THE EXCESS-PROFITS TAX OF 1940—A CRITIQUE

By CLIFFORD J. HYNNING*

THE Second Revenue Act of 1940¹ is a grating compromise of conflicting theories of excess-profits taxation, the end-result of which pleases neither Congress, the Treasury, nor business.² The ink was not yet dry on the enrolled bill when prominent administration spokesmen suggested that it, like the Revenue Act of 1935, would never go into effect because a better tax law would shortly supersede it. There is every expectation that the present law will be substantially amended, possibly within a few months, but according to a recent statement of the Chairman of the Senate Finance Committee these amendments will not apply to 1940 incomes. The recent "hardship" amendments, which passed both Houses of Congress without debate or discussion, are not really an exception to this statement since they invariably operate to the advantage of the taxpayer.

The excess-profits tax of 1940 will be in effect for at least one year and is worthy of study to the tax practitioners for that reason alone. More importantly, a study of the present law will indicate the major changes that may be expected from the forthcoming sessions of Congress. At the present time it is of course impossible to predict the precise nature of these changes, but one thing seems clear—the loopholes will be at least

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¹ 54 Stat. 974 et seq. (1940). This article is concerned only with Titles II, III, IV, and V of the act. Title II, entitled the Excess Profits Tax, became §§ 710-52 of the Internal Revenue Code (26 U.S.C.A.). (Section references will hereafter be to the Internal Revenue Code.) Title I raised the normal tax (including the defense tax increase on the larger corporations under the first Revenue Act of 1940). 54 Stat. 517 (1940), 26 U.S.C.A. § 13 (Supp. 1940). The normal tax on corporations with net incomes under \$25,000 remained unaffected by the Second Revenue Act of 1940. The result was a graduation in the rate structure of the normal tax from 14.85 per cent to 24 per cent, or a range of 9.15 per cent, which amounts to a greater rate preference for small corporations than has ever existed before. See Chapter II of the author's study for the Temporary National Economic Committee, *Taxation of Corporate Enterprises* (1941). Title VI of the 1940 act provides for national service life insurance for persons selected for military training, while Title VII is concerned with credits under the federal unemployment tax for payments to the states.

² The Treasury publicly disowned the tax in a stormy session before the Senate Finance Committee. N.Y. Times, col. 3, p. 1 (Sept. 12, 1940).

partially closed and a stiffer tax liability will result for most large corporations. Rising defense expenditures are reason enough for this action. The small corporations, however, can reasonably expect to continue their present exemption.

It is easy to become overly critical of the present measure. It is obviously not a "good" tax bill—in the sense that it will produce substantial revenue without inequities. Nor is it a "simple" or easily understood bill—most members of Congress have taken pride, apparently, in the fact that prior to passage they had not read it in its entirety or, having read it, did not understand its language. Yet it is a most important fact that the Congress, after consideration lasting only a few months, saw fit to resurrect the idea of taxing the excess profits of corporations, a tax which had been purged out of the statutes at large in 1921 by the unanimous chorus of complaints from tax collectors, tax legislators, and taxpayers alike. That first excess-profits tax was hated with even greater intensity than the late surtax on undistributed profits.

The official custodian of the tax, the Honorable Carter Glass, summarized his views on the excess-profits tax in his annual report as Secretary of the Treasury in 1920:

The Treasury's objections to the excess-profits tax even as a war expedient (in contradistinction to a war-profits tax) have been repeatedly voiced before the committees of the Congress. Still more objectionable is the operation of the excess-profits tax in peacetimes. It encourages wasteful expenditure, puts a premium on overcapitalization and a penalty on brains, energy, and enterprise, discourages new ventures, and confirms old ventures in their monopolies. In many instances it acts as a consumption tax, is added to the cost of production upon which profits are figured in determining prices, and has been, and will, so long as it is maintained upon the statute books, continue to be, a material factor in the increased cost of living.³

His successor, Secretary Houston, also advocated the repeal of the tax (urging in its stead a flat tax on "profits in excess of the distributed earnings" of corporations):

The reasons for the repeal of the excess-profits tax should be convincing even to those who on grounds of theory or general political philosophy are in favor of taxes of this nature. The tax does not attain in practice the theoretical end at which it aims. It discriminates against conservatively financed corporations and in favor of those whose capitalization is exaggerated; indeed, many overcapitalized corporations escape with unduly small contributions. It is exceedingly complex in its application and difficult of administration, despite the fact that it is limited to one class of business concerns—corporations. Moreover, it is rapidly losing its productivity. The invested capital of the average corporation, earning profits high enough to subject it to the excess-profits tax, is now estimated to be increasing at the approximate rate of 12

³ [1920] Treasury Ann. Rep. 23-24.

per cent a year, while the income of the average corporation is almost certainly declining at as great a rate. Both movements cut into the productivity of the tax. If the present changes in capital and income continue for some time in the future, as now seems probable, a large reduction may be expected in the yield of the excess-profits tax.⁴

Even the intellectual progenitor of the tax, Professor T. S. Adams, hastened to add his condemnation. If there had ever been a tax which was believed to have been permanently buried—and in unhallowed ground at that—it was the excess-profits tax.

During consideration in the Senate of the first Revenue Act of 1940, an amendment providing for an excess-profits tax on corporations was introduced by Senator La Follette⁵ on June 19, 1940. This amendment was adopted by a vote of 41 to 31, with 24 abstaining, only to be thrown out in conference. The technical staffs of the Treasury and the Joint Committee on Internal Revenue Taxation, it was understood, were assigned to study the war experience with excess-profits taxation and the various methods of avoiding the difficulties encountered previously in the United States and currently abroad.⁶

⁴ [1921] Treasury Ann. Rep. 38-39.

⁵ At the outset of his address Senator La Follette declared: "For Congress to broaden the tax base on individuals in the lower income-tax brackets, for the Congress to increase the inequities in our tax structure by tremendously increasing the burden which is levied without regard to ability to pay, through the excise taxes, and to fail to adopt an excess-profits tax to reach those who will profit out of the huge defense expenditures which Congress has voted will, in my opinion, go down in history as one of the most inequitable propositions Congress has ever passed." 86 Cong. Rec. 13027 (1940). Realizing that he was "swimming upstream" against the opposition of the Treasury and the majority members of the Finance Committee, the Senator continued: "But, Mr. President, if the Treasury takes the position and furnishes the ammunition against any proposed tax on excess profits merely because it thinks it has not yet had a chance to draft a perfect amendment, I will say that we will never have an excess-profits tax, for neither the Treasury experts nor the experts of the joint committee will ever be able to draw an excess-profits tax or any other kind of a tax amendment that will be perfect in character. . . . I say that it is no answer for Senators to rise here and say that this is a complicated question and that we will have to wait until the gentlemen from the Treasury Department have concluded their studies and rendered their Olympian opinions before we may act upon excess-profits legislation designed to spread more equitably the burden of this terrific tax that is being laid upon the people by making corporations pay in proportion to their ability to pay." *Ibid.*, at 13040.

⁶ On June 24, 1940, the Canadian Minister of Finance, Mr. J. L. Ralston, announced a radical revision of the excess-profits tax which had been enacted the previous fall. The optional graduated rate based on invested capital was abolished and a single tax of 75 per cent was imposed on the excess profits in any taxable year over those earned in the base of standard period (1936-39), in addition to a minimum tax of 30 per cent on all corporate profits, irrespective of the magnitude of profits in the base period. The former option was declared to be a very undesirable feature leading to unwarranted discriminations of the established firms

On July 1, 1940—little more than a week after the conference defeat of Senator La Follette's proposal—President Roosevelt sent a special message to Congress advocating the immediate enactment of a "steeply graduated excess-profits tax" on corporations and individuals. On August 8, 1940, a subcommittee of the House Ways and Means Committee reported on "proposed excess-profits taxation and special amortization." This report was a compromise between the views of the Treasury and the staff of the Joint Committee, with the former preferring the "capital method" of determining excess profits and the latter preferring the "income method." Coupled with the proposed tax was (a) the suspension of the Vinson-Trammell Act⁷ limiting profits on the construction of naval vessels and aircraft for the duration of the new excess-profits tax and (b) the allowance of accelerated depreciation or amortization of emergency facilities constructed in connection with the defense program. On August 29 the House passed the new bill, *viva voce* and with only two hours' debate on the floor; on September 19 the Senate passed a substantially revised bill; on October 1 the conference version was approved by both Houses; and on October 8 the bill was signed by the President. At one stage of the proceeding the bill was 489 drafting pages in length. The Treasury was particularly concerned over the option between the "in-

(which would pay little or no tax) versus new firms undergoing rapid expansion or firms located in depressed industries.

