[illegible] Morrill's note indicating article attached was published, but article is labeled "... confidential."

July 16, 1945

Mr. Eccles:

Since your attention may not have been directed to it, I think you will be interested in reading the article in Current Comments of May 23, 1945, on Federal taxation of banks, which not only indicates the trend of profits but also discusses particularly the question of excess profits and the question of borrowed capital as a factor in the payment of excess profits taxes.

Cm

Mr. Morrill didn't say whether he thought this should be sent on to you, but thought there might be some points in it you might wish to "maul over" with George, et al while out there.

Mail back to GSE.

Copy mailed to Mr. George Eccles
8/22/45 -

Confidential   May 22, 1945

FEDERAL TAXATION OF BANKS

by
Caroline Cagle

Introduction

Before 1940 commercial banks paid only small amounts in Federal taxes. Since the inauguration of the defense program and our entrance into the war, they have been paying growing amounts into the Federal Treasury. A rapid increase in Federal taxes has been common to all corporations but the rate of increase has been especially marked for banks. Nevertheless, banks have been paying a much smaller proportion of their net income in Federal taxes than other corporations. The reasons are these.

In the period 1936-1939 banks were not subject to all of the taxes paid by other businesses. Moreover, for most of this period they were segregated and treated as a "special class corporation" for income tax purposes. Instead of the mildly progressive income tax rates applicable to most other corporations, banks paid a flat rate on their taxable income. While this rate in 1939 was as high as the highest rate in effect for other corporations, banks escaped the full force of the rate because the income which they received from Government securities which were fully and partially exempt from Federal income taxes was equal to more than three-fourths of their net income for tax purposes. This made the effective rate for banks much lower than the actual rate.

The increased tax payments by banks since 1939 have been due in part to the fact that beginning in 1940 banks were grouped with other corporations for tax purposes. Under this arrangement they have been subject to all of the taxes imposed on other corporations and to the increases in the rate schedules on all Federal taxes. Moreover, the protection which banks had been receiving from interest on tax-exempt U. S. Government securities began to decline in March 1941, when the Federal Government ceased issuing securities bearing the tax-exempt privilege. But the most important reason for the increase in bank taxes is probably the growth in bank income. This expansion in income has been due mainly to the large increase in bank holdings of Government securities which has resulted from war financing. As a result, the fortunes of banks are tied more and more to the fiscal policies of the Treasury and to the interest rate and general monetary policies of the Federal Reserve System and the Treasury.

The large wartime income of banks differs from that of almost all other businesses in that it is likely to continue after the war. Government expenditures have inflated the wartime income of manufacturers, fabricators, raw material suppliers, and other businesses, but most of these payments will cease once the war is over. Banks, however, will continue to be large holders of the public debt and to receive a great part of their income from interest on Government securities. During the war banks have concentrated their purchases in short-term, low-yielding securities. If prices of Government securities continue to be supported in the postwar period, the differential between long- and short-term rates is almost sure to narrow. In this case bank earnings may expand even further. Furthermore, if the excess profits tax should be repealed in the near future, this would further increase the available income of banks.

Both the credit and tax authorities of the Government should give some attention to this problem. Bank earnings at a high level based on interest from the public debt might take away some of the incentives for banks to fulfill their traditional functions of being credit suppliers. Moreover, if the public should view this as war profiteering by banks, public support of the private banking system might weaken.

In the meantime, the credit authorities have a special and somewhat narrower problem in connection with the operation of the wartime excess profits tax. The provisions of this tax permit one-half of borrowed capital to be added to the base capital figure on which exemption from the tax is computed. It already appears that the discounting facilities of the Federal Reserve System, long dormant, are being used by some banks as a means of protection against excess profits taxation. As more and more banks come nearer the margin of liability for this tax, the problem may grow more acute.

This memorandum has no recommendations for the solution of these problems, but it undertakes to furnish the background for their consideration. It presents a brief history of Federal taxation of banks before and during the war and also outlines some of the problems that will be faced by taxing and credit authorities.

Prewar Tax Position of Banks

Prior to 1940 banks paid relatively small amounts in Federal taxes. In the four-year period 1936-1939 total taxes of banks (Federal and State) were fairly constant both in dollar amount and in relation to net current earnings. For member banks taxes during this period varied between 81-86 million, or about 17 per cent of net current earnings before taxes. The reasons are that the number of Federal taxes to which they were subject was small and the rate schedules were low. Moreover, because of the peculiar nature of the banking business, banks were able to exclude from their taxable income substantial amounts of interest received on tax-exempt Government securities. This made the effective income tax rate for banks much lower than the actual rate and much lower than the rates in effect on other types of businesses.

