where under-capacitation appears, we shall have missed an opportunity to avoid a disorderly rise of prices when the cycle moves upward again. It may be guessed that conditions of full employment and more adequate consumer-goods production will in the next several years, especially in view of shortening hours and a more adult distribution of the population, require a considerably greater expansion of productive capacity than was typically true of the twenties.

5. After a deep depression in which the classes that receive the bulk of dividends have made large cuts in their customary standard of expenditure, it is probable that additional dividends paid out because of the undistributed profits tax are quickly laid out by dividend receivers in repairing their customary expenditure standards, and it is probable that this expenditure will be undertaken more immediately and completely than if the money received in dividends had been retained by the corporation paying them. However, at the present stage of the business cycle, when the chief dividend-receiving classes in the economy have probably repaired their customary standard of expenditure, it is questionable to what extent additional dividend payments actually cause additional consumption. At the present time they are likely to become savings (less tax accruing by reason of the distribution) and, because of various factors in the capital market at the moment, to become idle balances. It is possible that corporate management, as contrasted with the investing classes that largely receive dividend payments, would be more willing to expend money at this time than those who receive the additional dividends forced out by the undistributed profits tax.

II. Alteration of the capital gains tax for the purpose of securing a current improvement in business or in the security market is a doubtful expedient, and an alteration is made more doubtful by very important considerations unconnected with immediate business prospects.

1. An adjustment of the capital gains tax of sufficient magnitude to create real enthusiasm in the business community would necessitate substantial additional taxes from other sources. It is difficult to determine what group of taxpayers could properly be asked to assume the burden from which capital gains would be relieved, and it is difficult to see what equivalent revenue sources could be levied upon without an equal or greater impact on the economy.

2. In view of the deterioration of current business prospects, a tax device expected to be of much assistance should place a premium on immediacy of results. How the capital gains tax could be satisfactorily adjusted to provide such a premium on immediate action is not apparent.

> (a) Perhaps a temporary permission to average for two or three years gains made on additional purchases would cause some immediate buying of securities. Such a provision, however, would instantly acquire so many administrative complexities, and would involve so many inequities, as apparently to preclude its use. Because of administrative factors and equity considerations (neither of which is here listed), an averaging device would apparently need to be of general application in the form of a provision not specifically temporary. And in view of the general points made here, especially No. 3, the writer would not be inclined to advocate a permission to average gains.

3. A considerable class of security owners, including large security owners, is now free to purchase additional securities in case they believe the market outlook is encouraging and want to do their own averaging. If they have unrealized losses they can acquire additional securities and, as the market moves up, close out their holdings at whatever point their losses equal their gains. So far as the purchase of additional securities is concerned, they are not frozen out of the market on the buying side by a long price decline that piles up unrealized losses.

4. An argument for the forwarding of losses can be made on the ground that large owners of securities who have currently realized losses would be tempted to purchase on the present market by the knowledge that their currently realized losses could be offset against future gains. This

argument is not entirely without merit, but the opposing considerations are probably of greater weight.

(a) The fact that there is no advantage in liquidating securities, unless the taxpayer has offsetting gains within this year, probably means that important blocks of securities are being held off the market at this time.

(b) A permission to forward losses would place a very great premium on realizing losses by means of sales in the market. To the extent that such realized sales were not immediately matched by equal purchases, the market would be injured rather than assisted; and at least a certain number of security holders would be tempted to realize losses and then to stay out of the market for a time until they were quite clear regarding the market direction, so that the net gain would be problematic.

(c) To the extent that a loss-forwarding provision were taken advantage of by realizing sales that were simply offset by equal purchases, the market would neither be injured nor aided. Purchases would be exactly offset by sales; and the Government would have lost a large revenue for no purpose.

(d) Either the averaging of gains or the forwarding of losses would introduce serious inequities into the tax system in comparison with the treatment of earned income under the individual income tax and would be a source of serious discontent to other classes of taxpayers.

5. The maintenance of a capital gains tax virtually intact is vital to any long-run program for a broader distribution of wealth and income in the United States.