PSF Taxes Subject File Box 186

PSF: Tax
file private

Miss Le Hand:

Please read this yourself and see that the President reads it, please.

B.O'C.

PSF: Tax

MEMORANDUM FOR F.D.R.

I haven't met anyone who does not feel very strongly that the proposed tax publicity after March 15th is not only particularly dangerous in these times but a grave political blunder on our part.

If it results unfortunately, as I personally believe it will, it will be pinned on the President, the Secretary of the Treasury and Congress. Inasmuch as all three of these happen to be Democrats, and inasmuch as the measure was passed by a Democratic Congress and signed by a Democratic President, any attempt at buck passing among these three will only afford amusement to others.

I am certain that casual reflection on this matter will show its tremendous seriousness, and I am equally certain that something should be done between now and March 15th to prevent this law from becoming effective.

I am told that the Treasury Department's attitude is one of neutrality, and I am informed that the slightest word from you to Congress will put Congress in line to repeal this Act.

I told you some time ago that when there was publicity of taxes before, the howl came not from the successful but from the little fellows who resented the Government's publishing their lack of success to their neighbors and their creditors.

Apart from this, however, one or two kidnappings as a result of such publicity will put the White House, Treasury Department and Congress definitely "on the spot" and they are kidding themselves if

any of them thinks that it can solve its particular difficulty by pointing its finger at the others.

Why spend a whole week in Washington on crime prevention and then permit a thing like this to happen?

B.O'C.

2/4/35

Secy:

file

This bill is to be followed by a bill dealing with Sec 21d (Refunds) and a few administrative tax provisions. The lawyers bill can be attached to that

LKO

Processing - if not what - Liquor?

PSF
Taxes

INTERCORPORATE DIVIDEND TAX

(1) There has not yet been incorporated in the new tax bill the principle, originated in the tax legislation of last year, of taxing intercorporate dividends so as to discourage holding companies.

(2) Such a tax is important not only to continue pressure on holding company structures but also for its revenue potentialities in lieu of processing taxes which the Ways and Means Committee may wish to drop. Robert Jackson, formerly General Counsel of the Bureau of Internal Revenue, estimates that for each 1% of the rate of such tax, the yield will be $100,000,000. The tax in the legislation of last year — lost in the new draft — was 1½%.

(3) An amendment to effect this tax has been carefully drafted in the Department of Justice and is ready for presentation to the Ways and Means Committee by Jackson. LaFollette and Jackson have talked to Oliphant. West has talked to Doughton; Doughton has called but not reached Jackson. Jackson seems to want more direct assurances than he has had to date that he will not be embarrassing the Treasury by going ahead.

ESTIMATE OF INCREASED REVENUE TO BE DERIVED DURING FISCAL YEAR 1937 FROM AN INCREASE OF ONE DOLLAR PER GALLON IN THE EXCISE TAX ON DISTILLED SPIRITS, ONE DOLLAR PER BARREL IN THE RATE ON FERMENTED MALT LIQUORS, AND SUBSTITUTING A BOTTLING TAX FOR THE RECTIFICATION TAX.

Distilled Spirits

At $2 rate:

Imports	8,250,000 gallons	$ 16,500,000
Domestic	120,000,000 gallons	240,000,000
	Total	$ 256,500,000

At $3 rate:

Imports	7,425,000 gallons	$ 22,275,000
Domestic	108,000,000 gallons	324,000,000
		$ 346,275,000
	Increase	$ 89,775,000

Fermented Malt Liquors

At $5 rate, 51,300,000 barrels	$ 256,500,000
At $6 rate, 48,735,000 barrels	292,410,000
Increase	35,910,000

Bottling Tax Substituted for Rectification Tax

30¢ Rectification Tax	$ 6,500,000
30¢ Bottling Tax	32,400,000
Increase	$ 25,900,000
Total Increase	$ 151,585,000

Note:

Above estimates assume a 10% decrease in consumption of distilled spirits and a 5% decrease in consumption of fermented malt liquors, as the result of the suggested rate increases.

It is believed that over a three year period the average annual increased revenues which would result from the suggested rate increases alone would aproximate $140,000,000.

The figure for the increase to be derived from substituting a 30¢ bottling tax would be subject to further enlargement when the gallonage of imported distilled spirits bottled in this country is ascertained.

PSF Taxes

THE SECRETARY OF THE TREASURY
WASHINGTON

Draft

My dear Mr. President:

The investigation of the income tax returns for each successive year reveals the increasingly stubborn fight of wealthy individuals and corporations against the payment of their fair share of the expenses of their Government. Although Mr. Justice Holmes said: "Taxes are what we pay for civilized society," too many citizens want the civilization at a discount. We are eliminating, one by one, devices for tax avoidance and evasion and loopholes in the law, but each one eliminated seems to cause an increased use of the remaining schemes. Sales between husbands and wives are no longer popular, since the Mitchell case; legislation following the Pecora investigation largely stopped tax evasion through security partnerships; and educational trusts of the pictures kept in one's house had too much publicity in the Mellon case to commend them to further use. But we still have too many cases of what I may call moral fraud -- that is, the defeat of taxes through doubtful legal devices which have no real business purpose nor utility, and to which a downright honest man would not resort to reduce his taxes.

Your Administration has been notable for demanding a higher standard of morality in commercial dealings. We need a higher standard of morality in the dealings of the citizen with his Government.

To give point to my statements, I want to list below some of the devices which have caused our 1937 revenues to be less than they should have been, and the names of the taxpayers employing them. Our audit of the 5,500,000 returns for 1936 is only beginning, but our initial check has revealed these facts, which I believe you ought to know at once.

1. The creation of multiple trusts for relatives and dependents. Splitting income two ways, between husband and wife, reduces income taxes, and leaves the family income intact. Splitting the family income by means of many trusts may effect a greater saving, while leaving the money actually in the same hands. Thus, Mr. Louis Blaustein of Baltimore has established 64 different trusts in favor of his wife and three children. The beneficiaries thereby claimed a tax saving in one year of $485,257. Mr. Charles E. Merrill and Mr. Edwin C. Lynch of Merrill, Lynch & Company, 40 Wall Street, New York, have 40 trust funds, as well as 23 personal holding corporations. They operate a great many numbered brokerage accounts and only at the end of the year identify for whose benefit the account has been operated. In this way innumerable transactions are carried on between the different corporations and trusts which have no effect upon the beneficial interest of Merrill and Lynch, but which are designed to reduce their tax liability very greatly. Grenville Clark of Root, Clark, Buckner & Ballantine, and his wife, have 16 trusts. There are undoubtedly a great many more instances of the same sort which will be disclosed in our audit of the 1936 returns.

2. Foreign personal holding corporations organized in the Bahamas, Panama, and Newfoundland, where taxes are low and corporation laws lax.

Americans have formed 64 such companies in the Bahamas alone in the last two years and 22 more were organized by Americans in the Bahamas during the past six weeks. Panama and Newfoundland seem to be even more fertile territory since their corporation laws make it more difficult to ascertain who the actual stockholders are. Moreover, the stockholders have resorted to all manner of devices to prevent the acquisition of information regarding their companies. Thus, Mrs. Dorothy Whitney Elmhirst originally organized her personal holding company in the Island of Guernsey and then moved it to Panama; and the corporate books are kept in Newfoundland. George Westinghouse, Jr. has a $3 million Bahamas corporation and in an attempt to prevent the Bureau of Internal Revenue from catching up with him, moves his home address from one small hamlet to another each year. He reported from Saanichton, Vancouver Island, British Columbia one year; the year before he reported from Seabold, Washington. The Bureau having secured access to the records of the International Corporation Company of New York, which is active in forming Bahamas and Panama corporations, it now organizes such corporations through its Paris subsidiary, International Corporation Company S. A., free from the possibility of our investigations.

Wallace Groves of the General Investment Corporation has two Bahamas corporations with a nominal capitalization. His General Investment Corporation, which is reported to have cost the public a loss of $67 millions between 1932 and 1936 out of total assets of $77 millions, is under investigation by the SEC, and Mr. Groves seems to have left the country. One of the transactions disclosed by the investigation was the sale of

the Buenos Aires subway, on which one Philip De Ronde was paid a commission of $250,000. De Ronde caused the commission to be paid to his Bahamas Company and is defying us to collect the tax upon it. By way of insult he has offered to compromise his admitted tax liability of $33,000 for past years by a payment of $1,700.

Another indication of the magnitude which this avenue of tax avoidance may assume is afforded by the case of Jules S. Bache of New York. Mr. Bache's personal return showed no taxable income for 1936. We have discovered, however, that Mr. Bache, his two daughters, and trusts in favor of the daughters own the Wenonah Development Company, Ltd. of Canada, which had income from American dividends in the amount of $1,606,000. No return has yet been filed for this corporation. It is interesting to note further that Mr. Bache deducted $89,400 on his personal return as interest on a loan made to him by his personal holding company.

The most flagrant case of this character is perhaps that of Jacob Schick, formerly a Lieutenant Colonel in the United States Army. Schick was the owner of all the stock of the Schick Dry Shaver Company of Connecticut. On December 18, 1935, he became a British subject through naturalization in Canada. He had been drawing a pension from the United States Army and he inquired from the Secretary of War if he could continue to draw his pension. The Secretary advised him on February 5, 1936 that he was no longer entitled to a pension and he was directed to return the retirement pay checks he had received after December 18th. On December 24, 1935, six days after his naturalization, Schick formed Schick Industries, Ltd. in the Bahamas and transferred to it his stock in the Connecticut

company. He thereby evaded the provision of our laws imposing a 25 percent tax on transfers of securities to foreign corporations. He owns the stock of three other Bahamas corporations, the purpose of which is not yet clear. The Intelligence Unit is now investigating Colonel Schick's case with a view to fraud charges.

3. Bahamas insurance companies

A New York insurance agent caused the organization of two insurance companies in the Bahamas with a view to enabling taxpayers to secure fake deductions for interest through an ingenious scheme for the issuance of large life insurance policies. Americans who went into the scheme purported to pay a large single premium for their policies, but immediately borrowed back practically the entire sum. Under the plan, the so-called "policy-holder" sought to obtain a large deduction for interest on this loan, although the fact was that no interest was really paid. By this means six Americans, Mr. Richard E. Dwight, Henry W. Lowe, Mr. Jacob Schwab, Mr. Lawrence Marx, Mr. George Thoms, and Dr. Winfield Ayres sought to evade nearly $550,000 in income taxes in the years 1932 to 1936. The fraud was discovered by the Special Intelligence Unit and all of the taxpayers have now submitted offers to pay the full amount of taxes evaded, plus interest. Mr. Dwight is a senior partner in the law firm of Hughes, Schurman & Dwight, 100 Broadway, New York.

4. Domestic personal holding companies

The rates of tax applicable to personal holding companies were reduced in 1936 and are not now sufficiently high to discourage the use of such companies as a valuable means of avoiding the surtaxes. The personal

holding companies that we have examined would have paid 81.7 percent more in taxes on their 1936 returns if the applicable tax rates had not previously been reduced. Thus, the personal holding company owned by the late Mr. Charles Hayden distributed none of its income in 1936; and Mr. Hayden thereby saved $322,958 in taxes. Mr. and Mrs. Alfred P. Sloan had their personal holding companies distribute a portion of the corporate earnings; but the use of the companies saved the Sloans $791,054 in 1936. Mr. and Mrs. Roy W. Howard have employed a personal holding company to great advantage in the purchase of additional newspaper properties. In 1936, their personal holding company reported over $500,000 of net income but the total taxes paid by the two Howards were less than $60,000. If the personal holding company were not in existence, they would have had to pay over $200,000 in additional taxes. The Schaefer Brewing Company of Brooklyn, an operating company owned by two brothers and their wives, showed an increase of net income from $1,050,204 in 1935 to $1,825,460 in 1936; but distributed only $300,000 in dividends in 1936 as against $500,000 in 1935. If the dividends had kept pace with the increased earnings, the Treasury would have collected $246,073 additional in taxes.

Another favorite device is to organize a considerable number of personal holding companies for the sake of reducing the tax and of increasing the Treasury's difficulties in auditing transactions between companies. I have already referred to the 23 personal holding companies of Mr. Charles E. Merrill and Mr. Edwin C. Lynch. According to our last

report (for 1933), Mr. William Randolph Hearst was interested in some 96 companies scattered all over the United States and England. We have not yet been able to discover how many companies he now utilizes, for their returns are filed all over the country, and the job of auditing their tangled transactions is tremendous.

5. Incorporated yachts and country places

Mr. Alfred P. Sloan's yacht is owned by Rene Corporation, one of his personal holding companies, along with $3 million in securities. He rents the yacht from his company and the company uses its income from securities to pay depreciation on the yacht, the wages of the captain and crew, and the expenses of operating the yacht. None of these items would be deductible if Mr. Sloan owned the yacht personally. A great many wealthy taxpayers are utilizing a similar arrangement for the operation of their country places. Other wealthy taxpayers using this method, the value of their country places and the tax savings they are effecting, are:

	Value of country place	Tax savings
Alfred I. Du Pont (now deceased)	$1,039,521	$59,000
Mr. & Mrs. Myron C. Taylor	1,000,000	15,000
Wm. H. Crocker & family	750,000	40,000
Wilhelmina Du Pont Ross	421,000	80,000
Harvey D. Gibson	978,000	20,000
Jacob Aron	1,166,457	20,000
Mr. & Mrs. Henry Ittelson	565,000	30,000

Mrs. Ross has improved on the general plan by causing her personal holding company which owns her country place to pay her husband a salary for managing it. She thereby supplies him with pocket money, and in effect secures a deduction for the expense of maintaining him.

6. Deductions for non-business interests, losses, etc.

Taxpayers are still taking large deductions for interest on loans to them by their own personal holding companies or on loans to them by their family trusts. I have already mentioned the deduction of $89,400

which Mr. Jules S. Bache took on the loan to him by his Canadian corporation. Mrs. Nathan L. Miller, wife of former Governor Miller, took a deduction of $35,639 in her 1936 return for a loan to her by her husband as trustee for their seven daughters.

7. Percentage depletion

This is perhaps the best example of legalized theft from the United States Treasury which the revenue laws still permit. Since 1928, the large oil and mining corporations have been entitled to deduct from 5 to 27½ percent of their gross income as an allowance for the depletion of their mines or wells, and the deduction may be taken even though the cost of the property has been completely recovered. Thus, in 1936, the Homestake Mining Company deducted $2,922,722 under this provision, although it had already completely recovered the cost of its property. The amount of the deduction was a sheer gift from the United States to this taxpayer, and the revenue that we lost thereby was $818,517. The similar loss of revenue in the case of the Gulf Production Company of Pittsburgh was $584,955 (1935); Texas Gulf Sulphur Company, $413,009 (1935), $557,487 (1936); Shell Oil Company, $512,452 (1935); Sun Oil Company, $272,041 (1934), $267,091 (1935); Stanolind Oil & Gas Company, $202,244 (1934); Amerada Petroleum Corporation, $152,025 (1935). I recommended in 1934 that this provision be eliminated but nothing was done, presumably because of the heavy pressure from the large oil and mining companies which are profiting immensely at the expense of other taxpayers.

8. Division of income between husband and wife, particularly in the 8 community property states

This is another legalized fraud on the revenues at the expense of taxpayers in the 40 states which do not have community property laws. A New York resident with a salary of $100,000 pays about $32,525 Federal income tax; a Californian with the same salary may cause one half to be reported by his wife, and the Federal income taxes payable by the two will be only $18,626. The loss of revenue due to the refusal of members of Congress from the community property states to permit the taxation of their citizens on the same basis as citizens from the other 40 states runs into the millions.

The existence of this legalized discrimination has stimulated the formation of fake partnerships between husbands and wives and their children in other states. Thus, at the end of 1935, Granberry & Company, a New York brokerage firm, took into partnership the four minor children (two boys and two girls) of C. K. Reynolds, one of the partners. The tax saving to Mr. Reynolds in 1936 amounted to $55,000.

9. Increasing purchases of tax-exempt bonds by wealthy citizens

The last statistics which we have show enormous holdings of tax-exempt state and municipal bonds by our wealthiest citizens. Our records are very incomplete since these individuals do not report fully what their actual holdings are, but our last compilation shows that John D. Rockefeller, Jr. owned over $32 millions of state and municipal bonds; Frederick W. Vanderbilt, $28,700,000; H. Sylvia Wilks, $31,895,000; Mary G. Thompson, $17,778,000; the late E. H. R. Green, $14,254,000. Such returns as we have been able to check for 1936 indicate a gradual increase in these holdings.

One of the most disheartening facts disclosed by our investigation is that lawyers of high standing at the bar are advising their clients to utilize devious tax avoidance devices, and they are actively using them themselves. Mr. Dwight and Mr. Clark, prominent New York lawyers, are mentioned above. Among the New York law firms which have formed Panama, Bahamas, or Newfoundland corporations for their clients, are: Sullivan & Cromwell; Palmer & Searles; White, Sims & Houston; and Davis, Polk, Wardwell, Gardiner and Reed.

A recent case decided by the Sixth Circuit, Morsman v. Commissioner, illustrates the same point, and also the long struggle which the Treasury confronts in ferreting out tax evaders and in collecting from them. One Morsman, desired to sell two lots of stock in 1929 at a large profit. Advised by his lawyer brother, he transferred the stock to himself as trustee to accumulate the income for his own benefit for five years, and thereafter to distribute it to himself. He was, therefore, not only settlor and trustee, but sole beneficiary. Having sold the stock during the next week as "trustee" at a profit, he contended that the trust, not he, was taxable thereon. The court has just now, eight years later, decided in favor of the Treasury, and we can now collect the tax and interest. Even so, one dissenting circuit judge could not see Morsman, the individual, behind the legal mask of Morsman, the trustee, for Morsman the sole beneficiary.

In conclusion, I have two observations to make from the evidence before me. In the first place, the instances I have given above were disclosed by a quick check of comparatively few returns. Most of the

large corporation returns have not yet been filed. The general audit of 1936 returns is just beginning. I regret to say that I am afraid the cases I have digested above are symptomatic of a large number of others, which will be disclosed by a careful audit. In the second place, the ordinary salaried man and the small merchant does not resort to these or similar devices. The great bulk of our 5,500,000 returns are honestly made. Legalized avoidance or evasion by the so-called leaders of the business-community is not only demoralizing to the revenues; it is demoralizing to those who practice it as well. It throws an additional burden of taxation upon the other members of the community who are less able to bear it, and who are already cheerfully bearing their fair share. The success of our revenue system depends equally upon fair administration by the Treasury, and upon completely honest returns by the taxpayers. We have a right to expect higher standards of morality in high places than the 1936 returns disclose.