In the period 1936-1939 the principal Federal taxes to which banks were subject were (1) the income tax; (2) the capital stock tax; and (3) the excess profits tax (now known as the declared value excess profits tax).[1] The income tax rate in effect in 1939 for banks was a flat rate of $16\frac{1}{2}$ per cent of special class net income, regardless of amount. Special class net income was defined as net income for tax purposes minus the credit for interest on tax-exempt Government obligations and minus the credit for dividends received from domestic corporations. In 1939 interest on tax-exempt Government obligations accounted for 88 per cent of the net income for tax purposes of banks.

The capital stock tax and the declared value excess profits tax are very closely related and in dollar amount they are of only minor importance. The declared value excess profits tax is, in fact, designed to induce banks to place a sufficiently high valuation on their capital stock, and where this is accomplished, no declared value excess profits tax is paid.

Wartime Tax Position of Banks

Total Tax Burden.—Tax payments by banks have increased markedly since 1939. In that year total taxes (Federal and State) amounted to 85 million dollars; in 1944 the figure was 269 million. Taxes represented about 17 per cent of net current earnings before taxes in 1939; in 1944 the figure was about 32 per cent. Federal income taxes account for nearly all of the growth in bank taxes and they now constitute about 63 per cent of all taxes paid. State taxes have remained fairly constant over the past 10 years, although State income taxes (in those States which have an income tax) have been increasing since 1942.

1 During this period the principal tax applicable to other corporations to which banks were not subject was the undistributed profits tax.

Factors Responsible for the Increase in Bank Taxes.—Changes in the tax laws account for some of the increase in Federal taxes. Beginning in 1940, banks, which had previously been treated as a special class of corporation for income tax purposes were grouped with other corporations for tax purposes. In that year the present excess profits tax was introduced and the old excess profits tax was retained but its name was changed to "declared value excess profits tax." In 1941 the surtax was introduced which was aimed, in addition to raising revenue, at taxing income received from partially tax-exempt Government securities. At present there are five principal Federal taxes to which banks are subject: (1) the normal tax; (2) the surtax, (3) the excess profits tax, (4) the declared value excess profits tax, and (5) the capital stock tax. Most banks, however, do not have to pay all five of these taxes.

In addition to the new taxes imposed, the rate schedules for all Federal taxes were increased. Rates for the normal tax were increased from a flat rate of 16-1/2 per cent in 1939 to present rates which vary from 15 - 24 per cent; rates for the surtax were increased from 6 - 7 per cent in 1941 to 10-16 per cent; for the excess profits tax rates in 1940 varied from 25 - 50 per cent; at present the rate may go as high as 95 per cent.[1]

Aside from the changes in tax laws which account for some of the increase in bank taxes, bank earnings have increased substantially. This increase is largely the result of the tremendous volume of Government securities handled by the banking system. Gross earnings of member banks in 1939 were 1,296 million and net profits 347 million; in 1944 the figures were: gross earnings, 1,874 million; net profits, 649 million. Member bank holdings of U. S. Government securities increased during the same period from 14,328 million to 67,685 million.

A third factor in the increase in bank taxes is the decline in the amount of tax-exempt interest received, which will be discussed in a later section.

Differences in the Incidence of Federal Taxes on Large and Small Banks.—There is considerable difference in the incidence of Federal income taxes on large and small banks. The effect of Federal income taxes on member banks was studied in some detail for the year 1943, the latest year for which complete earnings data are available. This study had two primary objectives: to compare the effect of Federal income taxes on large and small banks and to determine approximately how many banks were subject to the

1 Under the 1943 Revenue Act, the excess profits tax may be the lesser amount of the following:

(1) 95 per cent of the entire adjusted excess profits net income, or
(2) An amount which when added to the normal tax and surtax equals 80 per cent of the surtax net income determined without reduction by the credit for the adjusted excess profits net income.

excess profits tax. Internal Revenue data on Federal income tax payments of banks are not available since 1941; it was therefore necessary to rely on estimates for the year 1943. Two forms of estimating were used: (1) a study of the estimated Federal income taxes paid by the average member bank in seven deposit size groups and (2) a study of the Federal income taxes paid by a sample of 98 State member banks.

From the study of the average member banks it appears that:

(1) Relatively few banks paid an excess profits tax in 1943 (see next section).

(2) The average small bank (less than $2,000,000 deposits) had normal tax net income of $5,000 or less and consequently fell into the lowest bracket of the tax (15 per cent). It also had surtax net income of less than $8,000 and was in the lowest bracket of the surtax (10 per cent). Banks of this size represent about 48 per cent of all member banks.

