Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 24, 1941

To Chairman Eccles

Subject: The Revenue Act of 1941

From Martin Krost

MK

The Revenue Act of 1941 is described in the attached memorandum. The act as signed by the President differs in the following major respects from the bill passed by the House:

1. Personal exemptions under the individual income tax are reduced from $2,000 to $1,500 for married persons and from $800 to $750 for single persons. Under the lowered exemptions, from 20 to 25 per cent of all income-recipients, who receive about half of the national income, will pay Federal income taxes.

2. The 10 per cent defense taxes are integrated with the permanent schedules of individual income, corporation, estate and gift, and excise taxes.

3. A simplified individual income tax return is provided for the optional use of taxpayers with gross income of $3,000 or less.

4. The rates of corporation surtax are increased from 6 per cent on the first $25,000 and 7 per cent on the excess, as provided in the House bill, to 7 and 8 per cent, respectively.

5. The act as passed eliminates 10 per cent special excess profits tax imposed by the House bill on the difference between average base period earnings and the invested capital credit for corporations using the invested capital option.

6. The Senate eliminated the taxes on soft drinks, outdoor advertising, and radio broadcasting, and added a tax on light bulbs. Of about a billion dollars in additional revenue from excise taxes, the bulk comes from whiskey, automobiles and accessories, amusements, a use tax on automobiles, and a new tax on local telephone bills.

7. The act sets up a committee to investigate the reduction of non-essential Federal expenditures, consisting of three members of the House, three members of the Senate, the Secretary of the Treasury, and the Director of the Bureau of the Budget.

The aggregate additional yield of the act is estimated at about $3,600 million on a full year basis at the 1941 level of incomes. Total accruals under the Federal tax structure as modified by the new act on a full year basis will be in excess of $15 billion.

September 23, 1941

THE REVENUE ACT OF 1941

by

George Jaszi

The Revenue Act of 1941 received the signature of the President on September 20, almost five months after hearings on it started before the House Ways and Means Committee. Most of this period was occupied by extended public hearings and consideration of the legislation by the Ways and Means Committee and Senate Finance Committee. Debate on the floor of the House and Senate was brief and related chiefly to committee proposals for revising the present method of taxing the incomes of married persons. The present method is left unchanged by the legislation as passed, but this problem may receive consideration again, together with a number of technical and administrative problems, in another bill upon which the Ways and Means Committee will begin work in a few weeks. It is also expected that in the near future the Treasury and other agencies will advance suggestions for increasing payroll taxes currently to provide increased social insurance benefits in the future.

Yield

The estimated additional yield of the Act, on a full-year basis, is shown in the following table.

Estimated Increase or Decrease (-)
Over Yield of Present Law 1/
(Millions of dollars)

Income taxes:	
Corporation:	
Normal tax	-493.3
Surtax	763.1
Excess profits tax	1,112.3
Total corporation income taxes	1,382.1
Individual	1,144.6
Total income taxes	2,526.7
Miscellaneous internal revenue:	
Capital stock tax	22.3
Estate tax	141.6
Gift tax	16.0
Total	179.9
Manufacturers and retailers 2/ excise taxes	499.1
Miscellaneous taxes	347.7
Total excise and miscellaneous taxes 2/	846.8
Total miscellaneous internal revenue 2/	1,026.7
GRAND TOTAL 2/	3,553.4

Owing to increased estimates of defense expenditures, the Revenue Act will fall short of the Treasury's original objective of financing two-thirds of expenditures, exclusive of expenditures under the Lease-lend Act, out of taxation. On a full year basis less than 60 per cent will be so financed and in the current fiscal year only about 50 per cent, reflecting the lag in collection of income taxes and the fact that increased excise

1/ Treasury Department, Division of Research and Statistics. All estimates show full year effects. Estimates for corporation and individual income taxes are based on levels of income estimated for calendar year 1941; all other estimates are based on income levels estimated for fiscal year 1942.