An administrative agency entitled the Board of Referees was established within the Department of National Revenue to ascertain standards of profits for new businesses or businesses depressed during the standard period, subject to the following considerations: (a) in the case of depressed industries the standard profits shall be not less than 5 per cent or more than 10 per cent of capital employed; (b) in the case of new industries other than gold mines or oil wells, the board shall establish a standard of profits equal to the average rate of return of taxpayers in similar circumstances engaged in the same or analogous classes of business; and (c) in cases of gold mines or oil wells, the board shall establish a standard of profits "at such an amount which they think just on the basis of a presumed volume of production during the standard period equal to the volume of production in the taxation year and a presumed selling price for the product during the standard period equal to the average selling price of the said product during the standard period."

The following businesses were exempted from the new excess-profits tax, as amended: (a) small businesses the profits of which do not exceed \$5,000 before withdrawals by proprietors or share-holders, (b) personal corporations acting solely as investment-holding agencies of individual Canadian taxpayers, and (c) non-resident-owned investment corporations. The item of capital was redefined "having regard to the cost price of the assets presently employed by the taxpayer, less depreciation or depletion thereof, and deducting borrowed money and debts, with a proviso that non-productive assets, assets not actually employed in the production of profits, and assets producing tax exempt income, shall not be included."

⁷ 48 Stat. 505 (1934), 34 U.S.C.A. § 496 (Supp. 1940), suspended by 54 Stat. 1003 (1940), 34 U.S.C.A. § 496a (Supp. Feb. 1941).

come method" and "capital method" of determining excess profits and over the nature of governmental control of the amortized facilities. On both issues the viewpoint of the Treasury was rejected.⁸

From a revenue standpoint the present bill is very disappointing. According to the 1942 budget message the Government expects a mere \$106,000,000 for fiscal 1941 (which includes approximately half of the tax liability for calendar 1940) and only \$522,000,000 for fiscal 1942. During World War I the reported tax liabilities under the excess-profits tax of 1918 amounted to two and a half billions, more than five times the estimated figure for 1942!

CORPORATIONS SUBJECT TO THE TAX

By its terms the present excess-profits tax will apply to only a small number of corporations. In 1937, for example, not more than 38,000 (i.e., corporations with a net income above \$5,000) out of the 529,000 corporations which filed income tax returns with the Bureau of Internal Revenue would have been required to file an excess-profits tax return, and certainly less than half of these would have reported taxable excess profits.⁹ In 1940 the Treasury representatives testified that they expect not more than 70,000 corporations to be affected by the new excess-profits tax. This larger figure is not unreasonable in view of the rising level of industrial production and profits.

The following types of corporations (in addition to the corporations already exempt from the normal corporate income tax) are expressly exempt from the new excess-profits tax:¹⁰

- (a) Corporations with adjusted net income of not more than \$5,000.¹¹
- (b) Mutual investment companies.¹²
- (c) Registered diversified investment companies.
- (d) Personal holding companies (already subject to special taxation under the 1937 Revenue Act¹³).

⁸ See *infra* pp. 449-53.

⁹ The exemption of most investment income and the inclusive definition of invested capital may be expected to exempt substantially all public utilities and financial corporations, of which in 1937 there were 17,922 with net incomes above \$5,000.

¹⁰ § 729(b).

¹¹ § 729(b). Net income for this purpose is defined as corporate profits (i.e., receipts less the ordinary deductions) less the following: (a) all dividends received; (b) federal income taxes; (c) long-term capital gains; (d) income from retirement or discharge of bonds; (e) refunds and interest on AAA taxes; (f) interest receipts on government obligations; and (g) recovered bad debts, which amount shall be added; (h) 50 per cent of interest paid out.

¹² § 727.

¹³ See Paul, *The Background of the Revenue Act of 1937*, 5 Univ. Chi. L. Rev. 41 (1937).

- (e) Foreign personal holding companies.
- (f) Foreign corporations not engaged in business in the United States and not having any office located in the country.
- (g) Domestic corporations, 95 per cent of the gross income of which is derived from activities outside the United States during the three-year period immediately prior to the tax for the year (with the further proviso that at least 50 per cent of such gross income must be derived from the active conduct of business or trade).

The definitions of taxable income will operate to exempt substantially the following from tax liability under the excess-profits tax:

- (h) Holding companies, in view of the exemption of intercorporate dividends.¹⁴
- (i) Aviation companies having mail contracts.¹⁵
- (j) Companies having merchant marine contracts.¹⁶
- (k) Personal service corporations (at least 70 per cent of the stockholders must be actively engaged in the business), the stockholders of which have agreed to be individually taxed on their undistributed profits.¹⁷
- (l) Corporations engaged in the mining of tungsten, quicksilver, manganese, platinum and antimony, chromite, or tin, insofar as income is attributable to same.¹⁸

This favoritism of corporations concerned with "strategic minerals" closely parallels the special concessions (via extraordinary depletion) which were made to oil companies during World War I.

AN ATTACK ON CORPORATE BIGNESS?

The Second Revenue Act of 1940 is on its face the most incisive attack on corporate bigness that the federal revenue laws have ever attempted. The rate structure of the new excess-profits tax varies directly with the dollar magnitude of "excess profits."

Excess Profits	Statutory Rate Applicable (in per cent)
Of less than \$20,000.....	25
From \$20,000 to \$50,000.....	30
From \$50,000 to \$100,000.....	35
From \$100,000 to \$250,000.....	40
From \$250,000 to \$500,000.....	45
Over \$500,000.....	50

Under the excess-profits tax of World War I the rate varied with the excessiveness of the rate of profit as measured in relation to invested capital. That is to say, the higher the rate of return on the capital the greater the tax rate. The 1917 act contained five brackets ranging from a 20 per cent tax on profits between 9 and 15 per cent on capital to a 60 per cent tax on profits in excess of 33 $\frac{1}{3}$ per cent on capital. The 1918 act reduced the num-

¹⁴ § 711.

¹⁵ § 727.

¹⁶ § 726.

¹⁷ § 725.

¹⁸ § 731.

ber of brackets to two, with the dividing line put at profits of 20 per cent on capital. The original proposal of the House Ways and Means Committee in 1940 varied the rate with the ratio between excess profits and the credit for normal income (whether computed under the income or invested capital methods) in terms of which the former was computed. The final version of the tax results in much greater revenue productivity since the highest tax rate (50 per cent) becomes applicable to substantially all large corporations with excess profits, although their rate of return may be barely over the minimum credit (8 per cent) under the "capital method."

Any plan of graduating the tax rate with the dollar magnitude of income is threatened with evasion through the splitting of the taxpaying units. In the field of individual income tax the choice method is separate returns for husband and wife and even minors. In order to guard against avoidance of the higher rates of the excess-profits tax the new law introduced a very complicated provision in Supplement B entitled "Computation of Highest Bracket Amount in Connection with Exchanges."¹⁹

This provision operates to accelerate the graduation of the rate structure whenever corporations subdivide for the purpose of tax avoidance so as to make the effective tax rate the same as if the corporation had not split up into smaller entities. Such a provision would be unnecessary if the graduation of the rates were based on corporate earning power (as measured by the rate of profit on capital) rather than the dollar magnitude of profits, for since earning power does not change with a nominal division of a corporation, firms would no longer have any tax incentive for split-ups. This provision may on the whole be of rather academic interest since the present tax applies only to the larger corporations which cannot easily alter well-established patterns of corporate structure for tax purposes.²⁰

DEFINITION OF INCOME

The efficacy of high statutory rates obviously depends upon the methods of determining the tax base to which these rates apply. This problem is the focal point of the great controversy about the present tax and of course is the very essence of any proposal for taxing excess profits. Profits may be said to be "excess" only in relation to a concept of "normal" profits.

In determining whether or not a corporation has excess profits, it is necessary to start from the concept of "taxable income" as developed in

¹⁹ § 752.

²⁰ For a fuller discussion of Supplement B, see *Mobilization for Defense*, 54 Harv. L. Rev. 326-27 (1940).

the administration of federal corporate income taxation. Given this definition of income, the 1940 law provides²¹ for a series of adjustments of a plus-and-minus character to be made both in the taxable year and in the so-called base period (for corporations electing to determine their excess-profits tax liability under the "income method"²²). These adjustments take the form of the deduction or exclusion of items from taxable income, as shown in Table 1. The different types of adjustments of taxable income can only be rationalized in terms of the pecuniary interest of the taxpayer. No rule of policy seems in evidence.

