BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date October 21, 1947

To Chairman Eccles

From Thomas Lee Smith T.L.S.

Subject: Effect of income tax on net interest income of commercial banks

Several persons have raised the question of the effect of income taxes and the tax status of commercial bank holdings upon net interest income received by commercial banks. The question is raised in connection with the estimates of the reduction in interest paid to the banks under various refunding policies outlined in the memorandum to you dated October 10, 1947 and table dated October 14, 1947, which made no allowance for the corresponding changes in tax liabilities of commercial banks.

The reduction in bank earnings might be only two-thirds as great as the reduction in interest paid to the banks. That is, the rate of tax on interest received by commercial banks on Treasury securities which will mature between October 31, 1947 and October 31, 1952 is estimated at 32-33 per cent. This includes bills and certificates and makes adjustments for the Treasury's financing program through October 1947.

However, the effective rate of tax on interest received by commercial banks would be close to 38 per cent were it not for the sizeable bank holdings of partially tax-exempt securities. Banks now hold an estimated 14 billion dollars of a total of a little over 17 billion of Treasury bonds partially exempt from Federal income taxes. Commercial bank holdings of fully exempt bonds amount only to about 15 million dollars of Postal Savings and Panama Canal bonds.

Commercial banks own an estimated total of about 48 billion dollars of marketable public securities maturing between October 31, 1947 and October 31, 1952, of which 8 billion are partially tax-exempt securities and 40 billion are fully taxable securities. The interest from the 8 billion dollars of partially tax-exempt bonds is taxed at substantially 14 per cent and the remaining interest is taxed at 38 per cent. The effective tax rate works out at approximately 32-33 per cent. The exemption from normal tax of the interest from the 8 billion dollars of partially tax-exempt bonds is worth about 45 million dollars to commercial banks.

The nature of the partial tax exemption is as follows. The interest on partially tax-exempt bonds is entirely exempt from the normal tax rate which for most banks would be 24 per cent.[1/] The interest which is derived from the first $5,000 of principal amount owned by any one holder is exempt from the surtax rate, which is generally 14 per cent,[2/] but the interest on principal in excess of $5,000 is subject to surtax. (The former excess profits tax applied in the same way as the surtax, but practically no banks incurred excess profits tax liability.) Practically all of the interest exempt from normal tax is subject to surtax.

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1/ If the normal tax net income exceeds $50,000, the normal tax rate is 24 per cent, and if the surtax net income exceeds $50,000, the surtax rate is 14 per cent making a combined rate of 38 per cent. Normal tax net income is less than surtax net income primarily by reason of the credit for partially tax-exempt U. S. interest.

The rates, however, are progressive for corporations with less than $50,000 net income. Corporations with net incomes of $25,000 or less pay at a surtax rate of 6 per cent and pay at normal tax rates as follows: Up to $5,000, 15 per cent; over $5,000 to $20,000, 17 per cent; and over $20,000, 19 per cent. Corporations with net incomes over $25,000 but not over $50,000 pay a surtax of $1,500 plus 22 per cent of the surtax net income in excess of $25,000 and pay a normal tax of $4,250 plus 31 per cent of the normal tax net income in excess of $25,000.

2/ Ibid.