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REVISION OF UNDISTRIBUTED EARNINGS TAX

The purpose of this note is to discuss the relative merits of two proposed amendments to the Undistributed Earnings Tax.

1. Exempt a certain percentage of earnings of non-financial corporations that are expended for new plant and equipment in excess of expenditures equal to current depreciation charges. At the same time impose a penalty rate on all earnings in excess of this percentage and also on earnings below this percentage that are not expended for new plant and equipment. This exemption might either be continued indefinitely or be gradually reduced from the initial rate in the first year.

The arguments that may be urged in support of this proposal are as follows:

Economic and practical considerations, as well as those of equity, must be related to fiscal and tax policy. On occasion an attempt to meet all these requirements involves compromise. The tax under discussion is a case in point. On grounds of equity and revenue, all net earnings of corporations belonging to the stockholders of corporations should either be included in their income for tax purposes, or taxed proportionally in other ways. Politically, this did not prove possible to accomplish. Corporations can still retain 40 percent of their earnings after the normal corporation tax on the payment of an average tax of 13.2 percent; they can retain 100 percent on the payment of an average tax of 20.5 percent. These percentages are much more than small stockholders would have to pay if

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earnings were distributed. On the other hand, they are far less than wealthy stockholders would have to pay. In other words, under the present law, there is still a powerful incentive for the wealthy and dominating stockholders to cause corporations to retain earnings and this victimizes smaller stockholders. The present law provides, moreover, no incentive to use depreciation charges or retained earnings for actual plant and equipment expenditures.

The proposed amendment is designed, on the one hand, to provide an incentive for the actual expenditure of depreciation accounts and of a percentage of retained earnings and, on the other, to impose a heavy penalty on the non-expenditure of a portion of earnings for expansion of new plant and equipment and on the retention of earnings above, say, 30 percent.

Since corporations in any case can be expected to retain some 30 percent of their earnings the direct loss to the Treasury from the exemption would amount to 12 percent of this amount. Against this direct loss, however, must be offset the gains arising (a) from the payment of a tax of, say, 50 percent on retained earnings not exempt and/or (b) from increased surtax yields arising from distribution of earnings to people whose incomes fall in the high tax brackets. Corporation owners can now cause all earnings to be retained and incur an average tax of 20.5 percent of this amount; under a 30 percent exemption and 50 percent tax rate, the retention of all earnings would entail an

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average tax of 35 percent. In addition, insofar as increased expenditures result as a consequence of the amendment, national income generally would be higher and tax yields thereby increased. It does not appear, therefore, that the proposed amendment would result in any diminution of Federal revenues.

It is difficult to gauge the probable effectiveness of the stimulus to increased expenditures, as this depends in large part on the trend of business activity. It is possible, however, to arrive at some idea of the theoretical maximum figure.

In the first place, corporations reporting no net earnings would have no particular incentive to expend additional amounts of their depreciation charges. In order to isolate the sphere of influence of the proposed incentive, therefore, it is necessary to estimate the annual depreciation and depletion charges of non-financial corporations reporting net earnings. This figure may be estimated at $3 billion. Net statutory earnings of these corporations, less normal tax, are estimated to approximate $7 billion in 1937. The theoretical maximum stimulus, therefore, would be $3 billion plus 30 percent of $7 billion, or approximately $5 billion in all.

If it is assumed that such corporations would have made in any case expenditures equal to one-half their depreciation charges and would retain 30 percent of their earnings, an additional expenditure of $3½ billion would result in a tax saving of $1 billion. Another way of illustrating the incentive is to point out that corporations will have the alternative either of adding $4 billion

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to their capital assets in the form of plant and equipment expenditures or of adding only $3 billion dollars to their other assets.

If corporations choose to pay out all their earnings rather than avail themselves of the exemption, Federal revenues would benefit as a result of increased personal income tax payments and total community expenditures would benefit as a result of increased spending of dividends. There would be no offset to these gains as presumably corporations failing to avail themselves of the exemption have no need of expansion and would not have spent retained earnings for this purpose.

In one set of circumstances, however, the proposed amendment may result in some discouragement to capital expenditures. If a corporation, under the present law, would have retained and expended more than 30 percent of its earnings, and if it cannot or will not raise new capital or borrow for expansion, the imposition of a tax of 50 percent on retained earnings in excess of 30 percent would discourage capital expenditures. This objection to the proposal under discussion would be somewhat removed by the adoption of another suggestion to exempt entirely earnings up to $15,000. If, in addition, the 30 percent exemption applied to retained earnings in excess of $15,000 this would permit corporations earning up to $50,000 to retain one-half of their earnings without penalty. It is these smaller corporations that would have most difficulty in raising new money or borrowing.

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Before penalty rates could be assessed on earnings not used for plant and equipment expenditures, a partial exemption in the form of special low rates of, say, 10 percent should be provided in the case of those corporations who cannot disburse earnings because of provisions in bond indentures or statutory prohibitions of dividend payments in case of capital impairment.