Faithfully,

May 21st 1937.

Henry Morgenthau Jr.

The President,

The White House.

file Confidential

PSF Taxes

TAX BILL

(1) In a confidential conversation which he hoped could be somehow indirectly relayed to the President, X told me today that--

(a) he had been observing very closely the working out of the Administration's proposal for taxes on corporation earnings in the House Ways and Means Committee;

(b) he had a number of conversations on the subject with Senator LaFollette, Oliphant, Helvering and Arthur Kent (Acting General Counsel of the Bureau of Internal Revenue who is working daily with Oliphant before the House Committee);

(c) LaFollette, Helvering, Kent and X are convinced that the original proposals have already been so riddled with exemptions and exceptions which cannot now be eliminated that it is very likely that taxes received from corporation earnings under the new legislation will aggregate less than taxes received from corporation earnings under present tax legislation;

(d) Oliphant is so absorbed with the idea of establishing the principle of taxation on surpluses and so harrassed by the multitude of original problems involved in the working out of the new scheme, that he seems impractically oblivious to the manner in which the exemptions and exceptions are gutting both the application of the principle and the expected revenues;

(e) both the principle of the intercorporate dividend tax to discourage holding companies and the principle of graduated corporation tax on size established in last year's tax legislation are likely to be lost in the shuffle.

(2) X proposed as a way out of the difficulty the adoption of a plan which seems to be LaFollette's idea for the proceedings in the Senate Finance Committee -- leave the present corporation taxes as they are, possibly raising the intercorporate dividend tax from 1½ to 2% and add a new surtax on undistributed corporation profits.

X pointed out that this plan would---

(a) establish the principle of taxing undistributed corporation profits, which Oliphant is trying to do with the more complicated plan;

(b) assure the raising of the amount of revenue required without taking risks on complicated and unpredictable new proposals;

(c) retain the principle of the intercorporate dividend tax with its salutary effect upon complicated corporate structures and the principle of the graduated tax on size, both of which risk being lost in the present confusion before the Committee;

(d) give an opportunity for a year's study of difficulties not clearly foreseen at the time the proposal was first made in the application of the principle of taxing undistributed profits.

PSF Taxes

Excerpt from P. C. 531 - March 21, 1939.

Q: There is a great deal of discussion about a long-range tax program; that is, one that would be at least for five years, the idea being that some curtailment of the government revenues would undoubtedly result from such a program in the first year or two but that over a five-year peridd the revenues would at least probably equal and possibly exceed those we receive today from the present structure. Would that, in your opinion, be barred as a possibility in view of your statement that no reduction in corporate taxes is contemplated?

A: THE PRESIDENT: Again, if you will read the annual message to the Congress you will find the answer.

In other words, quite simply, we have the choice of following the policy recommended in the annual message or adopting the policy which has been advanced by perfectly well-meaning people, that is, cutting down certain expenditures of the Government, which, as I pointed out in that annual message, must, in order to be substantial, come out of certain obvious items which can be readily cut.

They include: relief for the unemployed, all forms of public works, social security for the aged, slum clearance and various other items which today give work in large volume -- all of those being predicated on the guess of many well-meaning people that thereby, taking away employment from several million workers, business will automatically pick up and employ that entire slack plus the other large number of people who are out of work but not in any way being helped by the Government.

If there was some guarantee that this would happen, it would be worth considering.

I doubt, however, whether this would meet with popular approval if it were tried and the results were not attained.

There is the answer. It is purely extemporaneous but I think I said a mouthful.

Q Can we quote that, too, Mr. President?

THE PRESIDENT: Yes.

#

FOR THE PRESS IMMEDIATE RELEASE MARCH 21, 1939

The following is an excerpt from the President's conference with the press of Tuesday, March 21, 1939:

Q: There is a great deal of discussion about a long range tax program; that is, one that would be at least for five years, the idea being that some curtailment of the government revenues would undoubtedly result from such a program in the first year or two but that over a five-year period the revenues would at least probably equal and possibly exceed those we receive today from the present structure. Would that, in your opinion, be barred as a possibility in view of your statement that no reduction in corporate taxes is contemplated?

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THE SECRETARY OF THE TREASURY
WASHINGTON

PSF
Tax file

June 3, 1939

My dear Mr. President:

In compliance with Miss Le Hand's request over the telephone, I am sending you herewith the statement of E. C. Alvord, presented to the Ways and Means Committee on June 2nd.

Yours sincerely,

H. Morgenthau Jr.

The President,
The White House.

STATEMENT OF ELLSWORTH C. ALVORD

(Presented to the Ways and Means Committee of the House of Representatives at hearings on revenue proposals, June 2, 1939)

Mr. Chairman, Gentlemen:

I am Ellsworth C. Alvord, an attorney, of Washington, D. C., appearing as the Vice Chairman of the Committee on Federal Finance, of the Chamber of Commerce of the United States.

Introduction

It is always difficult to discuss a revision of our revenue laws in the absence of specific proposals. It is additionally difficult this morning, for we are fully appreciative that the limitations of time necessarily restrict your Committee and the Congress and prohibit extensive changes in existing law.

We are attempting a two-fold classification of our suggestions: (1) those which we think can be considered and enacted prior to June 30th of this year; and (2) those which we believe should be considered a part of a more far reaching and more permanent revision, to be considered, for example, during the adjournment of the present session and prepared for the consideration of the Congress during the next session. We hasten to assure you, however, that our suggested classification is tentative indeed.

We are very happy to endorse and approve (with two minor exceptions, of perhaps no immediate importance, which will be discussed briefly hereinafter) the objectives and the program of the Secretary of the Treasury in his opening statement to your Committee last Saturday. We commend his constructive approach to the fiscal problems confronting the Congress and the country. It merits the support of every citizen. Differences of opinion with respect to the application of the principles enunciated and urged by the Secretary of the Treasury are, of

course, to be expected. But there can be no serious differences upon the objectives and principles he has advocated.

Fiscal Objectives

In the opening statement of these hearings, the Secretary of the Treasury presented the following basic objectives of a fiscal program:

(1) The maintenance of public finances in a sound and unassailable position;

(2) The promotion of free enterprise and private investment;

(3) The attainment of full business recovery;

(4) A just distribution of tax burdens, and a more equitable distribution of national income.

To accomplish these ends, the Secretary recommended the following program:

(1) A definite approach to a balanced budget;

(2) A Congressional Joint Committee on Fiscal Policy to coordinate expenditure and revenue programs;

(3) A non-partisan commission to examine the problems created by Federal-State tax conflicts;

(4) Revision of the Federal tax laws to remove manifest inequities or other defects, including

(a) provisions likely to hinder business expansion and investment,

(b) provisions constituting "tax irritants", and

(c) provisions raising questions of tax equity.

The Secretary correctly stated that the foregoing objectives are essential to the successful operation of our democracy; that full recovery and a sound fiscal position are imperative for an adequate national defense; that fundamental

objective of sound finance is a balanced budget; and that changes in our fiscal program must conform to this end. The Secretary might have added that they should guide not only fiscal decisions but all activities of Government.

One of our reservations is directed toward the fourth objective in tax policy, namely, "a more equitable distribution of national income". Our reservation is based upon the fact that we do not understand the statement. We merely make the point at this time, not for purposes of debate, but solely to avoid misunderstanding of our position.

The second reservation is directed toward coupling a reduction in individual surtax rates (which seem, we believe, to be admittedly far too high, and which must be reduced substantially if one of the most serious deterrents to private investment and industry is to be removed) with the taxation of future issues of Federal, State and municipal securities. We have advocated measures to reach both objectives. But we can not agree that they are so closely interrelated that neither should be brought about unless both are, and that the former should await the attainment of the latter.

Magnitude of the Problem

We are very far from the fulfillment of our objectives at the present time. In the years since 1931, we have "bought time to think", perhaps, but we have made little progress towards a permanent recovery.

(a) Maintenance of Sound Public Finances. -- On June 30, 1940, we shall have completed a ten-year period of continuous deficits, since the deficit of 1931. The books of the Federal Government will show the following results of operations over the period:

(1) Total expenditures of $72 billions, or $7 billions annually (in the last two years, $9 billions annually);

(2) Total deficits of $31 billions, averaging $3 billions a year;

(3) Gross Federal debt which will approximate $45 billions, excluding guaranteed obligations of about $5 billions;

(4) Gross Governmental debt, including State and local debts, of about $63 billions;

(5) An increase in the per capita debt, Federal, State, and local, from $289 to $482, in the space of ten years;

(6) An annual interest burden on the Federal debt of more than a billion dollars.

Tables marked (1) and (2) indicate the receipts, expenditures, deficits and debt, by years, from 1931 to 1940.

(b) Promotion of Private Investment. -- While public expenditures have more than doubled in the last decade, private investment has dwindled even more rapidly. In fact, new private investment seems almost to have disappeared.

At least two positive indications of this trend are at hand. Table (3) shows the decline in the volume of corporate security issues. Table (4) indicates the extent of the shift from private to public construction.

Professor Adolf A. Berle, in his recent testimony before the Temporary National Economic Committee, summarized the situation as follows:

> "The flow into capital construction may be said to have found its norm at a level of somewhere between eight and ten billions of dollars during the decade from 1920 to 1930. Of this, at least six billions went through the public markets -- that is, occurred by sale of stocks and bonds. The balance went into construction through the mortgage markets or through private placement. By 1931, the amounts going through the public markets had fallen to approximately half that amount; then withered to a mere fraction. At a maximum, since 1931, not more than two and one-half billions of true capital money has gone through the mechanism of the public markets. The average is considerably less.
>
> "The conclusion is obvious: American private markets are not funneling capital funds into capital construction at more than (roughly) one-third to one-half the rate they were doing in the 1920-1930 decade. This means that private activity in heavy industry is not being continuously generated in sufficient volume to keep those industries busy, or to keep the country continuously on an even economic keel."

To some extent, Government expenditure has taken up the slack in private financing. But it has been estimated, also in testimoney before the Temporary National Economic Committee, that in the years 1930-1937, inclusive, there was an accumulated deficit of $17 billions in new purchasing power, despite the billions expended by the Federal Government. If, as Chairman Eccles recommends, the Government had attempted to make good this shortage of private investment, it would have required an additional Federal deficit of more than $2 billions in each of these eight years.

(c) Attainment of Recovery. — Our recovery goal may be stated as the sum of the following:

(1) The maintenance of a democratic form of government;

(2) Adequate provision for national defense;

(3) Reduction of unemployment, at least to 1929 levels;

(4) A balanced budget, including provision for orderly debt retirement;

(5) A substantial increase in our national income -- to $80 billions to $100 billions annually.

How close are we now to this goal?

There are now between 15 and 20 million persons receiving public assistance financed by Federal, State, or local funds. The cost of relief to the Federal Government alone this year approximates $2-3/4 billions.

Industrial production last month was only 92% of the 1923-5 average; factory payrolls only 85% of wages paid in the period 1923-5, more than fifteen years ago.

The national income has not approached $80 billions since 1929 — has not, in fact, in all the intervening years been within $10 billions of our minimum objective.

The indexes of business recovery, and the statistics of relief, given

in tables (5) and (6) tell their own story of our failure to achieve recovery. They will repay study.

A Permanent Fiscal Program

It seems clear that a full, healthy and permanent recovery requires a transition from Government spending to private investment, a sound constructive fiscal program for the Federal, State, and local governments, a decrease in the demands for Federal assistance, a reduction in relief rolls with a corresponding increase in private payrolls, and a substantial increase in the national income.

These results can only be attained by the encouragement of private industry, private investment, and private employment.

In terms of a general fiscal program, this means:

(1) Adjustment of tax rates to the point of maximum business activity and hence maximum productivity;

(2) Removal of tax barriers to private enterprise and investment;

(3) Assurance of stability and certainty in the revenue system;

(4) Simplicity and ease of administration;

(5) An effective control expenditures, so that they may be kept within the revenue yields of a reasonably permanent tax system enacted to carry out the foregoing program.

Control of Expenditures

We commend for the consideration of the Congress, the recommendation of the Secretary of the Treasury that Congressional procedure be devised for the consideration of revenues and expenditures together as two interrelated aspects of a single problem. Stability and certainty in our fiscal program cannot be maintained without effective legislative control over expenditures and coordination of receipts and expenditures.

We are confident that the Congress can readily devise legislative procedure to improve the existing control. For example, a special Budget Committee of the House might be created, to consist of the Speaker, the Majority and Minority Leaders, and the ranking members of the Committee on Ways and Means, Appropriations, and Rules. This Committee could consider the Budget as a whole -- that is, the estimated revenues and the proposed expenditures -- and report to the House its recommendation as to the total appropriations to be made. The Committee's report could be subjected to full debate and the House decide upon a total for all appropriations, thus placing an effective "ceiling" below which they must be kept. The Appropriations Committee would then adjust its various appropriation bills and keep them within the maximum thus fixed. No appropriation could exceed the "ceiling", unless specially approved by the Budget Committee. If the Budget Committee concluded that the appropriation was essential, despite the previously fixed aggregate total, it could approve a Special Rule permitting its consideration; otherwise the appropriation would not be considered.

A similar committee, suitable to Senate procedure, might be developed for the Senate, which, of course, could act independently of the House.

Such a plan would seem to be flexible enough to allow extraordinary and emergency expenditures but it would permit fixation of a definite and well considered limit to expenditures and to legislation authorizing expenditures.

General Tax Recommendations

Obviously, it is not feasible to complete a revision of the revenue system before the end of the present session. Nevertheless, progress can be made. A stable, permanent revenue system is sorely needed as a foundation for maximum business activity, the first requisite of maximum yield of a revenue system.

As the first step in such a program, and for immediate action by Congress, we recommend the following specific changes:

(1) A flat rate normal corporation tax of 15%, with a specific credit of $2,000 to reduce the applicable rate on small incomes.

(2) Outright repeal of the 2-1/2% undistributed profits tax.

(3) A carryover of net business losses for three years.

(4) Simplification of the individual capital gain provisions, eliminating the unnecessary distinction between assets held 18 and 24 months and substituting a shorter holding period.

(5) The treatment of "long-term" capital gains and losses of corporations as ordinary gains and losses, thus more nearly according to corporations the treatment now accorded individuals.

(6) An annual declaration of capital stock value, beginning with the current year.

(7) Permission for affiliated groups to file consolidated returns.

(8) Elimination of double taxation by exempting all intercorporate dividends from tax, and excluding corporate dividends from individual normal tax.

(9) Remedying a few of the existing defects in the so-called technical or administrative provisions of the present law.

We believe that a long range program of tax revision should include the following:

(1) A reasonably permanent revenue system, based upon the principles above advocated -- that is, a system the basic principles of which are to remain in force, for example, for a period of ten years;

(2) Simplification of the present law, which can be effected in large part by the elimination of unnecessarily complicated policies and refinements;

(3) The reduction of individual surtaxes to the point where they will

not discourage private investment and individual initiative;

(4) A substantial reduction in the tax upon capital gains;

(5) An effective earned income credit;

(6) A revision and simplification of the present estate tax laws, including a substantial reduction in the present confiscatory rates;

(7) A provision for the setting aside of adequate funds (through insurance or otherwise), free of estate tax, for the payment of the estate tax;

(8) The repeal of the capital stock - excess profits tax system, as soon as the revenue requirements permit;

(9) Removal of the inequities now existing in our excise tax system;

(10) A procedure for the collection of excise taxes corresponding to the existing procedure for the collection of income taxes.

Attached, as Appendix A, are a series of examples, showing the effect of existing surtaxes upon the investment of individuals.

Corporate Normal Tax

The normal tax on corporations should not and need not exceed 15%. It is agreed, of course, that some allowance from the maximum rate should be made for corporations having an income, for example, below $25,000. A specific credit of $2,000 for this purpose is preferred on the ground of simplicity. Such a credit would reduce the effective rate to 9% on incomes of $5,000; 12% on $10,000, and 13.8% on $25,000.

It is usually assumed that a rate above 15% will produce more revenue. With this assumption, we can not agree. The fundamental factor in an income tax is the amount of income subject to tax. There is a point of maximum productivity. Above that point, increases in the rate diminish business volume and the total profits subject to tax.

Prior to the undistributed profits tax of 1936, general corporate rate was 13-3/4% for the years 1932, 1933, 1934 and 1935. The present normal corporate tax is 16-1/2%, which in itself constituted a very substantial increase -- attributable solely to the enactment of the undistributed profits tax. Adding other taxes, many corporations today are paying more than 50% of their net income in taxes. In our opinion, this is well above the point of maximum productivity. Attached is a table (Table 7), prepared from Registration Statements filed with the Securities and Exchange Commission, showing the total taxes paid and their relation to the net incomes of certain groups of corporations. It would seem that further proof is unnecessary.

The only way in which more revenue can be realized from corporations is by stimulating increased business activity. The possibilities are revealed by the following table, showing the rate of industrial production, the amount of corporate income subject to tax, and the revenue collected from corporations, by calendar years, from 1922 to date:

Year	F.R. B. Index Industrial Production	Corporate Net Income	Rate of Corporate Tax	Revenue from Corporate tax
1922	85	6964	12-1/2	775.3
1923	101	8322	12-1/2	937.1
1924	95	7587	12-1/2	881.6
1925	104	9584	13	1,170.3
1926	108	9673	13-1/2	1,229.8
1927	106	8982	13-1/2	1,130.7
1928	111	10618	12	1,184.1
1929	119	11654	12	1,193.4
1930	96	6429	12	711.7
1931	81	3683	12	399.0
1932	64	2153	13-3/4	285.6
1933	76	2986	13-3/4	416.1
1934	79	4275	13-3/4	588.4
1935	90	5149	13-3/4	707.9
1936	105	6732	(8-15 (*surtax	1,111.0
1937	110	7160 E.	(on undis- (tributed (profits	1,160.0
1938	86	4700E)		795.0 Est.
1939				
Jan.	101	---)	---	---
Feb.	99	---)	16-1/2 + 2-1/2%	
Mar.	98	---)	undistributed profits	1,005, Est.
Apr.	92 p.	)		
May	92 p.	)		
Year	98-100	6,200)		

p. -- Preliminary

Given an industrial production index of about 105 and a corporate tax base of $7 billions, a 15% rate would produce over a billion dollars, approximately the amount which will be collected for the current calendar year at present rates. It appears from the table that this is only a moderate expansion of business volume over the present estimates of 100 for the index and $6200 millions for the corporate base.

