BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Chairman Eccles

From Richard A. Musgrave R.A.M.

Subject: Interdepartmental Tax Committee

This is a brief progress report on the work of the Treasury Interdepartmental Committee on Postwar Taxation.

During the last four weeks the Committee had five sessions, attended by Mr. Blough, Mr. Shere and Mr. Keith from the Treasury's Division of Tax Research, Mr. Murphy from the Treasury's Division of Research and Statistics, Mr. Ben Cohen from Justice Byrnes' office, Mr. Pritchard from Judge Vinson's office, Mr. Colm from the Bureau of the Budget, Mr. Salant from the Office of Price Administration, and myself. It is hoped that the outlines of a postwar tax program will be formulated some time next month. At that time a report is to be prepared for the Secretary of the Treasury.

Transition Period

The earlier meetings were given to a discussion of the excess profits tax. There was little sympathy for continuation of the excess profits tax beyond the readjustment period. Rather, the problem under consideration was how to terminate that tax. There was agreement that the excess profits tax should not be repealed or reduced before the termination of hostilities. Assuming that the European war will end in late 1944 and that the Japanese war will end in late 1945, it was suggested that the tax should be maintained, at perhaps somewhat lower rates, for the income year 1946, and be repealed for the year 1947. For the year 1946 an increase in the specific exemption to say $50,000 might be desirable. (This step could be taken in the Revenue Act of 1945.) Repeal of the tax for the income year 1947 (possibly in 1946 legislation) would be accompanied by repeal of the carry-back provisions.

There was agreement that any rigid tax planning for the adjustment period is not possible at this stage, since much will depend on the termination of the war and economic conditions thereafter. There was definite agreement, however, that the excess profits tax would have to be maintained at least as long as there is a need for maintaining other inflation controls. It was recognized that it may be undesirable to go all out on eliminating the excess profits prior to also reducing other types of taxes, particularly the corporate normal and surtax rate. The desirability of early repeal of the declared value capital stock and excess profits tax was agreed on.

The Committee felt that its main job was to plan a desirable tax structure for the post transition period and then to work back from these conclusions to a tax policy for the transition.

Postwar Tax System

The last two or three meetings were concerned with the post transition problem. It was recognized that adjustment of the corporation income tax was the central problem. The discussion centered around two points: (1) What should be done about the "double taxation of dividends" problem, and (2) what specific steps might be taken to provide further investment incentives?

With respect to the dividend problem, there was considerable diversity of opinion. Some, in particular Mr. Colm and Mr. Murphy, think that this double taxation argument is fictitious,--merely a means to secure a tax reduction for higher incomes. They, on the contrary, argue that the "double taxation" is desirable for the very reason that it offers a way of taxing upper incomes more heavily, thereby lightening the tax burden on consumption. Others felt that a concession to the popular demand for reducing taxes on equity income was desirable, though more for political than for economic reasons. I rather believe that the Committee will accept this view and provide some dividend credit. Probably the technique of exempting dividends paid from the corporate base will be considered preferable, for technical reasons, to the British method of crediting corporate taxes to the individual.

With respect to investment incentives, the following proposals were considered:

(1) Provide some credit for dividends (either on the corporate or on the individual side), improve the definition of corporate net income by more liberal treatment of losses, depreciation, etc., and perhaps add a credit for net investment.

(2) Do away with the corporation income tax as such, but substitute a tax on corporate "hoarding". This would be done by defining taxable net income as (profits plus depreciation) - (dividend payments plus gross capital expenditures).

(3) Maintain the corporation tax more or less in its present form but add a penalty tax on hoarding as defined under (2).

Proposal (1) seems to me the most reasonable approach and the one with the best chance of being recommended in the end. Proposal (3) made by Mr. Colm seems politically quite unfeasible. Proposal (2) made by Messrs. Gilbert and Salant has much in its favor, theoretically. The outcome is desirable, whether it results in increased investment or in increased dividends which are then subject to the individual income tax. Since tax-free reinvestment of funds is permitted, the proposal is not subject to the main objection against the old undistributed profits tax, namely, that it would interfere with expansion, particularly of small corporations. Dick Gilbert believes that a tax of this kind would be politically feasible at a high rate, say 70 per cent. Objections to the plan were that it would cut down the corporate tax base too drastically; that it would be politically unpopular, particularly with labor and small business; that it would give a relative advantage to large corporations which can depend exclusively on internal financing; that Congress would be unwilling to go beyond, say, a 40 per cent rate. Discussion of this approach will continue at next week's meeting.

My guess is that the Committee's final recommendation will be along more conservative lines,--that is, a credit for dividends plus some more limited incentive features. Weekly meetings will continue. A copy of a memorandum to Mr. Shere, outlining my own position, is attached.