Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date July 22, 1940

To Mr. Despres

From Mr. Krost

Subject: Economic Effects and Estimated Yields of a Set of Tax Proposals Designed to Raise Revenue without Restricting Consumption.

List of Proposals

Proposals relating to corporation taxes:

1. Enactment of an excess profits tax.

Excess profits should be defined as the excess of profits in the taxable year over the average of the best two out of the three years preceding the imposition of the tax. In order to avoid excessive taxation of corporations making losses or exceptionally small earnings in the base period the taxpayer should be allowed the option of substituting an amount equivalent to a 5 per cent return on invested capital for the base as determined under the general rule. In order to prevent corporations having exceptionally high earnings in the base period from escaping the tax entirely the Government should have the option of substituting an amount equivalent to some reasonably high rate of return on invested capital for the base as computed under the general rule. The rates of tax upon excess profits as thus defined should be high.

Such a tax is needed at the present time in order to impose upon industry some sacrifice commensurate with the sacrifices that will be required from the broad masses of the people as a result of the introduction of conscription. It is needed to prevent the weakening of the public morale that will occur if the national defense program becomes an occasion for conspicuous increases in the number and amount of large private fortunes. It is also needed in order to reduce the growth in the public debt which will result from the defense expenditures unless the public revenues are appreciably increased.

2. An increase in the corporate income tax rate from its present level of approximately 21 per cent to 25 per cent.

The changes in individual income tax rates made by the Revenue Act of 1941 have resulted in increases ranging from 25 per cent to 60 per cent in tax payments of individuals in the income range from $3,000 to $100,000. The incentive to leave corporate earnings undistributed has been appreciably increased. An increase in the corporate income tax offers the only method of securing an appreciably increased contribution to our national defense effort from recipients of income able to take advantage of this method of tax-avoidance. Moreover, the corporation income tax provides a simple and effective method of collecting taxes at the source upon the incomes of the wealthiest 10 per cent of American families, a method that minimizes the possibilities of tax-avoidance and tax-evasion. The corporation income tax rate is now 37.5 per cent in the United Kingdom. It Germany it is now 40 per cent.

Proposals relating to the estate and gift taxes:

3. (a) Inclusion of gifts during the life of the donor in the computation of the taxable estate; that is, assessment of the estate tax on the total of estate passing at death plus gifts during life, with a credit for gift taxes previously paid.

Under existing law the initial transfers made under a tax-avoidance program designed to transfer an appreciable part of an estate by gift avoid taxation at the highest rate of estate tax to which the estate would be subject by incurring taxation at the lowest rates of gift tax. For example, a gift of $10,000 from an estate that will amount to slightly more than $1,000,000 at the death of the donor avoids a prospective estate tax of $3,200 by paying a gift tax of only $150. The proposal is designed to equalize the tax treatment of property passing by gift and by bequest.

(b) Substitution for the present specific exemptions of $40,000 under the gift tax and $40,000 under the estate tax of an exemption of $10,000 to be applied to the total of estate passing at death plus gifts during life.

(c) Elimination of the insurance exemption.

(d) Increase of estate tax rates to raise more revenue from estates of moderate size.

By making use of the $40,000 specific exemption under the gift tax, the $40,000 specific exemption, and the $40,000 insurance exemption under the estate tax, an estate of $120,000, or $120,000 of any estate, no matter how large, may be transferred to heirs free of tax. An additional $80,000 may be transferred by gift subject to taxes of only $5,100. Under the British estate duty, the transfer of $200,000 would be exempt from tax to the extent of only $400 and would involve taxes of $24,000.

Proposals relating to the individual income tax:

4. Abolition of the privilege enjoyed by husbands and wives of filing separate returns, with possible retention of the privilege for bona fide earned income of wives.

Under existing law a net income of $1,000,000 a year pays income taxes of $718,000. If a husband can succeed, by transferring assets to his wife, in giving her a taxable income of $500,000 and reducing his own to $500,000, the taxes payable on the two incomes amount to only $660,000, a tax saving of $58,000. For an income of $60,000, the potential saving attributable to the separate filing privilege amounts to $8,000.

Income utilized for the maintenance of a common household should be taxed as a single income, regardless of the fact that it may have nominally separate sources. The present state of the law represents serious discrimination, both against single individuals and against married persons with income derived solely from the husband's earnings. The practice of filing separate returns is so widely prevalent among high income families that the effectiveness of the progressive income tax is substantially impaired. Of the 3,908 married couples with incomes of more than $100,000 a year in 1937, 3,584 filed separate returns and were taxed at considerably lower rates than applied to equivalent incomes received by couples without property income or received by single persons.

5. Substitution for the present system of personal exemptions and credit for dependents, applied against net income before computation

of tax, of a system of flat credits, applied against the tax itself.

