Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 13, 1940

To Chairman Eccles

Subject:

From Emile Despres

In accordance with your request, there is attached a memorandum by Mr. Krost comparing the excess profits tax of the Ways and Means Subcommittee with that proposed by the Treasury.

Attachment

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Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 13, 1940

To Mr. Despres

Subject: Excess-Profits Tax Proposed By Ways and Means Subcommittee

From Martin Krost

MK

On August 8, the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee submitted an excess-profits tax proposal to the full committee. The proposal may be outlined as follows:

1. The tax is made applicable to corporate earnings of 1940 and subsequent years.

2. The base period for determining standard earnings is fixed as the years 1936 to 1939, inclusive.

3. Optional methods of determining standard earnings, or, in the language of the proposal itself, the excess-profits credit, are provided. The first is simply average earnings during the base period, with no "ceiling" provision. Under this method, average earnings are increased by 8 per cent of capital invested after the base period.

   The second method provides a floor of 6 per cent of the first $500,000 of invested capital plus 4 per cent on the remainder. It provides, more generally, that the excess-profits credit shall be an amount equal to the percentage of invested capital for the taxable year which a corporation's earnings during the base period have been to its invested capital during the base period, this percentage not to exceed 10 per cent; but there is no clearly apparent reason why any corporation should use this method, except to take advantage of the floor provision.

4. Invested capital is defined as the sum of equity capital plus varying percentages of borrowed capital, depending upon the amount of equity capital. Corporations with equity capital of less than $100,000 are allowed to include 100 per cent of borrowed capital up to the difference between the equity capital and $100,000; corporations with equity capital of $1,000,000 or more are allowed to include 33 1/3 of borrowed capital.

5. Net income subject to excess-profits tax is defined as net income subject to normal income tax, disregarding long-term capital gains and losses, minus normal income

tax. In addition to these adjustments, in cases where the percentage on invested capital method of computing the excess-profits credit is used, dividends received are excluded from net income (since holdings of stock are excluded from invested capital) and the interest deduction from net income is reduced by the percentage of borrowed capital included in invested capital. A specific exemption of $5,000 is provided.

6. Excess-profits net income is divided into brackets for the application of tax rates by reference to the excess-profits credit (standard earnings or the amount equal to a standard percentage of earnings). For example, an amount of excess-profits net income equal to 10 per cent of the excess-profits credit is taxed at the lowest rate, 25 per cent. The next bracket of excess-profits net income, also equal to 10 per cent of the excess-profits credit, is taxed at 30 per cent. The remainder is taxed at 40 per cent.

The Subcommittee proposal differs from the Treasury proposal in three important respects.

1. It lacks any "ceiling" provision and thus permits companies with exceptionally high earnings during the base period to go substantially untaxed.

2. It imposes rates of 25, 30 and 40 per cent, as compared with the Treasury rates of 25, 40 and 50 per cent; moreover it defines brackets in such a way as to favor companies with high earnings during the base period. (The Treasury proposal defined brackets in terms of percentages of invested capital.)

3. It exempts long-term capital gains from tax, while the Treasury proposed that such gains should be taxed at the highest rate applicable to excess profits excluding capital gains. The Subcommittee proposal does not permit the deduction of long-term capital losses from income, while the Treasury proposed that such losses should be recognized in full.

In general, the Subcommittee proposes a tax only on <u>increased</u> profits; the Treasury proposed a tax on <u>high</u>, as well as increased profits.