There is some question as to whether the 30 percent exemption should be extended indefinitely, should cease entirely after a certain period, or should be gradually reduced to a figure of 15 percent or 20 percent. It would appear politically impossible to remove the exemption entirely after a specified period and still retain high rates on undistributed earnings. The practical alternatives, then, are an indefinite continuance of the proposed exemption or gradual reduction. In this connection it may be noted that expansion of plant and equipment at a rate equal to 30 percent of earnings would be very modest. This follows from the fact that total earnings approximate only between 5 and 10 percent of net worth, and net worth in turn is considerably less than total capital investment.

2. The second proposal is to permit an amount equal to new plant and equipment expenditures in excess of expenditures equal to depreciation charges to be retained in 1938 and to be credited against undistributed earnings in the period 1938-40 in computing tax liability

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under the undistributed earnings tax. The theoretical maximum exemption is equal to three years' full earnings which, at the 1937 rate of earnings, would amount to $21 billion. This would be in addition to some $12 billion representing expenditures on depreciation accounts. The exemption could be coupled with increased rates on earnings withheld and not used for net expansion purposes.

This proposal is much more drastic than the previous one. It entails a wider departure from the equity consideration of taxing according to ability to pay, as it offers the possibility to wealthy owners of corporations of avoiding payment of personal income taxes or undistributed earnings taxes on their corporations' earnings for a three-year period. On the other hand, by the same token it offers a greater stimulus to capital expansion in the single year 1938.

In contrast to the proposal to exempt a flat percentage of earnings for expansion, the present proposal offers an incentive to corporations reporting no net income in 1938 to expand their facilities so that they may avail themselves of the privilege of withholding earnings in the following two years. The importance of this consideration is considerably diminished by the difficulty experienced by most corporations reporting no net earnings in raising new capital for expansion.

Another, and very important difference in the effect of the two proposals lies in the period during which the stimulus is effective. In the case of the first proposal the stimulus continues until such time as the exemption is removed. In the case of the second proposal, however,

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the stimulus ceases on December 31, 1938. In the two following years, depending on the extent to which corporations made new capital expenditures in 1938, there will be an incentive to retain earnings that can be used to retire debt or added to corporate reserves. The more effective the stimulus to expansion in 1938, and this is the main objective of the proposal, the more danger there will be that an abrupt cessation of the stimulus on a given date may lead to a decline in expenditures. This objection is modified by the consideration that it is a physical impossibility to crowd the necessary expenditures in the next three or four years into one year. The more probable effect would be to cause expenditures to be somewhat greater in 1938 and less in 1939 than they otherwise would be.

A practical difficulty attaches to that part of the proposal which envisages higher rates on earnings retained for purposes other than plant and equipment expenditures. Under the plan as proposed, such rates would have to be limited to a year, after which, presumably, reversion to present rates would occur. It appears politically difficult to secure higher rates than at present on undistributed earnings unless they are coupled with certain exemptions.

It is possible to work out a plan whereby expenditures in 1938 could be credited against undistributed earnings in 1938-40; expenditures in 1939 against undistributed earnings in 1939-40; and expenditures in 1940 against undistributed earnings in 1940. This would avoid the

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abrupt cessation of the stimulus to plant expansion. It would, on the other hand, probably permit too much stimulation over the three-year period and involve too wide a departure from equity considerations. It also would reduce somewhat the stimulus to expand in the next six months, during which period the stimulus is most desirable.

Politically, there is much to be said for a type of revision which, if possible, will be semi-permanent. A change that is designed to cover only a specified period invites renewal or further modification at the end of that period.

Speaking broadly, the choice between the two proposals is a choice that involves a compromise between stimulus and equity. The first proposal promises a certain amount of stimulus without departing seriously from the equity consideration back of the law. The second proposal promises a larger degree of stimulus but entails a considerable departure from the principle of taxation according to ability to pay.

3. It has been proposed that an exemption for new plant and equipment expenditures be supplemented by a further exemption to permit retirement of debt.

This proposal rests on the general view that debt retirement is both financially prudent for a corporation and socially beneficial for the community.

The objections to the proposal are as follows:

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1. Debt retirement in the present circumstances is deflationary and would tend to offset in part the stimulus afforded by the other exemptions. In the present circumstances the retirement of corporate debt would tend to swell the volume of unused funds of banks, insurance companies and private investors rather than to return immediately to the monetary circulation. Exemption for debt retirement is more appropriate as a boom-controlling device.

2. One of our present difficulties is that a large portion of savings and other capital funds are restricted in their disposal to obligations representing debt whereas, over a period of time, industry has shown less and less inclination to raise new money for expansion by the issue of such obligations. Unless our banking, insurance and trustee laws are drastically changed, the proper functioning of our system requires a larger and increasing volume of debts.

3. To permit corporations to retain earnings tax free for the retirement of debt would introduce a whole new series of inequities in our tax laws. In retiring debt corporation owners add to their net worth just as much as though they left the debt stationary and made net additions to plant facilities. Hence, the exemption of earnings to retire debt would permit owners of corporations which have heavy debt structures to add to their net worth while denying this privilege to owners of debt-free corporations, to partnerships and to private individuals.

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