

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 3, 1941

To Chairman Eccles

Subject: Tax Developments

From Martin Krost

MK

We are reliably informed through confidential sources that the House Ways and Means Committee will have before it at its executive session this morning two alternative proposals on the excess profits tax. These are in addition to the Treasury proposal which Assistant Secretary Sullivan will discuss before the Committee this morning.

The two alternative proposals prepared by the Committee's staff are as follows:

A. 1. Reduce the rate of return allowed on invested capital from 8 to 7 per cent with respect to that part of invested capital over \$5 million. The rate would be left at 8 per cent on the first \$5 million of invested capital.

2. Apply excess profits tax to net income before the deduction of normal tax and allow excess profits taxes paid as a deduction from normal tax net income. This represents a reversal of the present system in which normal taxes are deducted from income before excess profits tax is computed.

3. Add 10 per cent to each of the bracket rates in the rate structure under the existing law. Thus the 25 per cent rate applicable to excess profits of less than \$20,000 would be increased to 35 per cent and the maximum 50 per cent rate on excess profits in excess of \$500,000 would be increased to 60 per cent.

B. 1. The rate of return allowed on invested capital would be reduced from the existing 8 per cent to 7 per cent on the first \$5 million of invested capital and to 6 per cent on the amount in excess of \$5 million.

2. The bracket rates in the schedule under existing law would be increased by 15 per cent; thus the 25 per cent rate on excess profits of less than \$20,000 would be increased to 40 per cent, and the maximum 50 per cent rate would be increased to 65 per cent.

It should be noted that neither of these proposals contemplates any substantial limitation upon the use of the average earnings method although the proposal to reverse the order of deduction with respect to normal tax and excess profits tax would do something in this direction. Under the existing system a company earning a high rate of return with exactly the same net income after normal tax in the current year as in the base period would pay no excess profits tax. Under the proposed change it would pay excess profits tax on the difference between the relatively low normal tax it paid in the base period and the much higher normal tax it will pay under the 1941 rates.