July 25, 1940

A THREE-POINT TAX PROGRAM

I. An Excess Profits Tax

The reasons for the proposal

A rather steep excess profits tax is indispensable in implementing the President's pledge that our defense program will not create a new group of millionaires. At a time when industry is being granted generous amortization allowances and other special inducements in order to provide strong profit incentives for expansion of armament output, and when military conscription of manpower at $21 a month is being proposed, taxation of this type is essential to strengthen the sense of unity required for effective mobilization of the national effort and to prevent the growth of a cynical attitude among the broad masses of the people. The French experience strongly emphasizes the need, in a democracy, for sustaining and strengthening popular morale if free institutions are to be vigorously defended.

Imposition of an excess profits tax is in accordance with established precedent as a method of armament finance. We adopted a steep excess profits tax in the last war, and such taxation is now in effect in Great Britain and Canada.

This type of taxation is, moreover, peculiarly appropriate to our present economic situation. An intensive defense effort is bound to produce a most uneven expansion of corporate profits, with large increases in the specific lines benefitted by Government orders; an excess profits tax will weigh chiefly on these abnormal profits and on other abnormal profits due to monopoly situations, rather than upon normal business earnings. Since the revenues derived from the tax will be drawn in considerable part from idle accumulations of profits, their withdrawal in taxes will have a comparatively small repressive effect upon the flow of income and expenditure, and upon the general expansion of output and employment.

The proposal

1. Taxpayers subject to the tax: Corporations with net income (after ordinary corporation income tax) of $3,000.

2. The definition of standard earnings: Average earnings in two of the three years 1936, 1937, and 1938 selected by the taxpayer, adjusted to reflect new capital investment after the base period. If profits are less than 5 per cent of invested capital in the base period, standard earnings are defined as 5 per cent of invested capital in the taxable year. If profits are greater than 10 per cent of invested capital in the base period, standard earnings are defined as 10 per cent of invested capital in the taxable year.

3. The definition of invested capital: Net worth, inclusive of minority interest, with assets valued at cost less depreciation as determined for purposes of the ordinary corporation income tax.

4. The definition of excess profits: Net income (as computed for purposes of ordinary corporation income tax) minus (a) $3,000, (b) standard earnings, (c) corporation income tax.

5. <u>The tax rates on excess profits</u>: On that part of <u>excess</u> profits equal to not more than 10 per cent of invested capital a tax rate of 30 per cent. On excess profits of more than this amount, a tax rate of 60 per cent.

6. <u>Examples of excess profits tax computation</u>:

	Company A	Company B	Company C
Invested capital	1,000,000	1,000,000	1,000,000
Average earnings in 1936 and 1937	75,000	1,000	200,000
5 per cent of invested capital	---	50,000	---
10 per cent of invested capital	---	---	100,000
Standard earnings	75,000	50,000	100,000
Earnings in taxable year	250,000	250,000	250,000
Corporation income tax	52,500	52,500	52,500
Specific exemption	3,000	3,000	3,000
Excess profits	119,500	144,500	94,500
Taxable at 30 per cent	100,000	100,000	94,500
Taxable at 60 per cent	19,500	44,500	---
Tax at 30 per cent	30,000	30,000	28,350
Tax at 60 per cent	11,700	26,700	---
Total tax	41,700	56,700	28,350

7. <u>Revenue yield</u>:

On profits made in the year 1939	$600 million
On profits made in a year of $80 billion national income	700 million
On profits made in a year of $90 billion national income	800 million
On profits made in a year of $100 billion national income	1,000 million

II. Abolition of Husbands' and Wives' Privilege of Filing Separate Returns

Husband and wife living together have an option, as the law now stands, of filing separate returns or a single joint return including their aggregate income.

This permission to husband and wife to file separate returns results in unfair discrimination between persons whose income is derived principally from property and persons whose income is derived principally from personal services. Property owners frequently convey part of their property to their spouses, thus reducing income tax, whereas individuals deriving income from personal services are not able to secure a corresponding reduction in income tax, since an assignment of income from personal services is not recognized for income tax purposes. On the other hand, in the community property states income even from services is divided equally between husband and wife, which gives the citizens of these states a special substantial advantage over the income of citizens from the other 40 states. This situation may become aggravated by the fact that there is a tendency in some states to establish an optional community property system. It is understood that Oklahoma has recently passed such a statute.

Under existing law a married person earning a net income of $100,000 pays income taxes of $43,476. A man receiving a $100,000 income from property may succeed, by transferring assets to his wife, in giving her a taxable income of $50,000 and reducing his own to $50,000. Under these circumstances the couple pays taxes of only $28,256, saving $15,220, or 35 per cent of the tax liability on the $100,000 taxes as a single income. For an income of $60,000 the potential saving attributable to the separate filing privilege amounts to $8,000, or 42 per cent of the tax liability on the single income.

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, 3,583 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.

This proposal might be somewhat qualified to permit wives to file separate returns for bona fide earned income.

There are legal obstacles to this proposal, which are especially formidable with respect to income of taxpayers in community property states. But even if a joint return of income for such taxpayers cannot be obtained, the proposal remains justified on grounds of equity and will raise substantially the same revenue as if universally applied.

Revenue yield:

On incomes of the year 1939	$200 million
On incomes of a year of $80 billion national income	300 million
On incomes of a year of $90 billion national income	450 million
On incomes of a year of $100 billion national income	600 million

III. Elimination of Tax Exemption on Government Securities

At the present time bonds of the Federal Government are exempt from normal tax; Treasury bills and notes and obligations of states and local governmental units are wholly tax-exempt.

Interest upon all bonds, state and Federal, issued after the date of introduction into Congress of a new act should be taxed directly and completely. This would of course mean that Congress would have to refrain from authorizing any issue of tax-exempt bonds by the Federal Government or affiliated organizations, such as the Federal Farm Loan banks. Interest on future issues of state bonds should be taxed directly and completely.

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 or under the unemployment compensation tax.

The revenue yield of this proposal will be negligible for some years to come. Its importance as a revenue-producer will increase with the increasing magnitude of Federal borrowing under the defense program.