

BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date July 1, 1941

To Chairman Eccles

Subject: Tax Developments

From Emile Despres and Martin Krost

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The Ways and Means Committee has now made the following decisions relating to the new tax bill:

1. Corporate taxes. The Committee has adopted the Treasury's proposal for a surtax of 5 per cent on the first \$25,000 of corporate net income and 6 per cent on the excess. With respect to the excess profits tax, the Committee has proposed increasing the rates of the present rate schedule by ten percentage points in each bracket, lowering the rate of return allowed on invested capital in excess of \$5,000,000 from 8 to 7 per cent, and disallowing corporation normal and surtax as a deduction in computing excess profits tax. Under the last mentioned proposal, excess profits tax would be allowed as a deduction in computing normal tax; thus about half a billion dollars which would otherwise be collected in corporate income taxes will be collected as excess profits taxes. In addition the Committee has adopted the Treasury's proposal to levy a 10 per cent tax on that part of the increase in income over the base period level that is exempt from regular excess profits tax. The Committee proposes to exempt an amount equal to 8 per cent on the first \$5 million of invested capital and 7 per cent on the remainder; while the Treasury proposed to exempt an amount of only 4 per cent. Therefore under the Committee proposals a larger amount of profits will be taxed at the special rate than under the Treasury proposal. Except for the increase in tax rates, these changes will bear most heavily on corporations compelled to use the invested capital option. As long as the average earnings option is left in substantially its present form, similar results will be produced by any change designed to obtain additional revenue from the excess profits tax.

The excess profits tax revisions, while in appearance they greatly broaden the excess profits tax base and increase its yield by over a billion dollars, in reality increase the yield only about \$600,000,000. Corporations with low or moderate base period earnings, which are providing most of the present excess profits tax revenue, will pay most of the increased tax and those with a high average earnings base enjoy an even more favored position.

2. Individual income taxes. The Committee has adopted a rate schedule that results in somewhat more moderate taxes on incomes up to \$20,000 than any of the three proposals originally before the Committee. With respect to higher incomes, the Committee proposals involve taxes slightly higher than the Treasury proposed but not as high as those originally proposed by Mr. Stam. The smaller yield of the Committee's individual income tax rates is partly offset by revenue from the proposal to abolish the option of filing separate returns.

3. Estate and gift taxes. The Committee adopted none of the proposals placed before it for lowering or abolishing exemptions under the estate and gift taxes. A moderate schedule of rates increases has been adopted that will raise less than a third of the revenue the Treasury proposed to obtain from this source.

4. Excise taxes. The Ways and Means Committee has tentatively adopted a seven per cent tax on new cars and other excise taxes originally suggested by the Treasury, with the exceptions of increases in the taxes on beer, tobacco, gasoline, soft drinks and checks. Among the items adopted are increases on whiskey, admissions to places of amusement, tires and tubes, telephone and telegraph charges, furs, jewelry, cameras, clocks, radios, refrigerators, etc. Some of these goods and services are scarce and others are abundant. The Committee has also tentatively adopted a use tax of \$5 a year on automobiles. Other excise taxes sufficient to provide \$200,000,000 in revenue are still under consideration.

5. Yield. The following figures are to be taken as indications of the yield of the tax bill that will probably be reported late this week or early next week by the House Ways and Means Committee. This bill is likely to undergo important modifications before it becomes law. The yields are based on the calendar 1941 income level:

(Millions of dollars)

	Treasury proposals	Committee proposals
<u>Corporation taxes:</u>		
Excess profits taxes	530	1,118
Corporate income taxes		
Increased rates	780	651
Prior deduction of excess profits taxes	---	- 514
Total corporation taxes	1,310	1,255
<u>Individual income taxes:</u>		
Increased rates	1,521	1,056
Compulsory joint returns	---	305
Loss due to increased corporate taxes <u>1/</u>	- 213	- 135
Total individual income taxes	1,308	1,226
Estate and gift taxes	347	114
Excise taxes	1,249	<u>2/</u> 905
Total additional yield	4,214	3,500

1/ The differences between the two figures shown are apparently attributable primarily to differences in estimating methods.

2/ This figure is simply the difference between the Committee's announced revenue aim of \$3.5 billion and the total of the yield of the income, estate, and gift tax changes already agreed upon.

Conclusion

The Ways and Means Committee in the formulation of its tax program has shown a decided reluctance to draw on certain obvious and important sources of tax revenue, namely (1) the high profits of those corporations which have enjoyed high profits in the past, (2) the incomes of individuals in the middle-income groups, and (3) estates and gifts. As a result, the amount of revenue which would be forthcoming under the Committee's proposals is wholly inadequate to check the monetary stimulus of huge defense outlays. There is, moreover, no indication of a willingness to develop and enforce direct rationing methods as a means of restricting expenditure for civilian goods which are in scarce supply. Thus, while everyone is opposed in principle to inflation, there seems little likelihood for the present that adjustment between consumer disbursements and the available supplies of consumer goods will be brought about without price increases.

This situation is not yet immediately critical. During the initial phase of our defense program expansion of the output of civilian goods went hand in hand with enlargement of defense outlays. In the second phase, upon which we are now entering, defense requirements are beginning to necessitate curtailment in the supplies of some types of consumer goods. In the third phase, which is perhaps six or nine months away, curtailment of supplies will have extended to a wider range of civilian goods, and even among those goods the production of which can expand further, the rate of expansion will not, in general, keep pace with the expansion of incomes.

Some rise in prices is, in any event, a normal accompaniment of a transition from partial to full economic activity, and one would expect the abnormalities and distortions inherent in a rapidly expanding defense program to be partly reflected in price relationships. Nevertheless, unless we are prepared to use taxation and rationing to restrict the expenditures of those groups whose consumption can be curtailed without adverse social consequences, we are likely before long to enter a dangerous economic area.