BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 9, 1943.

To Chairman Eccles

From Richard A. Musgrave R.A.M.

Subject: Proposed changes in the Excess Profits Tax.

Changes in the Excess Profits Tax voted by the Ways and Means Committee include a reduction in the credit allowed under the invested capital method, an increase in the exempted excess profits income from 5,000 to 10,000 dollars and an increase in the excess profits rate from 90 to 95%.

1. The proposal to lower the credits under the invested capital method would leave the credit of 8% on the first $5 million of invested capital unchanged; it would reduce the 7% now allowed on the next $5 million to 6%, the 6% now allowed on the next $190 million to 5%, and the 5% now allowed on the remainder to 4%.

The proposal originated with Mr. Stam and is designed to check undue advantages which he believes large corporations derive from an increase in their invested capital base due to the retention of earnings. The provision, which is still in a preliminary form and likely to be changed before enactment, would be of little significance for the bulk of corporations, but would be important for some large corporations (numbering, perhaps 600 or 700) using the invested capital method, particularly large utilities, oil corporations and railroads.

On the whole, the function of the invested capital method is that of a relief provision. It is to assure an equitable minimum of excess profit credit to corporations with low base period earnings. Preliminary statistics for 1941 in fact show that (with the exception of very large corporations) "invested capital corporations" show a larger fraction of net income subject to excess profits tax than do "base period corporations". Nevertheless, there are indications that some large corporations receive undue benefits from the invested capital method. Since a number of other relief provisions--e.g. the privilege to reconstruct base period earnings--have become available, a tightening up of the invested capital method need not involve too serious a hardship for corporations using this method as a bona fide relief provision.

Mr. Stam's argument that large corporations derive undue advantages from increasing their invested capital base by retaining earnings is supported by the fact that retained earnings cannot be counted as an increase in capital under the base period earning method. But there is real doubt whether this advantage is derived only by large corporations. Also, it would seem more important how the addition to capital is used than how it has been obtained. Whatever the merits of the objective, the proposed reduction in credits allowed against invested capital is only a very rough method of meeting it. A more direct

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approach would be to change the treatment of retained earnings in the computation of invested capital.

Another and probably more important advantage which large corporations derive under the invested capital method results from the treatment of borrowed capital under the present law which permits one-half of it to be counted as invested capital. A large corporation borrowing at a low rate of interest may obtain tax savings in excess of the additional interest charges. Again, the direct remedy would be to change the treatment of borrowed capital, but the proposed scaling down of credits may have a similar result since it improves the position of small corporations (which borrow at higher rates) relative to that of larger corporations.

A general disadvantage of scaling down the credits rather than revising the definition of invested capital is the resulting discrimination against those corporations which utilize the invested capital method as a bona fide relief provision. However, this objection is weakened by the availability of other relief provisions and by the fact that the credits are to be reduced only for the higher capital brackets. A further implication of the proposed reduction in credits may be that it will discourage consolidated returns.

On the whole, the case for the proposed reduction in credits does not seem to be very strong, but neither are there strong objections against it.

2. The proposal to raise the exemption under the excess profits tax from 5,000 dollars to 10,000 dollars seems reasonable since, by and large, very small corporations are less capable of meeting the high excess profits rate than are medium sized and larger corporations.

3. The proposal to raise the Excess Profits rate from 90 to 95% appears hardly worthwhile. In those cases where the 80% overall limit is already reached, it will make no difference, and in other cases the actual increase in rates (net of refund) will be by 4 points only. Raising the rate to 95% may give the impression that the Excess Profits Tax is tightened seriously while actually this result could be achieved only by broadening the tax base, that is by tightening the provisions under which the excess profits credit is determined.

The Committee also voted on certain detailed provisions relating to the application of the Excess Profits Tax to a number of special industries.

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