In the recent publication "Taxation and Capital Investment" issued by The Brookings Institution, the author concludes:

> "As has been pointed out earlier in this analysis, the means of securing fiscal stability is to be found in the expansion of total national production. Taxation revenues will pretty much take care of themselves if we can achieve full economic recovery."

We are thoroughly in accord with this analysis.

Undistributed Profits Tax

There is no legitimate excuse for retaining the 2-1/2% undistributed profits tax. The principle of a penalty tax on earnings was repudiated at the last session of Congress. The tax produces no substantial revenue. The computation of a dividend paid credit introduces complexities which are wholly out of proportion to the importance of the tax.

It has been asserted that the repeal of the 2-1/2% undistributed profits tax will encourage tax avoidance by wealthy stockholders, who will prefer to leave profits in corporations under their control rather than to pay high personal surtaxes thereon. Naturally, every effort should be made to prevent tax avoidance in this or any other form. The whole problem, however, of tax avoidance by corporate stockholders has been grossly exaggerated. The personal holding company provisions, enacted in 1934 and strengthened in 1936 and 1938, are adequate to take care of "incorporated pocketbooks." In the rare case of an operating company being used for tax avoidance, section 102,

imposing penalty taxes on the unreasonable accumulation of surplus, affords sufficient protection to the Government. This section <u>can</u> be enforced, as the <u>National Grocery Company</u> case (304 U. S. 282) demonstrates — despite representations to the contrary before this Committee last year when the Title IB tax on closely-held operating companies was proposed. It will be recalled also that section 102 was purposely strengthened last year to make it more easily enforceable, by putting the burden of proof on the taxpayer to show the absence of a purpose to avoid surtax.

<u>Net Loss Carryover</u>

We urge that the privilege of carrying forward net operating losses be restored to the Revenue Act immediately.

The selection of a single year as the taxable period is admittedly arbitrary, and results in great hardship to industries and particular companies in which years of profit and loss alternate. If such companies are taxed in years of profit, without allowance for prior years' losses, their tax burden is wholly out of proportion to the income actually earned over the period as a whole. As compared with businesses having a stable income from year to year, moreover, they are at a severe competitive disadvantage. There are attached a series of computations (Appendix B) illustrating the effective rates of taxation upon corporations sustaining losses during one or more years of a five-year period.

The Revenue Act, from 1921 to 1933, recognized this hardship and permitted a net loss carryover. The privilege was abolished in the National Industrial Recovery Act in 1933, solely by reason of the urgent necessity of protecting the revenues at that time. It has never been disputed that such a provision is an essential feature of an equitable tax system.

The determination of the carryover period is necessarily arbitrary. The British income tax permits losses to be carried forward for six years. A

shorter period may be desirable for revenue purposes. In view of the abnormal conditions of the last ten years, and the wide fluctuation of business activity, incomes and values we have experienced, a carryover of at least three years should be allowed.

Capital Gains and Losses

The capital gain and loss provisions applicable to individuals, as revised by the 1938 Act, distinguish between assets held less than 18 months, taxable in full; assets held 18 to 24 months, taxable at a maximum flat rate of 20%; and assets held more than 24 months, taxable at a maximum flat rate of 15%. The "intermediate" period of holding, 18 to 24 months, appeared as a compromise provision, for which no real necessity existed. As a practical matter, it greatly complicates the structure of the section, and for purposes of simplification, it should be eliminated.

The dividing line between "short-term assets" and "long-term assets" is intended to separate speculative from investment transactions. Since assets bought for speculative purposes are rarely held longer than six months, a substantially shorter holding period than the 18 months now prescribed should be considered.

Corporate capital gains were ignored in the 1938 revision of the section. Such gains continue to be taxed in full regardless of the period of holding; while corporate capital losses are deductible only to the extent of gains plus $2,000. There is an obvious injustice in this situation which should be corrected. We recommend that "long-term" losses be allowed as a deduction, without limitation.

Capital Stock and Excess-Profits Taxes

While it is undoubtedly desirable to repeal these taxes, we believe that it is necessary to retain them, as a temporary proposition, for revenue purposes. The most serious objection to them is that they do not impose a tax

on true excess profits. The iniquitous feature of the present law is that it requires a corporation to declare a value for its capital stock which will serve as a basis for the computation of profits for the next three years. Since no corporation can estimate its profits beyond the current year with any degree of certainty, the declaration of a proper value is sheer guesswork, and no proper basis i s established for determining excess profits.

Accordingly, we recommend that the capital stock tax be revised to permit an annual declaration of value, beginning with the current year, with adequate precaution, if necessary, against any immediate reduction in its yield.

Consolidated Returns

The requirement of separate returns for a group of affiliated corporations is indefensible. Such a requirement leads to the statement of non-existent profits and losses on intercompany transactions and distorts the presentation of earnings of particular units. Accountants, the Stock Exchange and the Securities and Exchange Commission uniformly require or permit consolidated returns to reflect the financial position of the affiliated group. The Treasury Department has consistently supported the use of consolidated returns.

A mandatory requirement for consolidated returns is impracticable owing to constitutional and administrative difficulties. An elective provision similar to the one in force prior to 1934 is therefore recommended.

Double Taxation of Dividends

Prior to 1936, corporate dividends were excluded from the individual normal tax, since the corporation had already paid the tax upon the earnings out of which the dividend was paid to its stockholders. In the 1936 Act, dividends were subjected to the individual normal tax, but only because the undistributed profits tax, as originally drafted in the House, did not require the corporation to pay a tax on income which it distributed. With the restoration of a corporate normal tax, the imposition of a second normal tax upon the stock-

holders cannot be supported.

Intercompany distributions offer an even more severe instance of double or multiple taxation of corporate earnings. Such distributions are subject to taxation in the hands of the originating corporation, again to the extent of 15%, thereof in the hands of the receiving corporation, and finally when distributed to its stockholders.

On the other hand, bond interest, as distinguished from dividends, is allowed as a deduction to a corporation in computing net income and is taxed only once, as income to the bondholder. This situation has led the 20th Century Fund to conclude in a recent study that borrowed money is more attractive than venture capital, both to corporations and investors, with the result that a heavy permanent debt structure may be created which becomes unmanageable in times of depression.

We recommend that the exemption of dividends from normal tax be restored and that the intercorporate dividend tax be repealed.

Administrative and Technical Recommendations

In addition to the foregoing major recommendations, we believe that consideration of the following amendments of a technical nature should not be delayed, and should be acted upon at the present session:

(1) Correction of the Effect of the Hendler Decision. -- In United States v. Hendler, 303 U.S. 564 (1938), the Supreme Court held that the assumption and payment of bonded indebtedness by the transferee in a 112(b) (4) reorganization constituted "other property" taxable to the transferor under section 112(d). This decision was contrary to the long-established Bureau rule that the assumption of a liability was not "property" of the character referred to in 112(d), since it was not capable of distribution to stockholders. It also seems contrary to the policy and interest of Congress to accord similar treatment to reorganizations effected by consolidations or mergers, by acquisition of control, or by acquisition of assets. The Hendler decision has created great confusion in the reorganization field, not only because of uncertainty as to the scope of the Hendler rule for the future, but also because it affects countless prior reorganizations, opening the way to claims by the Government for increased taxes and claims by tax-payers to stepped-up bases with respect to transactions long since closed. In addition, under the definition of a "reorganization" in section 112(g)(1)(B) of the 1934 and subsequent Acts, there is a serious question whether reorganizations carried out after that date involving the assumption of liabilities were not taxable transactions in their entirety. A general retroactive amendment confirming the Bureau rule seems to be the only satisfactory method of avoiding these complexities, both for the Government and the taxpayer.

(2) Correction of the Effect of the Rosenfield Decision. -- R.S. 3186 provides for an automatic lien of the Federal Government for unpaid tax liabilities. The lien is not valid against a purchaser for value unless notice thereof

is filed in accordance with the law of the State in which the property subject to the lien is situated. In U.S. v. Rosenfield, (D. Ct. E.D. Mich., Dec. 8, 1938; 39 C.C.H. 3204), the Federal Court in Michigan enforced such a lien upon negotiable securities in the hands of a firm of Detroit stockbrokers, who had purchased the stock without actual notice of the lien. The lien had been properly recorded under Michigan law and the decision obviously conforms to the strict terms of the statute. Nevertheless, the fears and uncertainties of purchasers and security dealers created by the decision are apparent, since it is virtually impossible in the course of normal dealings in securities to determine whether there may be liens filed against securities presented for delivery. It is recommended that the Federal statute be amended to conform to the Uniform Stock Transfer Act, by providing that no lien shall attach to negotiable securities unless notice of the lien is stated on the certificate, or actual notice can be proved.

(3) Correction of the Effect of the Koshland and Gowran Cases. — From 1921 to 1936, the Revenue Act provided that all stock dividends were tax-free. The Treasury Regulations required, where a stock dividend was declared, that the basis of the original shares be apportioned between those shares and the dividend stock for computing gain or loss on the sale thereof. In Koshland v. Helvering, 298 U.S. 441 (1936), the Supreme Court held that a dividend of common stock on preferred stock was a taxable distribution. The Court further held, contrary to the Regulations, that where a stockholder had received such a dividend, and had sold the preferred stock, no part of its cost could be allocated to the dividend stock in determining gain or loss. In Helvering v. Gowran, 302 U.S. 238 (1937), the converse situation was presented, where the dividend stock had been sold, and the Court held that the cost of such stock to the taxpayer was "zero". These decisions overturning the Regulations may adversely affect either the Government or the taxpayer, depending on which stock the taxpayer may have parted with, a wholly fortuitous circumstance. It is suggested that the proper remedy is a

statutory ratification of the Department's regulation with respect to a taxpayer who still has one of the stocks and in disposing of the other computed gain or loss in accordance with that regulation.

(4) Inventory Amendment. -- Section 22(d) of the 1938 Act recognized, for the first time, the "last-in, first-out" method of valuing inventories, but severely limited its area of application. In accordance with the instructions of the Senate and House Conferees on last year's Bill, further study has been given to the manedment by the Treasury Department with a view to action at this session. It is understood that the Department is ready to present an appropriate redraft of the amendment, which should be incorporated in the Bill.

(5) Purchase of Bonds at a Discount. -- There is no specific provision in the Act with respect to the tax treatment of purchase or cancellation of indebtedness, but the Regulations provide that the purchase or cancellation of indebtedness at less than par results in taxable income to the extent of the indebtedness discharged, except where the taxpayer is insolvent after the cancellation. This regulation, in our opinion, is unsound. The purchase of indebtedness at less than par produces no real gain or income. Moreover, the regulation works extreme hardship on corporations in distressed financial circumstances, which are unable to reduce unhealthy debt structures because of the amount of taxable gain which would be realized in the transaction. A partial relaxation of the strict Treasury rule was afforded by the Chandler Act at the last session of Congress, which contained a specific provision that no taxable income shall be realized by virtue of indebtedness cancelled or reduced in a proceeding under that Act. The sound principle thus expressed, however, is too limited in application, since it does not apply to the purchase of indebtedness generally, or to reduction of indebtedness effected without the aid of a Federal bankruptcy court. A general principle that the purchase of bonds at a discount does not result in

taxable income should be written into the Revenue Act.

(6) Revision of Section 820. -- This complex and technical provision, relating to the correction of errors barred by the statute of limitations, requires revision in several important particulars. For present purposes, however, it is sufficient to call attention to one obvious deficiency. The section authorizes an adjustment against the taxpayer, if a determination establishes the proper year for a deduction or credit erroneously allowed by the Commissioner in a barred year. It does not, however, permit an adjustment in favor of the taxpayer if a deduction or credit has been erroneously disallowed by the Commissioner in a barred year, and a determination is later obtained establishing that fact. Correction of the section in this respect will not afford relief to the taxpayer who has failed to claim a bad debt deduction in the proper year, and seeks to correct the error after the statute of limitations has run; the deduction must have been claimed and improperly denied to get relief. But the amendment does cover an important type of case which the Subcommittee recommended should be covered, and which is necessary to dispense "even-handed justice" between the taxpayer and the Commissioner.

(7) Foreign Tax Credit. -- Section 131, allowing a credit for taxes paid to foreign countries, was designed to encourage and protect American citizens engaged in foreign trade or having investments abroad. A recent limitation on the credit, however, had deprived it of much of its effectiveness. This restriction arises from the change in the definition of "net income" made by the 1936 and 1938 Acts. For United States tax purposes, the term "net income" now includes partly-tax-exempt interest and intercorporate dividends, credits against net income being employed to remove these items, wholly or partially, from tax. For purposes of the foreign tax credit, however, the phrase "entire net income", used in computing the limit on the credit, includes both partly-tax-exempt interest

and intercorporate dividends, with the result of distorting the application of the formula and unjustly reducing the amount of the credit. We hope an amendment to correct this error will be promptly adopted.

(8) Pension Trusts. -- The pension trust amendment adopted in section 165 of the 1938 Act, together with the stringent new regulations adopted, threatens the creation and continued existence of many pension, bonus and profit-sharing trusts for employees. The amendment denies tax-exemption to these trusts, if there is any possibility, however slight, that funds may revert to the employer prior to the satisfaction of all liabilities -- both fixed and contingent -- to employees under the trust. The only exception is the possibility of recovery of amounts through erroneous actuarial computation. Since this requirement can be met only by a virtually irrevocable trust, which is usually undesirable, if not impossible, from a business standpoint, the effect will be to curtail seriously the number of these trusts, to the detriment of employees.

The 1938 amendment unquestionably went too far. The original law worked well, and no convincing reason was advanced for changing it. The amendment was based on the assumption that tax avoidance might occur through the use of revocable trusts. No actual cases were presented in support of this assertion. It is our recommendation that Congress, at this session, should return to the original law. If that is impossible, at least an amendment should be adopted to correct the present situation, preferably by limiting the requirement of irrevocability to that portion of the trust fund which is necessary to satisfy liabilities which have become fixed and certain, as contrasted with liabilities which are merely contingent.

(9) Deficiency Dividends. -- A credit was provided in the Revenue Act of 1938, permitting personal holding companies subject to the penalty surtaxes of Title IA to declare dividends to offset deficiencies determined by the Commissioner or the courts. All business corporations, with respect to 1936 and 1937

incomes, are liable to the heavy penalty surtaxes of the 1936 Act for failure to distribute income, if deficiencies are hereafter discovered. In the absence of a similar credit, a corporation which in good faith distributed all the income shown on its return for 1936 and 1937 may suddenly be confronted with an unexpected increase in its taxable income for these years and become subject to a heavy undistributed profits tax. We recommend provision for such a credit in the pending revision of the Act.

(10) Capital Gains of Personal Holding Companies. -- A very large amount of capital assets which have appreciated in value remain "frozen" in personal holding companies. Under the 1938 Act, complete liquidations could be effected at capital gain rates (sec. 115(c)) and, under certain circumstances (sec. 112(b)(7)), without any immediate tax, upon the stockholders. However, many of these companies could not, and can not now, be completely liquidated. A partial liquidation is prohibited, for it involves full taxation of the capital gains. Sale of the assets is out of the question, since the gain would be taxable first as corporate income and then either as an ordinary dividend at full normal tax and surtax to the stockholders or as undistributed income of the holding company at the 65-75% rate.

The personal holding company surtax was intended as a rough equalization of the taxes which would have been payable by the stockholders if the income had been realized by them directly. In the case of capital gains, however, the section goes far beyond this objective, since the stockholders would be entitled to the flat 15% rate if they disposed of the assets directly instead of through the corporation.

One solution would be the exclusion of capital gains from the definition of "undistributed net income" of personal holding companies. Another possibility is the extension of section 112(b)(7), which would permit the distribution of the appreciated assets with the tax postponed until subsequent sale

by the stockholders. Other suggestions deserving consideration are to permit the partial liquidation of such companies at capital gain rates, or with a carry-over basis and the tax postponed until the gain is actually realized by the stockholder, or to allow the corporation to sell its capital assets, paying the corporate rate thereon and thereafter to distribute the gain tax-free to its stockholders.

(11) Surtaxes upon Income from Personal Services Extending over a Period of Years. -- A very severe hardship under the existing law, which can be adequately and simply remedied at the present time, exists with respect to the taxation of income for personal services rendered over a period of years and paid for after completion. For example, inventors, authors, engineers, scientists, lawyers, and others frequently work for years, and receive their compensation upon the successful completion of their services -- usually all in one year. Consequently, their entire income, being accumulated and received in one year, is subject to the highest surtaxes. If this income had been received as their services were rendered, it would have been subjected to the lower rates of tax; and the aggregate taxes paid would have been substantially less than the amount payable under the present law. It would seem that the person who invests his time and services over a period of years should be in the same position as one who invests his funds in assets which appreciate over a period of years. We recommend that income from personal services extending over a period of more than two years should be taxed at the capital gain rates. A reasonably simple device to prevent evasion will afford effective protection.

Conclusion

We approve the program to revise our existing revenue laws, as extensively as time permits, in accordance with the principles advocated by the Secre-

tary of the Treasury. We urge the Congress to consider seriously other necessary changes, with a view to their enactment during the next session of Congress.

We always stand ready to assist the Congress and the Administration in its consideration of revenue legislation.