(3) The average large bank (over $50,000,000 deposits) had normal tax net income in excess of $900,000 on which it paid a tax of 24 per cent and had surtax net income in excess of $1,500,000 on which a tax of 16 per cent was paid. A few of these banks paid the excess profits tax. Banks in the largest size group constitute less than 4 per cent of all member banks but they hold about 70 per cent of deposits.

(4) Between the very small and the very large banks are a group of banks with deposits between $2,000,000 - $50,000,000. Such banks constitute almost half of the total number. The average bank in these three deposit size groups had net income for the normal tax between $8,000 - $50,000 on which the income tax rates varied between 15 - 31 per cent. Surtax net income for this group varied between $15,000 - $100,000 and was taxed at rates varying from 10 - 22 per cent. A small number of these banks paid an excess profits tax.

Estimates of Federal income tax payments by size of bank for the years 1944 and 1945 indicate that the principal differences between 1943 and later years are: (1) The average bank with deposits of less than 5 million may pay a little more in Federal income taxes in 1944 and 1945 than in 1943. Small banks experienced a decline in average gross earnings in both 1943 and 1944, probably as a result of a shift in type of earning assets from a large volume of assets with fairly high yield to primarily Government securities. Small banks have been able to maintain their good profits' experience largely because of sizable recoveries and profits. (2) The average bank of over 5 million deposits will pay much higher Federal income taxes in 1944 and 1945 than in 1943. This is partly because a larger number of banks in these size groups will pay an excess profits tax in 1944 and 1945 than in 1943 (see the following section).

Aside from the relative amounts of earnings of small v. large banks which places small banks in the lowest income tax brackets and large institutions in the highest, there are certain differences in the manner in which investments are usually handled which contribute to the disparity in amount of taxes paid. Small banks have, in the past, held an unusually large proportion of their earning assets in the form of long-term, tax-exempt securities. Their income is small at the start and the credit for income received on tax-exempt securities makes it possible to curtail substantially their taxable income. Large banks, on the other hand, have usually held a relatively smaller proportion of earning assets in tax-exempt securities than small banks so that the benefits which they have derived from this source have been much smaller.

Other factors bearing on the relative amounts of taxes paid by large and small banks are the yield on and the utilization of earning assets. Small banks have usually held a larger proportion of their portfolio in loans than big banks. With the decline in loans in recent years small banks have not been so quick as large banks to reinvest their funds in short-term fully-taxable Government securities. Furthermore, even when funds have been fully utilized differences in the yields on the two types of earning assets have resulted in reducing the gross earnings of small banks.

Effect of Excess Profits Tax on Banks.[1]--From the study of the average bank it appeared that in none of the seven deposit size groups studied did the average bank in 1943 earn enough to pay an excess profits tax. This we assumed indicated that there must be a relatively small number of banks affected by the tax. It was clear from this study that few if any small banks (with deposits of under $5,000,000) earned enough to pay the excess profits tax. With due allowance for errors of estimating and for banks whose earnings are far in excess of the average, the protection afforded from the excess profits tax by the invested capital credit and the specific exemption ($5,000 in 1943) was sufficient to eliminate these banks. For larger banks (over $5,000,000 deposits) the narrowing margin between excess profits net income and credits indicated that some of these banks might pay the tax.

To explore this situation more fully, a sample of 98 State member banks was drawn from the banks in the three deposit size groups over $5,000,000 and a study of their earnings and expenses was made to determine how many of them paid the excess profits tax.[2] Based on the study of taxes paid by the 98 banks in the sample, it is estimated that the following number of banks may have paid the excess profits tax in 1943:

[1] Estimates of the excess profits taxes paid by banks are based on the invested capital method of computation.

[2] The number of banks in the sample from each deposit size group was graduated in relation to the probability of the payment of the tax. For example, for very large banks (with deposits of $50,000,000 and over) the number of banks was largest, 58; this sample constitutes nearly one-fourth of all member banks in this size group and 70 per cent of all State members.