2/ Excluding $47.5 million non-recurring floor-stock taxes.

taxes will be in effect only for three-fourths of the fiscal year. Additional collections in fiscal 1942 may yield about $2.0 billion, instead of the full $3.6 billion. The budgetary deficit on the basis of the latest available official estimates will thus be reduced from $12.8 billion to about $11 billion, about twice the deficit for the fiscal year 1941.

Net Federal expenditures have been running since the end of June at a rate of about $900 million a month, as compared with about $300 million a year ago. Further expansion is expected to occur between now and next March, when collections of income taxes on 1941 incomes will begin to be received. Between March and the end of the fiscal year, increased revenues attributable to the new act and to increased business activity will reduce net expenditures to currently prevailing levels, unless the expansion of defense expenditures exceeds present expectations. Net Federal expenditures at their current rate, together with a large volume of private capital expenditure on plant, equipment, and inventories and heavy buying of consumer durable goods, have raised aggregate consumer income and expenditures to levels at which the cost of living has begun to rise. It seems unlikely that the supply of goods available for private purchase can continue to increase at the rate that has characterized the period since May, 1940. Under these circumstances, although prices will rise less than if taxes had not been increased, prices cannot be expected to stop rising or to rise appreciably less rapidly than in recent weeks, unless effectively checked by price ceilings, priorities, rationing, restrictions on consumer credit, and other direct governmental controls.

Excise Taxes

The act makes permanent the excise taxes imposed by the Revenue Act of 1932 and certain excise taxes imposed by the Revenue Act of 1940; it increases the rates of some existing excise taxes; and it imposes new excises on a number of items.

In the writing of the excise tax sections of the act two opposing ideas were at work. One view was that excise taxes should be spread as evenly as possible over the whole range of commodities, so that no product should be unduly handicapped in relation to others in competing for the consumers' dollar. The other was that excise taxes should be restricted to those commodities using resources needed for national defense, in order to curtail their civilian consumption. The excises actually imposed represent a compromise. Increased taxes are imposed on a number of goods that compete with the defense program. The rates on automobiles, trucks, etc., on radio receiving sets, refrigerators and air conditioners, tires and tubes are approximately doubled. New excise taxes are imposed on phonograph records, musical instruments, electric, gas and oil appliances, photographic apparatus, electric signs, business and store machines, rubber products, commercial washing machines, electric light bulbs and optical instruments. But the rates of tax imposed -- not exceeding, in general 10 per cent of the price of the articles -- appear to be inadequate to reduce consumer demand to the curtailed supply that will be available. Unless effectively checked by direct controls, prices can be expected to rise by considerably more than the amount of the increased tax, and the resulting increase of profit margins will increase the reluctance to make the drastic changes in the patterns of production that must be made if the present schedules of defense production are to be met. Moreover, no taxes, or no additional taxes, were imposed on a number of articles using scarce materials, for example firearms, clocks and watches, metal furniture, aluminum ware, jute products, oil cloth, linoleum, and paints and varnishes. And a number of taxes were imposed that will make for curtailment of consumption not called for by the defense program, such as taxes on distilled spirits, wines, amusements, telephone, telegraph, and radio communications, sporting goods, luggage, jewelry, and the transportation of persons.

Corporation Taxes

The act imposes a surtax on corporations; revises the excess profits tax; increases the rates of capital stock tax; and integrates the 10 per cent defense tax imposed by the Revenue Act of 1940 into the regular rate structures.

The new surtax on corporate profits is imposed at the rate of 6 per cent on the first $25,000 of net income and 7 per cent on net income in excess of that amount. It differs in its effect from an equivalent increase in the normal tax because it applies to income from partially tax exempt securities. Commercial banks are more seriously affected by this feature of the new tax than any other corporate group.