Table (1)

Federal Debt and Expenditures, 1931-1940

Fiscal Year	Total Receipts	Total Expenditures	Gross Deficits
1931	$ 3,189,638,632	$ 4,091,597,712	$ 901,959,088
1932	2,005,725,437	5,153,644,895	3,147,919,455
1933	2,079,696,742	5,142,953,627	3,063,256,885
1934	3,115,554,050	7,105,050,085	3,989,496,035
1935	3,800,467,202	7,375,825,166	3,575,357,964
1936	4,115,956,615	8,879,798,258	4,763,841,643
1937	5,293,840,237	8,105,158,548	2,811,318,311
1938	6,241,661,227	7,691,287,108	1,449,625,881
1939[a]	5,520,070,000	9,592,329,000	4,072,259,000
1940[a]	5,669,320,000	9,095,663,200	3,426,343,200
	$41,031,930,142	$72,233,307,599	$31,201,377,462

Source: Annual Report of the Secretary of the Treasury, 1937.

a — Estimated, President's Budget Message, January 3, 1939.

Table (2)

Federal, State, and Local Debt, 1931-1940

(Millions of Dollars)

June 30	Gross Federal Debt	Gross Debt, Including State and Local	Per Capita
1931	$16,801	$35,861	$288.94
1932	19,487	38,817	310.60
1933	22,539	42,056	334.39
1934	27,053	45,876	362.29
1935	28,701	47,673	373.84
1936	33,779	52,757	410.78
1937	36,425	55,579	429.99
1938	37,165	56,165 Est.	432.04
1939[a]	41,132	60,165 Est.	459.98
1940[a]	44,458	63,458 Est.	482.20

Source: Annual Report of the Secretary of the Treasury, 1937.

a — Estimated, President's Budget Message, January 3, 1939.

Table (3)

New Capital Issues in the United States (Government Obligations and Refundings Excluded)

(Millions of Dollars)

Year	Total Corporate	Domestic Corporate	Foreign Corporate
1919	2,303.3	2,246.4	56.9
1920	2,710.0	2,563.4	146.6
1921	1,823.0	1,700.7	122.3
1922	2,335.7	2,211.5	124.2
1923	2,702.5	2,635.4	67.1
1924	3,322.3	3,027.1	295.2
1925	4,100.7	3,604.5	496.2
1926	4,357.0	3,754.0	603.0
1927	5,391.0	4,656.8	734.2
1928	6,079.6	5,346.1	733.5
1929	8,639.4	8,022.0	637.4
1930	4,944.4	4,484.7	459.7
1931	1,763.5	1,550.7	212.8
1932	325.4	325.4	—
1933	160.7	160.6	.1
1934	178.3	178.3	—
1935	403.6	403.6	—
1936	1,216.9	1,193.9	23.0
1937	1,158.5	1,158.5	—

Source: Commercial and Financial Chronicle.

Table (4)

PUBLIC AND PRIVATE CONSTRUCTION AND MAINTENANCE IN THE UNITED STATES, 1920-1938

Including Part of Work Relief Construction

(Millions of Dollars)

Year	Total Construction	Public Construction	Private Construction	Percent of public to total
1920	8,563	2,044	6,519	23.9
1921	8,062	2,325	5,737	28.8
1922	9,346	2,358	6,988	25.2
1923	10,920	2,228	8,692	20.4
1924	12,049	2,555	9,494	21.2
1925	13,063	2,819	10,244	21.6
1926	13,779	2,862	10,917	20.8
1927	13,944	3,189	10,755	22.9
1928	13,710	3,330	10,380	24.3
1929	13,488	3,309	10,179	24.5
1930	11,814	3,733	8,081	31.6
1931	8,689	3,424	5,265	39.4
1932	5,445	2,539	2,906	46.6
1933	4,044	1,918	2,126	47.4
1934	4,860	2,474	2,386	50.9
1935	5,578	2,548	3,030	45.7
1936	7,731	3,496	4,235	45.2
1937	8,440	3,329	5,111	39.4
1938	8,396	3,711	4,685	44.2

Source: Table prepared for Temporary National Economic Committee by National Resources Committee. Basic data from Construction Activity in the United States, 1915-1937, Department of Commerce, and Survey of Current Business.

Table (5)

Year	Federal Reserve Board index of industrial production. Annual average. % of 1923-1925 average.	Bureau of Labor Statistics index of factory payrolls. Annual average. % of 1923-1925 average.	National Income paid out. Dept. of Commerce (Bill. $)
1925	104	101	69.9
1926	108	104	72.8
1927	106	102	73.4
1928	111	102	75.8
1929	119	109	79.8
1930	96	89	73.6
1931	81	67	62.6
1932	64	46	49.8
1933	76	49	47.9
1934	79	63	52.4
1935	90	71	55.1
1936	105	82	62.6
1937	110	98	69.3
1938	86	78	64.0 Est.
1939			68.0 Est.
Jan.	101	83	---
Feb.	99	85	---
Mar.	98	87	---
Apr.	92 p.	85 p.	---

p — preliminary

Table (6)

Federal Relief Costs (1)

(Figures in millions)

Year	Amount
1934	1,856
1935	2,361
1936	2,342
1937	2,467
1938	1,953
1939	2,741

Source: "Actual & Estimated Receipts and Expenditures of the Government for the Fiscal Years 1931-1939 on the Basis of Present Classification Shown in Daily Treasury Statement", published by Treasury Department, September 15, 1938. Year 1939, estimated, Bulletin of Treasury Department, Apri, 1939.

(1) Includes direct relief, work relief (W.P.A. and C.W.A.), and Civilian Conservation Corps.

Number of Persons and Households
Receiving Public Assistance Financed From
Federal, State, or Local Funds

Year		Households	Persons
Dec.	1933	7,000,000	24,800,000
"	1934	6,547,000	23,475,000
"	1935	5,886,000	19,851,000
"	1936	5,968,000	18,872,000
"	1937	5,390,000	15,605,000

Source: Preliminary Report, Special Committee to Investigate Unemployment and Relief, United States Senate, pp. 4-5. S. Rep. No. 1625, 75th Cong., 3d Sess., April 30, 1938.

Table (7)

Corporation Taxes - 1937

Industry	Number of Principal Companies	Number of Principal Companies and subsidiaries	Taxes[1] (Exclusive of sales, excises, etc.)	Net Income after Taxes	% of Taxes to net Income
Steel Producers	10	316	$149,215,305	$199,742,515	74.7
Meat Packers	4	157	21,495,637	19,324,716	111.2
Chain Variety Stores	10	30	29,804,997	64,516,968	46.2
Automobile Mfrs.	10	129	152,866,266	251,435,246	60.8
Tire and Rubber Mfrs.	16	219	43,934,899	27,178,443	161.7
Agricultural Implement Mfrs.	10	56	39,410,325	65,918,418	59.8
Cigarette Mfrs.	6	16	24,786,185	83,357,751	29.7
Sugar Refiners	14	53	15,745,628	19,720,972	79.8
Mail Order Houses	6	33	25,327,215	53,479,005	47.4
Oil Refiners	19	567	223,581,402	522,722,343	42.8
Office Equipment Mfrs.	10	92	14,963,832	34,728,285	43.1
Cement Mfrs.	8	21	2,888,433	6,571,240	44.0
Department Stores	27	232	30,758,286	28,940,073	106.3
Container Mfrs.	10	48	18,631,304	44,161,686	42.2
Chain Groceries	13	52	15,338,924	9,439,804	162.5
Chemical and Fertilizer Mfrs.	21	217	55,138,294	193,517,916	28.5
TOTALS	194	2,238	$863,886,932	$1,624,755,381	53.2

Source: Compiled from published reports sponsored by the Securities and Exchange Commission.

(1) Above figures on taxes exclude all excises, sales taxes and other imposts which may be regarded as "consumers' taxes", with the possible exception of minor amounts, if any, of such taxes which may not have been excluded from the data issued by the Securities and Exchange Commission. It is understood, however, that certain other taxes which might properly have been included in the total borne by the registrants were ignored.

Examples Showing the Effect of High Surtax Rates on Individual Incomes Under the Revenue Act of 1938

(Amounts of incomes here referred to are "surtax net income" after allowance for exemptions, etc. Amounts of tax are combined normal and surtax rates.)

I. (a) A man with $50,000 of net income (taxable at from 4% to 31%) will have a tax to pay of $9,700 (an average rate of 19.4%). He will have left, after tax, a net amount of $40,300.

(b) An additional $1000 of income will be taxable at 35%, so that the tax will take $350 of that amount, leaving him net, after tax, $650, or 65% of such additional income.

II. (a) A man with $100,000 of net income (taxable at from 4% to 59%) will have a tax to pay of $34,000 (an average rate of 34%). He will have left, after tax, a net amount of $66,000.

(b) An additional $1000 of income will be taxable at 62%, so that the tax will take $620 of that amount, leaving him net, after tax, $380, or 38% of such additional income.

III. (a) A man with $150,000 of net income (taxable at from 4% to 62%) will have a tax to pay of $65,000 (an average rate of 43-1/3%). He will have left, after tax, a net amount of $85,000.

(b) An additional $1000 of income will be taxable at 64% so that the tax will take $640 of that amount, leaving him net, after tax, $360 or 36% of such additional income.

(c) Considering the $150,000 net income by $50,000 blocks, the result is as follows:

Net Income	Tax Average %	Tax Amount	Remaining %	Remaining Amount
First $50,000 I(a)	19.4%	$9,700	80.6%	$40,300
Second $50,000	48.6%	24,300	51.4%	25,700
$100,000 II(a)	34.0%	34,000	66.0%	66,000
Third 50,000	62.0%	31,000	38.0%	19,000
$150,000 III(a)	43-1/3%	65,000	56-2/3%	85,000

IV. Considering 4% as the rate of interest which a reasonably safe industrial might yield, 6% as the rate for a bond or loan which carried a reasonable business risk, and higher rates of 8%, 10%, 15% and 20% as the possible yields which might be expected as greater elements of risk might be involved; then we find the net yields, after the federal income tax (but without considering state income or other taxes), if these represented additional income to A who already had $50,000 of net income, to B who already had $100,000 of net income, and to C who already had $150,000 of net income would be as follows:

Income Rate	Net Yield		
	To A after 35% tax	To B after 62% tax	To C after 64% tax
4%	2.60%	1.52%	1.44%
6%	3.90%	2.28%	2.16%
8%	5.20%	3.04%	2.88%
10%	6.50%	3.80%	3.60%
15%	9.75%	5.70%	5.40%
20%	13.00%	7.60%	7.20%

Possibly A might feel that the net yields which he could hope for would be sufficient to justify such investments if conditions were reasonably satisfactory. B and C could hardly be expected to make investments which involved such business risks as would normally call for 6%, 8% or 10% returns to make them attractive investments when B and C would only have 2%, 3% or 4% net left to themselves from such investments.

V. (a) If A, a man who already has $50,000 of net income, is contemplating investment of $100,000 in a business which he hopes will yield 10% a year, he finds that the $10,000 he hopes to receive will be subject to $3,660 tax so the net yield to him from his $100,000 investment will be $6,340, or slightly more than 6%. He may feel that this is sufficient to justify the investment.

(b) If B, a man who already has $100,000 of net income, is contemplating investment of $100,000 in a business which he also hopes will yield 10% a year, he finds that the $10,000 he hopes to receive will be subject to $6,200 tax, so the net yield to him will be only $3,800 or less than 4%. He

can hardly feel that such a net return is sufficient to justify him in making the investment.

VI. The high surtaxes work out to place excessive penalties on variations in income from year to year.

(a) A man with $50,000 a year net income pays $9,700. For 2 years on $100,000 of income thus received his tax would be $19,400, leaving to him a net amount, for the 2 years, of $80,600.

(b) A man with $20,000 net income in one year, on which he has to pay $2,060 tax; and $80,000 net income in the next year, on which his tax would be $22,600; would also have $100,000 net income for the two years, but his taxes thereon would be $24,660, leaving him a net amount, for the two years, of $75,340. Because of the irregularity of his income, he has to pay 27% more tax than if his income had been received in equal amounts in each of the two years.

(c) If a man had $50,000 loss in one year and $150,000 of income in the next, he also would have a net income of $100,000 for the two years, but his tax would be $65,000, leaving him net only $35,000. His tax will be over 3 times the amount of tax payable on $100,000 realized in equal amounts each year.

The Effect of Net Losses Upon Business Investment

Any man considering a new investment will be faced with many possible conditions which may develop. He must consider possibilities of success and possibilities of failure; possibilities of losses in some years and gains in others. He must balance the probability of a final result with gains to outweigh losses.

The man who would make a substantial business investment is probably a man who already has a substantial amount of other income. In measuring the advantages to him of making the investment, he will take into account the net result of the new venture to him, applying to it the rates which would be applied to it on top of his other income. Manifestly, unless this will yield to him a return in addition to his other income which is sufficient to cover the risk, he would be better off to be contented with his present income and not make the new investment, or possibly to make the investment in some conservative low-yield security.

In trying to determine the net result of the business the investor should take into account the possibility, or even probability, of having one, two or three years' losses before the new business could get on its feet and really start its earnings. Even after it has reached a point where it can show earnings in good years, he must still consider the possibility of some years of loss falling in any extended period of years. Of course, if he can feel well assured of the absence of serious risk in the investment and the reasonable expectation of steady income from it, he can make his investment with little regard to possibility of loss. Only rarely, however, will this condition exist with regard to any new enterprise.

A man may consider the results of the investment if he engages in it

individually (or through a partnership) so there will be no corporation tax to pay but only the individual income tax. In that case he can figure the additional tax he would have to pay on income from the enterprise received in addition to his other income, and may count on being able to apply losses on the enterprise in years of loss against his other income, with reduction of the amount of tax he would otherwise have to pay.

If, however, he makes an investment through a corporation, then the net amount remaining to him will be what is left after paying the corporate tax in any years in which the corporation has a gain (with no corporate tax to pay in years of corporate loss) and after paying his individual income tax on any net profits the corporation distributes to him.

We have set up certain rather typical examples of how this situation would work out as to tax and net gain from investments. First, as to a man with $100,000 of other income, so that any taxes he would have to pay on additional income would be at a rate of at least 62%; and second, for a man who had such income that the average rate of tax he would have to pay on additional income would be 31%. (This latter computation cannot be related to specific amounts of income as the 31% falls at a point where the gradations between rates are quite rapid. However, we are justified in making the computation on an assumption that a man might happen to have this exact rate to pay on additional income, or that he might be one of a number of men who were participating in the investment so that he would have an average rate of 31% to pay.)

For convenience of computation, we have assumed earnings of $100,000 a year in years of profit, with possibility that there might be a year or years in which there would be losses of $100,000. (Computations could, of course, be made as to fluctuating amounts of income in various years and fluctuating amounts of possible loss, but the computations are at best so complicated that the simple

case seems sufficient to illustrate the tendencies involved.)

For simplicity also we are assuming that the investor has a steady income from other sources which does not fluctuate from year to year. Perhaps the real tendency would be for his other income to be higher in the years when the new enterprise had income for distribution, and be lower in years when the new enterprise was sustaining loss, with the effect, as hereinbefore noted, thatthis would serve still further to increase the average rates of tax which he would have to pay.

On these assumptions we have set up various examples which in each case show the results for a five-year period:

(A) If the enterprise had steady earnings of $100,000 a year, with no years of losses;

(B) If the enterprise had earnings of $100,000 a year for four years of the five-year period and had one year of loss of $100,000;

(C) If the enterprise had three years of earnings of $100,000 a year, and two years of loss of $100,000 a year;

(D) If the enterprise had two years of profits of $100,000 a year and three years of loss of $100,000 a year each.

Some of these may seem rather extreme figures, but they are by no means beyond the possibilities with which an investor may be faced with regard to a new business.

The computations show how this would work out -

I(a) - For an individual conducting the business directly.

I(b) - For an individual who had the business conducted by a corporation under existing provisions where taxable income of each year was computed without deduction for losses of another year.

I(c) - For an individual who conducted the business through a corporation if the net income of one year was computed after allowance for deduction of losses of other years.

As a final computation we have figured what would be the average net return under the various conditions which would remain to the investor after paying the income taxes involved -

(1) On the assumption that a $1,000,000 investment was required to yield the estimated earnings (so that in years of profit the business would be earning 10% on its invested capital); and

(2) On the assumption that a $500,000 investment was was required to yield the estimated earnings (so that in years of profit the business would be earning 20% on its invested capital).

First, these are presented on the assumption that the individual has other income of $100,000, so that on any income from this enterprise he would be taxed at 62%.

As to computation I(a) if the business were conducted individually, it is assumed that the losses in any years of loss would have the result of offsetting $34,000 of tax which the individual would otherwise have to pay on his $100,000 of other income.

On computations I(b) and I(c) it is assumed that even though the corporation might have to pay tax on the full amount of income which it earned in years of profit, it would not be penalized for failure to distribute earnings to the extent that it was necessary to apply such earnings to offset the losses of other years.

Such computations, briefly summarized, show as follows:

	A	B	C	D
5 years	No losses	1 year loss	2 years losses	3 years losses
I(a) Business conducted by individual having other income of $100,000.		$100,000	$200,000	$300,000
Business earnings $100,000 per year except for losses as indicated.				
Net earnings................	$500,000	$300,000	$100,000	-$100,000
Net tax......................	310,000	214,000	118,000	22,000
Net gain...............	$190,000	$ 86,000	-$ 18,000	-$122,000
Average net gain per year.....	$ 38,000	$ 17,200	-$ 3,600	-$ 24,400
Percentage of earnings remaining to represent net gain to investor........	38%	28.67%	-18%	
Average annual net return on capital:				
(1) On $1,000,000 investment,	3.8%	1.72%	-	-
(2) On $ 500,000 investment,	7.6%	3.44%	-	-

There is here, of course, no inducement for investment if two years' losses or three years' losses are a probability, as in Columns C and D. Even an assumption of one year's loss in five would certainly leave no inducement for investment of $1,000,000 in such an enterprise. There is practically no inducement for the results in Column B to be obtained on a $500,000 investment.

If the business could reasonably be expected to make 20% a year on a $500,000 investment, with no years of losses, as in Column A, the possible 7.6% return on the investment might be sufficient to offset the probability of loss. There would hardly be sufficient inducement if it was necessary to make a $1,000,000 investment to obtain these results.

