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THE SECOND REVENUE BILL OF 1940

SEPTEMBER 11 (legislative day, AUGUST 5), 1940.—Ordered to be printed

Mr. HARRISON, from the Committee on Finance, submitted the following

REPORT

[To accompany H. R. 10413]

The Committee on Finance, to whom was referred the bill (H. R. 10413) to provide revenue, and for other purposes, having had the same under consideration, report favorably thereon, with certain amendments, and, as amended, recommend that the bill do pass.

ESTIMATES OF REVENUE

The amendments recommended by your committee increase substantially the estimated yield of revenue from the bill, as compared with the Treasury estimates under the House bill of a gross yield of $305,000,000 for the calendar year 1940 and a net yield of $260,000,000.

There are two estimates of yield under your committee bill, one by the Treasury showing a net yield of $305,000,000 for the calendar year 1940, and the other by the staff of the Joint Committee on Internal Revenue Taxation, showing a net yield for that year of $432,500,000. That the estimates of the staff of the joint committee are conservative is evidenced by the fact that the staff computed the excess-profits tax on estimated earnings for the calendar year 1940 of 27 corporations representing a cross section of industrial and mercantile establishments and that computation disclosed an excess-profits-tax liability of $102,000,000.

The estimates furnished the committee are as follows:

	Treasury	Joint Committee Staff
1940:		
From normal tax	$240,000,000	$232,500,000
From excess-profits	115,000,000	250,000,000
Gross revenue	355,000,000	482,500,000
Net revenue	305,000,000	432,500,000
1941:		
From normal tax	(1)	282,500,000
From excess-profits	(1)	600,000,000
Gross revenue	(1)	882,500,000

[1] No estimate.

In the opinion of your committee, the changes in the bill to provide this additional revenue are justified by current fiscal requirements and will accomplish the equitable distribution of an additional tax burden well within the power of corporate enterprise to sustain in a period of vast governmental expenditure for national defense.

Measure of Excess Profits

The bill as passed by the House combined two fundamental methods of measuring excess profits: (1) A comparison of the average earnings of a corporation with its earnings for the taxable year; (2) a comparison of the ratio of earnings to invested capital during the base period with such ratio for the taxable year. These methods of measurement were alternative but only corporations which were in existence for the entire base period (the years 1936 to 1939, inclusive) were allowed to elect. Corporations not in existence for this required period, except in the case of certain tax-free exchanges and reorganizations, were compelled to use the invested capital method of measuring their excess profits.

In order to afford relief to small corporations, the House bill contained three factors relating to the computation of the invested capital credit, varying with the size of the corporation.

(1) A tax-free return of 7 percent was allowed upon the first $500,000 of the invested capital, while the minimum tax-free return on capital in excess of $500,000 was limited to 5 percent.

(2) A minimum tax-free return upon new capital was allowed at 10 percent upon that portion of the new capital which did not cause the invested capital to exceed $500,000 and 8 percent upon new capital in excess of that figure.

(3) Varying percentages (100, 66⅔, and 33⅓) of borrowed capital were permitted to be included in invested capital depending upon the size of the equity invested capital.

These variable factors, while they did afford substantial relief to small corporations, were the cause of considerable complexity which your committee do not consider necessary in obtaining the desired result. It is felt that substantially the same result is achieved by replacing the varying percentages of minimum tax-free return for both old and new capital by the flat rate of 8 percent, and the varying percentages of borrowed capital allowed to be included in invested capital, by a flat 50 percent, regardless of the size of the corporation, and by raising the specific exemption, applicable to all corporations, from $5,000 to $10,000.

Another feature of the House bill, which required a number of pages of highly technical and complicated language, was that providing for the computation of the excess-profits credit by the invested-capital method. Under these provisions it was necessary for the taxpayer to determine both its invested capital for each of the years of the base period and its excess-profits net income for each of such years. This requirement, with respect to the years in the base period, has been eliminated. Taxpayers using the invested-capital method under the bill reported by your committee need only determine their invested capital for the taxable year and upon that they are allowed a tax-free return of 8 percent.

SUMMARY OF PRINCIPAL CHANGES

I. INCREASE IN NORMAL CORPORATE INCOME TAX

The House bill required corporations using the average-earnings method of computing the excess-profits credit to pay as a part of their excess-profits tax an amount equal to 4$\frac{1}{10}$ percent on the normal tax net income. Your committee substituted for this provision a general increase of 3$\frac{1}{10}$ percent in the normal tax payable by all corporations regardless of their liability for excess-profits tax.

The following table shows the normal corporate income-tax rate under existing law, the additional normal tax rate under the committee bill, and the total rate:

Corporate net incomes	Rate under existing law		Additional rate under the committee bill	Total normal tax rate
	Permanent rate	Temporary additional rate (defense tax)		
	Percent	*Percent*	*Percent*	*Percent*
Not over $25,000:				
Up to $5,000	13.50	1.35	3.1	17.95
$5,000 to $20,000	15.00	1.50	3.1	19.60
$20,000 to $25,000	17.00	1.70	3.1	21.80
Over $25,000	19.00	1.90	3.1	24.00

II. EXCESS-PROFITS TAX

In order that the features of the excess-profits tax as contained in the committee bill may be readily compared with similar provisions in the House bill, the discussion in this report follows the arrangement used in the report of the Committee on Ways and Means.

1. TAXABLE YEARS

As under the House bill, the tax imposed by the committee bill is applicable to all taxable years beginning after December 31, 1939.

2. CORPORATIONS TAXABLE

Under the House bill, corporations with excess-profits net incomes of not more than the specific exemption were not subjected to tax and were not required to file excess-profits tax returns. Your committee, having increased the specific exemption, correspondingly modified the requirement for the filing of returns. Increasing the specific exemption to $10,000 has the effect of limiting the application of the excess-profits tax to less than 46,000 corporations, since of the almost 500,000 active corporations in the United States, only about 46,000 have normal-tax net incomes exceeding $10,000.

It will be noted that the Ways and Means Committee amendments adopted by the House after the bill was reported, and therefore not mentioned in the Ways and Means Committee report, added to the exempt category 2 classes of corporations, namely:

(1) Domestic corporations with incomes largely derived from sources outside of the United States, and

(2) Certain air-mail carriers.

3. BASE PERIOD

The base period under the House bill, the years 1936 to 1939, inclusive, is retained for the purposes of the income method of computing the excess-profits credit. Under the committee bill, however, the invested capital method of computing the credit requires no reference to the invested capital or income of the base period. Those foreign corporations, further, which under the House bill were confined to the use of the income credit are, under your committee bill, permitted to use the income or the invested capital credit.

4. MEASURE OF EXCESS PROFITS

Corporations which may elect.—Under the House bill the privilege of electing the average earnings in the base period as the standard of measurement of excess profits was restricted to corporations actually or constructively in existence during the entire base period. Your committee bill also extends this privilege to corporations in existence during any part of the base period. Such a corporation is deemed to have had, in that portion of the base period when it was not in existence, earnings equal in amount to 8 percent of its invested capital at the beginning of its first taxable year in 1940.

The provisions of the House bill extending the privilege of election of the average earnings method of computing the excess-profits tax to corporations not in existence during the base period but considered to have been so in existence by reason of having acquired, or having resulted from the coalescing of, other corporations, have not been materially changed.

The election privilege has also been extended to foreign corporations engaged in trade or business within the United States at some time during each of the years in the base period.

The House bill provided two methods of computing the excess-profits credit, the use of either of which was at the election of the taxpayer as above-outlined. The committee bill continues this principle with the changes described under the following heading:

5. COMPUTATION OF THE EXCESS-PROFITS CREDIT

First method—Based on income.—Under the bill reported by your committee, corporations in existence during any part of the base period may use this method and for that purpose are allowed, for the part of the base period during which they were not in existence, a hypothetical income equal to 8 percent of their invested capital at the beginning of their first taxable year in 1940.

Second method—Based on invested capital.—Under the House bill the credit allowed under this method was that percentage of the invested capital for the taxable year which the average earnings during the base period were of the average invested capital in that period. The base period percentage so determined, however, was confined within fixed limits; namely, a minimum of 5 percent and a maximum of 10 percent, except that on the first $500,000 of invested capital the minimum was 7 percent. In addition, the House bill provided a 10-percent tax-free return on new capital to the extent that it would not cause the invested capital to exceed $500,000, and 8 percent on new capital in excess of that figure. In the opinion of your committee,

the allowance of a flat credit of 8 percent of the invested capital for the taxable year, in lieu of these varying percentages, and the elimination of computations of base period invested capital and earnings remove complexities of language and obviate difficulties of administration which appear incommensurate with the revenue involved as well as with the benefits sought to be obtained for the taxpayer.

6. EXCESS-PROFITS NET INCOME

To the adjustments provided in the House bill for the purpose of determining excess profits net income, your committee has added the following:

(1) Uninsured losses resulting from the demolition, abandonment, or loss of useful value of property. This adjustment applies only to years in the base period and the effect of it is to increase net income by the amount then allowed as a deduction from gross income.

(2) Losses and expenses resulting from the retirement or discharge by the taxpayer certain indebtedness outstanding for more than 18 months. This adjustment is applicable with respect to both the base period and taxable years thereafter, whichever method of computing the excess-profits credit is used, and has the effect of restoring these losses and expenses to net income.

(3) Refunds of processing taxes, including interest thereon. This adjustment applies to the taxable years after the base period, whichever method of computing the excess-profits credit is used, and reduces gross income by the amount of such refunds and interest.