	Number of banks in group	Banks in sample: Total number	Banks in sample: Number affected by excess profits tax	Banks in sample: E. P. T. banks as % of sample (Col.3 ÷ Col. 2)	Estimated no. of banks affected by excess profits tax (Col. 4 as % of Col. 1)
	(1)	(2)	(3)	(4)	(5)
Banks with deposits of:					
5 - 10 million dollars	777	10	1	10%	78
10 - 50 million dollars	665	30	5	17%	113
Over 50 million dollars	230	58	13	23%	53
					244

Gross earnings of member banks were 1,650 million dollars in 1943, 1,874 million dollars in 1944, and will probably be larger in 1945. Net profits were 649 million dollars, or 9.7 per cent of average capital accounts in 1944; they may be as high as 10.0 per cent of capital accounts in 1945.1/

Federal income taxes paid by member banks in 1943 amounted to 103 million dollars. This represents about 52 per cent of total taxes and about 14 per cent of net profits before taxes. In 1944 Federal income taxes paid by member banks were 169 million dollars, or about 63 per cent of total taxes and 18 per cent of net profits before taxes. In 1945 Federal income taxes will probably exceed 200 million dollars and represent 65 per cent of total taxes.

Part of the large increase in Federal income tax payments in 1944 and 1945 will be excess profits taxes. The number of banks paying the excess profits tax, it is believed, will be much larger in 1944 and 1945 than in 1943. From a study of estimated taxable income for the average bank in four deposits size groups: "under 5 million deposits," "5-10 million," "10-50 million," and "over 50 million," it appears that, as in 1943, very few small banks (under 5 million deposits) will earn enough to pay the excess profits tax. The specific exemption allowed all corporations for the excess profits tax was raised by the Revenue Act of 1943 from $5,000 to $10,000 effective for incomes earned in the taxable year 1944. This exemption plus the invested capital credit should provide most small banks with adequate protection from the excess profits tax.

1 In the Seventh War Loan Drive the maximum coupon rate of interest has been reduced on new issues available for ownership by banks. This will be an important factor tending to diminish the growth in bank earnings.

The average bank with deposits of over 50 million, however, will pay an excess profits tax in 1944 and 1945. This probably means that at least 40-50 per cent of the total number of banks in this group will be affected in 1944 and probably as many as 65-75 per cent of the total may pay the tax in 1945. The proportion of banks in the two size groups from 5 million to 50 million deposits paying an excess profits tax will also be larger in 1944 and 1945 than in 1943. The accompanying tabulation hazards a guess as to the maximum number of banks in the three size classes which will pay the excess profits tax for the taxable years 1943, 1944, and 1945.

The amount of excess profits taxes paid by banks in the last three years is difficult to estimate because we have no official figures since 1941. A rough gauge as to the total amount can be obtained by using the estimated maximum number of banks affected by the tax in 1943-1945 and assuming an average amount of excess profits taxes paid by each bank in a particular deposit size group. The average number and amounts for 1943 were estimated from the sample of 98 State member banks studied. For 1944 and 1945 we have arbitrarily assumed a certain rate of increase. These estimates are shown in the accompanying table. It should be borne in mind that the number of banks used is believed to be the maximum number affected by the excess profits tax.

Estimated Excess Profits Tax Liability
of Member Banks in 1943-1945 -- Number and Amount

Year	All member banks	Member banks with deposits of[1]		
		$5,000,000 to $10,000,000	$10,000,000 to $50,000,000	$50,000,000 and over
1943				
Number of banks	244	78	113	53
Average excess profits tax		3,000	10,000	100,000
Total excess profits tax	6,664,000	234,000	1,130,000	5.300,000
1944				
Number of banks	465	140	198	127
Average excess profits tax		5,000	15,000	150,000
Total excess profits tax	22,720,000	700,000	2,970,000	19,050,000
1945				
Number of banks	720	205	310	205
Average excess profits tax		8,000	20,000	200,000
Total excess profits tax	48,840,000	1,640,000	6,200,000	41,000,000

1 It was determined from a previous study that even with a large increase in earnings banks with deposits of under $5,000,000 would not be affected by the excess profits tax.

In 1941 the last official figure by the Internal Revenue shows total excess profits tax payments by banks and trust companies of $1,430,000. In 1943 it is estimated that the excess profits taxes paid by all member banks may amount to 6 million dollars; in 1944 to 22 million; and in 1945 to 48 million dollars.

Experience of British Banks with Excess Profits Tax.—It appears that banks in Great Britain have had much the same experience as American banks with the excess profits tax, that is, that through 1943 none of them were affected. The reasons advanced in the Economist (London) are that they were able to claim good standards owing to the special profits on realization of investments which fell during the EPT standard period. Another reason is that the banks were able to write off the whole of their German standstill commitments as a set-off against taxable profits. Another factor is the sudden fall in taxable profits during 1939-1941 before the banks had begun to feel the effect of increasing credits. Moreover, certain items making for lower net earnings were experienced, such as loss of foreign exchange and new issue earnings, higher staff costs, etc. It is said that deficits accumulated in these years have been carried forward to reduce profits in later years. It is also stated that perhaps in 1944 for some banks, and in 1945 for others, the deficits will be used up and the banks will start to pay excess profits taxes.