If, however, such a business is to be conducted by a corporation, under the existing law which denies right to apply losses of one year as deductions from profits of other years, and all earnings in excess of taxes and losses are to be promptly distributed to a stockholder (or to stockholders) taxable thereon at 62%, such computations briefly summarized show as follows:

I(b) 5 years	A No losses	B 1 year loss $100,000	C 2 years losses $200,000	D 3 years losses $300,000
Corporation earnings $100,000 per year except for losses as indicated.				
Net earnings distributed to stockholder taxable @ 62%.				
Net earnings..................	$500,000	$300,000	$100,000	-$100,000
Total tax (corporation and individual)	341,350	211,080	80,810	33,000
Net gain..................	$158,650	$ 88,920	$ 19,190	-$133,000
Average net gain per year......	$ 31,730	$ 17,784	$ 3,838	-$ 26,600
Percentage of earnings remaining to represent net gain to investor..	31.73%	29.64%	19.190%	-
Average annual net return on capital:				
(1) On $1,000,000 investment...	3.173%	1.778%	.3838%	-
(2) On $ 500,000 investment...	6.346%	3.557%	.7676%	-

This gives some variation from the results under Example III(a) where the business is conducted by the individual. In Column C (2 years losses), the tax would take substantially all the net earnings under I(b) but would not actually exceed the net earnings as it would under I(a).

Probably the only basis which would make such an investment reasonable under these conditions would be the assumption that the corporation could each year earn 20% on its invested capital, with no years of loss.

If, in computing taxes, losses of one year could be deducted from profits of other years, a somewhat better result would be shown, but at least the element of loss due to taxes would be minimized. Making this computation under the conditions of Example I (b), the results would be as follows:

I (c) 5 years	A	B	C	D
	No losses	1 year loss $100,000	2 years losses $200,000	3 years losses $300,000
Corporation earnings $100,000 per year except for losses as indicated.				
Losses deducted in computing tax on profits				
Net earnings distributed to stockholder taxable @ 62%				
Net earnings	$500,000	$300,000	$100,000	-$100,000
Total tax (corporation and individual)	341,350	204,810	68,270	-
Net gain	$158,650	$ 95,190	$ 31,730	-$100,000
Average net gain per year	$ 31,730	$ 19,038	$ 6,346	-$ 20,000
Percentage of earnings remaining to represent net gain to investor	31.73%	31.73%	31.73%	-
Average annual net return on capital:				
(1) On $1,000,000 investment	3.173%	1.903%	.635%	-
(2) " $500,000 investment	6.346%	3.807%	1.269%	-

The results in the first Column A (no losses) remain the same as in Example I (b) but the possible return under Columns B and C, while not an inducement in itself, is substantially better than in I (b). If the Column D situation should exist, the investor does not have to stand taxes to the Government in addition to a net loss of the business.

The foregoing Examples I (a), I (b) and I (c) are all on the basis of results to a stockholder (or stockholders) taxable at 62%.

We may assume an individual (or individuals) taxable @ 31%, without attempting to say exactly where in the tax scale that average result would come. Also we may assume that if the business were individually conducted any losses would result in a tax saving to the individual of 15% of the loss. On that basis, with conditions otherwise the same as in Examples I (a), I (b) and I (c), we may make the respective computations of II (a), II (b) and II (c).

II (a) 5 years	A	B	C	D
	No losses	1 year loss $100,000	2 years losses $200,000	3 years losses $300,000
As in Example I (a) except that individual is taxable @ 31% and losses give tax saving of 15%.				
Net earnings	$500,000	$300,000	$100,000	-$100,000
Net tax	155,000	109,000	63,000	17,000
Net gain	$345,000	$191,000	$ 37,000	-$117,000
Average net gain per year	$ 69,000	$ 38,200	$ 7,400	-$ 23,400
Percentage of earnings remaining to represent net gain to investor...	69%	63.67%	37%	-
Average annual net return on capital:				
(1) On $100,000 investment	6.9%	3.82%	.74%	-
(2) " 500,000 investment	13.8%	7.64%	1.48%	-

	A	B	C	D
II (b): 5 years	No losses	1 year loss $100,000	2 years losses $200,000	3 years losses $300,000
As in Example I (b) except that stockholder is taxable @ 31%.				
Net earnings....................	$500,000	$300,000	$100,000	-$100,000
Total tax........................	$211,925	138,540	65,155	33,000
Net gain.................	$288,075	$161,460	$ 34,845	-$133,000
Average net gain per year.........	$ 57,615	$ 32,292	$ 6,969	-$ 26,600
Percentage of earnings remaining to represent net gain to investor..	57.61%	53.82%	34.84%	-
Average annual net return on capital:				
(1) On $1,000,000 investment...	5.762%	3.229%	.697%	-
(2) " $ 500,000 investment...	11.523%	6.458%	1.394%	-

II (c)

	A	B	C	D
As in Example I (c) except that stockholder is taxable @ 31%.				
Net earnings........................	$500,000	$300,000	$100,000	-$100,000
Total tax..........................	211,925	127,155	42,385	-
Net gain..................	$288,075	$172,845	$ 57,615	-$100,000
Percentage of earnings remaining to represent net gain to investor......	57.61%	57.61%	57.61%	-
Average annual net return on capital:				
(1) On $1,000,000 investment	5.762%	3.457%	1.155%	-
(2) On $ 500,000 investment	11.523%	6.914%	2.311%	-

Only a brief review of these is necessary to show how much more of an inducement for investment is offered to the man taxable at 31% than is offered to the man taxable at 62%.

Admittedly, the computations here made deal with certain special situations which are adopted as assumptions for these computations. The results, however, are generally representative of the tendencies which exist in the present law, as will appear from even more extended computations of this kind which can be made.

While it is not perhaps the ordinary contemplation that a single investor will make the complete investment of $500,000 or $1,000,000 for financing an enterprise of this kind, computations made in this way will show the same tendencies as would face an investor if he were contemplating putting in only a part of the total amount, with the balance to be supplied by others.

File
New Tax file

PSF Taxes

PSF
Taxes

No. 1. Substitute for the corporation income tax applicable to corporations with net incomes of over $25,000. a flat rate of 18%.

Leave corporations with net incomes of under $25,000. subject to the rates provided for in existing law.

No. 2. Allow corporations a three year carry-over of net losses, excluding capital losses.

No. 3. Repeal the $2,000. limitation on the deduction by corporations of capital net losses from other income, insofar as such losses result from assets held over 18 months.

No. 4. Allow a corporation to increase its declared value for capital stock tax purposes for the fiscal years ending June 30, 1939, and June 30, 1940, but do not permit them to decrease such value for such years.

Estimates of revenue for the calendar year 1939 under such a plan.

Gains from (1)	$59,000,000.
Losses from (2) and (3)	$53,000,000.
Losses from (4)	3,500,000.
Net gain	2,500,000.

Jere Cooper

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No. 4. Allow a corporation to increase its declared value for capital stock tax purposes for the fiscal years ending June 30, 1939, and June 30, 1940, but do not permit them to decrease such value for such years.

Estimates of revenue for the calendar year 1939 under such a plan.

Gains from (1)	$59,000,000.
Losses from (2) and (3)	53,000,000.
Losses from (4)	3,500,000.
Net gain	2,500,000.

1. Under the first suggestion the little corporations will be left alone and the larger corporations will be subject to the flat rate of 18%. This will result in a slight increase for banks and insurance companies which now pay a flat rate of 16½%.

2. The second suggestion will allow corporations to carry over operating net losses to be applied against their net income for the succeeding year. And if in excess of the net income of the succeeding year to be applied against the net income for the second year. And if in excess of the net income for the second year to be applied against the net income for the third year.

3. This suggestion permits corporations which have capital net losses from assets held over 18 months to apply such losses against their other income for the same year. In this respect these corporations will be treated like individuals who are permitted to offset their capital net losses to a certain extent against their other income.

The $2,000. limitation will still apply as to capital net losses from the sale or exchange of capital assets held 18 months or less. This will prevent corporations from using these speculative losses to reduce their ordinary income. Unless this safeguard should be put in, the limitation on short-term capital losses applied to individuals might be evaded by the formation of personal holding companies and the elimination of investment income by speculative losses.

4. If we allowed a corpgration to declare a value for capital stock tax purposes each year, it might be that loss in revenue would result, especially with those corporations having fiscal years ending shortly after the close of the capital stock tax year, which ends June 30 of each year. Therefore, to avoid any loss of revenue from this source, it is suggested that for the fiscal years ending June 30, 1939, and June 30, 1940, the corporations be permitted to increase their capital stock value but not to decrease such value. This will only result in a slight loss of revenue from the excess profits tax, and because of the additional capital stock tax to be paid, it is not believed that it will exceed two and a half million dollars.

PSF
Taxes

New Dap file

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

OFFICE OF THE CHAIRMAN

April 11, 1941.

My dear Mr. President:

In response to your request, I have gone over the Currie tax memorandum which you gave me. The memorandum herewith attached was prepared in consultation with Dr. Currie, Dr. Hansen, and staff members.

I wish particularly to call attention to the main points stressed, as follows:

1. Public Concern over Debt, Deficit and Inflation

A budget deficit of $13 billions, with existing tax system, is indicated for fiscal year 1942. The public will be much concerned unless this gap is closed by a substantial amount. With respect to inflation, specific price control measures are of primary importance, but the public will not be reassured without substantial tax increases.

2. War Profits and Labor Trouble

Corporate profits in 1941 will rise rapidly. Unless these profits (mainly incident to defense expenditures) are taxed away, labor demands are almost certain to get out of hand. Without an honest program to take the profits out of war, we cannot hope for social and labor stability.

3. Progressive Taxes v. Sales Tax

Interested groups are pressing for a sales tax. If corporations are allowed large profits and sales taxes are imposed, inflammatory labor disturbances will be fed from two sources: (1) large corporate profits, and (2) rising labor costs.

4. Corporate Profits plus Broadening of Income Tax

Excess defense profits must be taxed away. But this is not enough. Everyone above a basic minimum income must contribute to defense. Only by broadening the income tax base and raising the normal rate can we head off a regressive sales tax.

5. Yield

The proposals made will yield about $2.5 billions additional revenue for fiscal 1942. The memorandum also calls attention to the prodigious yield of a strong excess profits tax when the national income reaches $100 billions. It is not only the most equitable tax, but it is also a great revenue producer.

Respectfully yours,

M S Eccles

M. S. Eccles
Chairman

The Honorable,
The President of the United States,
The White House.

April 11, 1941

A TAX PROGRAM

Excess Profits Tax - The present statute, falling far short of the intention stated in your message of July 1, 1940, "to see that a few do not gain from the sacrifices of the many" in the task of arming for national defense, should be drastically revised. Labor can not well be asked to moderate its demands if employers are permitted to retain huge profits. After paying taxes reflecting increases already made and in prospect, many individuals will have less money left than they had before the defense program got under way, while corporate earnings after taxes are sharply higher and many corporations are making more money than they have ever made before. In contrast to individual earnings, these corporate earnings escape the full force of the individual surtaxes because they may be retained without penalty. An effective excess profits tax is the best way to make them bear their fair share of the tax load.

Specific Proposal - Fix the excess profits base at not more than 10 per cent or less than 6 per cent on invested capital, the exact figure within these limits to be determined by past earnings experience. Eliminate borrowed capital from the statutory invested capital base. Retain the present specific exemption of $5,000. On excess profits over this exemption, levy rates as follows:

	(Per cent)
First $20,000	25
Between $20,000 & 45,000	50
Over $45,000	75

Retain the provisions of the present law allowing personal service corporations to escape excess profits tax if stockholders are taxed on their appropriate share of corporate earnings under the individual income tax.

An alternative plan would be to establish a uniform excess profits base of 6 per cent return on invested capital. A tax rate of 10 per cent might be applied to earnings between 6 and 7 per cent of invested capital; a rate of 20 per cent to earnings between 7 and 8 per cent; and the same scale of graduation continued until a rate of 100 per cent would apply to earnings in excess of 15 per cent on invested capital. A modification of this plan, beginning the rates at a level somewhat higher than 10 per cent and fixing a maximum rate of somewhat less than 100 per cent, might meet the objections that the schedule of rates first outlined would produce relatively large differences in taxes for corporations with relatively small differences in earnings, that fiscal productiveness would be impaired by a schedule taxing the very large volume of earnings between 6 and 8 per cent on invested capital at relatively low rates, and that a 100 per cent rate would deprive business of any incentive for efficient management.

Normal Corporation Income Tax - The maximum rate of normal corporation income tax should be increased from 24 to 30 per cent, a step generally anticipated and already reflected in corporate policy.

Personal Income Tax - This is the most equitable of all taxes and should be made the backbone of our tax structure. Up to now, however, we have failed to make as full use of the personal income tax as other democratic countries have done, with the result that it yields only about 20 per cent of total Federal revenue. Pressures on the Congressional Committees have resulted in an income statute shot through with inconsistencies, inequities and immunities for minority groups of taxpayers.

Specific Proposal -

(a) Disallow the personal exemption and credit for dependents for purposes of surtax. Present practice amounts to granting a subsidy that increases in value as income increases.

(b) Tax the incomes of husbands and wives as a single income. The privilege of filing separate returns is a tax-avoidance device that in practice is valuable only to wealthy couples, and practically all wealthy couples make use of it. Professional services of a high order at the Government's disposal are adequate to remove the legal obstacles to this proposal if the use of those services is not blocked by objectors whose opposition rests basically on political conservativism rather than on legal grounds.

(c) Lower the surtax exemption to $3,000 and increase surtax rates.

(d) Increase the normal tax rate from 4 to 8 per cent. The comparable British rate is now 32 1/2 per cent. Lower personal exemptions for married persons from $2,000 to $1,600. This exemption should not logically be more than double the present exemption for single persons of $800. Recognizing all the disadvantages of sharply increasing taxes on large numbers of comparatively low-income citizens, it now seems imperative to increase the number of citizens participating by the payment of direct taxes in the financing of the defense program.

Estate and Gift Taxes - On June 19, 1935, you said "The transmission from generation to generation of vast fortunes by will, inheritance or gift, is not consistent with the ideals and sentiments of the American people. Such inherited economic power is as inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our government." The task of bringing law into conformity with popular ideals, begun in the Revenue Act of 1935, ought to be finished now.

1. Establish a single schedule of rates applicable to the cumulative total of gifts during life plus estate passing at death. Under present practice, gifts subject to tax in the lowest brackets of the gift tax can be used as a means of avoiding taxes in the highest brackets of the estate tax. Great accumulations of wealth can be transmitted by gift as well as by bequest, and a consistent public policy would tax both types of transfer at the same effective rates. But if it were thought desirable to leave an incentive for the making of gifts, the total tax assessed on a gift might be arbitrarily reduced by ten per cent from the tax assessed on a transfer of the same amount made at death. Raise the now unduly low rates applicable to estates under $10 million.

2. For the present exemptions of $40,000 under the gift tax, $40,000 general under the estate tax, and $40,000 insurance under the estate tax -- a total of $120,000 -- substitute a single exemption of $25,000, applicable to insurance proceeds or property in any other form.

3. Limit the right to make tax-exempt gifts and bequests to educational and charitable institutions either by limiting the amount of such transfers or by requiring the gift or bequest to be certified as truly in the public interest by qualified expert opinion. Such transfers often merely reflect the whims of the donor and serve no useful public purpose.

4. Broaden the legal concept of "gifts" and "transfer at death" to include all transfers of property that transmit wealth from one generation to the next.

Revenue Yield - The yield of these proposals in the calendar year 1942 may be roughly estimated as follows:

	(Millions of dollars)
1. Excess profits tax revisions	800
2. Normal corporation tax	600
3. Individual income tax: 1/	
(a) Disallow credits against surtax	200
(b) Tax incomes of couples as single income	200
(c) Raise surtax rates and lower exemption	250
(d) Raise normal tax rates and lower exemptions	500
4. Estate and gift tax 2/	---
	2,550

With a national income of $100 billion, the proposed changes in the excess profits tax would result in an addition of $1,750 to the yield of the present law or a total revenue from excess profits tax of $3,500 million.

1/ In the estimates of individual income tax yields, full account has been taken of the effect of increased corporate taxation on dividends.

2/ Because of the long lag in collections, no appreciable yield is to be expected in calendar 1942, but about $500 in revenue would be realized in 1943 and subsequent years.

New Tax File folder 4-41

PSF Taxes

THE SECRETARY OF THE TREASURY
WASHINGTON

April 11, 1941.

MEMORANDUM FOR THE PRESIDENT:

Testifying before the Senate Finance Committee on the Public Debt Act of 1941, I expressed the hope that two-thirds of our current expenditures be met by current revenue and the other one-third be financed through borrowings. If this is to be accomplished it will be necessary to enact at this session of Congress a tax bill yielding an additional $3.5 billion per year.

Estimated expenditures for fiscal 1942 . .	$19,000 million
Two-thirds of expenditures	12,667 million
Estimated net revenue fiscal 1942	9,223 million
Balance to be raised by new taxes	3,444 million

The attached schedule presents a suggested plan for raising approximately $3.5 billion. This amount represents new tax liabilities which would accrue during the fiscal year of 1942. However, because of the lag in collections in the case of income, excess profits and estate taxes, the actual collections in fiscal 1942 will be substantially less than the total of $3.5 billion.