(4) Interest on tax-exempt securities. Interest on Federal securities subject to excess-profits tax is included in gross income and such securities are treated as admissible assets. If the taxpayer elects to treat other tax-exempt securities as admissible assets, he must include the interest therefrom in his gross income. This adjustment is applicable only to taxable years after the base period and to cases where the excess-profits credit is computed under the invested capital method.

(5) Unusual and nonrecurring claims, judgments, awards, and decrees. Unusual or abnormal amounts paid out because of claims, judgments, awards, and decrees are not deducted from the gross income of years in the base period.

7. SPECIFIC EXEMPTION

The specific exemption of $5,000 provided in the House bill has been increased to $10,000. It is the opinion of your committee that the allowance of this increased exemption and the uniform 8-percent credit are adequate compensation for the discontinuance of the preferential treatment applied to the first $500,000 of invested capital under the House bill.

8. RATES OF TAX

Under the House bill, the excess-profits tax included as a part an amount equal to 4 1/10 percent of the normal-tax net income in the case of corporations electing to use the average-earnings method of computing their excess-profits credit. This penalty tax has been eliminated by your committee. The 3 1/10 percent increase in the normal corporate income-tax rate, adopted by your committee, applies to

corporations generally regardless of the method employed in computing the excess-profits credit.

In addition, your committee has removed the 5-percent differential in the graduated excess-profits tax rate schedule which favored corporations electing to compute their excess-profits credit on the invested-capital method.

The bill reported by your committee contains one such schedule, which is the higher of the two provided in the House bill. This schedule is as follows:

Amount of excess profits:	Rate of tax, percent
First $20,000	25
Next $30,000	30
Next $50,000	35
Next $150,000	40
Next $250,000	45
Over $500,000	50

9. INVESTED CAPITAL

Your committee has made no change in the determination of equity invested capital except to clarify the provisions which were designed to avoid any overstatement of invested capital as the result of duplicating amounts in the items of earnings and profits and property paid in. Such a duplication might otherwise arise in the computation of invested capital in cases of reorganization and other tax-free exchanges.

With respect to the portion of borrowed capital which is includible in invested capital your committee has provided a flat 50 percent in lieu of the graduated percentages of 100, 66⅔, and 33⅓, provided in the House bill.

10. ADMISSIBLE AND INADMISSIBLE ASSETS

Under the House bill all State and local securities, obligations of corporate agencies of the United States, and obligations of the United States or its possessions were "inadmissible assets." The committee bill provides that such assets which, under their terms, are not exempt from excess-profits tax shall be classed as "admissible assets." With respect to such securities which are exempt from excess-profits tax, the taxpayer may, if he so elects, treat them as "admissible assets," in which case the interest thereon is included in gross income.

11. PERSONAL-SERVICE CORPORATIONS

No change is made by your committee in the provisions of the House bill relating to personal-service corporations.

12. FOREIGN CORPORATIONS

Your committee has extended to foreign corporations engaged in trade or business within the United States at some time in all the years in the base period the same right of election of the method of computing excess-profits credit as is allowed domestic corporations.

13. CREDIT FOR FOREIGN TAXES

No change has been made in the allowance of the credit for foreign taxes provided in the House bill.

14. EXCESS PROFITS CREDIT IN CONNECTION WITH CERTAIN EXCHANGES

First method—based on income.—The privileges allowed under the House bill to corporations resulting from statutory mergers or consolidations are extended in your committee bill to similar reorganizations in States in which mergers or consolidations are not defined by statute.

Second method—Based on invested capital.—

Your committee has replaced the varying percentages of tax-free return allowed with respect to the first $500,000 of invested capital in the House bill by a flat 8 percent. In addition, it has substituted a flat 50-percent allowance of borrowed capital to be included in invested capital in lieu of the graduated percentages of 100, 66⅔, and 33⅓, provided in the House bill. While these preferential methods of treatment for small corporations were in the bill it was necessary to guard against the serious loophole open to large corporations which by splitting up into smaller entities, could obtain undue advantages and accomplish substantial tax avoidance. The action of your committee has removed the necessity for many of the extremely technical and complicated provisions of supplement B.

15. SPECIAL RELIEF PROVISIONS

The House bill contained a number of special relief provisions, generally in the form of adjustments in arriving at the excess-profits net income. To these, your committee has added further adjustments to take care of some unusual cases of hardship. These further adjustments are described in the discussion of excess-profits net income.

In addition, your committee has provided a relief provision of much wider and more general application. This provision allows relief in the taxable period where abnormalities in income occur because of amounts of income (*a*) arising out of claims and judgments; (*b*) resulting on long-term contracts; (*c*) resulting from long-term exploration, discovery, prospecting, research, or development of property, patents, or processes; (*d*) falling into one taxable year rather than another because of a change in accounting periods or methods; or (*e*) arising upon the termination of a lease from improvements on the leased property.

To be entitled to relief in such cases, the type of income must be abnormal in the case of the particular taxpayer, in the light of its business, or if of a type normally received by it, must be grossly disproportionate to its income of the same class in the 4 preceding taxable years.

Where, with respect to any particular item of income the taxpayer is entitled to relief under this provision, such item of income will be allocated to the years in which it is properly attributable and the taxpayer's income for the taxable year in which such item would otherwise fall is correspondingly reduced.

In addition, taxpayers, 80 percent or more of whose gross income is derived from processing, canning, or otherwise preparing for market any seasonal fruit or vegetable or any fish or other marine life, are allowed to carry over for 2 years the unused excess-profits credit for any taxable year subject to the excess-profits tax.

16. CONSOLIDATED RETURN

Your committee has provided that an affiliated group of corporations may file a consolidated return in lieu of separate returns. This privilege is conditioned upon the consent by each of the corporations of the group to the regulations prescribed by the Commissioner with respect to such returns. When a consolidated return is filed, only one specific exemption of $10,000 is allowed.

III. SUSPENSION OF THE VINSON-TRAMMELL ACT

Under the House bill the provisions of the Vinson-Trammell Act were suspended so far as applicable to contracts entered into or completed in any taxable year subject to the excess-profits tax.

Your committee extends such suspension to contracts entered into but not completed before the date of the beginning of the taxpayer's first excess-profits tax taxable year beginning in 1940.

IV. AMORTIZATION OF EMERGENCY FACILITIES

Your committee extended the amortization deduction benefits to certified construction after January 1, 1940, in place of July 10, 1940, as provided in the House bill.

In addition, subsections (i), (j), and (k) of section 201 of the House bill (section 301 of the committee bill) have been eliminated. In lieu thereof, your committee has inserted a new subsection (i) providing that if a taxpayer has been or will be substantially reimbursed by the Government for all or a part of the cost of any emergency facility pursuant to a Government contract relative to such facility or for the purchase of supplies, or otherwise, the taxpayer will not be allowed amortization with respect to such facility unless the Advisory Commission to the Council for National Defense and either the Secretary of War or the Secretary of the Navy certify that the contract contains provisions adequately protecting the public interest with reference to the use and disposition of the facility.

The methods of procuring new defense facilities were described before your committee by a member of the Advisory Commission to the Council of National Defense in the hearings before your committee as follows:

RECOMMENDED METHODS OF PROCURING NEW FACILITIES

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 loan.

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.

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.

DESIGN OF FACILITIES AND SUPERVISION OF THEIR CONSTRUCTION

To insure proper facilities for the work and expedite placing such facilities in production, the manufacturer should supervise their design and construction, even in case plan III is followed. In connection with plans II and III, the Government departments concerned should review the building plans and the cost estimates to determine whether the facilities proposed and the cost of the same are reasonable for the purpose prior to any commitments.

COMBINATION OF PLANS

Machinery, for instance, may be Government furnished by plan III, while the plant may be provided by plans I or II should this be desired.

The variations in these methods used by the Government in dealing with producers of articles necessary for the national defense demonstrate the inadvisability of attempting to cover all of these cases with a rigidly uniform statutory rule.

Detailed Explanation of the Changes in the House Bill

TITLE I. CORPORATION INCOME TAX

Title I of the committee amendment consists of one section increasing by 3⁄10 percent the ordinary taxes imposed by chapter I of the Internal Revenue Code upon corporations. Such increase applies to the entire rate schedule contained in sections 13 and 14. This provision is new and was not contained in the House bill. Section 710 of the excess-profits tax as passed by the House did, however, provide as a part of the excess-profits tax in the case of corporations which elected to compute their excess-profits credit on the average-earnings plan for the payment of an additional amount equal to 4⁄10 percent of the normal tax net income. As indicated below, your committee recommends that such provision be eliminated.

Under the proposed amendment the permanent general corporate tax rate will be 22⁄10 percent. It is provided, however, that in computing the 10-percent increase in tax imposed by section 15 of the Internal Revenue Code, added to such code by section 201 of the Revenue Act of 1940, the corporate tax prior to the 3⁄10-percent increase proposed by the bill is to be used as the basis for such computation.

