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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Chairman Eccles

From Martin Krost

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Subject: The Treatment of Earned Income under the Proposal for Mandatory Joint Returns

The earned income credit is in general equal to ten per cent of earned net income (wages, salaries, etc.).1/ For a single taxpayer it is limited to a maximum of $1,400 by the rule that not more than $14,000 may be counted as earned income. Net incomes up to $3,000 are considered to consist wholly of earned income, even if none of the income is actually earned; and $3,000 of any income, however large, is counted as earned income, even if none of the income is actually earned.

For husbands and wives filing separate returns, these rules apply as if each was a single taxpayer. Thus while a husband earning more than $14,000 may take no more than the maximum $1,400 earned income credit, his wife may take an additional $300 earned income credit on her separate return if she has property income of $3,000 or more. If she has actual earnings from wages, salaries, or business profits she may take an earned income credit of ten per cent of the amount so earned up to the $1,400 maximum. It is thus possible for a husband and wife both of whom are earning high salaries to have a combined earned income credit of $2,800.

Until this year the same rules applied to husbands and wives filing joint returns. But at the beginning of 1941, as a result of Supreme Court decisions tending to treat a husband and wife filing a joint return as a single taxpayer for the purpose of computing taxable capital gains, the Treasury decided that husbands and wives filing joint returns should also be treated as a single taxpayer for the purpose of computing the earned income credit. This meant that when the earned income of a husband exceeded $14,000, no additional credit would be allowed for the wife's income, even if that income was actually earned. This change in procedure was of practical significance in the comparatively few cases where filing of joint returns would have been desirable in order to offset capital losses of one spouse against the gains of the other.

1/ More precisely, the earned income credit is equal to ten per cent of net income or earned net income, whichever is smaller. Net income is the net income as defined for purposes of income tax, that is to say total income minus deductions (such as contributions paid, interest paid, taxes paid, etc.). "Earned net income" means wages, salaries, professional fees, and other compensation for personal services minus the ordinary and necessary expenses chargeable against earned income. Where a taxpayer is engaged in a trade or business in which his personal services are an income-producing factor, a reasonable allowance for his personal services, not in excess of 20 per cent of his share of net profits, is considered as earned income.

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The treatment of the earned income credit under the Ways and Means Committee's proposal for mandatory joint returns in the pending tax bill gave taxpayers no reason for complaint. It simply returned to the pre-1941 rule of considering a husband and wife filing a joint return as separate taxpayers for purposes of the earned income credit and thus gave relief to the comparatively small group who had been adversely affected by the recent ruling.1/

Another aspect of the proposal for mandatory joint returns was responsible for the criticism of it made by the President and by the Treasury. The taxation of the incomes of husband and wife as a single income when those incomes came largely from property was generally conceded to be desirable as the only feasible method of preventing avoidance through gifts made with the objective of minimizing taxes. But the taxation of two incomes derived largely from earnings as a single income was objected to because it resulted in a combined tax greater than that paid by two unmarried persons with the same incomes. The leadership of the Committee and many others, however, thought that two married persons each of whom earned half of a combined income of $10,000 should pay the same tax as two married persons one of whom earned $10,000, rather than the lower tax paid by two single persons earning $5,000 each.

While the argument for special treatment of the separate incomes earned by married persons has considerable merit, the refusal by the President and the Treasury to endorse the proposal unless modified to give earned income such special treatment contributed to its defeat on the floor of the House. The practical effect is to continue the present tax discrimination against the vast majority of married persons in favor of two groups not generally regarded as deserving favored treatment:

1. Those in a position to transfer property with the objective of minimizing taxes.

2. Those residing in the community property states.

1/ The treatment of the earned income credit has no great importance in terms of tax dollars, since it is deductible only in computing income subject to normal tax (and the defense tax based on normal tax). Therefore the maximum tax saving attributable to the earned income credit allowable on a separate return would be $61.60 (4.4 per cent of 10 per cent of $14,000). The maximum tax saving if the income was wholly from property would be $13.20 (4.4 per cent of 10 per cent of $3,000). The savings attributable to rendering income subject to tax at low, rather than high, surtax rates are, of course, very much greater than the savings attributable to the additional earned income credit that may be claimed on a separate return.

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