TABLE 1
DEDUCTIONS OR EXCLUSIONS FROM TAXABLE INCOME

SPECIFIC INCOME AND EXPENDITURE ITEMS	UNDER THE INCOME METHOD		UNDER THE INVESTED CAPITAL METHOD
	In the Taxable Year	In the Base Period	
Federal income taxes.....	Yes	Yes	Yes
Long-term capital gains and losses.....	Yes	Yes	Yes
Income from the retirement of bonds.....	Yes	Yes	Yes
AAA refunds and interest.....	Yes	Yes	Yes
Bad debts recovered.....	Yes	No	Yes
Dividends on stocks of:			
Domestic corporations.....	Yes	Yes	Yes
Foreign corporations.....	No	No	Yes
Foreign personal holding companies.....	No	No	No
Casualty losses.....	No	Yes	No
Abnormal adjustments.....	No	Yes	No
Special expenditures for oil and gas drilling and development.....	No	Yes	No
Interest paid out.....	No	No	Yes*
Interest received on government obligations	No	No	Yes†

* One-half allowed.

† Only if included in invested capital.

In response to the frequently voiced demands at the hearings for a general or a series of special relief provisions designed to take care of hardships or "abnormalities in income" during the taxable period, the Commissioner of Internal Revenue was authorized to spread over several years any "abnormal" (i.e., in type) or "grossly disproportionate" (i.e., in amount) income of any one or more of the following classes:

- (a) Arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or
- (b) Constituting an amount payable under a contract the performance of which required more than 12 months; or

²¹ §1711.

²² The choice of the profits standard is discussed *infra* p. 453 et seq.

- (c) Resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing extending over a period of more than 12 months; or
- (d) Includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or
- (e) In the case of a lessor of real property, amounts included in gross income for the taxable year by reason of the termination of the lease; or
- (f) Dividends on stock of foreign corporations, except foreign personal holding companies.²³

A relief provision was also adopted for the determination of equity capital where records have been lost or destroyed.²⁴

The special relief provisions will give rise to a new body of administrative law, the cumulative effect of which will undoubtedly facilitate subsequent legislation by having the "details" on hand instead of awaiting "the filling in." The problem is one of the scope of administrative discretion of a very considerable magnitude with little or no statutory guidance and little likelihood of judicial review.²⁵ Only the most vocal complainants obtained a hearing, and whether there are many unrecognized "injustices" that cannot be handled under this section is not as yet apparent. Undoubtedly there are some.²⁶ The conference report promised that further study would be given to the subject.²⁷

AMORTIZATION—TO ENCOURAGE DEFENSE EXPANSION

Special deduction for the amortization—or accelerated depreciation—of special war-time facilities is permitted²⁸ corporations certified by the

²³ § 721. To these six classes the 1941 amendments added two general classes of income: abnormal in *kind*, irrespective of whether such income fell under any of the six classes, and abnormal in *amount* (i.e., in excess of 125 per cent of such income during the four previous years).

²⁴ § 723. Equity capital in this case consists of "(a) the money plus (b) the aggregate of the adjusted basis of the assets of the taxpayer held by the taxpayer at such time, such sum being reduced by the indebtedness outstanding at such time."

²⁵ See *Williamsport Wire Rope Co. v. United States*, 277 U.S. 551 (1928). Note, however, that the Board of Tax Appeals is specifically authorized to review such determination of the commissioner. § 722.

²⁶ Under § 713(a) no adjustment is provided for capital changes during the base period. Where such adjustments are in the interest of the taxpayer he will undoubtedly claim, and probably obtain, relief under § 721. But the Treasury can probably make no claim for relief.

²⁷ The 1941 amendments are the consequence of this promise. Note that "abnormalities" are now recognized not only during the taxable year but also during the base period as well (under § 722).

²⁸ § 124. 54 Stat. 999 (1940). Emergency facility is defined as "any facility, land, building, machinery, or equipment, or part thereof, the construction, reconstruction, erection, or installation of which was completed after June 10, 1940, or which was acquired after such date." § 124(e)(1).

Advisory Commission to the Council of National Defense and the Secretary of War or Navy. The basis for amortizing such emergency facilities is to be determined, not by the Treasury Department, but by the Defense Commission. The cost of such facilities may, at the option of the corporation, be fully amortized over a five-year period in equal installments. If, however, it should appear that the emergency has ceased before the expiration of this five-year period, as ascertained by a Presidential proclamation, the taxpayer may elect to amortize such cost fully within the period that was actually regarded as emergency in character. In the alternative the taxpayer may elect to take ordinary depreciation over the normal expectancy of usefulness of the facility. A clause of the amortization section provides that all contracts between the government and corporations, out of which amortization claims may arise, shall be matters of public record.²⁹

Conflict arose between representatives of the Treasury and the Defense Commission as to the type of governmental control to be exercised over the future use and disposition of such facilities for which special amortization was allowed for tax purposes. The Treasury was successful in persuading the House Ways and Means Committee to insert a provision in the House bill, under which the taxpayer could not alter or destroy amortized facilities without the express consent of the Secretary of War or Navy. If such consent were not forthcoming, the government was obligated to purchase the facilities in question from the taxpayer at a nominal cost (i.e., at "not to exceed the adjusted basis but not to be less than \$1").³⁰

²⁹ § 124(i).

³⁰ These sections of H.R. 10413 as it stood on August 27, 1940, were as follows:

"(i) *Destruction, etc., of facility.*—Any taxpayer taking deductions for amortization of emergency facilities pursuant to the provisions of this section may not thereafter destroy, demolish, impair, or substantially alter such emergency facilities without the consent in writing of the Secretary of War or of the Secretary of the Navy. In the event such consent is not given within a period of ninety days from the date of receipt of written request therefor, the Secretary of War or the Secretary of the Navy, as the case may be, shall and he is hereby directed to purchase such facilities at a price which he shall fix not to exceed the adjusted basis but not to be less than \$1. In case such facilities consist of buildings, or fixtures not removable without substantially affecting the structure to which the same are affixed, the taxpayer shall have an option to repurchase such facilities at the price which he was paid before such facilities are resold to any other person.

"(j) *Consent to provisions of subsection (i).*—No deduction for amortization under the provisions of this section shall be allowed in any case unless the taxpayer files with the Commissioner a signed statement acknowledging, and consenting to the application of, the provisions of subsection (i). Such statement shall be signed and acknowledged under oath by the person or persons required to swear to returns made by the corporation under this chapter.

"(k) *Penalty for destruction, etc., of facility.*—If the Secretary of War or the Secretary of

At the hearings before the Senate Finance Committee several members of the Defense Commission appeared to protest the Treasury formulation which the House had adopted. It was contended that the cases of amortization were so numerous and varying in quality that the protection of the government's interest in the future disposition of such amortized facilities was more amenable to contract provisions than to legislative rule.³¹

the Navy certifies to the Secretary of the Treasury that a taxpayer subject to the provisions of subsection (i) has wilfully destroyed, demolished, impaired, or altered substantially any emergency facility without having first obtained the written consent of the Secretary of War or the Secretary of the Navy to such destruction, demolition, impairment, or alteration, then such taxpayer shall be liable to a penalty in an amount equal to the unadjusted basis of such facility in the hands of the taxpayer for the purpose of computing gain, to be assessed, collected, and paid in the same manner as if it were a tax imposed by this chapter. Such penalty may be assessed or a proceeding in court for the collection of such penalty may be begun without assessment at any time within one year after the date of such certification."

³¹ A memorandum submitted by the Defense Commission outlined the following three methods of procuring new facilities and the applicable rule of amortization:

"PLAN I.—*Private ownership with no government interest.*

Purpose: When manufacturer desires to own the facilities at all times and does not include in the product price an abnormal amount for depreciation or amortization.

Financing: Private, including Reconstruction Finance Corporation loans.

Title: Vested in manufacturer.

Methods of operation: By manufacturer in the normal way.

Reimbursement: None other than by way of normal depreciation.

Amortization: Certified for tax purposes as needed for national defense.

Termination: No protection for contractor.

Provision for subsequent use by manufacturer: Continued use by the contractor.

"PLAN II.—*Private ownership with government interest.*

Purpose: For plants in which the manufacturer desires to preserve a future interest.

Financing: Private, including Reconstruction Finance Corporation loans.

Title: Vested in the manufacturer.

Method of operation: By manufacturer.

Reimbursement: Cost to be repaid to manufacturer in five equal annual installments.

Payments to be subject to acceleration if supply contracts run out.