Thus, the general effective rate applicable to corporations so long as the defense-tax provisions of section 15 are in force will be 24 percent, computed as follows:

	Percent
Tax under permanent provisions	22$\frac{1}{10}$
Plus 10 percent of 19 percent (the rate applicable under the permanent provisions prior to their amendment by the bill)	1$\frac{9}{10}$
Total	24

TITLE II. EXCESS-PROFITS TAX

SECTION 710. IMPOSITION OF TAX

Under the House bill the excess-profits tax imposed upon corporations which elected to compute their excess-profits credit on the average-earnings method consisted of 4$\frac{1}{10}$ percent of the corporation's normal-tax net income plus a graduated tax of from 25 to 50 percent of the corporation's adjusted excess-profits net income. The excess-profits tax imposed upon corporations which elected to compute their excess-profits credit on the income and invested capital method consisted solely of a graduated tax of from 20 to 45 percent of the corporation's adjusted excess-profits net income. In the case of any corporations which had been through certain types of tax-free exchanges, it was provided that adjustments were to be made in the dollar amounts constituting the dividing lines between the various brackets on the basis of the relationship of the taxpayer's preferential rate amount to $500,000. The House bill defines the term "adjusted excess-profits net income," which constituted the measure of the graduated tax, as the excess-profits net income less a specific exemption of $5,000 and the amount of the taxpayer's excess-profits credit for the taxable year.

In the bill as reported by your committee the additional 4$\frac{1}{10}$ percent of the normal tax net income of corporations electing the excess-profits tax based on average earnings has been eliminated. The graduated rate schedule applicable under the House bill to such corporations has been made applicable to all corporations whether computing their excess-profits credit on the average-earnings method or on the invested-capital method. The excess-profits tax of any corporation, therefore, is based on the following rate schedule:

Amount of adjusted excess-profits net income:	Rate of tax, percent
First $20,000	25
Next $30,000	30
Next $50,000	35
Next $150,000	40
Next $250,000	45
Over $500,000	50

The adjustments made to the dollar amounts in the above rate schedule in the House bill, on account of certain tax-free exchanges, are retained, except that the term "preferential rate amount" has been changed to "highest bracket amount." The computation of the highest bracket amount is contained in section 752 and is substantially the same as the computation of the preferential rate amount contained in section 759 of the House bill. Such adjustment is necessary to prevent corporations from obtaining undue advantage by breaking up into several smaller corporations by means of tax-free transactions.

The definition of adjusted excess-profits net income contained in the House bill is retained except that the specific exemption deductible in computing such adjusted excess-profits net income is increased from $5,000 to $10,000.

SECTION 711. EXCESS-PROFITS NET INCOME

Under the House bill the excess-profits net income was the normal-tax net income with certain adjustments. If the excess-profits credit was computed on the average-earnings plan, the normal-tax net income was adjusted by the exclusion of gain or loss from the sale or exchange of capital assets (whether depreciable or nondepreciable) held for more than 18 months, the deduction of the normal corporate income tax, and the exclusion of income arising from the retirement or discharge of the taxpayer's own indebtedness.

If the excess-profits credit was computed on the invested-capital plan, the normal-tax net income was further adjusted by increasing the credit for dividends received to 100 percent and making it applicable to dividends on the stock of all corporations, whether domestic or foreign, except dividends (actual or constructive) on stock of foreign personal holding companies; and by reducing the deduction for interest paid or accrued by an amount which was the same percentage of the interest on borrowed capital as the borrowed invested capital was of the total borrowed capital.

The above adjustments applied whether the computation was made for the base period or the taxable year. Relative to the base period the normal-tax net income (or its equivalent) was to be further adjusted by disallowing certain casualty losses and certain deductions on account of repayments of Agricultural Adjustment Act taxes to vendees.

Under the bill, as reported by your committee, the adjustments to normal-tax net income in computing the excess profits net income which were provided in the House bill are retained, but certain changes have been made therein and certain additions made thereto as follows:

(1) The treatment of gains and losses on depreciable assets held for more than 18 months as long-term capital gains and losses has been eliminated. In lieu thereof a provision has been inserted providing that only the excess of gains arising from the sale or exchange of such assets over any losses arising from the sale or exchange of such assets shall be excluded from the computation. The effect of this provision is to allow losses from the sale or exchange of depreciable assets held for more than 18 months to be deducted from ordinary income to the extent such losses exceed the gains from similar transactions.

(2) The adjustment on account of income derived from the retirement or discharge of bonds, etc., has been rewritten to make certain that amounts which would be otherwise includible upon such retirement or discharge on account of any premium received upon issuance shall be left out of the computation, and that the adjustment shall apply although the indebtedness retired or discharged is indebtedness which has been assumed by the taxpayer and, although it is evidenced, so far as the taxpayer is concerned, only by a contract with the person whose liabilities have been assumed.

(3) A new adjustment has been added, applicable whether the excess-profits credit is computed under the income or invested capital

plan and to taxable years in the base period as well as to taxable years under the excess-profits tax, requiring that any deductions otherwise allowable on account of the retirement or discharge of indebtedness shall be disallowed if the taxpayer's obligation has been outstanding for more than 18 months. The amounts so to be disallowed include the deduction otherwise allowable under section 23 (a) for expenses paid or incurred in connection with such retirement or discharge (including any premium paid upon any such retirement or discharge), the deduction for losses otherwise allowable in such connection, and the deduction otherwise allowable on account of the issuance of the bonds or other evidence of indebtedness at a discount.

(4) A new adjustment has been added applicable only to taxable years under the excess-profits tax requiring the exclusion of income attributable to refunds of Agricultural Adjustment Act taxes and interest upon such refunds.

(5) The adjustment applicable to the invested capital method on account of interest has been simplified on account of the substitution of a flat 50-percent rule for the inclusion of borrowed capital in invested capital in lieu of the varying percentages contained in the House bill.

(6) It is provided that, if the excess-profits credit is computed under the invested capital plan, the normal-tax net income shall be increased by an amount equal to the interest on Federal obligations not specifically exempted from excess-profits taxes and in addition thereto, the interest on all other Federal, State, or local obligations, if the taxpayer elects, under section 720 (d), to treat all such other obligations as admissible assets for the taxable year.

(7) The adjustment on account of casualty losses has been expanded so as to exclude from the computation of excess-profits net income for taxable years in the base period, losses arising from the demolition, abandonment, and loss of useful value of property.

(8) The adjustment on account of repayment of Agricultural Adjustment Act taxes to vendees has been rewritten to remedy certain technical defects contained in the House bill.

(9) An additional adjustment is provided, applicable only to taxable years in the base period, to the effect that deductions attributable to any claim, award, judgment, or decree against the taxpayer, or interest thereon, will not be required to be taken into account if, in the light of the taxpayer's business, it is abnormal for the taxpayer to incur a liability of such character or, if the taxpayer normally incurs liabilities of such character, the amount of the particular liabilities of such character in the taxable year is grossly disproportionate to the average amount of liabilities of such character in each of the 4 previous taxable years.

The House provision applying section 117 of the Internal Revenue Code (relative to capital gains and losses) to taxable years in the base period has been retained. Certain changes have been made therein in view of the revised treatment above described in the case of depreciable assets. In addition, section 23 (g) and (k) of the Internal Revenue Code have been made applicable to taxable years in the base period, in order that long-term losses due to securities (stocks and bonds) having become worthless shall be disallowed in computing excess profits net income for taxable years in which such losses were not treated as capital losses under the income-tax law applicable to such years.

SECTION 712. ALLOWANCE OF EXCESS-PROFITS CREDIT

Domestic corporations.—Under the House bill a domestic corporation was permitted to choose between the income credit and the invested capital credit only if it had been in existence during the entire 48 months prior to the beginning of its first taxable year which began in 1940. All other domestic corporations were required to compute their excess-profits credit on the invested capital plan.

Under the bill as reported by your committee any domestic corporation which was in existence before January 1, 1940, may choose between the income credit and the invested capital credit. It is further provided that any domestic corporation which for any taxable year does not file a return must compute its excess-profits credit on the invested capital plan.

Foreign corporations.—Under the House bill a foreign corporation subject to excess-profits tax was required to compute its excess-profits credit on the average-earnings plan if it was in existence during the entire 48 months prior to the beginning of its first excess-profits tax taxable year beginning in 1940 and was engaged in trade or business within the United States or had an office or place of business therein at any time during each of the taxable years in the 48 months prior to such date. All other foreign corporations subject to excess-profits tax were required to compute their excess-profits credit on the invested capital plan.

Under the bill as reported by your committee the first class of foreign corporations is entitled to choose between the income credit and the invested-capital credit. If the corporation fails to file a return its excess-profits credit for the taxable year is computed under the invested-capital plan. The treatment of other foreign corporations subject to tax is the same under this section as it was under the House bill.

SECTION 713. EXCESS PROFITS CREDIT BASED ON INCOME

Owing to the fact that section 712 has been changed so as to allow a domestic corporation which was not in existence during the entire base period to choose the income credit, section 713 has been changed by the insertion of additional provisions giving corporations which were not in existence during the entire base period an excess-profits net income for that portion of the base period during which they were not in existence. For each 12 months of such period the excess-profits net income is deemed to be 8 percent of the corporation's daily invested capital for the first day of its first taxable year subject to the excess-profits tax reduced on account of inadmissibles by the same ratio as is applicable under section 720 in reduction of the average invested capital of the preceding taxable year. Thus if the ratio of inadmissibles to total assets in the last taxable year of the base period were as 1 to 3, the daily invested capital as of the day following the close of such taxable year would be reduced by one-third thereof, and 8 percent of such reduced amount would constitute the corporation's excess-profits net income for each period of 12 months in the base period during which it was not in existence. The excess-profits net income for a period of less than 12 months during which it was not so in existence is a proportionate part of such amount.