Comparison of Bank Taxes with Those Paid by Other Businesses.— It has been known for some time that banks have been affected less by Federal income taxes than other types of businesses. The latest year for which complete official data are available is 1941. In that year the accompanying tabulation shows that banks and trust companies paid in Federal income taxes a much smaller proportion of their net income than other types of business. For example, Federal income taxes were 40 per cent of net income for income tax purposes for all industrial groups combined; for the financial group of which banks are a part and for banks and trust companies the proportion was only 15 per cent.

Ratio of Federal Income Taxes[1] to Net Income for Tax Purposes
for All Business Enterprises Grouped by Type of Industry, 1941 [2]

	Taxes as % of Net Income
All industrial divisions	39.6
Mining and quarrying	32.0
Manufacturing	46.7
Public utilities	33.9
Trade	38.8
Service	29.3
Finance, insurance, real estate, etc.	14.7
Banks and trust companies	15.0
Construction	41.0
Agriculture, forestry and fishery	28.0
Nature of business not allocated	27.8

1 Federal income taxes include the normal tax, the surtax, the declared value excess profits tax, and the excess profits tax.

2 Statistics of Income, 1941, Part II.

If recent data were available for a comparison such as this it is believed thatbanks would have even more advantage over other businesses because relatively few banks have thus far been subject to the excess profits tax.

Factors Responsible for the Favorable Tax Position of Banks.— There are a number of reasons for the difference in the incidence of Federal income taxes on banks:

(1) The sources of bank earnings are different than for most other types of businesses. For a considerable period banks have received a sizable portion of their income from Government securities. The accompanying table shows that in 1941, the latest year for which official Internal Revenue data are available, interest on tax-exempt Government securities (State and local as well as Federal Government) amounted to 318 million, or 62 per cent of compiled net profits (gross income less the deductions permitted therefrom for tax purposes but before the credits allowed against such income). If banks had been forced to pay income taxes on the 318 million of tax-exempt interest at even the minimum rate for the normal tax (15 per cent), the increase in taxes would have amounted to 48 million as compared with total Federal income taxes actually paid in 1941 of 51 million. Federal income taxes as a percentage of net income for tax purposes would then have amounted to about 30 per cent for banks as compared with 40 per cent for all industrial groups. This is the minimum increase which would have resulted because some banks would undoubtedly have paid a higher rate of tax on this income and some probably would have been forced into the excess profits tax bracket. It is clear that interest on tax-exempt securities has been the principal factor in the favorable tax position of banks.

Ratio of Interest on Tax-Exempt Securities to Compiled Net Profits of All Business Enterprises Grouped by Type of Industry, 1941[1]

Industrial groups	Compiled net profits	Int. on tax-ex. Gov't sec. Total	Subj. to decl. value E.P.T. & surtax	Subject to surtax only	Wholly tax exempt	Int. on tax-exempt securities as % of compiled net pfts.
All industrial groups	17,999	496	293	55	148	2.8%
Mining and quarrying	432	2	1	-	1	0.5
Manufacturing	10,457	20	11	1	8	0.2
Public utilities	2,054	4	3	-	1	0.2
Trade	2,192	4	2	-	2	0.2
Service	255	-	-	-	-	-
Finance, ins., real estate, etc.	2,316	361	274	53	134	15.6
Banks and trust companies	511	318	250	51	117	62.2
Construction	196	-	-	-	-	-
Agriculture, forestry, fishery	80	1	1	-	-	1.3
Nature of business not allocated	16	-	-	-	-	-

[1] Statistics of Income, 1941, Part II.

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Such benefit as banks have enjoyed in the past from interest on tax-exempt U. S. Government securities is now declining. As of March 1, 1941, the issuance of tax-exempt securities was discontinued and all such securities outstanding are being retired as they become due or callable. The volume of fully tax-exempt U. S. Government securities is declining rapidly and nearly all will be due or callable by the end of 1945. Partially tax-exempt U. S. Government securities are also declining but much more gradually. The accompanying tabulation shows the amount of tax-exempt public marketable U. S. Government securities outstanding by term to maturity or call date as of December 31, 1944.

