

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 10, 1940

To Chairman Eccles

Subject: _____

From Emile Despres

Attached is a memorandum summarizing the Second Revenue Act of 1940, which was prepared by Mr. Krost in accordance with your request.

Attachment

ED

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 9, 1940

To Mr. Despres

Subject: The Second Revenue

From Martin Krost

Act of 1940

After an exceptionally complex legislative history, The Second Revenue Act of 1940 was passed by both houses of Congress and sent to the President on October 1. The Act provides for an excess profits tax, raises the normal corporation income tax, permits accelerated amortization of expenditure for national defense facilities, suspends the limitations of the Vinson-Trammel Act on profits from military airplane and naval construction, makes technical amendments to the Internal Revenue Code and sets up a system of life insurance for National Guardsmen and those called into active service under the Selective Service Act.

It is difficult to summarize revenue legislation without omitting many details of little general interest; this is especially true of the measure under review. The following account is intended only as a general description, not as a detailed guide to the statute.

THE EXCESS PROFITS TAX

The base of the tax

The tax is applicable to corporate income for 1940 and subsequent taxable years. Excess profits are defined as the difference between:

(A) Net income for normal income tax purposes, minus normal income tax, long-term capital gains and losses, dividends received, and a series of minor adjustments; and

(B) The sum of a specific exemption of \$5,000, an excess profits credit computed as described below, and, for corporations with net income of \$25,000 or less, a one-year excess profits credit carry over.

It will simplify exposition to substitute the more familiar term "normal earnings" for the statutory term "excess profits credit". Normal earnings may be computed under either of two methods. Under the "income method", normal earnings are defined as 95 per cent of average net income during the base period 1936-1939 inclusive, plus 8 per cent of additions to capital, or minus 6 per cent of reductions in capital. Base period net income is computed with the same adjustments as those which are applied to net income in the taxable year; losses during the base-period year of heaviest loss are counted as zero. No limitations are placed on the amount of base period net income that may be counted as normal earnings for tax purposes.

Under the "invested capital" method, normal earnings are defined as 8 per cent of current invested capital. Invested capital is defined as the sum of equity capital plus 50 per cent of borrowed capital, reduced by a percentage amount equal to the percentage of inadmissible assets to total assets. Since intercorporate dividends are excluded in the computation of income for tax purposes, holdings of corporation stocks are treated as inadmissible assets in computing invested capital. Taxpayers may treat wholly or partially tax-exempt securities as admissible assets only if they elect to include income from such securities in net income for excess profits tax purposes. Only 50 per cent of interest paid may be deducted from gross income in computing income subject to tax if the "invested capital" method of computing normal earnings is elected.

Cases accorded special treatment and exemptions

Personal service corporations, corporations with contracts under the Merchant Marine Act, and corporations engaged in mining strategic minerals are accorded special treatment. Mutual investment companies, domestic corporations with substantially all income derived from foreign operations, corporations receiving air-mail subsidies, and some minor classes of corporations are exempt from the tax. Consolidated returns are permitted under regulations to be prescribed by the Commissioner of Internal Revenue. The Commissioner is also given very broad powers to adjust "abnormalities in income and capital".

Statutory rates and effective rates

The tax rates fixed on excess profits as defined by the statute are as follows:

	<u>Amount of</u> <u>Excess Profits</u>	<u>Per Cent</u>
First	\$20,000	25
Next	30,000	30
Next	50,000	35
Next	150,000	40
Next	250,000	45
Over	500,000	50

Caution is required in assessing the significance of these rates as measures of the severity of the tax. The following table shows total excess profits taxes payable on excess profits of varying amounts:

(Amounts in dollars)

Statutory Excess Profits	Excess Profits Tax	Tax as Per Cent of Excess Profits
20,000	5,000	25.0
50,000	14,000	28.0
100,000	31,500	31.5
250,000	91,500	36.6
500,000	204,000	40.8
1,000,000	454,000	45.4
10,000,000	4,954,000	49.5

Still more significant is the rate expressed in terms of the total profits of which excess profits form a part. The first of the following tables shows excess profits taxes payable by corporations which have increased their earnings from 10 per cent on equity capital in the base period to 15 per cent in the current period. Borrowed capital is assumed to equal half of invested capital in all cases; equity capital is assumed to have remained unchanged.