SECTION 714. EXCESS-PROFITS CREDIT BASED ON INVESTED CAPITAL

Under the House bill the invested capital credit for any taxable year reflected, in part, the base period experience of the taxpayer. In general, the excess-profits credit consisted of an amount representing the same rate of return (but not less than 7 percent or more than 10 percent on the first $500,000 and not less than 5 percent or more than 10 percent on the remainder) on so much of the corporation's invested capital for the taxable year as did not exceed its invested capital at the close of the base period, plus 10 percent of so much of the remaining invested capital as did not bring the total invested capital beyond $500,000, and 8 percent of the remainder.

Under the bill as reported by your committee the base period experience of a corporation electing the invested-capital credit has been eliminated from consideration. In lieu of the varying percentages contained in the House bill, a flat rate of 8 percent of the taxpayer's invested capital for the taxable year has been substituted.

SECTIONS 715–717. INVESTED CAPITAL

These sections are the same as in the House bill except that the references to the taxable years in the base period have been eliminated owing to the fact that base-period experience is not taken into account in computing the excess-profits credit based on invested capital.

SECTION 718. EQUITY-INVESTED CAPITAL

This section is substantially as it was in the House bill except for certain clerical and technical changes. The most important of these are as follows:

(1) Section 718 (c) (4) of the House bill provided that, in making the computations required by subsections (a) and (b), the earnings and profits of a transferee corporation were not to include the earnings and profits of another corporation which would otherwise be included by reason of property of such other corporation having been paid in for stock, or as a contribution to capital, or as paid-in surplus, of the transferee corporation. This subsection has been inserted as section 718 (b) (3) and made an actual step in the computation.

(2) Section 718 (d) of the House bill has been omitted because of the treatment of this matter under section 501 (sec. 401 of the House bill).

SECTION 719. BORROWED INVESTED CAPITAL

Under the House bill borrowed capital (i. e., indebtedness evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust) was included in invested capital under a graduated limitation at varying percentages (100, 66⅔, 33⅓), these percentages depending upon the amount of equity-invested capital.

Under the bill as reported by your committee all borrowed capital, as defined in the House bill, is includible in invested capital at 50 percent.

SECTION 720. ADMISSIBLE AND INADMISSIBLE ASSETS

Except for technical changes, section 720 of the House bill has been changed in only one respect, as follows: If the excess-profits credit for any taxable year is computed on the invested-capital plan, the follow-

ing obligations are to be considered as admissible and not as inadmissible assets for such taxable year:

(1) United States obligations and obligations of Federal instrumentalities the interest from which is not exempt from excess-profits taxation; and

(2) All other Federal, State, and local obligations, if the taxpayer so elects in its return for such year. A taxpayer may not make such an election relative to only a portion of such obligations. The election must be made relative to all such obligations, or none of such obligations may be treated as admissible assets.

Under section 711 (a) (2) (H) (i) the interest described in paragraph (1) above increases the normal tax net income for excess-profits tax purposes. Under section 711 (a) (2) (H) (ii), if the election described in paragraph (2) is made, then all the interest on all such obligations increases the normal-tax net income.

SECTION 721. ABNORMALITIES IN INCOME IN TAXABLE PERIOD

Section 721 of the committee amendment is a new section, no comparable provisions having been included in the House bill. Subsection (a) of this section is designed to provide relief in enumerated cases in which the taxpayer's income in any taxable year is abnormally large because of certain special circumstances. The special types of income with respect to which relief may be accorded by this section are as follows:

(1) Income arising out of a claim, award, judgment, or decree, or out of interest on any of the foregoing;

(2) Income received with respect to a contract whose performance required more than 1 year;

(3) Income resulting from the exploration, discovery, prospecting, research, or development of tangible property, patents, formulas, or processes, providing that such exploration, etc., extended over a period of more than 1 year;

(4) Income which is required to be included for the taxable year as a result of a change in the taxpayer's accounting period or method of accounting;

(5) Income received by the lessor of real property on the termination of the lease as a result of improvements on the property during the lease.

If the taxpayer receives income of any of the above classes, the section provides that relief shall be accorded if either (1) in the light of the taxpayer's business it is abnormal for it to receive such income or (2) although the receipt of such income may be normal, the income so received for the taxable year is grossly disproportionate to the amounts of such income received by the taxpayer in the 4 previous taxable years. If either of these conditions is satisfied with respect to income falling in an enumerated class, the relief accorded by the section is as follows: There is first determined the amount of such income received in the taxable year which is attributable to any previous taxable year or years and the amounts so attributable to such years. Such determination is to be made under rules and regulations prescribed by the Commissioner with the approval of the Secretary. It is expected that such regulations will provide general rules prescribing the method by which the taxable years to which the income is to be attributed and

the amounts to be attributed may be ascertained. There is then computed the aggregate of the excess-profits taxes which would have been placed on such income had it been received in the taxable years to which it is thus attributed, as described above, including the taxable year in which the income was in fact received. For the taxable year in which the income was received, the excess-profits tax attributable to such income cannot exceed the aggregate of the taxes so computed. If it is determined that the income received in the taxable year is attributable to years in the base period, the amount of such income so attributable to such years will have the effect of increasing the base period net income and thus the credit under the average-earnings method.

Subsection (b) provides in limited cases a 2-year carry-over of any excess of the excess-profits credit for any taxable year beginning after December 31, 1939, over the excess-profits net income. Such carry-over constitutes an additional subtraction from excess-profits net income in arriving at the adjusted excess-profits net income. Such carry-over is available only to corporations 80 percent or more of the gross income of which for the taxable year is derived from processing or otherwise preparing for market any seasonable fruit or vegetable, or any fish or other marine life.

SECTIONS 722-724 (SECTIONS 721-723 OF THE HOUSE BILL). EQUITY INVESTED CAPITAL IN SPECIAL CASES—FOREIGN CORPORATIONS, INVESTED CAPITAL—PERSONAL SERVICE CORPORATIONS

There have been no changes in these sections as contained in the House bill except for the elimination of a reference to the base period in section 722.

SECTION 725. CORPORATIONS COMPLETING CONTRACTS UNDER MERCHANT MARINE ACT, 1936

This section is the same as section 724 of the House bill except for a clarifying change.

SECTIONS 726-728 (SECTIONS 725-727 OF THE HOUSE BILL). EXEMPT CORPORATIONS—MEANING OF TERMS USED—LAWS APPLICABLE

No change has been made in these sections as contained in the House bill except the following:

(1) Section 726 (d) relating to investment companies registered as diversified companies under the Investment Company Act of 1940 is amended to allow such companies until July 1, 1941, to so register and thereby obtain exemption from the excess-profits tax, instead of December 1, 1940, as under the House bill.

(2) Section 727 (b) of the House bill provided that no return need be filed by a corporation whose excess-profits net income (placed on an annual basis in the case of a taxable period of less than 1 year) was not greater than $5,000. In view of the fact that the specific exemption has been raised from $5,000 to $10,000, this provision has been changed to provide that no return need be filed unless the corporation's excess-profits net income is in excess of $10,000.

SECTION 729. CONSOLIDATED RETURNS

This section was not in the House bill. It permits consolidated returns to be filed by affiliated groups of corporations under certain circumstances, among which is the requirement that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made must consent to regulations prescribed by the Commissioner, with the approval of the Secretary, prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent.

The regulations which the Commissioner is authorized to prescribe are such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the excess-profits tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability in addition to the matters which, in the light of current and previous consolidated returns regulations, are expected to be covered in detail in the regulations to be issued by the Commissioner, are the extent to which and the manner in which the following items, among others, will be computed and given effect in determining the excess-profits-tax liability of an affiliated group: (*a*) Equity invested capital, borrowed capital, and invested capital, (*b*) admissible and inadmissible assets, and excluded capital, (*c*) net capital additions and reductions, (*d*) consolidated net operating losses, net operating losses incurred by members of the group in taxable years prior to that for which the consolidated return is filed, and the net operating loss deduction of members of the group in taxable years following that for which the consolidated return was filed, and (*e*) excess-profits net income and adjusted excess-profits net income.

If a consolidated return is filed, only one specific exemption of $10,000 is allowable for the year for the entire affiliated group.

The term "affiliated group" is defined to mean one or more chains of corporations connected through stock ownership with a common parent corporation if—

(1) At least 95 percent of each class of the stock of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations; and

(2) The common parent corporation owns directly at least 95 percent of each class of the stock of at least one of the other corporations.

Foreign corporations, China Trade Act corporations, and corporations entitled to the benefits of section 251 by reason of receiving a large percentage of their income from possessions of the United States are not to be deemed to be affiliated with any other corporation within the meaning of section 729 For the purpose of this limitation, a 100-percent owned foreign subsidiary of a domestic corporation, organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, may, at the option of the domestic parent corporation, be treated as a domestic corporation.

It is also provided that a notice of deficiency for any taxable year mailed to a corporation shall suspend the running of the statute of limitations as to all corporations with which such corporation made a consolidated return for such taxable year.

SUPPLEMENT A. EXCHANGES: EXCESS-PROFITS CREDIT BASED ON INCOME

Except for technical changes and the changes indicated below, this supplement is the same as the House bill.

SECTION 740. DEFINITIONS

This section is the same as it was in the House bill except for the definition of "acquiring corporation," which has been expanded to take into account certain types of transfers not covered by the House bill. Subsection (a) (1) has been rewritten.

Subparagraph (A) is substantially the equivalent of the entire subsection (a) (1) as it appeared in the House bill.