HMJr-

Tax changes aggregating approximately an additional $3,600 million of revenue 1/

Source		Estimated increase (In millions)
Individual income taxes		$1,517.1
Increase surtax rates, adopting attached schedule (with defense tax)		
Estate and gift taxes		353.0
Estate tax changes: (1) reduce exemption to $25,000; (2) adopt attached estate tax rate schedule (with defense tax) (3) reduce insurance exclusion to $25,000		
Gift tax changes: (1) reduce exemption to $25,000; (2) increase the gift tax rates to three-fourths the rates in the estate tax schedule		
Corporation taxes		933.5
(1) Surtax on normal tax net income, 6%	533.5	
(2) Excess profits tax: Reduce the average earnings credit from 95 to 75 percent and the invested capital credit from 8 to 6 percent	400.0	
Tobacco		200.8
Cigarettes: Additional 75 cents per 1,000	125.2	
Cigars, tobacco and snuff: Double rates	75.6	
Other excise taxes		1,056.0
Gasoline, 2 cents per gallon additional	400.0	
Soft drinks, 1 cent a bottle and equivalents	132.5	
Automobiles, parts and accessories, double rates	78.3	
Check tax, 2 cents per check	56.0	
Admissions, reduce exemptions from 20 cents to 9 cents	55.0	
Jewelry, 10 percent of retail sale price	50.0	
Tires and tubes, increase rates from 2½ and 4½ cents to 5 and 9 cents	43.5	
Telephone, telegraph, cable, etc., lower exemptions and increase rates	37.0	
Telephone bill, 5 percent	30.0	
Passenger transportation, 5 percent of amount paid	30.0	
Candy, chewing gum, 5 percent	20.0	
Furs, 10 percent of retail sale price	15.0	
Photographic apparatus, etc., 10 percent	13.0	
Toilet preparations, revise basis	12.0	
Clocks, watches, etc., 10 percent	11.0	
Club dues, initiation fees, lower exemptions and redefine base	9.5	
Mechanical refrigerators, increase rate from 5½ to 10 percent	9.0	
Matches, 2 cents per 1,000	8.0	
Cabarets, change base and impose occupational tax	7.5	
Dentifrices, toilet soap, etc., 5 percent	7.2	
Sporting goods, 10 percent	6.5	
Radio sets and parts, increase rate from 5½ to 10 percent	5.0	
Musical instruments, 10 percent	5.0	
Bowling alleys, $15 per alley, billiard or pool table	5.0	
Trunks, suitcases and other luggage, 10 percent	4.0	
Playing cards, increase rate from 11 to 15 cents	2.0	
Safe deposit boxes, increase from 11 to 20 percent	2.0	
Phonographs and phonograph records, 10 percent	2.0	
Summation of items		4,060.4
Less: Allowance for interrelated tax bases (approximate)		460.4
Total		3,600.0

Treasury Department, Division of Tax Research — April 10, 1941

1/ Estimates for individual income taxes are on basis of calendar year 1941 levels of income; all other estimates are at business levels estimated for the fiscal year 1942.

441-5

Individual surtax rate schedule

Surtax net income (In thousands of dollars)	Bracket rate (percent)	Total surtax cumulative
$ 0 - 2	11	$ 220
2 - 4	14	500
4 - 6	16	820
6 - 8	19	1,200
8 - 10	21	1,620
10 - 12	23	2,080
12 - 14	25	2,580
14 - 16	27	3,120
16 - 18	29	3,700
18 - 20	31	4,320
20 - 22	33	4,980
22 - 26	36	6,420
26 - 32	39	8,760
32 - 38	42	11,280
38 - 44	45	13,980
44 - 50	48	16,860
50 - 60	51	21,960
60 - 70	54	27,360
70 - 80	57	33,060
80 - 90	59	38,960
90 - 100	61	45,060
100 - 150	62	76,060
150 - 200	63	107,560
200 - 250	64	139,560
250 - 300	66	172,560
300 - 400	68	240,560
400 - 500	70	310,560
500 - 1,000	72	670,560
1,000 - 2,000	73	1,400,560
2,000 - 5,000	74	3,620,560
Over - 5,000	75	-

Treasury Department, Division of Tax Research March 31, 1941

441-5

Comparison of surtax rate schedules under present law and proposal

Surtax net income ($000)	Bracket rate (percent)		Total surtax cumulative	
	Present law	Proposal	Present law	Proposal
$ 0 - 2	-	11	-	$ 220
2 - 4	-	14	-	500
4 - 6	4	16	$ 80	820
6 - 8	6	19	200	1,200
8 - 10	8	21	360	1,620
10 - 12	10	23	560	2,080
12 - 14	12	25	800	2,580
14 - 16	15	27	1,100	3,120
16 - 18	18	29	1,460	3,700
18 - 20	21	31	1,880	4,320
20 - 22	24	33	2,360	4,980
22 - 26	27	36	3,440	6,420
26 - 32	30	39	5,240	8,760
32 - 38	33	42	7,220	11,280
38 - 44	36	45	9,380	13,980
44 - 50	40	48	11,780	16,860
50 - 60	44	51	16,180	21,960
60 - 70	47	54	20,880	27,360
70 - 80	50	57	25,880	33,060
80 - 90	53	59	31,180	38,960
90 - 100	56	61	36,780	45,060
100 - 150	58	62	65,780	76,060
150 - 200	60	63	95,780	107,560
200 - 250	62	64	126,780	139,560
250 - 300	64	66	158,780	172,560
300 - 400	66	68	224,780	240,560
400 - 500	68	70	292,780	310,560
500 - 750	70	72	467,780	490,560
750 - 1,000	72	72	647,780	670,560
1,000 - 2,000	73	73	1,377,780	1,400,560
2,000 - 5,000	74	74	3,597,780	3,620,560
Over - 5,000	75	75	-	-

Treasury Department, Division of Tax Research March 31, 1941

Comparison of present and proposed individual income taxes on net incomes of selected sizes 1/

Married person - no dependents

Net income before personal exemption 2/	Amount of tax 3/		Effective rates		Increase in tax under proposal	
	Present law	Proposal	Present law	Proposal	Amount	Percent
2,500	$ 11	$ 72	.4%	2.9%	$ 61	554.5%
3,000	31	152	1.0	5.1	121	390.3
4,000	70	312	1.8	7.8	242	345.7
5,000	110	506	2.2	10.1	396	360.0
6,000	150	700	2.5	11.7	550	366.7
8,000	317	1,131	4.0	14.1	814	256.8
10,000	528	1,628	5.3	16.3	1,100	208.3
12,500	858	2,316	6.9	18.5	1,458	169.9
15,000	1,258	3,073	8.4	20.5	1,815	144.3
20,000	2,336	4,800	11.7	24.0	2,464	105.5
25,000	3,843	6,824	15.4	27.3	2,981	77.6
50,000	14,128	19,540	28.3	39.1	5,412	38.3
75,000	27,768	35,127	37.0	46.8	7,359	26.5
100,000	43,476	52,474	43.5	52.5	8,998	20.7
500,000	330,156	346,122	66.0	69.2	15,966	4.8
1,000,000	717,584	738,086	71.8	73.8	20,502	2.9
5,000,000	3,916,548	3,937,050	78.3	78.7	20,502	.5

Treasury Department, Division of Tax Research — April 9, 1941

1/ Under the proposal the attached surtax rate schedule is substituted for the present schedule.

2/ Maximum earned income assumed.

3/ Includes 10 percent defense tax.

Estate tax rate schedule

Net estate after specific exemption (in thousands of dollars)	Bracket rate (Percent)	Cumulative tax on higher amount
$ 0 - $ 5	4	$ 200
5 - 10	8	600
10 - 20	12	1,800
20 - 30	16	3,400
30 - 40	20	5,400
40 - 60	23	10,000
60 - 80	26	15,200
80 - 100	29	21,000
100 - 150	32	37,000
150 - 200	35	54,500
200 - 250	38	73,500
250 - 300	41	94,000
300 - 500	44	182,000
500 - 1,000	47	417,000
1,000 - 2,000	49	907,000
2,000 - 3,000	51	1,417,000
3,000 - 4,000	53	1,947,000
4,000 - 5,000	55	2,497,000
5,000 - 6,000	57	3,067,000
6,000 - 7,000	59	3,657,000
7,000 - 8,000	61	4,267,000
8,000 - 9,000	63	4,897,000
9,000 - 10,000	65	5,547,000
10,000 - 20,000	67	12,247,000
20,000 - 50,000	69	32,947,000
Over - 50,000	70	-

Treasury Department, Division of Tax Research April 9, 1941

441-5

Proposed estate tax rates compared with present estate tax rates

Net estate after specific exemption (in thousands of dollars)	Proposed rates 1/		Present rates 1/	
	Bracket rate (percent)	Cumulative tax on higher amount	Bracket rate (percent)	Cumulative tax on higher amount
$ 0 - $ 5	4	$ 200	2	$ 100
5 - 10	8	600	2	200
10 - 20	12	1,800	4	600
20 - 30	16	3,400	6	1,200
30 - 40	20	5,400	8	2,000
40 - 60	23	10,000	10 - 12	4,200
60 - 80	26	15,200	12 - 14	6,800
80 - 100	29	21,000	14	9,600
100 - 150	32	37,000	17	18,100
150 - 200	35	54,500	17	26,600
200 - 250	38	73,500	20	36,600
250 - 300	41	94,000	20	46,600
300 - 500	44	182,000	20 - 23	89,600
500 - 1,000	47	417,000	23 - 29	222,600
1,000 - 2,000	49	907,000	32 - 35	557,600
2,000 - 3,000	51	1,417,000	38 - 41	952,600
3,000 - 4,000	53	1,947,000	44 - 47	1,407,600
4,000 - 5,000	55	2,497,000	50 - 53	1,922,600
5,000 - 6,000	57	3,067,000	56	2,482,600
6,000 - 7,000	59	3,657,000	59	3,072,600
7,000 - 8,000	61	4,267,000	61	3,682,600
8,000 - 9,000	63	4,897,000	63	4,312,600
9,000 - 10,000	65	5,547,000	65	4,962,600
10,000 - 20,000	67	12,247,000	67	11,662,600
20,000 - 50,000	69	32,947,000	69	32,362,600
Over 50,000	70	-	70	-

Treasury Department, Division of Tax Research — April 9, 1941

1/ Exclusive of temporary defense tax.

Comparison of proposed estate tax with present estate tax on net estates (before exemption) of selected sizes 1/

Net estate before exemption (000)	Amount of tax 2/		Effective rate		Increase in tax	
	Present law	Proposal	Present law	Proposal	Amount	Percent
$ 50	$ 220	$ 2,860	0.4%	5.7%	$ 2,640	1,200.0%
60	660	4,840	1.1	8.1	4,180	633.3
80	2,200	9,735	2.8	12.2	7,535	342.5
100	4,620	15,290	4.6	15.3	10,670	231.0
200	21,780	50,325	10.9	25.2	28,545	131.1
400	64,460	139,700	16.1	34.9	75,240	116.7
600	113,740	238,975	19.0	39.8	125,235	110.1
1,000	232,100	445,775	23.2	44.6	213,675	92.1
2,000	597,960	984,225	29.9	49.2	386,265	64.6
4,000	1,527,680	2,127,125	38.2	53.2	599,445	39.2
6,000	2,706,220	3,358,025	45.1	56.0	651,805	24.1
10,000	5,430,260	6,083,825	54.3	60.8	653,565	12.0
20,000	12,799,380	13,453,275	64.0	67.3	653,895	5.1
40,000	27,978,500	28,632,725	69.9	71.6	654,225	2.3
60,000	43,268,060	43,922,450	72.1	73.2	654,390	1.5
100,000	74,068,060	74,722,450	74.1	74.7	654,390	.9

Treasury Department, Division of Tax Research April 9, 1941

1/ Under the proposal the attached rate schedule is substituted for the present schedule and the specific exemption is reduced from $40,000 to $25,000.

2/ Includes 10 percent defense tax.

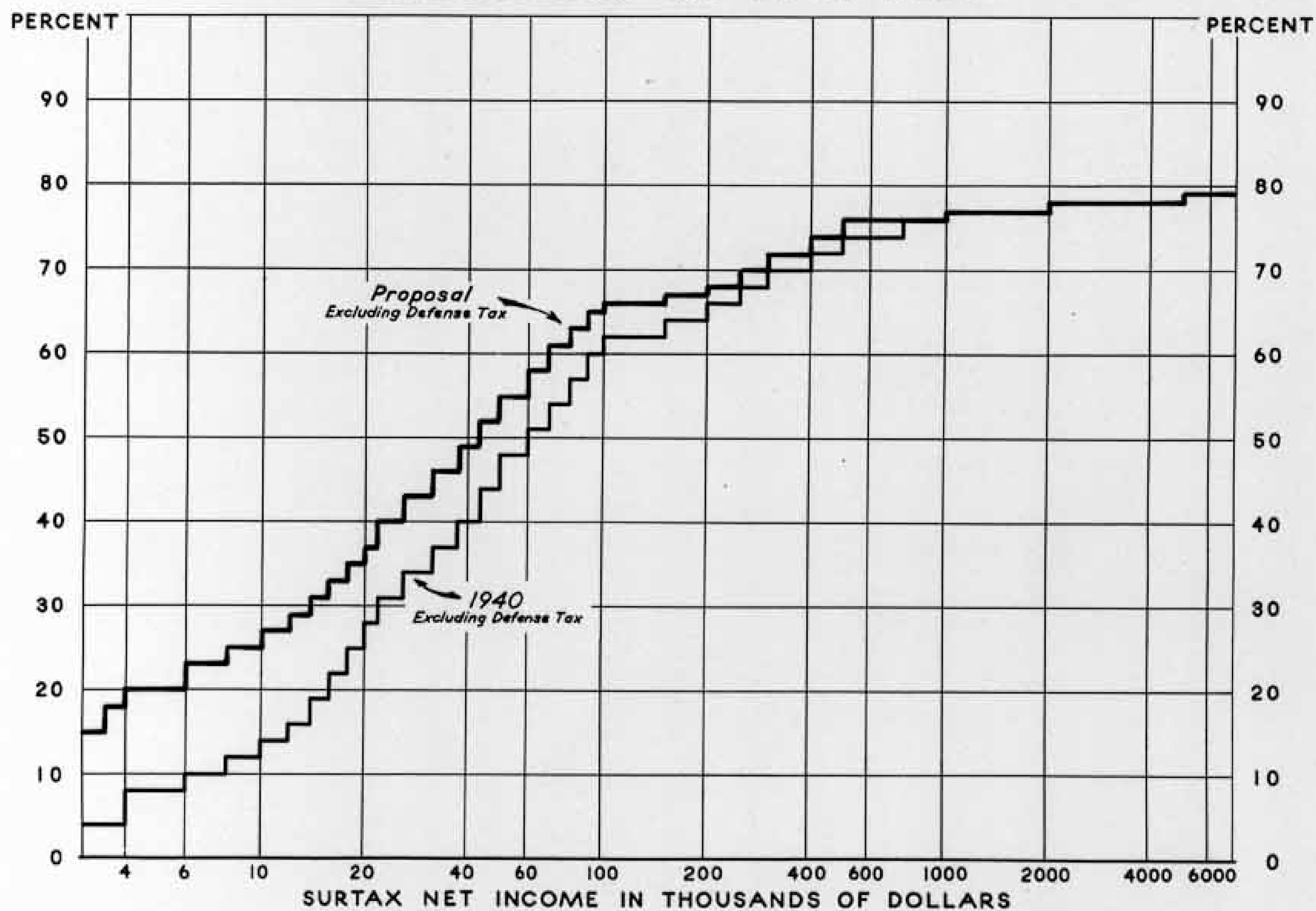
Other excise taxes

		Estimated increase (In millions)
Gasoline	Increase rate 2 cents per gallon additional	400.0
Soft drinks	1 cent per bottle with equivalent taxes on unbottled drinks and fountain syrups	132.5
Automobiles	Increase rates on automobiles, etc., from 3½ to 7 percent and on parts or accessories from 2½ to 5 percent	78.3
Check tax	Re-enact the 2-cent tax, Act of 1932	56.0
Admissions	Reduce exemption from 20 cents to 9 cents	55.0
Jewelry	10 percent of retail sale price	50.0
Tires and tubes	Increase rates from 2½ and 4½ cents to 5 and 9 cents	43.5
Telephone, telegraph, cable, etc.	Lower exemptions and increase rates	37.0
Telephone bill	Impose 5% tax on amount paid	30.0
Passenger transportation	5 percent of the amount paid	30.0
Candy, Chewing gum	5 percent	20.0
Furs	10 percent of retail sale price	15.0
Photographic apparatus, etc.	10 percent	13.0
Toilet preparations	Increase rate and revise basis for sale price	12.0
Clocks, watches, etc.	10 percent	11.0
Club dues, initiation fees	Tax amounts in excess of $10 per year and extend scope of tax	9.5
Mechanical refrigerators	Increase rate from 5½ to 10 percent	9.0
Matches	2 cents per 1,000	8.0
Cabarets	Change rate to 4 percent of amount paid for refreshments, etc., and impose tax on operators	7.5
Dentifrices, toilet soap, etc.	5 percent	7.2
Sporting goods	10 percent	6.5
Radio sets and parts	Increase rate from 5½ to 10 percent	5.0
Musical instruments	10 percent	5.0
Bowling alleys	$15 for each alley, billiard or pool table	5.0
Trunks, suitcases and other luggage	10 percent	4.0
Playing cards	Increase rate from 11 to 15 cents	2.0
Safe deposit boxes	Increase rate from 11 to 20 percent	2.0
Phonographs and phonograph records	10 percent	2.0
	Total	1,056.0