Public Marketable U. S. Government Securities Outstanding
by Tax-Exemption Provision and by Maturity or Call Date, Dec. 31, 1944
(In millions of dollars)

	Out-standing Dec. 31, 1944	Due or callable by December 31					
		1945	1948	1950	1951	1955	After 1955
Wholly tax-exempt	914	718	-	-	-	-	196
Treasury notes	718	718	-	-	-	-	-
Bonds	196	-	-	-	-	-	196
Partially tax-exempt	22,939	2,510	6,049	3,463	3,500	4,017	3,386
Bonds	22,170	1,755	6,049	3,463	3,500	4,017	3,386
Guaranteed issues 1/	768	755	-	-	-	-	-

1 Includes 13 million of F.H.A. debentures not classified by maturity or call date.

Banks have shown a tendency in recent years to increase their holdings of fully and partially tax-exempt securities by purchasing from other investors. Between the end of October and the end of December 1944 commercial bank holdings of fully tax-exempts increased 33 million while the total of such securities outstanding remained unchanged. Bank holdings of partially tax-exempts relative to the total outstanding have also increased. Between the end of 1942 and the end of 1944 bank holdings of partially tax-exempt securities declined by only 684 million while the volume of these securities outstanding declined during the same period by about 6,500 million. In terms of percentages, commercial bank holdings of fully tax-exempt securities relative to the total outstanding represented 19 per cent at the end of October 1944 and 23 per cent at the end of December 1944. Of partially tax-exempt securities, banks held 44 per cent of the total outstanding at the end of 1942 and 59 per cent at the end of 1944.

In addition to tax-exempt U. S. Government securities banks may still escape taxation on their earnings on State and local obligations which continue to be fully tax-exempt. Their dollar holdings of this class of investment, however, have not shown any marked change in recent years.

(2) In recent years recoveries on charged-off assets have been an important part of the earnings of most banks. It is believed that the handling of recoveries permitted by tax law has helped banks to reduce their income tax payments. The wording of the law permits the exclusion from gross income for the normal tax of all recoveries which did not result in a tax benefit in the year in which they were charged off, or, in case a tax benefit was received, to exclude that portion of recoveries which did not result in a tax benefit. This means that many banks have been able to make rather substantial reductions in their gross income, because, during the early 1930's banks were required by supervisory authorities to charge-off large losses and these were years in which they got little or no tax benefit from the charge-offs. Furthermore, in figuring the income base for the excess profits tax additional recoveries may be excluded. For this tax any recovery which was charged off in a pre-excess-profits tax year (before the taxable year 1940) may be excluded from excess profits net income. It is quite unlikely that other corporations charged off losses to the same extent as banks during the depression, since they are not required to do so by supervisory authority and probably little or no tax benefit would have resulted.

(3) Banks also have certain advantages over other businesses in the handling of losses for tax purposes. (a) Banks are permitted to deduct a net loss on the sale or exchange of capital assets consisting of bonds, notes, debentures, etc., directly from income. For most other corporations capital losses may be used only to offset capital gains. (b) As compared with corporations which are not in the business of granting credit, banks also have a tax advantage. Credit losses are a regular and expected part of the banking business. Aside from the larger losses induced by the wide swings of the business cycle, these losses could be treated as virtually an actuarial risk which should be chargeable as an expense in the year in which the credit is granted. But the tax regulations permit banks to charge off these credit losses in a later year. In effect, this provides a form of loss carry forward provision for banks.

Differences between Banks and Other Corporations in the Taxation of War Profits

The taxation of war profits is quite a different problem for banks than for most other corporations. If the philosophy behind the excess profits tax is to take away from all businesses that part of their profits which is the result of financing or contributing to a common struggle for our mutual protection, then the excess profits tax fails to accomplish its objective in the case of banks. For most businesses the increase in profits during the war is the result of a high level of business activity. This activity is built up rapidly after the beginning of the war, reaches its peak early in the war period, and continues at this level until near the end of hostilities, when there is a rapid decline. For banks, however, the earnings curve is quite different. For them war profits are the result of financing the Government debt. This is, of course, built up gradually over the entire period of the war and frequently does not reach its peak until after the war is over. Even then the decline in the debt is quite gradual and banks continue to receive war profits for a long period after the war. It is clear, therefore, that an excess profits tax in force only during the war period will fail to get a large share of the war profits of banks. This is borne out by the preceding section which indicates that few banks through 1944 have been affected by the excess profits tax.

Should the Excess Profits Tax Be Continued For Banks After It Has Been Removed for Other Corporations?

A repeal of the excess profits tax in the next year or so could have important consequences on bank earnings. It might put banks in a much better earnings position than many other corporations. It is anticipated that banks will have net profits of about 10.0 per cent on their capital accounts in 1945 assuming no change in tax legislation and no change in the level of interest rates. This is the highest return in almost 25 years. Repeal of the excess profits tax would make available a large additional sum.