Amortization: Certified for tax purposes as required for national defense.

Termination: At end of 5-year period, or earlier termination of the emergency, the manufacturer may continue to use the facilities if he pays to the Government the then fair value thereof as determined by arbitrators; otherwise contractor transfers title to the new facilities to the Government.

Provision for subsequent use by manufacturer: No right to use unless payment made as set forth under heading "Termination" above.

"PLAN III.—*Government ownership.*

Purpose: For plant in which Government desires to have permanent interest or in which the manufacturer has no future interest.

Financing: Government funds, either Reconstruction Finance Corporation, Defense Corporation, Army or Navy.

Title: Vested in the Government.

Method of operation: Leased to the manufacturer.

The House version, it was argued, was the equivalent of throwing out all hopes of private financing of defense facilities.³²

The compromise measure reached was the rather superfluous requirement that the certificate (as to the emergency character of the facility) should contain a declaration on the part of the Defense Commission that existing contracts contain provisions which "adequately protect the United States with reference to the future use and disposition of such

[Footnote 31 continued from page 451]

Reimbursement: Not applicable (Government owned).

Amortization for tax purposes: Not applicable (Government owned).

Termination: Government will take over facilities whenever lease terminates.

Provision for subsequent use by manufacturer: None."

Senate Finance Committee Hearings on H.R. 10413, 76th Cong. 3d Sess., at 186 (1940).

³² The argument may be summarized in the following quotations from Commissioner Henderson's testimony:

"Mr. Henderson. Let me say this: If (i), (j), and (k) were left in, as far as the possibility of the use of plan 1 is concerned, I believe you might just as well drop this whole rapid amortization out of the picture, because what you are in effect saying under (i), (j), and (k), is that a manufacturer having paid for facilities out of his own funds, has got to surrender those, in effect, to the Government.

"Now you take in this case of the \$1,000,000 increase in facilities which the manufacturer put up under the example given by Mr. Biggers, in which there is a recapture of \$150,000 for tax allowances, now all of it has been depreciated, has it not, at \$200,000 a year?

"Mr. Biggers. Yes.

"Mr. Henderson. And under the circumstances existing here, the Government can recapture that for about a dollar. It is not the Government's property, Senator Clark, it is a plain question of whose property this is. There is just absolutely no reason in the world for passing this rapid amortization feature as any kind of encouragement to the use of private capital if you leave subsections (i), (j), and (k) in. . . ."

"Senator Clark. Mr. Henderson, I understand perfectly that you cannot write into the statute every detail of negotiations. In spite of the very complex details we have in the tax bills, we still have a good deal of regulation. It seems to me that the Congress at least ought to write the rules into the statute; in other words, the classifications at least which the Defense Council itself has made, which are presented to us by Mr. Biggers. They ought to be written into the statute.

"Mr. Henderson. Well, I see a great deal of difficulty under that Procrustean bed, in negotiating that kind of contract, to negotiate for the thousands of articles that there are.

"Senator Clark. That is not any more a Procrustean bed to the Congress than it is to the Defense Council, to lay down the rules.

"Mr. Henderson. I disagree with you.

"Senator Clark. You mean to say that the Defense Council can depart from rules laid down by itself? I think that is true.

"Mr. Henderson. I think they should. If they do their work honestly, I think they should, because what is needed in the instant years is to get the material at the lowest price.

"Senator Clark. That has always been the excuse for the war contractor to gouge the Government.

"Senator Barkley. You have got to be able to deviate now and then from the rules in order to prevent the other fellow from having the biggest end of the skid pole." *Ibid.*, at 176-77.

emergency facility." This requirement is superfluous because the contract either does or does not protect the public interest. If it does, the declaration is unnecessary. If it does not protect the public interest, it is equally obvious that the contract should never have been made. It serves only to put the defense contractors on guard as to this particular phase of the contracting process.

The amortization deduction will undoubtedly result in a substantial loss in revenue from what the same would have been if only ordinary depreciation had been allowed. This statement is true, however, only if the excess-profits tax is repealed or substantially lightened after five years. If the tax remains in effect at the present or higher levels, the revenue has primarily been postponed and not permanently lost. The available data on amortization so far claimed (but not necessarily allowed) indicates surprisingly small magnitudes. Tax "certificates of necessity" issued by the Defense Commission through the month of January total up to \$192,000,000 for 116 companies, the largest claim being that of the Bethlehem Steel Company.³³ Yet the net tax savings for specific corporations is apt to be very substantial, as may be illustrated by Bethlehem Steel Company, where it is estimated that approximately two-fifths of the cost of new plant facilities will probably be recouped as a net tax saving.³⁴

CHOICE OF THE PROFITS STANDARD

The taxpayer may ordinarily elect to determine the fact and the amount of "excess profits" either (a) by a comparison of earnings in the taxable year with earnings during the base period of 1936-39 inclusive,

³³ Office of Production Management, press releases of Jan. 21 and Feb. 10, 1941.

³⁴ This may be shown by considering the following figures:

Assumptions	
Proposed expansion of the Bethlehem Steel Co.....	\$38,794,000*
Maximum permissible 1940 earnings.....	42,000,000†
Estimated 1940 earnings after ordinary depreciation.....	70,000,000
Gross savings via amortization‡	
From normal tax (24 per cent of amortised expansion).....	9,310,560
From excess-profits tax (50 per cent of amortised expansion).....	19,397,000
Total gross savings.....	\$28,707,560
Deduct§	
Normal depreciation, 1941-45	
Normal tax (24 per cent of expansion).....	\$ 2,237,640
Excess-profits tax (50 per cent of $\frac{1}{2}$ of expansion).....	4,849,250
Normal depreciation, 1946-61 (20 per cent of $\frac{1}{2}$ of expansion).....	5,819,100
Total deductions from gross savings.....	12,905,990
Net savings.....	15,801,570
Percentage of original cost saved.....	40.5

* OPM press releases.

† Derived from Table 4, *infra*, p. 465.

‡ Assuming profits for 1941-45 will range at least as high as for 1940.

§ Assuming ordinary depreciation at 20 years, no excess-profits tax after 1945, and normal corporate tax at 20 per cent.

or (b) by a computation of the rate of return on invested capital.³⁵ Under the 1941 amendments it is necessary for a corporation to include computations of tentative tax liability under both methods unless it expressly "disclaims" one or the other method. The final tax liability will be determined by whichever method results in the lower liability.³⁶ This election between these two very different methods of determining excess profits may be made (a) by all domestic corporations in existence prior to January 1, 1940, including any "acquiring corporation which was in existence on the date of the beginning of its base period" (i.e., 1936) and (b) by any foreign corporations which were in existence for the forty-eight months prior to the taxable year. All other corporations must employ the invested capital method.³⁷

Under the original House version, the election between the two methods was confined, logically, to corporations with earnings records throughout the base period. Since there is no "ceiling" to profits under the income method and a "ceiling" of 8 per cent is placed on profits under the invested capital method, it is obvious that well established corporations with high earning records³⁸ in the past will find themselves with a distinct advantage over new and expanding corporations whose earnings record has not been sufficiently long to serve as a base period (i.e., 1936-39). A Senate amendment permits the computation (according to the invested capital method) of putative earnings for such years in the base period as the corporation was not in existence, and the employment of the actual dollar earnings for such years as are available (including in all cases 1939, a year of very high earnings for many companies). The 1941 amendments go one step further by providing for a special upward adjustment of the earning credit for corporations with substantially higher earnings in the second half (1938-39) of the base period as compared with the first half (1936-37). In practical effect this amounts to the selection of 1939 earnings as the definition of standard profits for all corporations with comparatively low earnings in 1937. Other corporations will not avail themselves of this adjustment. To this extent the election between the two methods has become available to new and expanding corporations which otherwise (that

³⁵ § 712.

³⁶ § 729. Under the regulations, failure of the corporation to present the dual computations in its tax return, without an express disclaimer, shall be regarded as failure to file a tax return, with all that that implies in the way of penalties.

³⁷ § 740.

³⁸ Prior years' earnings must have at least exceeded 8.42 per cent of capital in order to make the election of the "income method" advisable.

is, under the House version) would have been compelled to employ the invested capital method.

