

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 19, 1942

To Chairman Eccles

Subject: Letter on corporation taxes

From Martin Krost

Attached is a draft of the letter you requested on the general corporate tax situation. I should be glad to make another draft if this is not what you want.

MR

August 19, 1942

Mr. Randolph E. Paul
General Counsel
Treasury Department
Washington, D. C.

Dear Randolph:

I am becoming more and more impressed with the thought that corporate taxation may become a menace to productive efficiency when rates are as high as those now under discussion. I have come to feel that the total of normal tax and surtax should not exceed 40 per cent. Moreover, I feel that great care should be taken to avoid disrupting the operations of individual corporations, particularly those playing an important part in the war effort, that will be subject to a disproportionately heavy burden under the excess profits tax.

In the last few years we have shifted our emphasis from the corporate income tax to the excess profits tax. This shift in emphasis, necessary as it has been, has opened up many possibilities for inequities between individual corporations. In particular, inequities are likely to arise between companies with high base period profits or large invested capital, and companies with low base period profits or small invested capital. Many important companies in the war industries fall into this latter group. These companies, with negligible profits before the war, have now vastly expanded their output. They are finding that a very large part of their net income is taxed as excess profits. For them, the effective tax rate almost equals the excess profits rate; taxes will leave them little net income. Under these conditions, producers are not finding sufficient inducement to hold down costs of production and to make the most effective use of essential materials. They are reluctant to accept additional orders essential to our war effort. They have no strong motive for opposing inflationary increases in wages and other costs which will accentuate our inflationary problem.

With these cases in mind, I believe it would be desirable to place an over-all limit of 75 per cent on the percentage relationship of

taxes to net income. Such a ceiling rate might be a more effective way of dealing with cases of extreme hardship than introducing more and more numerous and complex special relief provisions, which not only complicate the law but are likely to open new loopholes for tax avoidance at the same time that they correct old inequities. Corporations compelled to meet heavy debt repayments may require such special treatment, although even for these the more basic answer would seem to be providing adequate machinery for refunding and the adjustment of amortization schedules.

As you know, many corporations are also seriously concerned about anticipated losses in the post-war period, and an expected lack of funds to meet such losses and to cover costs of reconversion to a peace-time basis. I think we must recognize that this is not a matter that can be appropriately dealt with by adjusting current tax policy; here our major attack must be in the direction of a vigorous and intelligent post-war economic policy, aimed at preventing a disastrous inflation immediately after the war and an equally disastrous deflation a little later. Such a policy must include provision for liquidating war business in an orderly manner and accelerating conversion to peace-time production. We could greatly ease the present fears of business men, however, by giving assurance that adequate tax relief for future losses will be available. Corporations now wholly occupied with war production are afraid that they will not be able to offset the considerable losses which they may suffer in the post-war period against taxable profits, because profits may be low for a series of years. Would it not be feasible to allow losses during the first two years after the war to be offset against profits made during the war? I believe this could be done without reducing the Treasury's current revenue and without reducing its future revenue should these anticipated losses fail to materialize.

If we could provide for a 75 per cent over-all ceiling on taxes and for a "carry-back" of post-war losses, I believe that business would begin to lay greater stress on efficiency in its contribution to the war effort, even if the excess-profits rate stood at 90 per cent, with a 10 per cent refund, or at 100 per cent, with a 20 per cent refund.

Sincerely yours,

H. S. Reeles, Chairman



GENERAL COUNSEL
TREASURY DEPARTMENT
WASHINGTON

SEP 19 1942

Dear Marriner:

I wish to thank you for your letter of August 19, 1942, referring to the subject of corporate taxation, and suggesting modifications which you consider desirable.

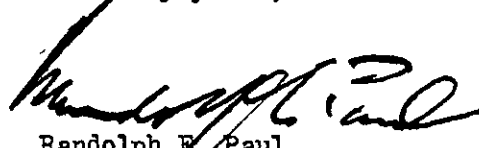
As you know, the Senate Finance Committee has already acted favorably on our proposal for an overall ceiling on taxes at 80 percent. I should like to point out, however, that this ceiling will not apply to the great majority of corporations subject to excess profits tax and that for such corporations it will accordingly have no bearing upon efficiency of operations.

The Senate Committee has also accepted our proposal for a 2-year carryback of losses which should provide substantial relief for corporations suffering severe setbacks during the first two years after the war.

As to your suggestion that the combined normal and surtax should not exceed 40 percent, I am inclined to believe that a higher rate can be safely imposed. However, the Finance Committee has tentatively adopted a rate of 40 percent.

Thank you again for your letter.

Sincerely yours,



Randolph E. Paul,
General Counsel.

Honorable Marriner S. Eccles,
Chairman, Board of Governors of
the Federal Reserve System,
Washington, D. C.

FOR DEFENSE