Subparagraph (B) covers exchanges described in section 112 (g) (1) (C), that is, the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, the assumption by the acquiring corporation of a liability of the other or the fact that property acquired is subject to a liability being disregarded in the determination of whether the exchange is solely for voting stock. This makes it possible for certain types of mergers and consolidations to quality under the bill, though they are not statutory mergers and consolidations, owing to the absence of any State laws on the subject. Your committee is informed that there are approximately 12 States which have no statutory provisions relative to corporate mergers and consolidations.

Subparagraph (C) covers transfers before October 1, 1940, by one corporation of property to another corporation solely as paid-in surplus or a contribution to capital in respect of voting stock owned by such other corporation. Since the property transferred must be received solely as paid-in surplus or a contribution to capital made solely in respect of voting stock, it is necessary that (1) the transferor corporation receive nothing upon the exchange and (2) that, at the time the transfer takes place, the transferor own no stock of the transferee other than voting stock of the transferee.

Subparagraph (B) or (C) shall apply only if the corporation transferring such properties is forthwith completely liquidated in pursuance of the plan under which the acquisition is made, and the transaction of which the acquisition is a part has in all respects the effect of a statutory merger or consolidation.

SECTION 742. AVERAGE BASE PERIOD NET INCOME

This section is the same as in the House bill except for a technical change and for the addition of a new sentence to subsection (b) to prevent too great a reduction of the average base period net income of an acquiring corporation in cases where such corporation became an acquiring corporation in a taxable year beginning after December 31, 1939, and the component corporations involved in the transaction were at least 75 percent owned by the acquiring corporation. Such 75 percent ownership must have existed prior to the enactment of

the bill and have been present at all times thereafter until the transaction. In such cases the average base period net income of the acquiring corporation shall not be less than either (1) its average base period net income computed without reference to the base period experience of the component corporations involved in the transaction, or (2) the average base period net income of that component corporation which possesses the highest average base period net income.

SUPPLEMENT B. EXCHANGES: HIGHEST BRACKET AMOUNT AND INVESTED CAPITAL

SECTION 750. DEFINITIONS

Under the House bill the term "exchange" was defined to mean certain exchanges "described in section 112 (b) (4) or (5)" and related sections and certain transfers of property by one corporation to another corporation the basis of which in the hands of the acquiring corporation is or was determined under section 113 (a) (8) (B), or would have been so determined had such section been in effect. The type of exchanges or transfers described would therefore have been included regardless of whether they were controlled by corresponding provisions of the revenue laws in force at the time when made. This definition has been changed so as, in effect, to include only exchanges and transfers occurring after December 31, 1917. Broadly speaking the tax-free exchange provisions did not appear in the income-tax law until after such date.

The definitions of transferor upon an exchange and transferee upon an exchange contained in section 750 (b) (c) of the House bill have been brought into conformity with the changed definition of exchange.

The definitions of "predecessor", "successor", "first borrowed capital base", and "second borrowed capital base", contained in section 750 (e), (f), (h), and (i) of the House bill have been eliminated as no longer necessary in view of the elimination of the sections in which such terms were used.

The definition of "preferential rate amount", contained in section 750 (g) of the House bill, has been moved to section 750 (e) and as so transferred has been retained except that the term "preferential rate amount" has been changed to "highest bracket amount".

SECTION 751. DETERMINATION OF PROPERTY PAID IN FOR STOCK AND OF BORROWED CAPITAL IN CONNECTION WITH CERTAIN EXCHANGES

The only change made in this section of the House bill is the elimination of the matter in parentheses in subsection (a) thereof, which excluded from the computation stock received which was neither an admissible nor inadmissible asset in the hands of the transferor. Section 752 of the House bill, which made such stock neither admissible nor inadmissible in the hands of the transferor, has been eliminated.

SECTIONS 752-758 AND SECTION 759 (OF THE HOUSE BILL). EXCHANGES: EQUITY INVESTED CAPITAL—ADMISSIBLE AND INADMISSIBLE ASSETS—BASE PERIOD OF SUCCESSOR—SUCCESSOR BASE PERIOD NET INCOME—SUCCESSOR BASE PERIOD INVESTED CAPITAL—LOWEST INVESTED CAPITAL—BASE PERIOD PERCENTAGE—BORROWED CAPITAL BASES

These sections in the House bill required computations in the determination of certain factors employed in the computation of the invested capital credit under the House bill, necessary in order to

prevent tax avoidance through tax-free exchanges. Because of the change recommended by your committee in the computation of the invested capital credit, the necessity for these sections disappears and they have, therefore, been eliminated.

SECTION 752. HIGHEST BRACKET AMOUNT

(Sec. 759 of the House bill. Preferential-rate amount)

Section 759 of the House bill provided rules for the computation of the preferential-rate amount of a corporation following certain tax-free exchanges. The preferential-rate amount was the point at which, in computing the invested capital credit, there was a shift from 10 to 8 percent in the rates applicable to new capital, and the point at which the corporation was compelled to use its base-period percentage even though such percentage was less than 7 percent. For example, in the case of a corporation which had not been through a prior tax-free exchange, new capital which would not produce a total invested capital in excess of $500,000 was entitled to a rate of 10 percent and any new capital in excess of such amount was entitled to a rate of only 8 percent. The $500,000 amount which constituted this dividing line was the corporation's preferential-rate amount. If such corporation split up in a tax-free exchange it was necessary to divide this amount between the two resulting corporations in order that the two together might not have the benefit of the 10-percent rate on a larger amount of new capital than the original corporation was entitled to in the first place. Section 759 of the House bill provided the rules pursuant to which such adjustment was to be made.

Under the House bill the relationship of the preferential rate amount to $500,000 was also used in the adjustment of the rate schedules contained in section 710 to prevent a corporation from obtaining an undue advantage in connection with such rate schedules as a result of a tax-free reorganization.

Under the bill as reported by your committee it is unnecessary to retain the preferential rate amount for the purpose of determining the rates applicable to old and new capital, owing to the changes which have been made in the computation of the invested capital credit. It is still necessary, however, to make adjustments in the dollar amounts of the rate schedules contained in section 710 similar to those made in the House bill. Section 759 of the House bill has, therefore, been retained, but it has been made section 752. Since the computation is applicable only for the purpose of adjusting the rate schedules, however, the term "preferential rate amount" has been given the more appropriate title of "highest bracket amount."

Owing to the fact that section 752 of the House bill has been eliminated and the adjustment on account of inadmissibles is not made until the close of a taxable year, it has been necessary to insert a new subsection preserving, for the purposes of the computation of the "highest bracket amount," the adjustment formerly required by section 752 (a) in the House bill.

The only change made in the actual computation under new section 752 is in subsection (c) (1) (A) [section 759 (b) (1) (A) in the House bill]. In order to prevent a corporation from deriving undue advantage, in the taxable year in which an exchange took place, from any increase in capital in that portion of such year following the exchange,

the House bill provided that the corporation's invested capital, if lower than the highest bracket amount, for that portion of the taxable year which preceded the exchange, should be used in the computation rather than the highest bracket amount. The limited use to which the highest bracket amount will be put under the bill as reported by your committee makes this restriction no longer necessary and subsection (c) (1) (A), therefore, provides for the use of the highest bracket amount in all cases.

TITLE III (TITLE II OF THE HOUSE BILL). AMORTIZATION DEDUCTION

The provisions of this title as they appear in the House bill (title II) have been changed in only the following respects:

(1) The dividing line for the application of the amortization provisions with respect to facilities has been changed from the date July 10, 1940, as provided in the House bill, to January 1, 1940.

(2) Subsection (i) of the House bill provided that emergency facilities with respect to which amortization deductions had been taken were not to be destroyed, demolished, impaired, or substantially altered without the written consent of the Secretary of War or the Secretary of the Navy, that if such consent was not given within 90 days after request the Secretary concerned was to purchase such facility for not more than its adjusted basis or less than $1, and that the taxpayer could repurchase any such emergency facility under certain circumstances. Subsection (j) provided that no deduction for amortization was to be allowed unless the taxpayer consented in writing to the provisions of subsection (i). Subsection (k) imposed a penalty for violation which was to consist of an amount equal to the adjusted basis of the facility in the hands of the taxpayer, to be assessed, collected, and paid in the same manner as the corporate income tax.

Under the bill as reported by your committee these provisions have been eliminated and in lieu thereof a new subsection (i) has been inserted. Such new subsection provides that if the taxpayer has been or will be paid or substantially reimbursed, directly or indirectly, by the Government for all or a part of the cost of any emergency facility pursuant to a Government contract relative to such facility or for the purchase of supplies, or otherwise, the taxpayer will not be allowed amortization with respect to such facility unless the Advisory Commission to the Council for National Defense and either the Secretary of War or the Secretary of the Navy certify to the Commissioner of Internal Revenue that the contract contains provisions, adequately protecting the public interest, with reference to the future use and disposition of the facility. Such certificate, to be valid, must be made within 30 days after the making of the contract above referred to or within 60 days after the date of enactment of the bill, whichever period expires the later. It is also provided that, if such reimbursement occurs after the beginning of the amortization period with respect to such facility and the prescribed certificate is not made, the tax liability for the preceding taxable years shall be recomputed disallowing the amortization deduction previously taken. The terms and conditions of all reimbursements and payments of cost, including the terms and conditions with respect to the protection of the Government's interest, are to be made available to the public.

(3) Subsection (d) (5) of the House bill provided for reopening of the statute of limitations for the purpose of making certain adjustments on account of a change in prior amortization or depreciation deductions taken with respect to an emergency facility. This provision has been retained but it has been expanded so as to cover the recomputation required by new subsection (i) discussed in (2) above.