(Amounts in dollars)

Statutory Net Income	Statutory Excess Profits	Excess Profits Tax	Effective Rate of Excess Profits Tax
10,000	0	0	0
50,000	0	0	0
100,000	4,333	1,083	1.1
1,000,000	88,333	27,400	2.7
10,000,000	928,333	418,166	4.2

The second shows similar figures for corporations which have increased their earnings from 10 per cent on equity capital in the base period to 20 per cent in the current period. The assumptions as to borrowed capital and equity capital are the same as in the preceding table:

(Amounts in dollars)

Statutory Net Income	Statutory Excess Profits	Excess Profits Tax	Effective Rate of Excess Profits Tax
10,000	0	0	0
50,000	8,000	2,000	4.0
100,000	21,000	5,300	5.3
1,000,000	255,000	93,750	9.4
10,000,000	2,595,000	1,251,500	12.5

It is evident from these figures that a corporation must be relatively large and that its profit experience must be rather favorable, both in terms of percentage return on capital and percentage increase from the base period, in order to make it subject to severe excess profits taxation under the present statute. It is also evident that the rates of tax in the statute are not reliable measures of the effective rate of the tax to be paid by the vast majority of American corporations. Less than 2 per cent of the active corporations filing returns in 1937 had net income of \$100,000 and over; not all of these will have excess profits taxable under the statute and many of them will pay relatively small amounts.

Increase in normal corporation tax

The Excess Profits Tax Act forms Title II of the Second Revenue Act of 1940. Title I increases the normal corporation income tax rate for corporations with net income of more than \$25,000 by amounts ranging up to 3.1 per cent for corporations with net income of over \$38,600. Taking into consideration the national defense tax imposed by the (First) Revenue Act of 1940, the normal rate for corporations of over \$38,600 has now been raised to 24 per cent.

Yield

The following are official Treasury estimates of the revenue yield to be expected from the Second Revenue Act of 1940.

(In millions of dollars)

Gross yield	1940 levels <u>a/</u>	Assuming Arbitrary Income Increase				
		10 %	15 %	20 %	25 %	30 %
Excess profits tax	185-294	400	505	610	725	850
Increase in normal tax	<u>220-230</u>	<u>240</u>	<u>250</u>	<u>260</u>	<u>270</u>	<u>280</u>
Total	405-525	640	755	870	995	1,130
Net yield <u>b/</u> :						
Excess profits tax	155-245	330	410	490	580	675
Increase in normal tax	<u>185-190</u>	<u>195</u>	<u>205</u>	<u>210</u>	<u>220</u>	<u>225</u>
Total	340-435	525	615	700	800	900

In recent years, taxable corporate profits have increased at roughly twice the percentage rate of increase in the national income, except in years of drastic change in commodity and security prices and other factors that have a more immediate impact on profits than on the national income as a whole. If the national income increases by 10 per cent in 1941 -- at the moment such an increase does not seem improbable -- and this relationship holds, the Treasury table indicates that the net yield of the Act on the incomes of that year would be \$700,000,000. Most of this sum would be collected in the calendar year 1942. Internal evidence drawn from the Treasury table suggests that the upper limit of the range estimates given for 1940 represents a more reasonable estimate than the lower. The 30 per cent increase in corporate net income, which is the largest "arbitrary" increase in income shown in the Treasury table, would provide a level of corporate income somewhat below that of the late Twenties.

ACCELERATED AMORTIZATION PROVISIONS

The bill provides that any expenditure certified as an "emergency facility" by the Advisory Commission to the Council of National Defense and either the Secretary of War or the Secretary of the Navy may be charged off for income ~~and~~ excess-profits tax purposes over a period of five years. If, before the expiration of the five-year period, the President proclaims that the utilization of emergency facilities is no longer required in the interest of national defense, the cost of the facility may be charged off over the shorter period ending with the approximate date of the Presidential proclamation. Plant construction completed and assets acquired before June 10, 1940, are not eligible for accelerated amortization. If the

a/ Probable range of revenue yields.

b/ Allows for decrease in income tax collections resulting from decrease in dividend payments by corporations because of added tax payments.

Government contracts to pay for all or part of the cost of the facility (either by direct installment payments or by paying a price for products fixed on a cost basis including an abnormally high depreciation allowance), the taxpayer may claim accelerated depreciation for tax purposes unless the Advisory Commission to the Council of National Defense and the Secretary of War (or Navy) fail to certify that the contract "adequately protects the United States with reference to the future use and disposition of such emergency facility".