Treasury Department, Division of Tax Research — April 10, 1941

INDIVIDUAL INCOME TAX RATES
1940 AND PROPOSAL

Combined Normal and Surtax Rates

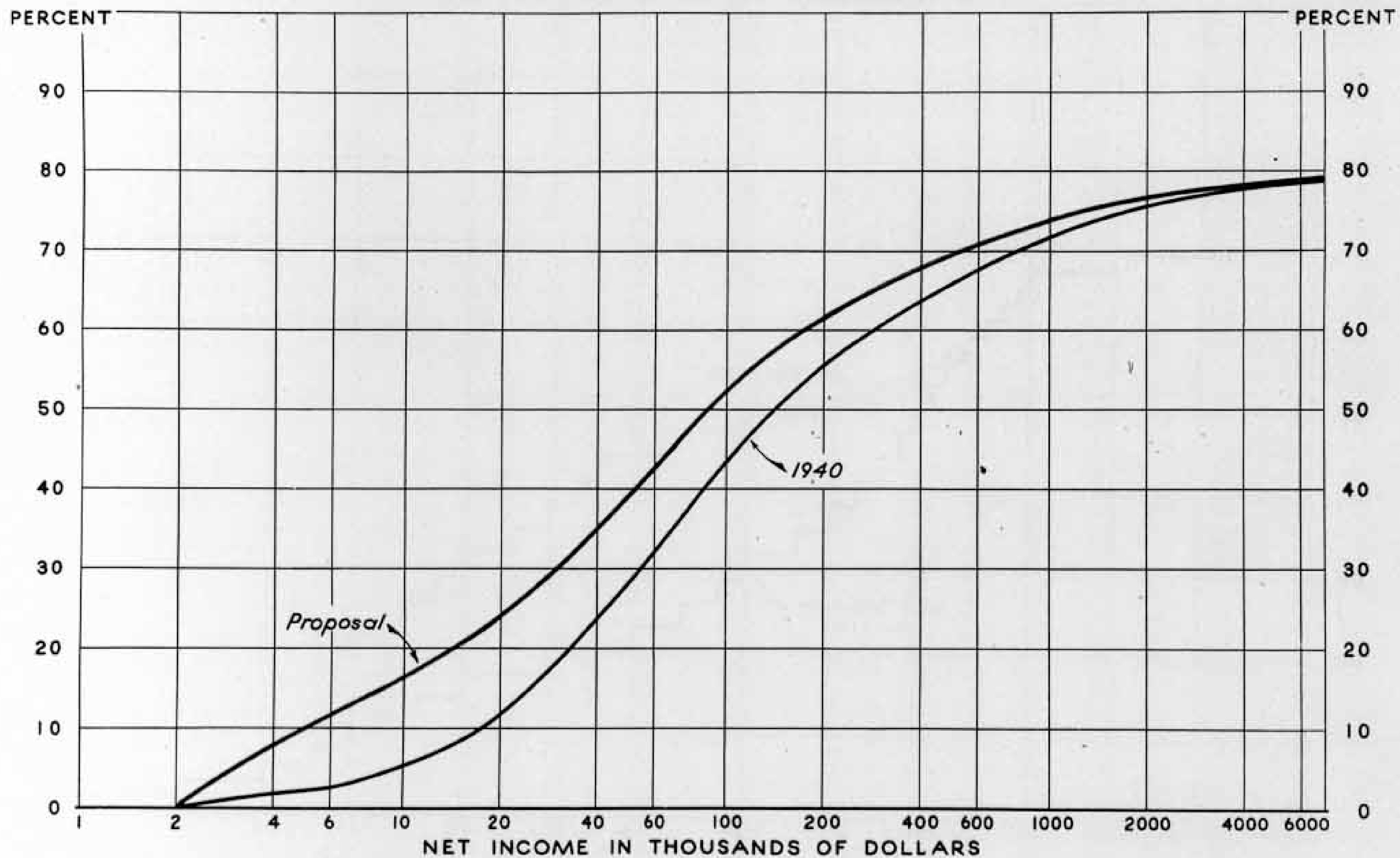


Office of the Secretary of the Treasury
Division of Tax Research

B-217-2

EFFECTIVE INDIVIDUAL INCOME TAX RATES WITH DEFENSE TAX

Married Person, No Dependents

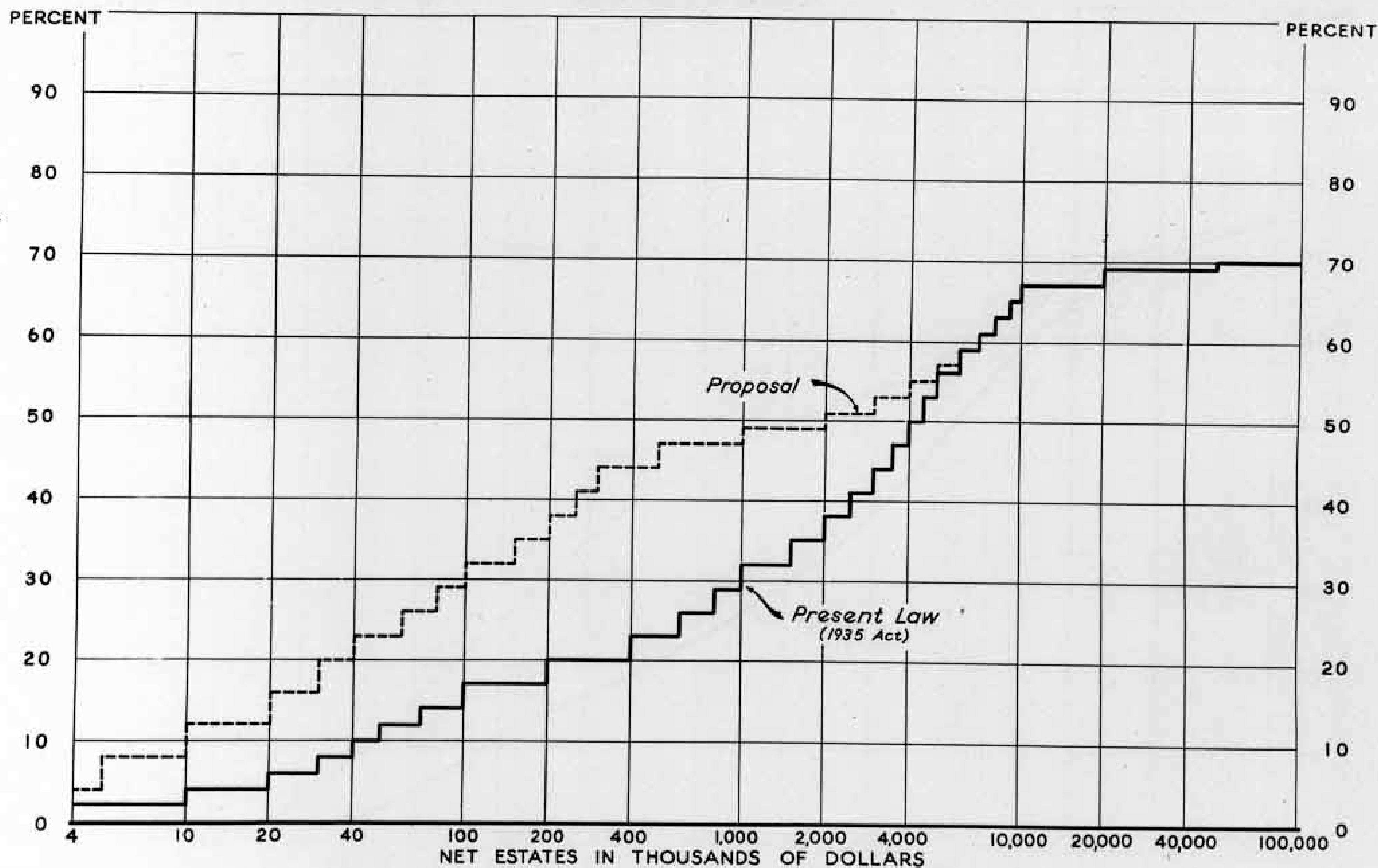


Office of the Secretary of the Treasury
Division of Tax Research

B-220-2

ESTATE TAX RATES, WITHOUT DEFENSE TAX

Bracket Rates



Office of the Secretary of the Treasury
Division of Tax Research

B-219-1

file personal

BF

New Tax File Folder 4-41

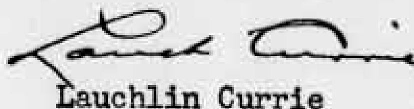
THE WHITE HOUSE
WASHINGTON

May 12, 1941.

MEMORANDUM FOR THE PRESIDENT:

Re: Tax Testimony of Eccles and Henderson.

The reaction to this testimony has been almost uniformly favorable. I am sorry, however, that Secretary Morgenthau has taken affront. I asked Minton to speak to Doughton as he knew him personally, and I thought that the matter could then be handled more informally. Unfortunately, under pressure, Doughton apparently acknowledged that the suggestion had emanated from the White House. I think the whole episode illustrates the possible usefulness of the proposed Fiscal-Monetary Advisory Committee, though probably the present is not an auspicious time to inaugurate it.



Lauchlin Currie

PSF - New Tax File

May 17, 1941.

File personal confidential

SUMMARY OF STATEMENT

The statement calls for putting a ceiling on the average earnings exemption basis of 10 percent of invested capital and for lowering the other exemption option from the existing 8 percent of invested capital to 4 percent. Rates, to be graduated in accordance with the rate of return rather than the existing absolute amount of excess profits, are not specified. A possible alternative mentioned is the reimposition of the undistributed profits tax.

Comments

1. Suggest deletion of sentence on page 12, reading, "It should be possible to raise the desired revenue with a lower rate scale on the average than under the present law because of the larger amount of profits that will be subject to tax", as this may convey the impression that no revenue over and above that yielded by the present law is desired.

2. Question the desirability of subjecting any profits below 4 percent on invested capital to an "excess" profits tax. Page 11.

3. Statement is completely silent on rates in mind and revenues anticipated. These were supplied for the other parts of the Treasury program and the Committee will doubtless expect them in this case.

4. Statement proposes shifting the basis for graduating the tax from an absolute earnings basis to a rate of return basis. Thus smaller semi-service corporations earning a high rate of return will be doubly hit: (a) by the imposition of a ceiling of 10 percent on average past earnings and (b) by being subject to the higher tax brackets. This might be met in part by raising the exemption from $5,000 to $10,000 or $15,000.

5. Statement is confined to excess profits tax. It would be desirable to have the Treasury suggest shifting the emphasis from consumer non-durable excise taxes to consumer durable excise taxes. (The reaction to the Eccles-Henderson proposals along these lines was very favorable.)

PSF [illegible] Tax Folder 4-41

July 9, 1941

MEMORANDUM FOR

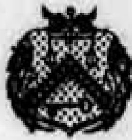
THE SECRETARY OF THE TREASURY

I am ready to make a strong statement to Congress on the tax bill whenever you think the time is appropriate. I would lay particular emphasis on the excess profits tax.

Will you consider also the means which I should employ to give expression to this matter.

F.D.R.

PSF
Taxes



THE SECRETARY OF THE TREASURY
WASHINGTON

July 15
1 hr.

July 10, 1941

My dear Mr. President:

I am simply delighted at receiving your memorandum of July 9, and learning that you are prepared "to make a strong statement to Congress on the tax bill".

In the light of this memorandum, I asked Speaker Rayburn's advice, in strictest confidence, as to how he thought we had better proceed. He informed me that the Ways and Means Committee will not report out the tax bill until a week from Tuesday. Both the Speaker and I feel that before you make any statement, it would be politic to send for Bob Doughton, Jere Cooper, John Sullivan and me, and review the whole matter.

Not later than Monday, I will have in your hands the pros and cons of the excess profits provisions of the bill as it is now written.

I am sending you herewith a summary that I have had prepared for myself on the status of the tax bill. You might like to glance through this.

Yours sincerely,

H Morgenthau Jr.

The President,

The White House.

July 8, 1941

MEMORANDUM FOR THE SECRETARY

From: Mr. Blough

Subject: Status of the Revenue Bill of 1941.

History

Congressional action on the measure might be said to have begun with the conference with congressional leaders in Secretary Morgenthau's office, Thursday, April 17. The Hearings before the Ways and Means Committee began with a statement by the Secretary on Thursday, April 24, followed by a more detailed statement by Mr. Sullivan. The Treasury was again heard on Monday, May 19, when Mr. Sullivan presented the Treasury recommendations on the excess profits tax. The public hearings were concluded Wednesday, May 28, and the executive sessions of the Committee began Monday, June 2. A tentatively adopted measure was turned over to the bill drafters on Wednesday, July 2. It is not likely that the bill will be ready for further action by the Committee before Monday, July 21.

Summary of bill as tentatively adopted by Ways and Means Committee

The additional revenue from the measure for the first full year of operation is estimated at $3,502.1 million. Changes are made in individual and corporation income taxes, excess profits tax, capital stock tax, estate and gift taxes, and numerous excise and miscellaneous taxes.

Personal income tax

Existing personal exemptions are retained. Compulsory filing of joint returns by husbands and wives

is provided. Surtax rates begin at 5 percent on the first dollar of income above exemptions and are much higher than at present. The additional annual yield from individual income taxes is estimated to be $1,154.5 million.

Corporation taxes

An additional corporation income tax in the form of a surtax is imposed at rates of 5 percent on the first $25,000 of net income and 6 percent on the balance. The existing plan of excess profits tax was retained with the following modifications?

> The excess profits tax is computed without deducting the income tax and is deducted in computing the income tax;
>
> The percent on invested capital allowed as a credit is reduced from 8 percent to 7 percent for invested capital in excess of $5,000,000. New capital is included in invested capital at 125 percent;
>
> Rates of tax are increased by 10 percentage points, and a special tax of 10 percent is placed on the amount of current profits in excess of the average earnings credit and not exceeding the invested capital credit.

The increased revenue from corporation income and excess profits taxes is estimated at $1,334.0 million.

Capital stock tax

The rate of the capital stock tax is increased from $1.10 to $1.25 per $1,000 declared value of capital stock. The estimated additional revenue is $12.5 million.

Estate and gift taxes

The existing estate and gift tax exemptions are retained and the rates increased. The estate tax rates begin at 3 percent instead of the present 2 percent. Gift tax rates are correspondingly increased to equal three-fourths of the estate tax rates. The estimated additional revenue is $102.6 million from the estate tax and $11.1 million from the gift tax.

Excise and miscellaneous taxes

Excise taxes are increased on numerous items and imposed for the first time on other items, as indicated on the attached detailed lists. The additional revenue from such taxes is estimated at $887.4 million.

Differences of bill from Treasury recommendations

In its general structure and in a large number of details the measure in its present form follows the recommendations of the Treasury Department. However, it differs from the recommendations of the Treasury Department in a number of respects, chief of which are the following:

(1) Additional individual income taxes are lower than asked for by the Treasury, surtax rates being lower than in the Treasury proposal on the first $12,000 of income. A married couple without dependents and with $5,000 net income would pay $506 under the Treasury proposal and $308 under the schedule adopted by the Committee.

(2) The Treasury Department made no recommendation regarding joint returns of husbands and wives.

(3) The Committee rejected the Treasury excess profits tax plan and voted not to tax excess profits

except when they were greater than the profits received during the base period. For most of the profits subject to the tax the rates adopted are much higher than were recommended by the Treasury. The total increased revenue from corporations is expected to be substantially greater than was asked for by the Treasury.

(4) The Treasury opposed increasing the capital stock tax.

(5) The Treasury proposed lowering the exemptions under the estate and gift taxes from $40,000 to $25,000 and proposed substantially higher rates so that the yield of those taxes would be increased by approximately $347.2 million, instead of by the $113.7 million provided by the Committee.

(6) The Committee rejected the Treasury proposals to increase the excise taxes on beer, tobacco, and gasoline. It refused to impose the recommended tax on bank checks. It imposed a $5 annual use tax on automobiles, yachts and airplanes, which was opposed by the Treasury. It adopted the original Treasury proposal to double the excise tax rates on passenger automobiles, voting not to adopt the revised proposal to increase the tax to 15 percent. The rates adopted on soft drinks are one-sixth of those proposed by the Treasury. The Committee imposed a number of other excise taxes not recommended by the Treasury, but not opposed by the Treasury.

PSF
Taxes

file
new Tax Bill

THE SECRETARY OF THE TREASURY
WASHINGTON

July 14, 1941

My dear Mr. President:

I am enclosing herewith a rough draft of a memorandum which we have prepared in the Treasury.

I have sent copies, in strict confidence, to Chairman Eccles, Mr. Sidney Hillman, Mr. Lauchlin Currie, Mr. Lubin and Mr. Henderson. They are coming to my office, at 8:30 tomorrow morning, to give me the benefit of their suggestions and criticisms. Therefore, when I see you at 11 o'clock, I will give you a second draft which will incorporate wherever possible the suggestions of these men.

Yours sincerely,

H Morgenthau Jr

The President,

The White House.

II. Comments on the Tax Bill

It is important that the yield of the tax bill shall not fall below the $3.5 billion level. In fact, it is apparent from the size of the appropriations and the pressures of consumer purchasing power on prices that taxes even beyond this amount will have to be raised not later than next year.

In formulating the excise tax program an important consideration should be to divert the demand of producers and consumers for scarce commodities which compete with the defense program. Thus the tax on passenger automobiles might well be made much higher than the 7 percent adopted by the Committee. The production of passenger automobiles will undoubtedly have to be greatly restricted. It would be extremely difficult to prevent price rises on cars sold by some retailers or the setting up of a "black market" in new and slightly used cars. It is probable that the excise tax will in large part come out of windfall profits which otherwise would be secured by profiteers in automobiles, rather than being passed on in full in higher prices.

Automobiles are mentioned because they are perhaps the most important example. Other commodities which may be in the same category should be examined to

determine whether an excise should be imposed and if so, whether it should be on the final product or on a scarce material entering into the product. Through such taxes the demands for the most scarce commodities and the large windfall profits which may be made by those evading price control would be reduced.

A basic revision of the excess profits tax plan is also very desirable. In some respects the excess profits tax plan tentatively adopted by the Committee is an improvement over the present excess profits tax. The revenue will be much larger although to a considerable extent this is due merely to higher rates. Some of the larger defense industries with low rates of return in the base years will pay excess profits tax, whereas they are now exempt.

However, the excess profits tax plan fails to correct one fundamental weakness of the present law. It exempts from the tax profits in excess of a reasonable return on invested capital unless those profits are also in excess of the profits of the base period years.

Substantial numbers of companies make large earnings. A study by the Treasury Department shows that one out of five profit-making corporations with assets of $1 million and over averaged more than 10 percent net income on their reported equity capital during the years 1935 to 1938 and that one out of 25 companies averaged more than 30 percent.

The manner in which the present law and the Committee's tentative plan exempt important amounts of excess profits is shown in the following examples.

After paying all taxes an automobile company made during the base period years of 1936 through 1939 approximately 28 percent (on the basis of published financial statements, as the company has not filed its excess profits tax return.) Practically all (95 percent) of this amount can be earned tax free under the present law and under the Committee plan. After deducting a computed excess profits tax on the 1940 earnings above the base period average the company, despite the higher income taxes, will still have left approximately 24 percent of its invested capital under the present law and 21 percent under the Committee proposal.

The tax returns of a manufacturer of tractors with approximately $43 million of equity capital indicate that after all taxes it averaged approximately 18 percent during 1936-1939, which amount continues to be tax-free.

A company which has practically a monopoly on one of the important defense materials had earnings after taxes during the base period years averaging approximately 19 percent of the 1940 invested capital, which it can continue to earn tax-free.

A large manufacturer of beverages can continue to earn free of tax over 25 percent of its 1940 reported equity capital.

Thus, large amounts of the kind of profits which are commonly defined as excess profits and were taxed as such under the 1918 Act are free from tax under the present law and the Committee plan.