No change is made in the general framework of the excess profits tax under which corporations are allowed to calculate the "normal profits" credit from which excess profits are measured with reference either to base period earnings or to invested capital. During the formulation of the act, the Administration objected to the unrestricted use of base period earnings as a measure of normal profits on the ground that it exempts corporations who have earned excessive profits in the past from excess profits tax on 95 per cent of an equivalent amount of current profits.

The rates of excess profits tax are increased by 10 percentage points in each bracket as shown in the following table.

Amount of Excess Profits	Rates (per cent) 1940	1941
First $20,000	25	35
Next 30,000	30	40
" 50,000	35	45
" 150,000	40	50
" 250,000	45	55
Over 500,000	50	60

The rate of return allowed on statutory invested capital is lowered from its present level of 8 per cent to 7 per cent with respect to invested capital in excess of $5 million. The change has limited significance, since it will not affect corporations who already find it more advantageous to elect the base period earnings method of determining normal profits, and will not fully affect corporations who will shift to that method as a result of the current revisions of the law.

The sequence of determining corporation income tax and excess profits tax liability is reversed. Under the existing law corporation normal tax was computed first and was allowed as a deduction both in computing base period earnings and current profits subject to excess profits tax. Under the Revenue Act of 1941 this sequence is reversed. Corporate normal tax and surtax is not allowed as a deduction in excess profits tax computations but excess profits taxes are allowed as a deduction in determining income for normal and surtax purposes. While part of the increased yield of the excess profits tax under the new scheme is offset by corresponding loss in the yield of the corporation income tax, the reversal of deductions results in a substantial increase of the combined tax charge. For corporations electing the invested capital option this reversal produces the same effect on combined income and excess profits tax liability as would be produced if the reversal of deductions had not been made and the "normal profits" deduction had been lowered by about 30 per cent. For corporations selecting the base period earnings method, the equivalent lowering of the deduction for "normal profits" would be only about 15 per cent, since for these corporations the disallowance of income taxes as a deduction produces a higher figure for base period earnings that partly offsets the increase in current earnings attributable to the same factor. The net effect on combined tax liability of reversing the order of deductions could have been approximated, if the present order had been left unchanged, by reducing "normal profits" under the invested capital option from 8 per cent of invested capital to about 5.6 per cent, and under the earnings option from 95 per cent of base period earnings to about 80 per cent. Thus, while this particular change increases the combined income and excess profits tax burden of all corporations, it increases the relative advantage of corporations that have had high base period earnings and are therefore able to elect the earnings option.

For corporations choosing the invested capital method, the Act provides that, with certain restrictions, 125 per cent of equity capital invested since December 31, 1941, shall be counted in determining invested capital. The Act also terminates the exemption from excess profits tax of excess profits derived from the mining of certain strategic metals in the United States.

Individual Income Taxes

The act reduces personal exemptions; increases the rates of surtax; provides for a simplified method of filing income tax returns for persons whose gross income does not exceed $3,000 and is derived wholly from specified sources; it disallows the credit for one dependent in cases where the taxpayer's status as head of family is occasioned solely by the existence of one or more such dependents; and it integrates the 10 per cent defense tax into the structure of surtax rates.

Personal exemptions are reduced from $2,000 to $1,500 for heads of families and from $800 to $750 for single individuals. Normal tax is left unchanged at its present level of 4 per cent in order to avoid increasing the value of the tax exemption privilege attaching to partially tax exempt securities. But rates of surtax are raised; and surtax is imposed on all income in excess of personal exemption and credit for dependents, instead of exempting, as heretofore, the first $4,000 of such income.

Under the Revenue Act of 1940 married persons earning in excess of $2,222, and single persons earning in excess of $889 became taxable at a rate of 4.4 per cent (normal tax plus defense tax) on the first dollar in excess of these sums. Under the current act they will be taxable at a rate of 6 per cent on the first dollar in excess of $1,500 and $750, respectively and taxable at a rate of 10 per cent on the first dollar in excess of $1,667 and $833, respectively.