TITLE IV (TITLE III OF THE HOUSE BILL). SUSPENSION OF VINSON-TRAMMELL ACT AND CERTAIN PROVISIONS OF THE MERCHANT MARINE ACT, 1936

In the House bill this was title III and contained only one section (301) suspending the profit-limiting provisions of the Vinson Act in the case of contracts or subcontracts entered into or completed in any taxable year subject to the excess-profits tax (or which would have been subject to the excess-profits tax if the contractor or subcontractor had been a corporation). This section has been renumbered section 401 and has been retained. A new sentence has been added at the end thereof extending the same treatment to contracts or subcontracts entered into before the beginning of the taxpayer's first excess-profits tax year, if they were not completed at the time such year began. Such contracts or subcontracts, like contracts or subcontracts entered into in a taxable year subject to the excess-profits tax, will not be subject to the Vinson Act even though, at the time they are completed, no excess-profits tax is in effect.

Your committee has also added a new section 402 suspending the profit-limiting provisions of the Merchant Marine Act, 1936, as to subcontracts, which would otherwise be subject to such act, entered into by a corporate contractor with a corporate subcontractor in any taxable year of the subcontractor subject to the excess-profits tax, unless at the time such subcontract was entered into or at any time thereafter up to and including the date of its completion, the principal contractor and the subcontractor were affiliated. The definition of "affiliated" applicable to this section is substantially the same as that contained in section 2704 (b) (1) of the Internal Revenue Code; i. e., two or more corporations shall be deemed to be affiliated (1) if one corporation owns at least 95 percent of the stock of the other or others, or (2) if at least 95 percent of the stock of two or more corporations is owned by the same interests. For the purposes of such rule the term "stock" is not to include nonvoting stock which is limited and preferred as to dividends.

TITLE V (TITLE IV OF THE HOUSE BILL). AMENDMENTS TO THE INTERNAL REVENUE CODE

SECTION 501. EARNINGS AND PROFITS OF CORPORATIONS

The committee amendment rearranges section 401 of the House bill but otherwise makes no substantial change. Three new subsections are added to section 115 of the Internal Revenue Code relating to distributions by corporations. Subsection (l) defines earnings and profits of a corporation as the sum of (1) its earnings and profits accumulated after February 28, 1913, (2) its earnings and profits accumulated before March 1, 1913, plus (3) the increase (to the extent provided in subsection (n)) in value of its property accrued before March 1, 1913, but realized on or after such date.

Subsection (m) prescribes rules for the computation of earnings and profits accumulated after February 28, 1913, and earnings and profits of the taxable year or other period after February 28, 1913. It deals with the following matters:

1. The basis upon which gain or loss, for the purposes of determining such earnings and profits, is to be computed.
2. The adjustments to be made to such basis in such computation.
3. The effect upon such earnings and profits of the application of the nonrecognition provisions of law to the gain or loss so computed.
4. The effect upon such earnings and profits of distributions from another corporation if such distributions actually reduce the basis of the stock in respect of which the distribution is made, or cause such basis to be allocated.

The subsection provides that the gain or loss realized from the sale or other disposition (after February 28, 1913) of property shall, for the purpose of computing the earnings and profits (for any period beginning after February 28, 1913), be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain. For example, stock in the X corporation was acquired by the Y corporation prior to March 1, 1913, at a cost of $90, its March 1, 1913, value was $120, and in 1939 it was sold for $100. The basis (under the law applicable to the year 1939) for determining gain is the cost or March 1, 1913, value, whichever is higher. As the Y corporation received $100 for the stock of the X corporation, and its value on March 1, 1913, $120, exceeded its cost, $90 (assuming that there are no adjustments to be made to the basis), the Y corporation realized a loss under the provisions of this subsection of $20. If such a loss is recognized under section 112, the decrease in the earnings and profits accumulated by the Y corporation after February 28, 1913, as the result of this transaction in 1939 was $20 notwithstanding provisions of the code to the effect that no deduction was allowable in computing net income.

The subsection also provides that the realized gain or loss shall increase or decrease the earnings and profits (for any period beginning after February 28, 1913) to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. This provision relates to gains or losses which are recognized, pursuant to the provisions of law, for instance, by reason of the provisions of section 112 of the Internal Revenue Code. It does not relate to losses disallowed or not taken into account such as those under section 24 (b), section 118 and section 117 of the code. For example, on January 1, 1939, the X corporation owned stock in the Y corporation which it had acquired in 1938 in an exchange transaction in which no gain or loss was recognized. The adjusted basis to the X corporation of the property exchanged by it for the stock in the Y corporation was $100. The fair market value of the stock in the Y corporation when received by the X corporation was $1,000. On April 9, 1939, the X corporation declared a cash dividend of $900 and, except for the possible effect of the transaction in 1938, had no accumulated earnings or profits. The excess of the fair market value of the stock of the Y corporation over the basis, $900, was not recognized gain under the provisions of section 112 of the Revenue Act of

1938. Accordingly, its earnings and profits are not increased by $900 and the distribution was not out of earnings and profits.

The subsection applies regardless of the form taken by the sale or other disposition resulting in the accumulation of earnings and profits. For example, suppose that oil property which X had acquired in 1922 at a cost of $28,000 was transferred to a corporation in 1924 in exchange for all of its capital stock; that the fair market value of the stock and of the property as of the date of the transfer was $247,000; and that the corporation, after 3 years' operations, effected in 1927 a cash distribution to X in the amount of $165,000. In determining the extent to which the earnings and profits of the corporation available for dividend distributions have been increased as the result of production and sale of oil, it is intended that depletion should be taken into account computed upon the basis of $28,000 established in the nontaxable exchange in 1924 regardless of the fair market value of the property or the stock issued in exchange therefor.

The subsection further provides that where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution is made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits (for any period beginning after February 28, 1913) of the first corporation in certain cases of tax-free distributions. For example, if in the illustration in the second preceding paragraph the cash dividend of $900 was received by the Z corporation, the sole stockholder of the X corporation, it would be applied (if the adjusted basis of the stock is not in excess of $900) in reduction of the stock in respect of which the distribution was made and would not increase the earnings and profits of the Z corporation.

Provision is also made for cases in which the adjustment of the basis prescribed by section 113 is different from the adjustment to such basis proper for the purpose of determining earnings or profits. The effect of such provision may be illustrated by the following example: The X corporation purchased on January 1, 1931, an oil lease at a cost of $10,000. The lease was operated only for the years 1931 and 1932. The deduction allowed for depletion in each of the years 1931 and 1932 amounted to $2,750, of which amount $1,750 represented percentage depletion in excess of depletion based on cost. The lease was sold in 1940 for $15,000. Section 113 (b) (1) (B) of the Internal Revenue Code provides that in determining the gain or loss from the sale of the property the basis must be adjusted for cost depletion of $1,000 in 1931 and percentage depletion of $2,750 in 1932. However, the adjustment of such basis, proper for the determination of earnings and profits, is $1,000 for each year, or $2,000. Hence, the cost will be adjusted only to the extent of $2,000, leaving an adjusted basis of $8,000 and the earnings and profits would be increased by the realized gain of $7,000 and not by the taxable gain of $8,750, the difference having previously been taken into account in computing earnings and profits.

If in the preceding example the property, instead of being sold, was exchanged in a transaction described in section 112 (b) or (c) for other like property having a value of $7,750 and cash of $7,250, then the gain for earnings and profits purposes amounts to $7,000, that is $15,000 ($7,750 plus $7,250) minus the base of $8,000. However,

for net income purposes the gain is $8,750, that is $15,000 minus ($10,000 less depletion of $3,750) of which only $7,250 is recognized for net income purposes because such gain cannot exceed the sum of money received in the transaction. Section 112 (c) (1), Internal Revenue Code and corresponding provisions of prior revenue laws. If, however, the cash received was only $2,250 and the value of the property received was $12,750, then the gain for earnings and profits purposes would be $2,250, that amount being the gain recognized under section 112.

Of course, mere increase or decrease in value (after February 28, 1913) of property while owned by a corporation does not increase its earnings and profits.

Under various provisions of the Internal Revenue Code dealing with exchanges and liquidations, the transfer of the property by a corporation to another corporation results in the nonrecognition, in whole or in part, of the gain or loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. These principles are to be given full effect under section 501. The requirement of section 501 that there shall be no increase or decrease in earnings and profits by reason of a wholly unrecognized gain or loss is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee.

Subsection (n) prescribes rules for determining that part of the earnings and profits which is represented by increase in value of property accrued but not realized prior to March 1, 1913. It provides that if any increase or decrease in the earnings and profits (for any period beginning after February 28, 1913), with respect to any matter would be different had the adjusted basis of the property involved been determined without regard to its March 1, 1913, value, then an increase (properly reflecting such difference) shall be made in that part of the earnings and profits consisting of increase in value of property accrued before March 1, 1913. The following examples illustrate the application of this subsection:

Example (1): Nondepreciable property was acquired prior to March 1, 1913, at a cost of $8, its March 1, 1913, value was $10, and it was sold thereafter for $12. The increase in earnings and profits based on the March 1, 1913, value is $2. If the basis was determined without regard to the March 1, 1913, value there would be an increase in earnings and profits of $4. The increase to be made in that part of the earnings and profits consisting of the increase in value of property accrued before March 1, 1913, properly reflecting such difference, is $2.

