Copy for Mr. Eccles

AIR MAIL
SPECIAL DELIVERY

April 22, 1942

Dr. Simeon E. Leland
Department of Economics
University of Chicago
Chicago, Illinois

Dear Sim:

If I understood you correctly yesterday, Mr. Eccles discussed with you over the telephone the joint memorandum to the President. Apparently Mr. Eccles raised a question as to whether the proposed tightening of the excess profits tax by lowering the capital ratio credit might not be a step in the wrong direction. You wanted us to answer immediately by wire. I felt, however, that this is such a complicated subject that it would be better to write a letter. Accordingly, I wired Mr. Eccles last night that we would answer his question by air mail.

In order to answer Mr. Eccles' question, it is first of all necessary to determine what changes in the taxation of corporate profits would be a step in the right direction. Only then it is possible to determine whether the specific proposal moves in the right or wrong direction. The group who drafted the joint memorandum apparently was of the opinion that a basic modification in the determination of excess profits would be desirable, but that such a fundamental change is not feasible at the present time. If I interpret the statement in the joint memorandum rightly, it implies a criticism of the present method of determining excess profits. The present method relies predominantly on the base income method. Under this method, tax liability is made dependent partly on what a corporation happened to earn in a base period. Corporations which happened to have relatively high profits in the base period are favored, and corporations which happened to have low profits are penalized. The invested capital method for determining excess profits is fundamentally a <u>relief</u> provision in favor of the taxpayer under the present and the proposed statute. The weakness of this method of determining excess profits made it necessary to increase the normal income and surtaxes on corporations in order to raise the amount of money allocated to corporate taxes.

I am under the impression that the group would have favored an arrangement by which some compulsory use would have been made of the invested capital method in order to catch corporations which had high profits in the base period; that it would have preferred to graduate the tax not in accordance with the absolute amount of profits but in accordance with the relationship between excess profits and normal profits; and that it would have favored a somewhat lower income tax and surtax on normal profits than that proposed by the Treasury.

If this interpretation of what would have been desirable is correct, then it apparently follows that the proposed modification is not a step in the right direction. By lowering the invested capital credit, more corporations will be brought under the average income method which seems to be the opposite of what is held desirable. This is apparently the point that Mr. Eccles has in mind.

After thinking it over, I personally believe that the specific proposal of lowering the invested capital credit may not be a step in the right direction but it is not a step in the wrong direction either. It would be an improvement within the framework of the present law. The use of the capital ratio method at the option of the taxpayer does not accomplish and does not even approximate the objectives of those who favor the basic use of the capital ratio method. Under present law, the capital ratio method is mainly used by corporations with high capitalization (and often excessive capitalization) which make substantial earnings but whose earnings are still low relative to their invested capital. Thus, in 1940 United States Steel did not pay any excess profits tax and will pay relatively little under present legislation. The railroads increased their profits substantially because of war business, but are practically exempt through use of the capital ratio option.

A statistical analysis of the 1940 excess profits returns, which showed no excess profits tax liability, permits the conclusion that it was mainly the larger corporations which claimed tax exemption on the basis of the capital ratio method. These statistics are not entirely conclusive because the breakdown of size is made according to excess profits "deficit classes" and not according to the size of the corporation. I am enclosing the figures for your personal information.

Lowering of the invested capital credit would narrow this relief provision and would bring under the law corporations with high capitalization which have increased their earnings above the base period. This measure will certainly not move in the direction of a shift from the taxation of war profits to the taxation of excessive profits. In this sense, it is not a step in the "right" direction. If we are compelled, however, to use the present framework of taxing profits (whether we like it or not) we must see to it that this method is used as equitably and effectively as possible. The specific proposal which Mr. Eccles discussed with you is only an attempt to restrict possible misuse of a relief provision in the present law. As such, it would be an improvement of the present law and the present Treasury proposals.

There is no doubt that this narrowing of the capital ratio credit may create hardship in particular cases. Two measures to minimize such hardship are contemplated. First, it is proposed to start the capital ratio credit at 6 percent for the smallest corporations and gradually reduce it to 4 percent for the largest corporations. Second, it is planned to establish a Board of Referees for examination of hardship cases. (The Treasury has already proposed such a board to deal with extraordinary conditions in the base period.)

We have been informally advised by the Treasury that further modifications are under consideration. If the top rate of 100 percent proposed in the joint memorandum should be adopted, an attempt will be made to graduate the tax according to the rate of excess profits rather than the absolute amount. In this case, two rate structures must be enacted: one for the base income method, one for invested capital method. Randolph Paul would like to make the rate structure under the capital ratio method more attractive than under the income method. This favoring of the capital ratio method would be a step in the right direction. It is very doubtful, however, whether he will be more successful with this than with his earlier attempt to lower the percentage of average base period earnings applicable in computing the excess profits credit, -- which was proposed for the same purpose.

The above technical details could not be set forth in the brief memorandum to the President. They were contemplated when it was decided to recommend a "tightening of the excess profits tax" proposals.

I saw in the morning papers that the Chicago Sun ran a story saying that the President is determined to eliminate entirely the average earnings method. This comes as a great surprise to everybody here and we still doubt it. Unfortunately, it looks now as if the voluntary savings method will be given a trial. The bad thing about this is that if the result is not satisfactory at first, the plan presumably will not be given up right away; rather it is likely that an attempt will be made to make it work by using more coercion. We heard in the Treasury that practically all the Secretary's advisors, except those directly responsible for the voluntary savings campaign, favor the "universal" savings program and expressed this preference to the Secretary.

With best wishes,

Cordially yours,

~~J.~~ Weldon ~~Jones~~

J. Weldon Jones
Assistant Director in Charge
of the Fiscal Division

Enclosure

cc Mr. Eccles via air mail
special delivery

NONTAXABLE EXCESS PROFITS TAX RETURNS, FORM 1121, WITH NORMAL-TAX NET INCOME OF $100,000 OR OVER AND/OR EXCESS PROFITS CREDIT OF $250,000 OR OVER RECEIVED IN THE BUREAU THROUGH DECEMBER 2, 1941

Number of returns by selected types and options and by adjusted excess profits deficit classes

(Adjusted excess profits deficit classes and money figures in thousands of dollars)

Adjusted excess profits deficit classes	Method of credit computation			
	Invested capital	Income		
		Total	General average	Increased earnings
Under 5	58	207	98	109
5 under 20	140	407	212	195
20 under 50	233	389	187	202
50 under 100	288	276	126	150
100 under 250	488	269	127	142
250 under 500	426	119	67	52
500 and over	522	90	43	47
Total	2,155	1,757	860	897

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