Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date January 18, 1938

To Chairman Eccles

From Mr. Bryan

Subject: Outline of Subcommittee Plans for Revising the Undistributed Profits and Capital Gains Taxes.

Under date of January 14, 1938, the Subcommittee of the Committee on Ways and Means of the House of Representatives has published a "Proposed Revision of the Revenue Laws."

I. The normal and undistributed profits tax plan

(1) On the first $5,000 of taxable income, a normal tax of 12½ percent.

(2) On the next $15,000 of taxable income, a normal tax of 14 percent.

(3) On the next $5,000, a normal tax of 16 percent.

Corporations earning $25,000 or less are thus to be entirely relieved of the undistributed profits tax.

(4) Corporations earning more than $25,000 a year are to pay a "tentative tax" of 20 percent on their entire taxable income. However, the 20 percent tax on such corporations can be reduced by 4/10ths of 1 percent for each 10 percent of income distributed. Thus, a corporation with $100,000 of earnings would pay 20 percent in case it distributed no earnings whatever; 19.6 percent in case it distributed 10 percent of its earnings; 19.2 in case it distributed 20 percent of its earnings; and so on down until a bottom level of 16 percent would be reached by corporations dis-

tributing their whole earnings.

The exemption of $25,000 of earnings from the undistributed profits tax is not intended as an exemption of $25,000 of the earnings for <u>all</u> corporations but is intended as an exemption only for those corporations that have <u>total</u> earnings of $25,000 or less. Inasmuch as the computation of tax liability under a rule of that sort would result in a corporation having slightly more than $25,000 of earnings paying a tax several hundred dollars in excess of the tax that would be payable if the net income were only $25,000, it has been necessary to draft a provision that will provide a gradual transition of rate at the critical $25,000 level, so that, say, a corporation with $25,001 of earnings will not be taxed disproportionately in comparison with a corporation having earnings, of say, $24,999.

(5) Provision is made for a one-year forwarding of operating losses (ignoring depletion, discovery value, and including tax free interest in gross income) as a credit against the undistributed profits surtax. Since the credit for loss is limited to 4 percent of the adjusted net income, the tax can not be reduced below 16 percent (except for corporations earning less than $25,000 or within the narrow transition bracket above that level).

(6) Provision is made for reducing the dividends paid credit during the taxable year by the amount of tax exempt interest on government securities that does not enter into the calculation of adjusted net income.

(7) Provision is made for a consent dividends credit. Corporations may file shareholders' consents with the Bureau of Internal Revenue and shareholders may thereafter cover undistributed earnings directly into their individual income tax schedules without a corporation declaring dividends either in cash or other form.

The Treasury calculates that the effective rate of tax under its new proposal is as follows:

Percentage of adjusted net income paid out in dividends	Effective rate of tax	
	On ordinary income	On dividends received
	Percent	Percent
100	16.0	2.4
90	16.4	2.8
80	16.8	3.2
70	17.2	3.6
60	17.6	4.0
50	18.0	4.4
40	18.4	4.8
30	18.8	5.2
20	19.2	5.6
10	19.6	6.0
0	20.0	6.4

In addition to the foregoing alterations and changes in structure of the present law, there is recommended a special surtax of 20 percent on the undistributed earnings of closely-held operating companies. This tax is so adjusted by means of deductions and income definition that it will apply only to those closely-held operating companies that have a net income in excess of $40,000 and that do not distribute at least 60 percent of their earnings; and the announced result of the 20 percent rate when applicable is to provide an effective net rate of tax slightly less in all brackets than the present undistributed profits tax. The objective of the new tax, of course, is to discourage the accumulation of undistributed earnings by operating companies that are so closely held as to furnish a presumption that retained earnings are for the purpose of avoiding individual surtaxes. The test of what constitutes a closely-held company is as follows:

More than 50 percent in value of the outstanding stock is owned, directly or indirectly, by or for one individual.

More than 53 percent in value of the outstanding stock is owned, directly or indirectly, by or for two or less individuals.

More than 56 percent in value of the outstanding stock is owned directly, or indirectly, by or for three or less individuals.

More than 59 percent in value of the outstanding stock is owned, directly or indirectly, by or for four or less individuals.

More than 63 percent in value of the outstanding stock is owned, directly or indirectly, by or for five or less individuals.

More than 65 percent in value of the outstanding stock is owned, directly or indirectly, by or for six or less individuals.

More than 68 percent in value of the outstanding stock is owned, directly or indirectly, by or for seven or less individuals.

More than 71 percent in value of the outstanding stock is owned, directly or indirectly, by or for eight or less individuals.

More than 74 percent in value of the outstanding stock is owned, directly or indirectly, by or for nine or less individuals.

More than 75 percent in value of the outstanding stock is owned, directly or indirectly, by or for 10 or less individuals.

II. The Capital Gains Tax Plan

Two essential alterations are proposed in connection with the capital gains tax:

(1) The taxable percentage of income from capital gains is reduced in accordance with a monthly scale, so that the present big jumps are avoided. Comparison of the results so far as typical periods are concerned is as follows:

Asset held	New plan	Present law
Less than 1 year	$100	$100
$1\frac{1}{2}$ years (18 months)	88	80
$2\frac{1}{2}$ years (30 months)	70	60
$3\frac{1}{2}$ years (42 months)	58	60
$4\frac{1}{2}$ years (54 months)	46	60
5 years (60 months)	40	60
$5\frac{1}{2}$ years (66 months)	40	40
Over 10 years	40	30

(2) There is established a maximum rate of 40 percent applicable against taxable gains. The combined result of the newly proposed system for scaling down capital gains and the establishment of a maximum tax rate is to lower substantially the maximum effective rate on capital gains. This is illustrated by the following table:

Time Held	New plan maximum tax rate on gain	Present plan maximum tax rate on gain
Less than 1 year	79.0	79.0
1½ years (18 months)	35.2	63.2
2½ years (30 months)	28.0	47.4
3½ years (42 months)	23.2	47.4
4½ years (54 months)	18.4	47.4
5 years (60 months)	16.0	47.4
5½ years (66 months)	16.0	31.6
Over 10 years	16.0	23.7