In order to offset the undoubted advantage of the income method to large successful corporations, the House bill provided for an additional normal tax of 4.1 per cent on all corporations choosing that method of computing excess profits. Much of the business testimony before the Senate Finance Committee centered on this penalty tax proposal. The final result was to raise the normal tax 3.1 per cent on all corporations with net incomes above \$25,000, irrespective of their method of com-

TABLE 2
CREDIT FOR "NORMAL" PROFITS UNDER INCOME AND CAPITAL
METHODS OF DETERMINING EXCESS PROFITS

INDUSTRIES	INCOME METHOD (IN MILLIONS OF DOLLARS)	CAPITAL METHOD (IN MILLIONS OF DOLLARS)	MAXIMUM (IN MILLIONS OF DOLLARS)	MAXIMUM—100	
				Income Method	Capital Method
Aircraft.....	9.7	6.6	9.7	100	65
Autos.....	184.9	79.7	184.9	100	43
Chemicals.....	91.7	66.7	91.7	100	73
Machinery.....	34.4	37.2	41.0	84	90
Nonferrous metals.....	85.6	84.9	107.9	79	79
Petroleum.....	139.1	195.9	195.9	71	100
Steel.....	84.9	178.4	178.4	48	100
Tires.....	23.5	30.1	30.1	78	100
Total.....	653.8	679.5	840.7	78	81

Source: Derived from Table 4, which presents the data for individual companies. Each industry in Table 2 is represented by three companies.

puting excess profits and to lower the credit for past earnings from 100 per cent to 95 per cent.³⁹

The option of the present law works to the disadvantage of the fisc, since each taxpayer will obviously choose the method resulting in the maximum credit for "normal" profits and consequently in the minimum liability under the excess-profits tax. The approximate magnitudes involved for eight industries more or less closely associated with defense efforts is shown in Table 2. The choice between the two methods of computing excess profits results, according to this table, in a credit for normal profits that is approximately 20 per cent higher than the credit computed under either method exclusively. In the case of steel, tires, and petroleum the maximum profits credit was identical with that com-

³⁹ The House version also contained a 5 per cent differential in the excess-profits tax rate structure, but this was abandoned in conference.

puted under the capital method, since these are industries with characteristically heavy capital structures. On the other hand, the maximum profits credit was identical with that computed under the income method in chemicals, autos, and aircraft—all industries with high profits records in the past.

Under the income method of determining excess profits,⁴⁰ a corporation is permitted to claim an excess-profits credit of 95 per cent of the "average base period of income" subject to the adjustments already set forth. Wherever a taxpayer experiences a loss in one or more of the years in the base period, he may treat such loss as zero if it occurs in one year, or if it occurs in more than one year he may treat the largest loss as zero and deduct the remaining loss from his income in the other years of the base period. In no case may the average base period of net income be a negative quantity. There is no attempt under the present law to make the earnings record in a taxable year strictly comparable with that in the base period. It is thus possible for a corporation with decreasing capital to continue to claim an excess-profits credit of the same magnitude as in the past, regardless of the fact that such past earnings accrued when the capital employed was substantially larger than it may be in the taxable year. Conversely, a corporation with increasing capital will find itself limited to the dollar amount of earnings in the past when its earnings were based on a smaller capital. The only provisions which may ameliorate these difficulties are to be found in the hardship clause and in the sections dealing with structural changes in the corporate entity.⁴¹ The former is only invocable upon call by the taxpayer and the latter applies only to changes occurring during the taxable year.

Under the income method it is possible for firms, which, by reason of their competitive position or otherwise, have enjoyed high earnings in the past, to continue earning such high profits without fear of federal taxation of "excess profits." This possibility is particularly true of those corporations which enjoyed an exceedingly high rate of return in the latter half of 1939, which was in many respects a war year for American industry.

The method of defining excess profits in the present by referring to profit standards in the past is suitable at best only for a short-run or emergency tax program. With the passing of time the standard will either become relatively obsolete or will have to be brought up to date by a moving average technique, and will thus include in its definition the high

⁴⁰ § 713(a).

⁴¹ §§ 721 and 740 et seq.

earnings of war years. Such a definition will tend to defeat itself. Any program which contemplates a permanent excess-profits tax requires, therefore, that the tax be predicated on some basis other than a mere dollar comparison of the earnings in prior years.

The provisions applicable to the invested capital method of determining excess profits are without question the most complicated part of the present excess-profits tax law.⁴² In fairness, however, it should be pointed out that these provisions are at present considerably less complex than those found in either the House or the first Senate version. Considerable simplification resulted from the divorce of the "invested capital method" from any comparison of earnings in the base period. Under the original version of the House Ways and Means Committee it was necessary for a taxpayer employing the invested capital method to compute the rate of return on capital during the four years of the base period and to compare the same with his rate of return in the taxable year. The excess of earnings over the average rate of return in the base period was taxable, provided that the rate of return in the taxable year was not less than 4 per cent and not more than 10 per cent. Under the present law excess profits are defined as any income in any taxable year in excess of 8 per cent of the "taxpayer's invested capital for the taxable year."⁴³

Invested capital for the taxable year is defined as the "average invested capital," which is in turn defined as the "aggregate daily invested capital for each day of such taxable year, divided by the number of days in such taxable year." "Daily invested capital" is in turn defined as "the sum of the equity invested capital for such day plus the borrowed invested capital for such day."⁴⁴ Equity invested capital is defined in essentially an historical sense⁴⁵ and consists of the sum of:

1. Money paid in (for stock, as paid-in surplus, or as contribution to capital).
2. Property paid in (other than money)—"in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange."

⁴² §§ 714-20, 723, 750-52.

⁴³ § 714.

⁴⁴ §§ 715-17. The statute contains a mysterious suggestion (of which the Regulations remain eloquently silent) that the daily basis of computing invested capital may be dispensed with whenever another determination differs from the former by not more than \$1,000. This difference can hardly be ascertained without making the daily computation, so why bother?

⁴⁵ See *LaBelle Iron Works v. United States*, 256 U.S. 377 (1921), where the Supreme Court sternly frowned upon marked-up valuations to take into account the appreciation of assets (e.g., the discovery of ore on agricultural lands), even where the mark-up occurred years before the imposition of the tax.

3. Distributions in stock (a) in prior years to the extent considered distribution of earnings and profit, or (b) during the taxable year to the extent considered distribution of other than earnings and profits of such taxable year.
4. Accumulated earnings and profits at the beginning of the year.
5. Increase on account of gain on tax-free liquidation. This amount shall be reduced by the sum of:
 - a) Distributions in previous years not out of accumulated earnings and profits.
 - b) Distributions in a taxable year out of earnings and profits other than of that taxable year.
 - c) Earnings and profits of another corporation.
 - d) On account of loss on tax-free liquidation.⁴⁶

The other part of invested capital is "borrowed invested capital" which is defined as 50 per cent of (1) the amount of outstanding indebtedness, excluding interest, which is "evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust;" and (2) contracts made before November 8, 1940, with a foreign government, upon which an advance payment was made subject to cancellation and repayment.

Invested capital, as above defined, may not include assets, the income of which is tax-exempt. Such assets are termed "inadmissible assets" and include (a) stocks in other corporations (except stock in a foreign personal holding company) and (b) government obligations, the interest on which is treated by the taxpayer as tax-exempt. The process of "inadmitting" these assets is not the simple and straightforward technique of subtracting the same from invested capital. The law provides instead that the taxpayer first compute the ratio of inadmissible assets to total assets and apply that ratio to invested capital (as defined above). The resultant figure is then deducted from invested capital.

The advantage accrues from the fact that the computed deduction is invariably smaller than the actual amount of inadmissible assets—since total assets are always greater than unadjusted invested capital—with the result that invested capital remains high, while inadmissible income is wholly excluded from the taxable income.

The scheme is said to be required because of the partial omission of borrowed capital from the invested capital base and the consequent difficulty of exclusively attributing inadmissible assets to either equity or creditor capital. This difficulty is largely theoretical, since corporations are wont to borrow money for the purpose of purchasing government securities or corporate stocks on only rare occasions and then largely in such industries as public utilities and finance which are practically unaffected by the

⁴⁶ § 718(a) and (b).

present tax. Comparison of the total amount of new bonds and notes issued during recent years by registered corporations and the amount thereof devoted to the acquisition of securities clearly supports this statement. The differential interest rates of public and private bonds make it most unlikely that creditor capital will be used for the purpose of acquiring government securities. Investment in fully controlled affiliates is, of course, not reflected in consolidated balance sheets. It is difficult to see much reason in the present provision since inadmissible income (i.e., dividend income and tax-exempt interest) can be so easily connected with the inadmissible assets (i.e., stocks and tax-exempt bonds) upon which the former accrues.

Observe, moreover, that the taxpayer is given the option of treating government obligations as an admissible asset provided the interest received on such obligations has been included in taxable income for both the normal tax and the excess-profits tax.