The following table shows income taxes as a percentage of net income at various income levels under last year's Revenue Act and under the Revenue Act of 1941, and comparable current figures for the United Kingdom and Canada.

Effective Rates of Individual Income Tax
(Married taxpayer, no dependents)

Income	United States Revenue Act 1940	United States Revenue Act 1941	United Kingdom	Canada
	Per cent			
$ 2,000	---	2.1	25.2	0.8
5,000	2.2	7.5	37.1	20.0
10,000	5.3	13.1	45.0	30.8
20,000	11.7	25.1	56.1	41.7
50,000	28.3	40.9	72.9	53.9
100,000	43.5	52.7	84.1	61.9

Note: Owing to differences between the three countries in methods of taxing capital gains and corporate income the percentage figures given are less comparable in the higher income ranges, where income derived from corporate sources forms an important part of total income. Figures roughly adjusted for those differences indicate that for very large incomes the gap between taxes in the United States and the United Kingdom is much smaller than shown by the table.

While the increase in tax burden under the new revenue act is drastic at levels of income up to $100,000, the income taxes paid on such incomes are still low relative to taxes in those major countries where the proportion of military expenditures to the national income is little higher than will soon be reached in the United States. The contrast between our rates and rates in foreign countries is especially marked for incomes of less than $20,000.

Estate and Gift Taxes

The gift and estate tax rates are increased, and as in the case of other taxes, the 10 per cent defense tax imposed by the Revenue Act of

1940 is incorporated in the regular rate structure. Exemptions and deductions for estate and gift tax purposes are left unchanged. Estates of $120,000 or less continue to be able to escape the estate tax entirely provided tax-free gifts are made to the maximum allowed by law and part of the estate is left in the form of tax-free insurance. Estates of considerably larger size continue to be comparatively lightly affected by these taxes. The following table shows effective rates of tax paid by estates of varying sizes under existing tax rates and under the rates of the 1941 act.

Net estate before exemption	Revenue Act 1940	Revenue Act 1941
$ 50,000	.4	1.0
100,000	4.6	9.5
200,000	10.8	19.4
400,000	15.9	25.2
800,000	20.9	29.6
1,000,000	22.9	31.1
10,000,000	53.2	60.6
100,000,000	72.5	75.4

Miscellaneous Provisions

Taxes on Non-resident Aliens and Foreign Corporations

The Act increases the tax on non-resident aliens and foreign corporations, and the rates of withholding tax at source, by means of which these taxes are largely collected. United States income taxes on these taxpayers operate only if special treaties reducing them are not in force. Authorization is extended to conclude such treaties with countries of the Western Hemisphere. Hitherto it was confined to countries contiguous to the United States.

Treatment of Certain Securities for Income Tax Accounting

The Act provides that a taxpayer reporting on a cash basis, who owns non-interest bearing obligations issued at a discount and redeemable for fixed amounts increasing at stated intervals, may report such increments of value as income on an accrual basis. This section is designed to benefit holders of non-interest bearing defense bonds. With respect to short-term obligations issued on a discount basis by the Federal, State, or local governments, the act provides that the issuing discount shall not be accounted on an accrual basis and that such obligations shall not be treated as capital assets. The main effect of these provisions is to simplify income tax accounting.

Non-essential Federal Expenditures

The Act establishes a committee composed of three members each of the Senate Finance Committee, the Senate Committee on Appropriations, the House Ways and Means Committee and the House Committee on Appropriations, and the Secretary of the Treasury and the Director of the Bureau of the Budget, to study the possibility of reducing non-essential Federal expenditures. In line with this provision of the Act the Senate Finance Committee has called upon the Director of the Budget to submit a report showing how non-defense and non-essential budget items may be reduced by alternative totals of (1) $1,000,000,000; (2) $1,500,000,000; (3) $2,000,000,000.