Example (2): Nondepreciable property was acquired prior to March 1, 1913, at a cost of $8, its March 1, 1913, value was $12 and it was sold thereafter for $10. The decrease in earnings and profits based on the March 1, 1913, value is $2. If the basis was determined without regard to the March 1, 1913, value there would be an increase in earnings and profits of $2. The increase to be made in that part of the earnings and profits consisting of the increase in value of property accrued before March 1, 1913, properly reflecting such difference, is $4.

Example (3): Nondepreciable property was acquired prior to March 1, 1913, at a cost of $10, its March 1, 1913, value was $12, and it was sold thereafter for $8. The decrease in earnings and profits based on the March 1, 1913, value is $4. If the basis was determined without regard to the March 1, 1913, value there would be a decrease in earnings and profits of $2. The increase to be made in that part of the earnings and profits consisting of the increase in value of property accrued before March 1, 1913, properly reflecting such difference, is $2.

Example (4): Depreciable property was acquired in 1908 for $100,000. Assuming no additions or betterments, the depreciation sustained prior to March 1, 1913, was $10,000 so that the adjusted cost was $90,000. Its March 1, 1913, value was $94,000 and in 1939 it was sold for $60,000. For the purpose of determining gain from the sale, the basis of the property is the fair market value of $94,000 as of March 1, 1913, adjusted for depreciation for the period subsequent to February 28, 1913, computed on such fair market value. If the amount of the depreciation deduction allowed (not less than the amount allowable) after February 28, 1913, to the sale in 1939 is the aggregate sum of $43,240 the adjusted basis for determining gain in 1939 ($94,000 less $43,240) is $50,760 and the gain would be $9,240 ($60,000 less $50,760). The increase in earnings and profits accumulated since February 28, 1913, by reason of the sale, based on the March 1, 1913, value adjusted for depreciation, is $9,240. If the depreciation since February 28, 1913, had been based on the cost of $100,000 instead of the March 1, 1913, value of $94,000, the depreciation sustained from that date to the date of sale would have been $41,400 instead of $43,240 and the actual gain on the sale based on the cost of $100,000 adjusted by depreciation on such cost to $48,600 ($100,000 less $10,000 less $41,400) would be $11,400 ($60,000 less $48,600). If the adjusted basis of the property was determined without regard to the March 1, 1913, value there would be an increase in earnings and profits of $11,400. The increase to be made in that part of the earnings and profits consisting of the increase in value of property accrued before March 1, 1913, properly reflecting such difference, is $2,160.

The amendments to the Internal Revenue Code made by section 501 (a) are by section 501 (c) made applicable to all prior revenue acts, effective as if they were a part of such act on the date of its enactment, thus effecting the application of a uniform rule for the determination of the earnings and profits of all corporations for all prior taxable years. The last sentence of the subsection provides that only the actual tax liability of a shareholder taxpayer for a particular year which is now pending before, or heretofore determined by, the Board of Tax Appeals or any court of the United States, shall remain unaffected by the provisions of section 501. These cases now actually in litigation are left to be determined as the Board or the court may see fit. The result is that the decision in each of these cases will merely determine the tax liability for the particular year of the particular taxpayer, but for every other purpose the determination of the earnings and profits, and of all matters dependent upon such determination the provisions of section 501 govern. Section 501 will therefore control

for all purposes as respects the corporation, and as respects the shareholder in litigation for every purpose except that the tax liability for the particular year, as finally determined by the Board or the court, will remain undisturbed.

SECTIONS 502–508 (SECS. 402–408 OF THE HOUSE BILL). TAX ON SHAREHOLDERS OF PERSONAL SERVICE CORPORATIONS—STATUTE OF LIMITATIONS IN THE CASE OF CONSTRUCTIVE DIVIDENDS—CREDIT OF NONRESIDENT ALIEN OF TAX AS SHAREHOLDER IN PERSONAL SERVICE CORPORATION—CREDIT OF FOREIGN CORPORATION OF TAX AS SHAREHOLDER IN PERSONAL SERVICE CORPORATION—CHANGE IN NAME OF EXISTING EXCESS-PROFITS TAX—PUBLICITY OF RETURNS OF SUBCHAPTER E EXCESS-PROFITS TAX—TECHNICAL AMENDMENTS

These sections are the same as sections 402–408 of the House bill.

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THE SECOND REVENUE BILL OF 1940

SEPTEMBER 12 (legislative day, AUGUST 5), 1940.—Ordered to be printed

Mr. LA FOLLETTE, from the Committee on Finance, submitted the following

MINORITY VIEWS

[To accompany H. R. 10413]

The Finance Committee has reported a highly objectionable tax bill to the Senate, H. R. 10413. It violates sound tax theory. It combines conflicting ideas on excess-profits taxation. The result is neither a reasonable nor equitable bill but one that is unnecessarily complicated. It will raise only $115,000,000 from excess-profits taxes in 1940. The balance, or $240,000,000, will be taken from all corporations by a flat increase in the corporate tax rate which has no relation either to the ability of corporations to pay or to their excess profits.

The excess-profits portion of this bill violates every principle of sound tax theory: (1) It raises no appreciable amount of revenue; (2) it is inequitable in that the small amount of revenue which is raised will be paid in the main by those corporations least able to pay while those corporations most able to pay are left untaxed; (3) it confirms and entrenches those corporations which possess a monopoly and quasi-monopoly position in our economy; (4) it will result in hopeless administrative confusion and will increase administrative expense out of all proportion to the revenues to be obtained. In addition, it will seriously impede the collection of our existing taxes upon which we must rely for our revenues; (5) its complexity and incomprehensibility are such that the cost to the taxpayer of ascertaining its tax liability will in many cases be far greater than the amount of such liability; (6) it will produce extensive litigation out of all proportion to its importance in our revenue system, with the result that it can be anticipated that many tax liabilities will not be finally determined for many years to come.

In an effort to favor high-earning companies with relatively low invested capital the bill attempts to combine two conflicting theories of excess-profits taxation and gives to all corporations paying an excess-profits tax a heads-they-win-tails-the-Treasury-loses alterna-

tive. Further, because of the two-headed plan, the bill is a complicated hodge-podge.

One of two things will happen to this bill. Either it will be repealed at the next session or the great advantage of high-earning corporations will become vested to the permanent disadvantage of competitors and new companies.

Either result would be tragic. Our Government faces the most serious fiscal situation in its history. More than $15,000,000,000 has been appropriated or authorized for expenditure for national defense at this session of Congress alone. We know this is but a beginning.

Huge increases in revenue must be provided if we are to escape disaster. A sound excess-profits tax can secure very substantial amounts for the Treasury. From 1917 through 1921 we raised $7,000,000,000 from an excess-profits tax based on invested capital.

It would be tragic if the Congress now enacted a tax so complicated and unworkable that this source of revenue would be abandoned.

Every effort must be made to raise as much of our revenue as possible upon the sound theory of ability to pay. Failure to do so means taxes on all the people in violation of that sound principle. Such a course means a lowered standard of living and decreased buying power. It means taking it out of the hides of the farmer, the worker, the small businessman, and the consumer.

We do not have to choose between "guns and butter" in this country. We have vast resources of productive capacity, capital, and manpower. Put these to work and we can rearm and increase our standard of living at the same time.

An adequate, equitable tax structure based on ability to pay is essential to these ends.

I shall offer an amendment in the nature of a substitute for titles I and II of the committee bill. It is based on our experience with the excess-profits tax, 1917–22. Improvements in the amendment have been made in the light of the study and recommendations of the Treasury experts since the amendment passed the Senate in June only to be rejected in conference. The committee bill and the amendment are discussed in greater detail in this minority report.

PART I. MAJOR DEFECTS IN THE COMMITTEE BILL

(1) THE MAJOR SOURCE OF REVENUE IN THE BILL IS NOT FROM EXCESS PROFITS

The regular corporation tax is increased by 3.1 percent on all corporate incomes, regardless of the size of the corporation and regardless of the source or rate of the profit. This increase in regular corporate taxes is without regard to benefits or injuries because of the defense program. Approximately 140,000 corporations which would pay no taxes under a real excess-profits tax would be required to pay a large share of the $240,000,000 that this flat increase in the normal corporation tax is estimated to yield for 1940.

The regular corporation income tax imposes lower rates on the smaller corporate incomes. No distinction is made in this flat increase of 3.1 percent. In effect, this raises the tax on corporations with less than $5,000 of income by 20.9 percent, compared with an increase of only 14.8 percent in case of corporations with income in excess of $25,000. In this respect it is even less desirable than the regular corporate income tax.

(2) THE BILL IS BASED ON A CONFUSED AND UNSOUND THEORY OF EXCESS PROFITS

The President in his message to Congress on July 1, 1940, urged that Congress enact an excess-profits tax to help pay for the defense program because, "it is our duty to see that the burden is equitably distributed according to ability to pay so that a few do not gain from the sacrifices of the many." Yet this bill is not based on any principle of ability to pay. Apparently it intends to tax merely the extra profits due to the defense expenditures—"defense profits" rather than "excess profits."

The so-called "earnings method" of the bill is supposed to measure defense profits directly. Earnings in the taxable year are compared with earnings in the base period and the increase, if any, is called "excess." Two basic assumptions are involved which are not true in a large percentage of cases: First, that the earnings during the base period are "normal." Second, that the increase is "excess" or due to defense expenditures. Actually, with respect to the former, a base period that is normal for corporations as a whole is almost invariably abnormal in varying degrees for corporations individually. With respect to the latter, there is no reasonable assurance that the increase is "excess," or due to defense expenditures.