Failure to tax such profits is unfortunate for a number of reasons:

(1) The highly prosperous, well established corporation which has been making 30, 40, 50 percent or more on its invested capital has a much larger ability to pay taxes than a corporation which has been earning

only 3, 4, or 5 percent on its invested capital, even though the dollar incomes of the two companies are the same. Taxation of corporations in accordance with ability to pay calls for higher taxes on the profits of corporations in excess of reasonable average return.

(2) The corporation which has been making high returns in the base period years is given a competitive advantage over newly organized concerns or concerns which have been struggling to establish themselves. The latter types are limited to a much smaller tax-free return than are the former. The effect is to confirm monopolies in their control and to protect well established prosperous businesses against competition.

(3) If we are to expect all classes of society, including laborers and farmers, to accept the sacrifices of the emergency period and not to press for every possible dollar of advantage, they must be convinced that sacrifices are being distributed according to ability and that no one is making unreasonably large profits. The stability of our prices and wages is thus to a considerable extent dependent on the imposition and enforcement of a true excess profits tax.

PSF
Taxes

MEMORANDUM FOR THE PRESIDENT

I. The Present Price Situation

Since the beginning of the war, September, 1939, wholesale prices have risen about 16 percent, of which rise the greater part has occurred during the past five months.

The cost of living index has increased 5-1/2 percent since the beginning of the war.

The index of 28 basic commodities has increased 48 percent since the beginning of the war. This latter constitutes a danger signal of inflation which must not be ignored. The wholesale price index always lags greatly behind the index of basic commodities, while the cost of living index does not show anything like the full effects of inflation until long after the seeds of inflation have taken deep root.

The pattern of price rises summarized above roughly resembles the price movements during the first two years of World War I -- little rise in the cost of living, a moderate rise in the wholesale price index, and a sharp rise in basic commodities. Apparently we are at the same point in price history as in 1916 -- on the edge of inflation.

The forces making for further price rise are both potent and persistent:

(1) Estimated Defense spending during the fiscal year 1942 will be two and a half times as much as in the fiscal year 1941, exclusive of any extension of the Defense Program since June 1.

(2) More important in its bearing on the danger of inflation than the figures for expenditures of the coming year are the estimates of deficit spending. The net deficit for the fiscal year 1942, as estimated by the Director of the Budget, will be $12.8 billions, compared with $5.1 billions for the previous fiscal year. This assumes the present tax structure. If the present tax bill is passed by Congress, the deficit will be reduced by $2-1/2 billions, (the revenue yield in fiscal year 1942 of the $3½ billion tax bill) but it will still be over $10 billion. This deficit does not take account, moreover, of the new defense appropriation estimates just submitted by the President, and whatever is expended on account of these estimates during fiscal 1942 will be added to the deficit.

(3) During the past year the inflationary force of the Federal deficit has been supplemented by an expansion of bank credit. Total loans of all member banks expanded by an estimated $2.8 billions,

or by 20 percent during the fiscal year 1941. This rise, moreover, has been proceeding at an accelerated pace -- 33 percent of the total estimated increase taking place during the final quarter.

(4) To the fiscal and monetary factors likely to cause price increases during the next fiscal year, the physical factors of reduced shipping space and other difficulties in the way of imports should be added.

Though there are factors to check inflationary trends, such as some surplus stocks of agricultural commodities, unemployed labor resources, and partially employed production facilities, most of these factors were present in the fiscal year 1941 in greater degree and yet did not serve to restrain price rises even though the forces making for price rises were then much weaker. It would, therefore, be unwise to count on these to any important extent.

Important governmental steps have already been taken or are being taken to check inflation.

Every effort has been and is being made to limit price rises through voluntary cooperation with OPACS. These measures to restrain price rises though they have unquestionably been helpful are inadequate to meet the situation confronting us. We have gone only a small part of the way it will be necessary to go. We must attack the problem on all fronts if we are successfully to check inflation.

We present below some specific tax comments. The problem cannot, however, be met by tax measures alone, but must be attacked on a broad front by a variety of methods. In addition to these tax proposals, we recommend supplementary action along the following lines:

(1) <u>OPACS must be given the power to fix prices where necessary.</u> Price fixing must be regarded as a supplement to priorities and rationing. Without the power to impose a ceiling on prices of commodities where necessary, the task of restricting price rises is made much more difficult. The mere possession of such power tends to make the exercise of that power unnecessary.

On the other hand, in the absence of an adequate fiscal program to mop up excess buying power, the attempt to prevent unwanted price increase by fiat is bound to break down here, as it has elsewhere, when unaccompanied by these essential supplementary methods.

(2) <u>Increase the supplies of goods required for military and civilian needs.</u> Increased output is in itself a major objective of our defense program and the most effective and desirable means of preventing inflation. There should be further exploration of the possibilities of inducing expansion of production facilities and labor supply where such response could not be expected to occur automatically.

(3) Extension of the present system of priorities to include systematic rationing of scarce supplies to consumers.

(4) Extension of the general controls over bank credit.

(5) Establishment of controls over the entire field of consumer credit.

(6) Creation of controls over capital issues.

(7) An extension of the Social Security program along lines by which greater coverage and contributions would increase the inflow of funds from current income during the emergency and would not involve any substantial increase in the present outflow.

(8) A reduction of non-essential Federal expenditures and the Federal lending and underwriting program, such as non-emergency housing expenditures and mortgage guarantees.

(9) Promotion of economy in State and local governmental expenditure and a curtailment of their borrowing for non-emergency expenditures.

Even with substantial action along all of these lines it seems probable to us that a substantial amount of undesirable price inflation will occur in this fiscal year if our tax

program is not carried farther than has as yet been proposed. We, therefore, urge that the tax program now under consideration by Congress be reexamined in the light of the following considerations.

PSF Taxes

MEMORANDUM FOR THE PRESIDENT

I. The Present Price Situation

Apparently we are at the same point in price history as in 1916 -- on the edge of inflation.

The pattern of price rises summarized below roughly resembles the price movements during the first two years of World War I -- little rise in the cost of living, a moderate rise in the wholesale price index, and a sharp rise in basic commodities.

Since the beginning of the war, September, 1939, the wholesale price index has risen from 75 to 87, or about 16 percent. The greater part of this rise has occurred during the past five months.

The cost of living index has increased 5-1/2 percent since September, 1940. Half of this increase has occurred in the past two months.

The index of 28 basic commodities has increased 48 percent during the same period, despite the fact that the prices of many basic raw materials have been controlled by the Office of Price Administration and Civilian Supply. This increase constitutes a major danger signal of inflation which must not be ignored. The wholesale price index always lags greatly behind the index of basic commodities,

while the cost of living index does not show anything like the full effects of inflation until long after the seeds of inflation have taken deep root.

The forces making for further price rise are both potent and persistent:

(1) The Budget estimates Defense spending during the fiscal year 1942 will be $15 billion, or two and a half times as much as in the fiscal year 1941. This increased estimate does not take account of extension of the Defense Program made after June 1, and of additional sums needed for Lend-Lease.

(2) More important in its bearing on the danger of inflation than the figures for expenditures of the coming year are the estimates of deficit spending. The net deficit for the fiscal year 1942, as estimated by the Director of the Budget, will be $12.8 billions, compared with $5.1 billions for the previous fiscal year. This assumes the present tax structure. If the present tax bill is passed by Congress, the deficit will be reduced by $2-1/2 billions, (the revenue yield in fiscal year 1942 of the $3-1/2 billion tax bill) but it will still be over $10 billion.

Again this estimated deficit does not take account of the expansion of the Defense Program after June 1, 1941.

(3) The inflationary force of the Federal deficit has been supplemented during the past year by an expansion of bank credit. Total bank loans expanded by an estimated $3 billions, or about 20 percent during the fiscal year just past. This rise, moreover, has been proceeding at an accelerated pace.

(4) Prices will be increasingly stimulated by (a) the shortage of raw materials for civilian goods, (b) increased absorption of idle capacity in many industries, (c) further increases in agricultural prices and wages.

Also making for further price increases are the heightened obstacles to imports, such as reduced ship space, higher shipping costs, and cutting off of normal foreign sources of supplies.

Though there are some factors in the situation operating to check inflationary trends, such as surplus stocks of some agricultural commodities, unemployed labor resources, and partially employed production facilities, most of these factors were present in the fiscal year

1941 in greater degree and yet did not serve to restrain price rises even though the forces making for price rises were then much weaker.

Important steps have already been taken or are being taken to check inflation. Congress has made provision for the Treasury to sell defense savings bonds and stamps and so to absorb, for the Defense Program, funds which might otherwise be used for civilian purchase of goods. This program is well under way.

The Treasury Department has also launched a plan for selling tax anticipation notes which will facilitate the prepayment of income taxes and will more promptly withdraw purchasing power represented by such taxes.

The Ways and Means Committee is holding firmly to the goal of $3.5 billion from the tax bill.

The Office of Price Administration and Civilian Supply is making every effort to obtain the cooperation of producers and distributors in limiting price rises.

These measures to restrain price rises though they have unquestionably been helpful are inadequate to meet the situation confronting us. We have gone only a small

part of the way it will be necessary to go. We must attack the problem on all fronts if we are successfully to check inflation.

Certain tax matters relevant to the problem of inflation are discussed later. The problem, however, cannot be met by tax measures alone. There should be additional action along the following lines:

(1) OPACS should be given the statutory power to fix prices where necessary. Price rises cannot be controlled when inflationary forces are at work without effective power to impose price ceilings with direct penalties. The mere possession of such power tends to make its exercise unnecessary.

The attempt to prevent unwanted price increases by fiat, however, is bound to break down here, as it has elsewhere, unless it is accompanied not only by an adequate fiscal program to absorb buying power, but also by the additional methods listed below.

(2) Increase the supplies of goods required for military and civilian needs. Increased output is in itself a major objective of our Defense Program and the

most effective and desirable means of preventing inflation. There should be further exploration of the possibilities of inducing expansion of production facilities and labor supply where such response could not be expected to occur automatically.

(3) Delegation to OPACS of priority authority to provide systematic rationing of scarce supplies to industries making civilian goods. In order to obtain a fair distribution of scarce supplies among consumers it may later prove necessary to extend the rationing to ultimate consumers.

(4) Extension of the general controls over bank credit.

(5) Establishment of controls over the entire field of consumer credit.

(6) Creation of controls over capital expenditures.

(7) An extension of the Social Security program along lines which would increase the flow of funds to the Treasury from current income during the emergency and would increase the outflow of funds when needed in the post-defense period.

(8) **A reduction of the Federal lending and underwriting program, such as non-emergency housing expenditures and mortgage guarantees.**

(9) Reduction of non-essential Federal expenditures, also an appeal for economy in State and local governmental expenditure and for curtailment of their borrowing for non-emergency expenditures, thus building a back-log for the post-defense period.

Even with substantial action along all of these lines it seems probable to us that some undesirable price inflation will occur in this fiscal year. Other methods must be sought to control it. The principal mechanism for diverting this rising stream of buying power from inflationary outlets is taxation. It is the most effective of all the ~~bought~~ broad powers at the command of the government. The tax system should be designed as far as possible to reduce consumer demand for goods of which the supply is inadequate. We, therefore, urge that the tax program now under consideration by Congress be reexamined in the light of the following considerations.

PSF Taxes

II. Comments On The Tax Bill

It is important that the annual addition to the Treasury revenues provided by the new tax bill shall not fall below the $3.5 billion level. In fact, it is apparent from the size of the appropriations and the pressures of consumer purchasing power on prices that further increases in rates or extensions of taxes are necessary.

In formulating the excise tax program an important consideration should be to reduce the demand of producers and consumers for scarce commodities which compete with the Defense Program and to absorb windfall profits resulting from scarcity of supply relative to demand. Thus the tax on passenger automobiles might well be made much higher than the 7 percent adopted by the Committee. The production of passenger automobiles will undoubtedly have to be greatly restricted. It would be extremely difficult to prevent price rises on cars sold by some retailers or the setting up of a "black market" in new and slightly used cars. It is probable that a sufficiently high excise tax will prevent increased prices from resulting in windfall profits for dealers and middlemen and will not increase prices of automobiles to consumers beyond what they otherwise would be.

Automobiles are mentioned because they are perhaps the most important example. Other commodities which may be in the same category should be examined to determine whether an excise should be imposed and if so, whether it should be on the final product or on a scarce material entering into the product. Through such taxes the demands

for the most scarce commodities and the large windfall profits which may be made by those escaping price control would be reduced.

A basic revision of the excess profits tax plan is urgently needed. The excess profits tax plan tentatively adopted by the Committee is in some important respects an improvement over the present excess profits tax. However, it fails to correct one fundamental weakness of the present law. It leaves exempt from the tax profits in excess of a

reasonable return on invested capital to the extent that those profits are also in excess of the profits of the base period years.

Substantial numbers of companies are in this category. One out of five profit-making corporations with assets of $1 million and over averaged more than 10 percent net income on their reported equity capital during the years 1935 to 1938 and one out of 25 companies averaged more than 30 percent. These companies can continue to earn profits at virtually these rates without paying excess profits tax under either the present law or the Committee's tentative plan.

The way in which the present law and the Committee's tentative plan leave exempt large amounts of excess profits is illustrated by the following actual examples.

A. After paying all taxes an automobile company made during the base period years of 1936 through 1939 approximately 25 percent. Practically all (95 percent) of this amount can be earned and yet be free from excess profits tax under the present law and under the Committee plan. In 1940 the earnings of this concern, after the payment of taxes, will be approximately 26 percent of its invested capital, under the present law.

B. The earnings of a manufacturer of tractors with nearly $50 million of invested capital averaged, after all

taxes, approximately 18 percent of invested capital during 1936-1939, which amount will be free of excess profits tax under the present law and the Committee's tentative plan.

C. Similarly a company which has practically a monopoly on one of the important Defense materials had earnings after taxes during the base period years averaging approximately 19 percent of its 1940 invested capital, which it can continue to earn free of excess profits tax.

D. A large manufacturer of beverages can continue to earn free of excess profits tax over 25 percent of its 1940 reported equity capital.

Thus, large amounts of the kind of profits which are commonly defined as excess profits and were taxed as such under the 1918 Act are free from excess profits tax under the present law and the Committee plan.

Failure to apply excess profits taxation to such profits is unfortunate for a number of reasons:

(1) The highly prosperous, well established corporation which has been making 30, 40, 50 percent or more on its invested capital has a much larger ability to pay taxes than a corporation which has been earning only 3, 4, or 5 percent on its invested capital, even though the

dollar incomes of the two companies are the same. Taxation of corporations in accordance with ability to pay calls for higher taxes on the profits of those corporations which have the higher rates of return.

(2) The corporation which has been making high returns in the base period years is given a competitive advantage over newly organized concerns or concerns which have been struggling to establish themselves. The latter types are limited to a much smaller rate of return free of excess profits tax than are the former. The effect is to confirm monopolies in their control and to protect well established prosperous businesses against competition.

(3) If we are to expect all classes of society, including laborers and farmers, to accept the sacrifices of the emergency period and not to press for every possible dollar of advantage, they must be convinced that sacrifices are being distributed according to ability and that no one is making unreasonably large profits. The prevention of inflation is thus to a considerable extent dependent on the imposition and enforcement of a true excess profits tax.

PSF: Tax Bill file

OFFICE OF WAR MOBILIZATION

WASHINGTON, D. C.

JAMES F. BYRNES
DIRECTOR

February 26, 1944

MEMORANDUM FOR THE PRESIDENT:

In your tax message you referred to the relief granted the airlines. The attached clipping from the Wall Street Journal of this date (February 26) indicates the operation of this particular provision in behalf of the needy. I have asked the Treasury to prepare a statement indicating what this provision will mean to all the air lines.

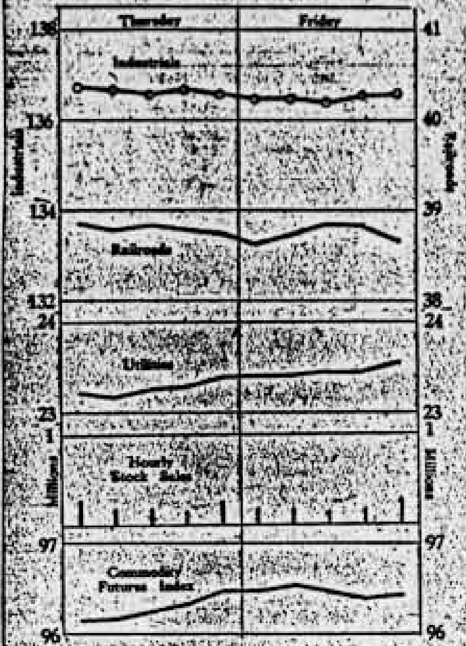
J. F. B.

JAMES F. BYRNES

PSF

THE WALL STREET JOURNAL, SATURDAY, FEBRUARY 26, 1944

Dow-Jones Averages and Futures Index Hourly 11 A. M. to Close



the company paid off $975,000 in bank loans due in 1944 and 1945 reducing debt from $4,225,000 to $3,250,000, or slightly less than cash on hand plus U. S. Treasury notes due in 1944, a total of $3,512,490. Last November the management arranged to reduce the rate of interest on the company's first mortgage bonds (due February 1, 1953) from 4½% to 3¼%.

* * *

Domestic Industries, Inc.—

A post-war program was outlined at a recent conference of Domestic Industries, Inc., executives. Discussions covered new product designs, improved production plans, more economical distribution methods, analysis of domestic and foreign markets and the immediate establishment of a greatly enlarged industrial division. The firm manufactures a wide line of metal cutting tools and maintains three tool and product engineering divisions.

* * *

Airlines Taxes—

Passage of the revenue law over the Presidential veto will ease the impact of excess profits taxes on some airlines. The new act expands a special relief clause applying to air mail carriers. American Airlines for the nine months ended September 30 reported taxes, including excess profits tax, of $5,210,000 after deducting the post-war refund. Of this total, excess profits tax probably amounted to a little over $4 million after deducting post-war refund. If the new tax provision in the law works out as indicated, American may be relieved of this liability. Similarly, Eastern Air Lines set up $2 million reserve for 1942 against possible excess profits tax liability, although the matter never was settled with the U. S. Treasury. Under the new law, this reserve, or most of it, might now be returned to surplus. However, it is not indicated that Eastern will be relieved of excess profits tax liability for 1943 or 1944.

OLIVER J. GINGOLD