There is now little prospect for any significant change in corporation taxation applicable to the calendar year 1945 but there is considerable possibility that some tax reduction may occur in 1946. In the preceding section it was estimated that excess profits tax liability in 1945 may be as high as 48 million dollars. It is a fair assumption that earnings and tax payments will be at least as great in 1946 as in 1945. If that is the case, a repeal of the excess profits tax in 1946 might increase member bank net profits by something like 48 million, or 0.7 of 1 per cent of estimated capital accounts.

The excess profits tax is, of course, viewed as a temporary measure and there will undoubtedly be considerable pressure to eliminate it after hostilities cease. It has already been indicated in the preceding section that it is not feasible to tax the war profits of banks in the same way as other corporations because of the difference in timing of receipt of these profits. Other methods could be used, however, to accomplish the same results.

The excess profits tax on banks could be retained after it is repealed for other corporations or an additional levy might be placed on banks during the war period. Perhaps the most important objection to these methods is that they would take away the incentive of banks to engage in risk lending. Banks should be encouraged to fulfill their traditional role of financing commerce, industry, and agriculture, if we are to have a private banking system. If all except a minimum of their profits is to be taken from them by additional tax levies, there will be no incentive for banks to engage in anything except riskless Government financing. Banks would then be scarcely more than an arm of the Treasury Department, in effect, a Government agency. Why should they not then be nationalized?

Aside from the objection just mentioned, there is the additional criticism that special levies on banks alone would be inequitable. Other groups of corporations may have fared as well as banks from a tax standpoint, but because they are not so easily segregated, they would be exempt from the additional tax levies applied to banks.

The suggestion has been made that the excess profits tax might be retained for banks after it has been repealed for other corporations in order to continue the incentives for maintaining a differential between long and short-term interest rates. This proposal can be objected to on several grounds. If its purpose is simply to apply indirect pressure to keep banks in shorter term Government securities, why shouldn't the same thing be done by direct action? It is generally admitted that the financing of Government debt by the banks is quite a different problem than other such financing and the idea of special issues for banks is certainly reasonable. The arguments for this position have been developed elsewhere.

There are, moreover, valid reasons why banks might be allowed to retain a part of their profits from war financing. They could use these funds to strengthen their capital position. During the war period banks have not increased materially dividend payments but have retained their increased earnings to strengthen their capital position. It has been estimated that banks have in the past few years been paying out in dividends only about one-fourth of net profits; three-fourths have been retained as additions to capital funds. It should be noted, however, in this connection that there is considerable difference of opinion among banking authorities as to the need for increased bank capital. Banks might, on the other hand, increase wages of bank personnel which for the rank and file of bank employees have been very low. This is brought out very forcefully by the war period when banks are having difficulty in maintaining adequate staffs because they are not competing with the salaries paid by other businesses. Banks might also use their increased earnings to reduce service charges on deposit accounts or perhaps to increase interest on time deposits. From all of these uses the public as well as the banking system would benefit.

Borrowed Capital as a Factor in the Payment of Excess Profits Taxes

The special provisions of the Federal excess profits tax may make for an appreciable change in the borrowing at Federal Reserve Banks in the near future. Until 1944 relatively few banks were affected by the excess profits tax. Because of the increase in earnings and the decrease in exemptions more banks will probably pay the excess profits tax in 1944 and 1945. Efforts by banks to avoid the tax will undoubtedly be made. Since banks are permitted to count one-half of borrowed capital in their base for computing exemption from excess profits taxes, there are certain circumstances in which borrowing becomes definitely advantageous. For example, if a bank's invested capital credit for the excess profits tax plus its specific exemption and any unused excess profits credits from the two previous years are not sufficient to offset its excess profits net income, borrowing will enable a bank to build up its average daily invested capital credit sufficiently to cover its excess profits net income for the year and thus avoid payment of the excess profits tax. The tradition against borrowing may very well be sharply reduced if borrowings are resorted to very much in order to build up exemption to taxes. Since it is the larger banks that are mainly faced with the liability for excess profits taxes, the leadership of these banks might have a bearing on the disposition and willingness of other banks to borrow.