The concept of "invested capital" as set forth above was believed generally to be an improvement over the definitions contained in the old excess-profits tax, particularly by abandoning the old distinction between tangible and intangible contribution and by attenuating the distinction between equity and creditor capital. The first is definitely an improvement since the 1917-21 laws hopelessly confused the concepts of tangible and intangible property.⁴⁷

The partial inclusion of creditor capital is quite another story. Under the original House version it was proposed to vary the proportion of borrowed capital which might be included according to the size of the corporation. Where equity capital was less than \$100,000, borrowed capital was fully includible insofar as the sum of the invested capital and borrowed capital did not exceed \$100,000; the balance of borrowed capital up to a sum of equity and borrowed capital of \$1,000,000 at the rate of $66\frac{2}{3}$ per cent and the balance exceeding \$1,000,000 at the rate of $33\frac{1}{3}$ per cent.

This gradation in the proportion of borrowed capital which may enter into invested capital was designed to favor small enterprise. It was said that small enterprise has greater difficulty in obtaining equity capital in the market than big business. This statement may not be entirely true. A more correct generalization would be that small corporations experience substantial difficulties in obtaining funds in the capital market irrespective of the nature of such capital.

There are much greater industrial differences in the relative importance

⁴⁷ See the author's monograph, *op. cit.* supra note 1, at 122.

of borrowed and invested capital than there are size differences. Borrowed capital is very important to railroads and practically all types of public utilities, and also to hotels, apartment houses, all types of real estate concerns, and many corporations classified as "financial."⁴⁸ Since the rate of interest on borrowed capital is rarely in excess of 4 or 5 per cent,

TABLE 3
PREFERENTIAL CREDIT FOR BORROWED INVESTED CAPITAL
UNDER THE EXCESS-PROFITS TAX
(In Millions of Dollars)

COMPANIES	(1) CAPITAL CREDIT*	(2) CREDIT FOR BORROWED CAPITAL†	(3) ONE-HALF OF INTEREST PAID 1939	(4) (5) PREFERENTIAL CREDIT FOR BORROWED CAPITAL‡	
				Amount	% of (1)
Bethlehem.....	45.7	7.3	3.6	3.7	8.1
Republic Steel.....	23.9	3.4	2.2	1.2	5.0
U.S. Steel.....	119.5	9.6	4.7	4.9	4.1
Allis-Chalmers.....	6.7	1.0	.5	.5	7.5
Firestone.....	10.5	1.8	1.0	.8	7.6
Goodyear.....	12.1	1.8	.8	1.0	8.3
U.S. Rubber.....	10.4	1.7	.9	.8	7.7
Anaconda.....	40.9	2.0	1.2	.8	2.0
Socony-Vacuum.....	50.9	6.0	2.4	3.6	7.1
Standard Oil (N.J.).....	116.4	12.1	4.8	7.3	6.3
Texas Co.....	37.5	4.3	1.8	.5	1.3
Total.....	474.5	51.0	23.9	25.1	5.3

* 3 per cent of invested capital at the end of 1939. Invested capital includes equity capital less inadmissible assets plus 50 per cent of borrowed capital.

† 8 per cent of 50 per cent of borrowed capital.

‡ (2) less (3).

Source: Computed from SEC Survey of American Listed Corporations.

and the ceiling provision in the excess-profits tax is placed at 8 per cent, it is obvious that any provision which permits the inclusion of both borrowed capital and interest for computing excess profits operates to depress the rate of return from what it would be with reference to the earnings of equity capital. This provision will operate to the advantage of corporations having substantial borrowed capital.

The importance of preferential credit for borrowed capital to eleven corporations is shown in Table 3. The maximum credit, according to Table 4, is computed under the capital method. Observe that in several

⁴⁸ Ibid., at 30, 91-95.

cases (notably in steel, rubber, and petroleum refining companies) this preferential credit for borrowed capital amounted to as much as 8 per cent of the total credit claimable for invested capital.

A parallel case is the option of the taxpaying corporation to include in taxable income all interest received on governmental securities and likewise to expand invested capital by including therein the value of tax-exempt securities upon which such interest is payable. It is definitely to the advantage of the corporation to exercise this option whenever it has a tentative excess-profits tax liability arising out of other income and the rate of interest on tax-exempt securities does not exceed $6\frac{1}{2}$ per cent.⁴⁹ The excess credit—i.e., difference between the yield on the tax-exempt securities after the normal tax and 8 per cent of the value of the tax-exempt securities—operates to reduce the amount of the excess-profits tax on such other income.

To illustrate, a corporation has excess profits from operating sources in the amount of \$1,500,000. Its excess-profits tax thereon would amount to \$704,000. Assume it has \$300,000 in interest received from state and local bonds which, capitalized at 3 per cent, are valued at \$10,000,000. By exercising this option the corporation will find itself subject to an additional normal tax of \$72,000 on its tax-exempt interest, but it will also acquire an unused excess-profit credit of \$572,000 (i.e., \$800,000 less \$228,000) which, when applied against operating excess profits of \$1,500,000, reduces taxable excess profits to \$928,000. Instead of an excess-profits tax liability of \$704,000 the corporation by exercising this option can reduce the same to \$418,000 plus an additional normal tax of \$72,000, making a total tax liability of \$490,000. This is equivalent to a tax saving of 30 per cent. The effect of this option will therefore be to reduce substantially the excess-profits tax liability on operating income of all corporations holding tax-exempt securities.

The inclusion of undistributed profits in equity capital will undoubtedly operate as a powerful incentive further to retain profits within the corporation instead of distributing them to stockholders. The famous undistributed profits tax of 1936-37⁵⁰ no longer threatens corporations that

⁴⁹ The maximum interest rate was calculated as follows. Assumptions: normal tax of 24 per cent and excess-profits tax of 50 per cent. The excess-profits credit for tax-exempt interest must exceed the sum of (a) tax-exempt interest after the normal tax and (b) double the amount of the normal tax. Expressing tax-exempt interest as 100, capital is $\frac{76 + 48}{8} \times 100 = 1,550$, and the rate of return is $\frac{100}{1,550} = 6.4516$ per cent.

⁵⁰ For an examination of its operation in different industries and size groups, see the author's monograph, *op. cit.* supra note 1, at 70-79, 88-90, 95.

retain a high proportion of their profits, while the high individual surtax rates continue to furnish a strong tax inducement to delay realization. There is in fact every indication that corporate savings will grow by leaps and bounds. There is need for expansion, of course, but the tax preference arising from large borrowed capital is more conducive to defense expansion financed by borrowing than by internal sources. The prospect under the new excess-profits tax is therefore further stimulus to (a) non-distribution of corporate profits and consequent avoidance of the individual surtax and (b) debt financing.

The present internal revenue laws permit the taxpayer to carry over his net operating loss for a two-year period.⁵¹ This net loss carry-over provision is of course applicable to the determination of excess-profits tax liability. The present law makes no other provision for the carry-over of operating losses. However, a carry-over of the unused profits credit for one year is permitted in corporations with net income not in excess of \$25,000.⁵² As originally drafted in the Senate version, this carry-over of the unused excess-profits credit was limited to corporations in the preservation or canning of food, vegetable, and fish products. In the course of the conference discussion, this provision was converted from one limited to the specified industries to one applicable to all small corporations.

The failure to consider to a greater extent the role of industrial fluctuations will probably lead to some of the most serious inequities of the excess-profits tax. There are many industries where profits fluctuate widely from year to year, and the occurrence of a substantial profit for one year to be followed by several lean years is hardly a case of "excess profits." The artificiality of the calendar year for tax purposes will perhaps be nowhere more keenly felt than in the administration of excess-profits taxation.

A procedural innovation of substantial importance to the revenues is the reintroduction of permissive consolidated returns for purposes of the excess-profits tax. Normal tax liabilities will continue to be determined upon an unconsolidated basis save in the case of railroads and related carriers. This privilege is confined to closely interaffiliated corporations, at least 95 per cent of the voting stock of which is owned by the various members of the affiliated group.⁵³ It should be noted that only a single

⁵¹ § 23(s).

⁵² § 710(b)(3). Under the 1941 amendments the limitation as to size of income has been removed and another year added to the carry-over.

⁵³ § 730.

exemption of \$5,000 is allowed a consolidated group regardless of the number of corporations within such group.

