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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Chairman Eccles

From Mr. Bryan

Subject: Comments on the Subcommittee's Proposals for Tax Revision

This memorandum is an attempt to set down certain of the more obvious aspects of the Subcommittee's report.

1. One of the chief points of the program is the relief for small corporations, namely, those earning under $25,000 a year; and the proposal does in fact exempt such corporations from the undistributed profits tax. The prospective value of the relief is considerably lessened, however, by the fact that the undistributed profits tax surtax is itself to be reduced to an almost nominal rate: a maximum of 4 percent on ordinary corporations that retain their entire net income. This becomes an important point when it is noticed that the relief suggested for these small corporations is not being granted free of charge. It is to cost a considerable increase in the normal corporate tax rate.

For instance, under the proposed schedule of rates, a corporation having $25,000 of ordinary net income would pay a total tax of $3,525, or a net effective rate of 14.1 percent. Under the existing statute a corporation with $25,000 of ordinary taxable income would pay a normal tax of $2,890, which is a rate slightly less than 11.6 percent. In short, it will apparently cost small corporations having an identical kind of earning of $25,000 a normal tax increase of approximately 2.5 percent in order to secure the relief proposed; and there will be varying amounts of increase in the normal tax for corporations earning less than $25,000.

It is not possible from the published data to make an absolutely exact calculation concerning what would have been the tax payments for corporations earning less than $25,000 in 1937 in comparison with what they actually paid in accordance with existing law. It is possible, however, to make a complex calculation that will yield approximate results. Thus for corporations earning under $5,000, the published figures of a net effective rate (on net income for income-tax computation) are 12.52 percent, which consisted of 8.67 percent normal tax and 3.85 percent undistributed profits tax surtax. Based on the figures through August 31, 1937, as published by the Committee, the rate of 11.5 percent may be calculated as the approximate[1/] rate that would have been paid under the new proposal. This shows a saving of about 1 percent in total tax. The same sort of calculations for corporations earning between $5,000 and $20,000 a year seem to indicate that they would also have saved approximately 1 percent; and corporations between $20,000 and $25,000 would apparently have saved approximately 2 percent. In short, the relief for small corporations is not substantial. If real relief had been intended, the obvious process would have been to repeal the undistributed profits tax for small corporations and to leave the normal tax rate largely undisturbed.

1/ The word approximate must be used because figures for tax exempt interest were not published, and an inexact allowance is necessary.

2. It has from time to time been argued in various ways that there is no need for an undistributed profits tax. One of the points often made is that, even though annual individual taxes are avoided by the retention of corporate earnings, the result of retained earnings is to increase the value of corporate securities, and the eventual result is to increase substantially the amount of capital gains taxes that will be levied and collected.

Without regard to the manifold demerits to the foregoing argument, it needs to be observed that the Subcommittee's report involves a substantial relaxation of the tax system both with respect to the undistributed profits tax and the capital gains tax. If the undistributed profits tax is to be diminished, there is all the more reason for keeping the capital gains tax unimpaired; and, on the other hand, if the capital gains tax is to be diminished, there is all the more reason for keeping the undistributed profits tax at more than nominal rates. I do not myself see the logic involved in so substantially reducing both of these taxes at the same time.

3. So far as the undistributed profits tax is concerned, the proposed revision apparently maintains the principle of the tax unimpaired. However, the principle of the tax is preserved by an almost complete abandonment of the tax; and it is fair to ask whether it might not have been better in this case to have forgotten some of the principle and kept the tax rather than to have kept the principle and forgotten the tax.

It may be granted, I think, that the undistributed profits tax as it now stands presents problems that are exceedingly difficult, if not im-

possible, to resolve entirely. Moreover, I can not know, of course, what efforts the Treasury may have made to iron out the rough spots in the existing law or what considerations may have motivated the Subcommittee of the Ways and Means Committee; but it is certainly true that, so far as published reports are concerned, the whole effort at a solution has consisted simply in reducing the rate on the undistributed profits tax to negligible proportions. Practically any tax can be made acceptable by that method.

4. The plan for taxing closely-held operating corporations that could easily avoid the individual surtaxes by retaining earnings is attractive because of its declared purpose. It may, indeed, be of some service, but I do not convince myself that the program is especially impressive.