The purpose of this proposal is to eliminate the differential subsidy to higher incomes involved in the present system. The $2,000 exemption for married persons is worth $1,580 (79 per cent of $2,000) in tax saving to a person with an income in excess of $5,000,000; it is worth only $80 (4 per cent of $2,000) to a person with an income of $5,000. If subsidies of this type were paid by the Treasury in the form of cash outlays, the unjustified expense would be generally condemned; in their present form they are as costly and just as little justified as if they were paid in cash.

A tax credit of $32 might be substituted for the present personal exemption of $800 for single person; a tax credit of $80 for the present personal exemption of $2,000 for married persons; and a tax credit of $16 for the $400 credit for each dependent. The present rate of 4 per cent on surtax net income of $4,000 to $6,000 might be lowered to 1 per cent in order to avoid a sharp increase in taxes for those who are now exempt from surtax by only a small margin and for those who now pay small surtaxes.

6. Repeal of the provisions restricting the rate of tax on long-term capital gains to a maximum of 15 per cent.

Under the rates of the Revenue Act of 1940, an income of $50,000 derived wholly from wages or salaries pays income taxes of $14,128. Under the existing procedure with respect to the taxation of capital gains an income of $50,000 derived wholly from long-term capital gains need pay income taxes of only $7,500. The provision that only 50 per cent of capital gains on assets held more than two years should be taken into account in computing net income constitutes adequate recognition of the difference between capital gains and other types of income; the present differentiation in the rate of tax is unnecessary.

7. Removal of tax exemption from future issues of Federal, State and local Government securities.

This proposal is opposed only by the comparatively small group of wealthy investors in tax-exempt securities and by State financial officers who believe that it would greatly increase the cost of borrowing to the States. Consideration should be given to a number of means of bringing pressure to bear upon the States to discontinue their opposition to this proposal: a) repeal of the legislation permitting the States to levy income taxes on the salaries of Federal employees, b) less generous allowance of credit for payment of State taxes under the estate tax and under the unemployment compensation tax, c) less generous Federal grants to States for public roads, old-age assistance, work relief and many other purposes.

Estimated Yield of Proposals

The following tables show the estimated yield of the existing tax structure and of the proposals listed in this memorandum at varying levels of the national income.

TABLE 1

ESTIMATES OF YIELD OF THE EXISTING FEDERAL TAX STRUCTURE (AS MODIFIED BY THE REVENUE ACT OF 1940) AND OF THE PROPOSALS ADVANCED IN THIS MEMORANDUM, AT VARYING LEVELS OF THE NATIONAL INCOME 1/

(Billions of dollars)

Tax revenues and other available funds	National Income of Preceding Year 70	80	90	100
EXISTING TAX STRUCTURE				
Income, estate, and gift taxes	3.5	5.3	7.6	10.3
Other budgetary receipts	2.8	3.2	3.8	4.3
Total budgetary receipts	6.3	8.5	11.4	14.6
Net social security funds	1.1	1.2	2.1	2.5
U. S. savings bonds	0.8	0.8	0.9	0.9
Total funds available without open-market borrowing	8.2	10.5	14.4	18.0
Additional yield from proposals of this memorandum 2/	1.4	1.8	2.4	3.0

1/ The amounts shown would be collected in the calendar years following the calendar years in which the national income reached the levels indicated. Estimates of fiscal year collections would differ only slightly from the estimates shown. For purposes of estimating transactions which have a predictable trend over time, the calendar year in which these collections are made are assumed to be 1941 (year following \$70 billion national income), 1942 (year following \$80 billion national income), 1943 (year following \$90 billion national income), and 1945 (year following \$100 billion national income).

2/ Estimates of the yield of each of the proposals are shown in Table 2.

TABLE 2

REVENUE YIELD OF SEVEN PROPOSALS ADVANCED IN THIS MEMORANDUM, AT VARYING LEVELS OF NATIONAL INCOME 1/

(Millions of dollars)

	Fiscal year 1941	National income of preceding year			
		70	80	90	100
Excess profits tax	300	600	700	800	1,000
Increase in corporation income tax	125	250	280	320	350
Estate and gift tax changes	--	250	350	475	600
Abolition of privilege of filing separate returns	120	200	300	450	600
Substitution of flat tax credit for personal exemption	60	100	150	225	300
Abolition of optional capital gains tax rate 2/	--	--	--	100	150
Total 3/	605	1,400	1,780	2,370	3,000

1/ The figures shown are estimates of collections in calendar years following the calendar years during which the national income reaches the indicated levels. Security prices are assumed to be moving upward without serious break as national income increases and the general price level is assumed to be moving slowly upward without serious reversals in trend.

2/ Since the yield of this proposal depends on its effect on the taking of capital gains, which in turn depends largely on taxpayers' views as to whether taxation of capital gains at high rates is to be temporary or permanent, the estimates of yield shown represent merely an indication that an appreciable yield is to be expected from this proposal at high levels of national income if taxpayers do not expect a decrease in the taxes on capital gains for a considerable number of years.

3/ The proposal to eliminate tax-exemption from Government securities applies only to future issues of such securities, and hence will yield a negligible amount of revenue in the immediate future.