This reintroduction of permissive consolidated tax returns was made in response to the practically unanimous request of business spokesmen and was only half-heartedly resisted by representatives of the Treasury. It should be observed, however, that it is permitted only in the case of excess-profits taxation and that single returns must be filed for the normal tax and the declared-value excess-profits tax by each corporation regardless of the character of its affiliation with other corporations. Corporations may consequently file tax returns on both a consolidated and unconsolidated basis. Under such circumstances it is difficult to see what administrative convenience—to either the tax collector or the taxpayer—may lie in this method.

However, the consolidated tax returns device does possess real tax advantages to the paying corporation, particularly in a period of declining profits. The author has demonstrated elsewhere⁵⁴ that consolidated tax returns result (a) at most in the same amount of revenue that would be collected from the taxation of each corporation as a unit, irrespective of its affiliations with other corporations, and (b) frequently, especially in a period of declining profits, in a very substantial loss of revenue. The loss of revenue results from the deduction from the profits of one corporation of the losses of another corporation, both of which are members of an interaffiliated system.

The argument in favor of consolidated returns is predicated on the principle that the tax laws should conform to economic reality—a proposition from which it is difficult to dissent in the abstract—and that a parent and subsidiaries are all members of one big happy family. Anyone who has studied intercorporate relationships knows that this unity is evidenced only in happy relationships, and that whenever an unhappy question is raised the members of the interaffiliated system are quick to assert their separate identities. In other words, the consolidated returns device operates as a distinct tax advantage to holding companies and related types of intercorporate affiliations. Its restoration at the present time on the ground of administrative convenience or necessity will amount to just that.

The other argument, of course, is that the Treasury has more difficulty in enforcing the tax laws when separate tax returns are required from each corporation, regardless of its relationship to other corporations. This administrative argument has been particularly stressed in the case of

⁵⁴ Monograph, *op. cit.* supra note 1, at 45-52.

excess-profits taxation. There is obviously some merit in it. There can be no question but that it takes more time to audit a series of separate returns than to audit consolidated returns. But this increased administrative problem must be balanced against the loss of revenue entailed in the consolidated method. Under the normal tax, for example, it is estimated that the reintroduction of consolidated returns along the lines provided in the Revenue Act of 1928 would result in a loss of revenue of between sixty and two hundred million dollars. It may be suggested that with one million dollars it is possible to hire a flock of very good tax auditors.

The language of the new section closely parallels the terms laid down by the Revenue Act of 1928, and invests the Commissioner of Internal Revenue with full regulatory authority to fill in the necessary details. These details are going to be extremely hard to provide, especially in the case of corporations electing to determine their excess profits under the income method. This difficulty arises out of the fact that their taxable receipts and deductions for the taxable year will be prepared on a consolidated basis which are to be compared to their earnings in the base period during which, of course, no consolidated returns were permitted except in the case of railroads and related common carriers. If such a comparison is to mean anything, it will be necessary to consolidate the receipts and deductions for all the members of the affiliated group for the base period, a rather sizable job. Even in the case of the excess-profits tax, the Treasury has more to gain from separate tax returns than it stands to lose in the way of increased administration. From the side of economic policy, the tax laws should not be permitted to give further advantages to the holding company device.

It should be clear from the foregoing that the present excess-profits tax cannot fall very heavily on most industrial corporations. This conclusion derives statistical support from the following table which presents data for twenty-four large companies in chemicals, steel, autos, aircraft, machinery, tires, nonferrous metals, and petroleum refining. The calculations are based on the profit-and-loss statements and balance sheets filed by the companies with the Securities and Exchange Commission under the authority of the Securities Exchange Act of 1934.⁵⁵

It is of course obvious that the SEC records are not strictly comparable with tax records. The error, however, is apt to be in the way of an overstatement of tax liability. Since the attached table shows that the typical excess-profits tax liability is zero or relatively low for most of the selected

⁵⁵ See also the report of Standard Statistics, Excess Profits Taxes (Nov. 4, 1940).

TABLE 4
EXCESS-PROFITS TAX CREDITS FOR 24 LARGE CORPORATIONS IN
8 MANUFACTURING INDUSTRIES
(In Millions of Dollars)

COMPANIES	PROFIT RATE 1939* (IN PER CENT)	CREDIT FOR "NORMAL" PROFITS†		PROFITS SUBJECT TO EPT		TAX- FREE IN- CREASE 1939- 40	ESTIMATED EPT	
		Income Meth- od‡	Capital Meth- od‡	1939§	1940		Amount	Effective Rate¶
Allied Chemical and Dye.	14.38	18.2	10.7	19.3	21.5	0	1.6	5.4
duPont.....	15.30	40.5	34.7	52.5	79.8	0	19.6	13.6
United Carbide & Carbon	13.17	33.0	21.3	35.5	**	0	**	**
Bethlehem.....	5.26	17.9	42.2	24.6	55.0	76	6.4	7.2
Republic Steel.....	4.56	6.7	21.6	10.4	15.8	107	0	0
U.S. Steel.....	3.16	60.3	114.6	40.6	100.0	182	0	0
Chrysler.....	24.03	39.8	13.5	36.8	46.4	8	3.3	5.4
General Motors.....	18.41	142.6	63.0	154.3	219.8	0	38.5	12.0
Packard.....	1.27	2.5	3.2	.6	**	478	**	**
Curtiss-Wright.....	16.25	2.8	2.9	5.2	**	0	**	**
Glenn Martin.....	24.73	2.0	2.3	4.1	4.3	0	2.3††	26.0
United Aircraft.....	29.47	4.9	1.4	9.4	25.7	0	10.4†††	30.7
Allis-Chalmers.....	6.52	4.3	6.2	3.7	5.0	66	0	0
International Business Machines.....	20.22	7.8	4.0	8.9	10.9	0	1.5	10.4
International Harvester.	3.93	22.3	27.0	13.0	20.4	108	0	0
Firestone.....	6.34	7.2	9.5	6.7	**	42	**	**
Goodyear.....	8.32	8.1	11.1	9.8	11.4	13	.1	6.5
U.S. Rubber.....	10.03	8.2	9.5	10.2	13.7		2.0	11.1
Anaconda Copper.....	4.01	17.4	39.7	20.0	**	99	**	**
International Nickel....	16.96	37.1	19.3	36.8	**	1	**	**
Kennecott Copper.....	11.03	31.1	25.9	33.8	**	0	**	**
Socony-Vacuum.....	4.97	30.8	48.6	23.6	**	106	**	**
Standard Oil (N.J.).....	7.24	77.9	111.6	67.6	**	65	**	**
Texas Co.....	7.10	30.4	35.7	27.7	28.3	24	0	0

* Net profit after all charges as per cent of tangible net worth.

† Italics indicate method most advantageous to the particular firm.

‡ 95 per cent of net after all charges (excluding dividend income), 1936-39.

§ 8 per cent of invested capital less $\frac{1}{2}$ of interest paid in 1939.

|| Net after all charges less dividend income.

¶ Estimated from Wall Street Journal and other sources (using same definition as in note §).

¶ Tax as per cent of 1940 profits before Federal income taxes.

** Not available.

†† Under the 1941 amendments this liability will probably be reduced to \$300,000, since the income credit is raised to 95 per cent of the 1939 earnings (\$3,900,000).

†† Under the 1941 amendments this liability will probably be reduced to \$24,000,000, since the income credit is raised to 95 per cent of the 1939 earnings (\$8,910,000).

Source: Computed from SEC Survey of American Listed Corporations.

corporations, with the notable exception of aircraft—and this exception may not remain so “notable,” in view of upward adjustment of the income credit under the 1941 amendments—this error does not affect the main point that the present tax will prove very light. The error arises principally out of the fact that the balance sheet items as tabulated by the Securities and Exchange Commission contain substantial write-downs in capital which it is unlikely that the corporations will report in their tax returns. It is not believed that any substantial error⁵⁶ arises out of the consolidated basis upon which the commission’s statistics are compiled, since corporations may choose to file consolidated tax returns insofar as the excess-profits tax is concerned.

CONCLUSION

An excess-profits tax may be designed to (1) reduce or prevent monopoly profits, (2) curtail war profits, or (3) serve as an administrative adjunct to some other tax (e.g., the capital stock tax). The excess-profits tax in effect since 1933 falls in the third category and should be forthwith repealed, especially since it is so onerous on small business.⁵⁷ The excess-profits tax enacted as part of the Second Revenue Act of 1940 falls largely in the second class, which is, to that extent, an “emergency” tax. In the following remarks the author is primarily considering the excess-profits tax as a permanent type of federal taxation.