In the first place, some 30 percent of earnings can be retained without the surtax in this bracket. That arrangement places the law on the position of saying that closely-held corporations, for the payment of a 4 percent undistributed profits tax, can avoid individual surtaxes to the extent of 30 percent of their earnings. Just why they should be permitted to avoid the individual surtaxes on 30 percent of the corporate earnings is not clear. Moreover, corporate deficits for the preceding and current year are to be allowed as a deduction from undistributed earnings. It should be noted in passing that this arrangement, doubtless defensible, is one that, had it been applied to all corporations in connection with the undistributed earnings tax, would have removed from the application of the tax a very large fraction of all justifiable complaints against it. Just

the logic in giving these advantages to closely-held corporations is not apparent except for the circumstance that the undistributed profits tax on other corporations is to be so drastically reduced. The question may be asked, if this device will make the undistributed profits tax palatable for closely-held corporations why could not the rates have been kept up or even advanced and the same device used not merely for closely-held but for all corporations?

In the second place, the rate for closely-held operating corporations is calculated to be slightly less under all circumstances than the present normal tax and undistributed profits tax. The present rates are approximately 15 percent for the normal tax and 20.5 percent for the undistributed profits tax in cases where all earnings are retained, a total of approximately 35 percent. The new tax is intended to be fractionally less than that amount. Now, an individual having about $60,000 of income will find his individual tax rate at the same figure proposed for the closely-held operating companies, and it will pay to retain earnings in the corporation rather than to declare them out.

In short, the controlling owners of any closely-held corporations in which the amount of earnings accruing to the individual controlling stockholders are more than $60,000 will still find it advantageous to effect the retention of corporate earnings. The proposal is thus in a position of saying that, among the various closely-held corporations, those whose controlling stock ownership is vested in persons in the upper income tax brackets will be allowed to avoid the rates that would fall on their indi-

vidual incomes while the controlling owners of corporations in the lower income tax brackets will not be allowed to escape. This is an unsatisfactory result under almost any way of looking at the matter, but, in fairness, it must be admitted that it is the same sort of result as is effected by the present statute. In fairness, also, it may be true that it is impossible at the moment to make any rate increase, even with respect to closely-held companies, that would have altered this situation.

If the undistributed profits tax is supposed to be a tax actually intended to fall on the corporation as such there is no fiscal reason to differentiate between closely-held corporations and other corporations. In the field of corporate taxation, as such, the issue of whether or not a company is owned by few or many stockholders seems to be irrelevant. On the other hand, if the intention of the undistributed profits tax is to enforce the taxation of individuals, then the undistributed profits tax at a higher rate on closely-held corporations has a curious effect: it would apply very unequal taxation to equal individual incomes. For instance, if a man had a large income derived from a corporation or corporations falling within the closely-held definition, he would be compelled either to pay out the corporate earnings and be taxed in accordance with the individual rates or would be subjected to a special penalty tax for retained earnings; but if he had exactly the same income from stock ownership in corporations not falling within the closely-held definition his penalty tax for retained earnings would be only 4 percent. The only reason that can be urged for results of this character is the assumption that the person avoiding indi-

vidual surtaxes will in the one case be able deliberately to determine the avoidance and in the other case will not be able so deliberately to determine the avoidance. But whatever the volitional and purposive aspects of the situation may be, the fact remains that of two equal incomes the one retained in a closely-held corporation will be particularly penalized and the one retained in the non-closely-held corporation will suffer a much less severe penalty. All this does not result in as neat and logical a tax structure as could be desired.

The method of defining the closely-held operating corporation has one outstanding merit. It is exact; and perhaps it is to be urged that exactness is the paramount consideration. The very exactness of definition, however, is going to lead to some capricous results. There will be a good many borderline cases; and there will be numerous instances in which the control of relatively much smaller blocks of stock than those specified will in fact give effective control of dividend policy.

5. The crucial point in the capital gains tax recommendations is the fact that the effective rates of tax applicable to capital gains are to be greatly reduced. In this connection, it is worthwhile repeating a table presented in a previous memorandum:

Time Held	New Plan Maximum Tax Rate on Gain	Present Plan Maximum Tax Rate on Gain
Less than 1 year	79.0	79.0
2	30.4	63.2
3	25.6	47.4
4	20.8	47.4
5	16.0	47.4
Over 10 years	16.0	23.7

It may be observed, also, that the impact of the tax on assets held less than 1 year is to be somewhat lessened by permitting net losses to be carried forward one year and deducted from any capital net gain arising in the subsequent taxable year from the exchange or sale of taxable assets held one year or less.