The situation presents a rather delicate issue to the credit authorities of the System. There are many who have been hoping that the discount privileges of the System might be used and considered available so that excess reserves could be allowed to dwindle without creating any feeling among banks of credit tightness. The System, however, would hardly want to be a party to promoting a channel of tax evasion. The difficulty arises because of the very thin margin that separates "legitimate" borrowing from that which is unnecessary. The Federal Reserve System has within its hands the power to create the credit conditions that would make borrowing either more or less "legitimate". For example, if the System should tighten reserves, there would be more cases in which member banks could demonstrate a real need for borrowing.

Taxes and the Interest Rate Structure

During the war not only have interest rates been kept low, but even further, short-term interest rates have been maintained well below long-term ones. This pattern of rates has been enforced on banks to a considerable extent by the character of securities available to them. If, however, banks had been disposed to resist the imposition of this pattern of rates, they could have rendered it largely nugatory by buying only long-term securities. The Federal Reserve System would then presumably have been forced to take up the slack. This occurred to a considerable extent with the bill rate. The pattern of maturities and rates established by the Treasury has certainly operated with respect to certificates and notes. The disposition of banks to accept the pattern has no doubt been influenced by the prospect that marginal additions to earnings would be taxed away by the excess profits levies. As long as the future of interest rates and security prices was in doubt, the small amount of net gain retained from longer-term rates was hardly worth the risk. The acute phase of this problem would arise if the excess profits taxes were repealed. Even if the general average of interest rates should remain low, it is possible that the extraordinarily low short-term rates might lose market significance while the longer-term rates might be beaten down by the strong demand.

There is some reason to believe that the active buying of the longer maturities that banks have recently been engaged in stems, in part, from a desire to be sure of getting an adequate portfolio of longer-term Government securities (among those eligible for bank investment). Such strong buying based on anticipation illustrates the pressure on prices and yields that might come with an assured removal of excess profits taxes. And in the postwar period the issue of long-term interest rates with its implications for investment institutions such as insurance companies will take on even greater importance. This is apart from the even broader public interest in the influence of interest rates on business activity.

An effort has been made to estimate the effect on bank earnings should increases varying from 1/16 per cent to 1/2 per cent occur in each of the short-term rates on U. S. Government securities. While significant changes in interest rates may not occur in 1945, it is possible that some increases will occur in 1946. To show the minimum effect that might be expected, the estimates are based on earnings at 1945 levels and on average member bank holdings of U. S. Government securities equal to those estimated for 1945, that is $71,000,000,000. Also, to keep the problem as simple as possible and to show primarily the effect of this one change, it has been assumed that: (1) some increases in short-term rates can occur without affecting the interest rates on longer-term securities, and (2) the ratio of bills, certificates, and notes to total U. S. Governments held by member banks would be about the same as at the end of 1944. Under these conditions an increase in yields of 1/16 per cent for each of the three classes of short-term securities would increase earnings by about 21 million, 2/16 per cent by 42 million, 3/16 per cent by 64 million, 1/4 per cent by 85 million, 3/8 per cent by 127 million, and 1/2 per cent by 169 million.

These increases in earnings would not be <u>net</u> increases, however. It is estimated that taxes (assuming the present tax structure) would take at least 30 per cent of the increase. Nevertheless, net profits in 1945 as a percentage of capital accounts would increase from 10.0 at present yields to 10.2 per cent with an increase of 1/16 per cent in short-term yields; to 10.4 per cent with an increase of 2/16 per cent; to 10.6 per cent with 3/16 per cent; to 10.8 per cent with 1/4 per cent; 11.7 per cent with 3/8 per cent; and 11.6 per cent with an increase in yields of as much as 1/2 per cent. In other words, should short-term yields increase by as much as 1/2 per cent the return on invested capital would be about 1.6 per cent higher than at present yields.

The preceding estimates show the possible effect of an increase in short-term yields on bank earnings <u>before</u> the repeal of the excess profits tax. Should these increases occur along with or immediately after the repeal of the excess profits tax, which is very probable, there might be an even greater increase in the net profits of banks. It has already been estimated that excess profits taxes will absorb about 48 million dollars of bank earnings in 1945. Assuming that these taxes will be at least as great in

1946 or later as in 1945, this alone could increase net profits by 0.5 to 0.7 of 1 per cent of estimated capital accounts. Furthermore, in the preceding paragraph it was estimated that taxes would absorb at least 30 per cent of the increase in earnings resulting from increased yields on short-term securities. If the excess profits tax is repealed, this percentage would undoubtedly be smaller. Occurring in the same taxable year, a repeal of the excess profits tax and an increase of as much as 1/2 of 1 per cent in yields on short-term U. S. Government securities could increase net profits of banks by 2 per cent or more of capital accounts, assuming, of course, that the increase in yields was felt for an entire year.