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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 1, 1942

To Mr. Goldenweiser

From George Jaszi GJ

Subject: Corporate Tax Plan of Ways and Means Committee

According to press reports Treasury officials and the technical experts of the Ways and Means Committee have agreed upon an excess profits tax plan to be substituted for the plan originally advanced by the Treasury. The Ways and Means Committee is to take a formal vote on the proposal today.

The new plan provides for a flat 90 per cent tax on excess profits. This rate compares with graduated rates running from 35 to 60 per cent under the present law, and from 50 to 75 per cent under the original Treasury proposals.

The new plan would also reduce the "normal" rate of return which is exempt from excess profits taxation under the option of determining excess profits tax liability by reference to invested capital. Under both the present law and the original Treasury proposal the excess profits credit under the invested capital option is 8 per cent on the first $5 million of invested capital and 7 per cent on the balance. Under the new plan it would be reduced to 6 per cent on invested capital in excess of $10 million but not in excess of $200 million, and to 5 per cent on invested capital in excess of $200 million. No corresponding reduction of excess profits credit under the base period earnings option is contemplated. It is to remain at 95 per cent of base period income.

As far as normal and surtax is concerned, it is likely that the Ways and Means Committee will substitute a combined rate of 40 per cent for the original Treasury proposal of 55 per cent.

Yield of new plan

The stiffening of the excess profits tax would compensate only partly for the revenue loss that would be the result of reducing combined normal and surtax. Rough calculations indicate that the new plan would yield only three-fourths of the original Treasury proposals. If the original Treasury proposals would have yielded about $3 billion additional revenue, the new plan will yield $750 millions less.

Incidence of new scheme

The downward revision of the invested capital credit will hit hard a few very large corporations who had low earnings in the base period. It

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will be of lesser concern to smaller corporations with poor base period earnings. And it will not affect at all the bulk of corporations, whether large ~~and~~ or small, who had base period earnings sufficiently high to make it advantageous to them to determine their normal profits by reference to base period earnings rather than to invested capital.

Failure to reduce the excess profits credit under the base period earnings option means the passing up of a fertile source of additional revenue. Reduction of this credit would have tapped more effectively corporations who were prosperous in the base period and who, under the present structure of the excess profits tax, are allowed to continue to earn 95 per cent of these profits -- however high they may be -- without becoming subject to the excess profits tax.

Stiffening of the excess profits tax and reduction of combined normal and surtax (as compared with the original Treasury proposal) will have the effect of shifting the relative burden of taxation from corporations that have not experienced a great increase of earnings over base period earnings to corporations who have experienced such an increase. For a corporation choosing the base period earnings option aggregate tax liability under the new plan will fall short of aggregate tax liability under the original Treasury proposals unless the corporation has experienced an approximately 3 2/3 fold increase over base period earnings. Only corporations that have experienced a larger increase will be hit more severely under the new plan. For corporations choosing the invested capital option the situation is essentially similar, except that in their case the increase of earnings will in general have to be even larger for tax liability under the new plan to catch up with or exceed tax liability under the Treasury proposals.

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