The proposed plan, as will be recalled, scales down the taxability of capital gains by 2 percent each month for 24 months and thereafter by one percent each month until, for capital gains held 5 years, or more, 40 percent of the realized gain is taxable. This makes for a much evener and less abrupt schedule than the present law and may be presumed almost completely to eliminate any tendency to hold securities in order to take advantage of the present relatively large reductions in taxability that occur at the end of 1 year, 2 years, 5 years and 10 years. This feature appears to be an improvement upon the present statute.

In addition, there seems no reason to quarrel, in so far as it goes, with the proposed provision for the forwarding of losses on assets held less than 1 year or with the proposal to except from the definition of capital assets such property as is actually used for the operation of trade or business when that property is of a character subject to the depreciation allowance. This provision will correct the present unequal situation regarding the treatment of losses when a loss exists because an asset has become worthless and because it was disposed of at a price less than its purchase cost, minus depreciation.

The real damage done to the capital gains tax by the present proposal consists of the limitation of 40 percent as the maximum tax rate applicable

on the share of the taxable proportion of capital gains. This means, in short, that the person having large capital gains not merely receives a scaling down of the taxable proportion of income on the theory that the gain has in fact accrued evenly from the time of purchase to the time of sale, but the taxpayer is also given the advantage of an over-all limitation of rate on the capital gain portion of his income, regardless of what his total income may be. Roughly speaking, this change benefits all those taxpayers who have taxable incomes in excess of $60,000. The change is thus clearly a partial abandonment of the principal of progressive taxation and also clearly deals more leniently with capital gain income than with earned income or other types of property income. It is a curious capitulation for the Subcommittee report to arrive at. The report lists the popular objections to the capital gains tax, argues the points excellently well, and rejects their validity.

The point regarding the place of the capital gains tax in the progressive tax system is, without elaborate statistical review, worth certain additional comments. For instance, the Committee publishes a table of income tax statistics through August 1937. This shows that net taxable capital gains for all individuals reporting more than $100,000 of income to have been somewhat more than 16 percent of the total capital gains, whereas the same individuals reported something more than 12 percent of the total income returned for tax purposes. This demonstrates a tendency (though not great on the face of the figures) for capital gains to be concentrated in the high brackets. All of these taxpayers would be benefited substantially by the limitation of capital gains tax rates to 40 percent, since their incomes are well in excess

of the level at which such a rate would begin to apply. Actually, however, the concentration of capital gains in the upper income tax brackets is far greater than any indication given by the percentages just calculated. That is because the properties on which capital gains accrue are held for much longer times by the upper bracket taxpayers than by the lower bracket groups; and the scaling down of the taxable fraction of capital gain income in accordance with the percentage reductions allowed by law operates disproportionately for the benefit of those in the upper brackets.

The point is demonstrated by another table printed by the Committee. It does not apply (presumably because the information is not yet available) to the year 1937 but to incomes for 1934. That table indicates that, for all taxpayers under $100,000 of income, 38 percent of all capital gains were from properties held less than 1 year, 17 percent of all capital gains were from properties held less than 2 years. On the other hand, for the income classes above $100,000, only 13.8 percent of all capital gains were from properties held less than 1 year and 8.5 percent from properties held 1 to 2 years. For income classes above $100,000, 70.2 percent were from properties held 10 years or over. In brief, whatever its merits or demerits, the percentage scaling down of taxability in accordance with the time held is in overwhelming measure a concession to the higher income groups to whom, if the new proposals are adopted, the tax limitation concession will also apply. Of course, capital gains have in recent years been a relatively small source of income subject to Federal taxation; but, with anything like economic operation at ~~the~~ a prosperity level, capital gains become an important part of upper-bracket incomes. This may be illustrated by figures taken from the Statistics of Income for 1928 and 1929.

PERCENTAGE OF INCOME FROM CAPITAL GAINS

	1928		1929	
	Held less than 2 years	Held more than 2 years	Held less than 2 years	Held more than 2 years
Under $5,000	2.38	---	2.87	---
$5,000-$10,000	7.35	---	6.22	---
$10,000-$25,000	15.21	---	12.84	---
$25,000-$50,000	20.46	1.74	17.75	1.10
$50,000-$100,000	16.74	11.70	12.66	13.15
$100,000-$150,000	16.14	19.07	8.83	24.34
$150,000-$300,000	15.24	25.34	8.63	33.05
$300,000-$500,000	14.54	29.63	6.59	41.21
$500,000-$1,000,000	14.65	35.76	6.71	45.71
$1,000,000 and over	12.11	47.31	7.14	54.76