Industrial unit of excess-profits taxation.—An excess-profits tax must logically be restricted to corporations and should not apply to partnerships or proprietorships, the excessive profits of which can be most effectively reached by the individual income tax. Only one possible exception can be conceived to this statement of policy and this exception arises out of the tax-exempt character of income derived from government obligations. Such income is ordinarily believed to be exempt from federal taxation on constitutional grounds. These grounds might be less obstinate in the case of an excess-profits tax on a business firm than in the case of an individual income tax,⁵⁸ and to this extent an excess-profits tax on noncorporate business may be justified. Of course, the proper solution should be to reach such income under the individual income tax.

Having determined that the proper unit of an excess-profits tax is the corporation, the question naturally arises as to the definition of the cor-

⁵⁶ Such error as may be will result in an overstatement of tax liability since the income credit may be understated as a consequence of the reduction in income by offsetting subsidiary losses.

⁵⁷ See the author’s monograph, *op. cit. supra* note 1, at 67–70.

⁵⁸ *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911).

porate entity and the treatment of intercorporate transactions. The statement of policy can again be rather simply made, and that is that the definition of a corporate unit should approximate reality. But it by no means follows from this commonplace observation that consolidated tax returns are in order. In order to determine the true income and, consequently, a realistic picture of the excessiveness of corporate profits, it may be necessary for the tax collector to examine the consolidated accounts of interaffiliated corporations. Existing legislation already permits him to do so insofar as the normal tax is concerned,⁵⁹ but this by no means results in a consolidated tax return, upon which tax liability is to be predicated. The consolidated accounts are submitted for informational or auditing purposes only in order to cast light on the reality of intercompany transactions. This power is ample to take care of any of the specific examples that may be cited of the alleged need for consolidated tax returns under the excess-profits tax. The danger of revenue loss from consolidated tax returns is less serious in a period of increasing profits since subsidiary losses (that may be offset against the profits of other companies) are usually nonexistent.

The filing of consolidated tax returns may be justifiably permitted, however, wherever the members of the interaffiliated group desiring to file such a return agree in advance to be regarded as a single entity for all practical purposes and not only for tax purposes. Such an agreement would relieve the combine of all the irresponsible features of the holding company device. Under such circumstances the employment of the consolidated tax return would not operate as an affirmative tax advantage to holding companies. The only cases where the corporations would be willing to make such a declaration probably would be in the case of railroads and certain other quasi-public enterprises where multiple state incorporation is frequently required for regulatory purposes. In these cases the employment of subsidiaries is not for the purpose of circumventing state control but for the purpose of compliance with the same. In all other cases, however, it is not likely that a declaration of a common entity would be made by the members of an affiliated group, because such a declaration would be tantamount to abandonment of all the advantages of the holding company technique. The denial of consolidated tax returns under such circumstances and the increased taxation of intercorporate dividends would lead, salutorily, to the simplification of corporate structures and increased public revenues—both of which are desirable objectives.

⁵⁹ Int. Rev. Code, § 45.

Definition of excess profits.—The determination whether a given amount of dollar income represents excess profits that should be subject to special taxation is a problem that depends upon (a) the method of measuring the excess profits and (b) upon the time period during which such income accrued. The definition of excess profits is technically simple—profits above normal profits. It is the definition of the latter term that constitutes the main problem. Normal profits may be defined in terms of either (a) performance in the recent past (the income method) or (b) the relationship of income to capital (the invested capital method).

In view of the wide fluctuations to which various industries and enterprises within industries are subject, it is obvious that it is realistically impossible to define excess profits in as short a period as the calendar year. It is, therefore, necessary to take into account the earning experience of the corporation over a period of time in order to prevent injustices arising among industries and corporations. The present law seeks to take into account the factor of industrial differences by the "income method" whereunder the earnings in the four years immediately preceding the taxable year are taken as a measurement of "normal" profits, the excess over which are defined as "excess profits" in the taxable year. Under the invested capital method the time span is completely ignored and profits are measured as excessive in relation to invested capital. The difficulties with the income method arise out of the necessity for comparing the taxable year with a base period which is really suitable for comparisons—by no means an easy problem, since corporations are constantly changing the direction and magnitude of their activities from month to month.

The income method, moreover, is subject to the very grave criticism that it places a tax premium on all corporations with high or monopoly profits in the recent past and permits these profits to continue in magnitude without taxation (other than the ordinary corporate income tax). It is therefore suggested that the income method be forthwith abandoned and exclusive reliance be placed upon the invested capital method for determining excess profits.

Adjustment for annual fluctuations.—Such a change, however, must be accompanied by (a) the extension of the net loss carry-over provision from two years (as presently permitted) to include five or possibly six years, (b) a redefinition of invested capital, and (c) a technique of precluding excessive capitalization.

Wherever a corporation over a period of time (say five years) has earnings in excess of 6, 7 or 8 per cent on capital, such excesses are clearly

excess profits and not the accidental results of industrial activity in any given year. As excess profits they could be subject to heavy taxation without any deleterious effect upon corporate activities or industrial expansion. The accounting period should be sufficiently long to iron out all differences and fluctuations among industries.

Such a method would also eliminate most of the complicated statutory provisions of the present law regarding changes in corporate structure. The net loss carry-over provision should be available only insofar as the taxpayer's corporate entity remains the same. In the case of reorganization, or liquidation, or succession, etc., operating losses are reflected in the reappraisal of capital structures and are therefore automatically adjusted. No provisions are consequently necessary in these special cases.

An important question is, of course, the date as to when the net carry-over provision should be permitted. If net operating losses in the past years are to be allowed as deduction from excess profits in the taxable year 1940, it may well turn out that profits derived from war armaments will escape taxation in view of the low earnings record of munitions manufacture in the past. This may or may not be a desirable consequence. If it is deemed essential that profits arising out of the present defense effort should be at least partially recouped via taxation, irrespective of the earnings record of such corporations in the past, the net carry-over provision should be prospective only, that is to say, only operating losses in the future should be counted. In the event that such operating losses in 1941-42-43 should outbalance the profits in 1944, it might be well to provide for a redetermination of the tax liability in 1940-41, as was done when the net loss carry-over provision was originally introduced by the Revenue Act of 1918.

If, however, it is not necessary that policy focus with special emphasis upon the profits from war contracts, it would be easiest to start the net carry-over provision on the basis of the earnings in the past four years.

The definition of invested capital must be revised in order to eliminate the present preference shown corporations with a high proportion of borrowed capital or with extensive holdings in tax-exempt securities or in corporate stock. It will likewise be necessary to guard against over-capitalization of equity money and to assure that recent write-downs in capital structure will not be lightly undone. These objectives are probably accepted by most tax-men but their achievements are believed to be beset with many and insuperable difficulties.

The principal rationales for the partial inclusion of borrowed capital

were the plea of favoring small business and the administrative argument of attenuating the practical need for distinguishing between guaranteed preferred stock and bonds. The former is simply not in accord with the facts—the preference will be of most advantage to industries that are characterized by heavy debt financing and not to small enterprise as such. The latter can be met by an objective rule of thumb, namely, the size of the so-called “interest” or “dividend” rate. Where this rate is above 5 per cent, say, the capital should be regarded as equity in character; where below, as creditor capital and be fully excluded.

Likewise, the optional treatment of governmental securities as admissible or inadmissible assets should be removed at once. Certainly no further premium on tax-exempt securities is warranted at the present time.

The danger of overcapitalization can be met by a requirement that capital may not be so great that the sum of profits or deficits for the past decade—or some suitable period of years—shall be less than a stated per cent of invested capital—say 2 or 3 per cent. Where the rate of return over such a period of time is exceedingly low it is obvious that a reorganization of capital structure is indicated. This problem may not prove in practice so serious as it may loom in theory, for much has recently been accomplished in readjusting capital to actual earning capacity. And these adjustments should not be lost sight of in modern tax administration.

Valuation is clearly a difficult matter of administration. But the difficulties are by no means comparable to those confronting the Bureau of Internal Revenue during World War I. Its own files contain a continuous record of the profit-and-loss statements and the balance sheets of substantially all large corporations for practically the last three decades. Since 1934 most large corporations have been compelled to file trustworthy accounts with the Securities and Exchange Commission under the direct sanction of law. Other federal agencies likewise possess relevant information on earnings and capital. It is not contended that tax liabilities may be based on data submitted to the government for non-tax purposes, but tax data and such other data are not wholly irreconcilable. If discrepancies arise they must be specifically explainable. There is thus in Washington a wealth of information which cannot but greatly offset the conventional difficulties of administering a tax based on invested capital. To use these new sources efficiently, of course, requires imagination and ingenuity that may not always be found in bureaucracy, but that does not imply at all that the job cannot be done, and done ably.