Witness after witness testified before the Ways and Means and Finance Committees that their earnings were abnormal during the base period or that increased earnings had nothing whatsoever to do with the defense program. Obviously, the bill exempts large amounts of defense profits and taxes large amounts of nondefense profits without any recognition of the sound principle of ability to pay.

Furthermore, there is no satisfactory way of distinguishing between defense profits and other profits. No chemical test can be applied to make a precise separation. Dollars lose their identity when flowing through the economic system. Products which have an important use in the defense program may have a simultaneous important use in normal industrial activity. Paint for a battleship is the same as paint for industrial machinery. Shoes for the Army are the same as shoes for the farmer. Even with complex accounting systems no satisfactory separation of profits can be made. Surely no rule-of-thumb method of comparing profits in the taxable year with profits during some previous years affords an adequate separation.

The most serious defect in the bill from the standpoint of tax theory is the attempt to combine two opposing theories of taxation in one bill. The net effect is to include the shortcomings of both without the advantages of either. The loopholes in the bill are doubled. The revenue yield is reduced well below what might be obtained under either method separately. The situation becomes a "heads you win, tails I lose" proposition for the Treasury. In addition, highly inequitable situations are created among competitive corporations which are forced by circumstances to use different methods of tax computation. The slight semblance of equality which existed between the two methods in the bill as it passed the House has been destroyed by the majority of the committee with the removal of the 4.1 percent privilege tax on the "earnings method" and the 5-percent differential on the rate in the various tax brackets.

Each of these defects are discussed in more detail later in this report, but all are indicative of the confused and unsound theories upon which H. R. 10413 is based.

(3) THE BILL AFFORDS UNWARRANTED PREFERENTIAL TREATMENT TO CERTAIN CORPORATIONS

The large prosperous corporations with consistent substantial profits are those most able to pay an excess-profits tax. Under this bill, they will pay little or no tax. No matter if they are earning 20, 50, 100, or 1,000 percent on their invested capital, they may continue, under the average earnings method of this bill, to earn those profits without additional tax. A tremendous advantage is accorded the established prosperous corporation, against a competitor who suffered a depressed condition during the base period or the newly organized corporation which has not become established.

Another example of preferential treatment is the case of a corporation which has either liquidated part of its business during the base period or which after the base period determines in effect to departmentalize its business by dividing it among several subsidiary corporations. For example, suppose a corporation has average earnings during the base period of $3,000,000 and an invested capital of $12,000,000. After the base period this corporation subdivides into three corporations so that each corporation now has invested capital of $4,000,000. However, the assets producing the greatest return are retained by the original corporation. Although it has been reduced in size by one-third, the original corporation will nevertheless possess under the average-earnings method a credit of $3,000,000, its base-period experience. It will thus be enabled to increase its profits on the retained assets to the extent of earning 75 percent upon those assets without paying any tax. In addition, the two new corporations will each secure a credit under the invested capital alternative of $320,000 each, thus increasing the credit of the entire business by more than 21 percent as a result of the transaction. This already extremely profitable business, which had consistently earned 25 percent upon its investment, would thus be enabled to earn $640,000 of additional profits from the defense program without paying any excess-profits tax at all. This illustration serves to show the extensive premium which the committee amendments offer to tax avoidance through the creation of increasingly complex corporate structures.

As another example, take a corporation with the following invested capital and earnings record during the base period:

Year	Invested capital	Profits
1936	$1,000,000	$200,000
1937	500,000	100,000
1938	200,000	40,000
1939	100,000	20,000

The above corporation had a uniformly profitable business, earning exactly 20 percent on its invested capital each year. It simply reduced in size, which may have occurred for any of a variety of reasons. Its average earnings for the 4 years are $90,000. It is entitled to earn

$90,000 or 90 percent on its present investment even though throughout the base period it earned only 20 percent on its invested capital and during the last year of the base period was earning only $20,000 a year. This concern could have $70,000 of defense profits in 1940 or thereafter without paying any tax at all on excess profits.

(4) THE BILL ENCOURAGES MONOPOLY AND DISCRIMINATES AGAINST COMPETITORS OF PROSPEROUS ESTABLISHED CORPORATIONS

If there was ever a tax measure which promised to perpetuate monopolistic corporations in their monopolies, it is this one. Three corporations, A, B, and C, are competitors. Corporation A is a quasi monopolist earning profits of 25 percent on invested capital during the base period. Corporation B, struggling against terrific odds, earned 9 percent. Corporation C is newly organized. In 1940, corporation A continued to earn 25 percent; B earned 15 percent; C, 9 percent. This would be typical experience because it is a well-known fact that a certain development period with low profits is typical of the new corporation.

Under the average earnings method of this tax bill, corporation A would pay no excess-profits tax whatsoever. Corporation B would pay a substantial tax though its earnings were much less. Corporation C would also have to pay an excess-profits tax, unless it were small enough so that the $10,000 flat exemption gave it relief.

This tax would be an insurmountable barrier to fair competition among the corporations. No more powerful club than this could be placed in the hand of corporation A. No other concern could successfully challenge its quasi-monopolistic position. If during any future year corporations B or C did achieve the same level of profits as corporation A, they would pay most of it in additional taxes while corporation A went untaxed. The most likely result would be bankruptcy for B and C; a complete monopoly for A.

This inequity inherent in the committee amendment may be further illustrated by the following example, which shows the excess-profits tax that would be payable under the committee amendment by each of two corporations having the same invested capital and excess-profits net income during the taxable year. One of these corporations—corporation A—is, however, an established company with stabilized earnings and the other, corporation B, is a growing enterprise competing with corporation A.

	Corporation A	Corporation B
Current year:		
Excess-profits net income	$1,000,000	$1,000,000
Invested capital	$5,000,000	$5,000,000
Rate of return ... percent	20	20
Base period:		
Excess-profits net income (average)	$1,000,000	$200,000
Invested capital (average)	$5,000,000	$5,000,000
Rate of return (average) ... percent	20	4
Taxable excess profits:		
Average earnings method	0	$790,000
Invested capital method	$590,000	$590,000
Tax.		
Average earnings method	0	$349,000
Invested capital method	$249,000	$249,000
Tax liability [1]	0	$249,000

[1] Excludes the 3.1 percent increase in normal corporation income tax.

This fundamental defect in the average earnings method of computing tax liability under an excess-profits tax would not be remedied by any provisions for "abnormal" cases. If such were the case, it would mean establishment of arbitrary control over all competitive situations. Further notice should be taken of the fact that this is not an isolated exceptional case, but rather the typical situation whenever and wherever a semimonopolistic corporation which was prosperous during the base period dominates a particular field.

Statistics published in a recent report of the National Resources Committee (The Structure of the American Economy, pt. I, p. 100) and statistics submitted during the joint hearings on this bill (pp. 123–127) indicate that a considerable number of the largest corporations in America are exactly in this position. No more effective means could be devised to stifle further competition for these concerns, unless it would be an outright monopoly franchise by government.

It is a serious charge that this bill should condone and encourage monopoly, but perhaps even more serious is the severe penalty that is placed on the new or growing corporation. Such a corporation probably received little profit during the initial years and is now entering into a period when the work of earlier unprofitable years is beginning to bear fruit. The bill allows no future prosperous years for the new or growing corporation; it envisages an economy with the present inequities "frozen" into the future. The precedent herein set will make it all the more difficult at some later date to tax these "privileged" corporations adequately. The hue and cry then will be raised, just as it has been raised to a certain extent now, that the stockholders who have recently purchased stock at high prices because of anticipated high earnings have a vested interest which should not be disturbed. The idea is fallacious, but to allow it to go unchallenged here in this tax bill would give it a cloak of validity which would be hard later to remove.

Entirely disregarded in H. R. 10413 is one of the cardinal principles of taxation: That the burden should be fairly distributed. The preponderance of testimony during the hearings clearly demonstrates that many taxpayers are more concerned about the equity of the tax than the amount of the tax. Aside from those corporations with high earnings which will be able to take advantage of the average earnings tax method, corporations in general are willing to bear almost any reasonable load provided their competitor is treated similarly. The average earnings method and the hodge-podge of a dual method of computing tax liability precludes equal treatment for all.

It has been said in answer to the above contentions that it is not the function of a tax bill to remove existing competitive disadvantages or advantages. This answer is specious. One can agree that it is not the purpose of a tax bill to equalize competitive conditions. But it is undeniable that tax bills should not distort existing competitive conditions and place unwarranted tax handicaps upon one class of corporations as opposed to another, thereby creating an indefensible competitive advantage in favor of the latter. The objection to the committee amendment is not that it does not equalize existing competitive conditions. Rather the objection is that the committee amendment in and of itself creates new and far-reaching competitive advantages. The invested-capital method, on the other hand, does not create or give rise to either new competitive advantages or new

competitive disadvantages. It simply imposes an excess-profits tax which falls alike on corporations regardless of their competitive position and thereby does not disturb existing competitive conditions.

(5) THE RATES OF THE TAX IN THE BILL ARE NOT GRADUATED FAIRLY

The rates in the bill are graduated according to the amount of so-called excess profits. This means that a large corporation may make only a very small percentage of excess profits on its capital and still pay the highest rate of tax. Thus, a corporation with $100,000,000 of invested capital and $1,000,000 of taxable excess profits will pay the same tax as a corporation which has the same amount of taxable profits on an invested capital of only $1,000,000. In other words, the brackets are now graduated without reference at all to the earnings or size of a corporation, and a corporation which had excess profits amounting to a 100-percent return on invested capital would pay no more tax than a corporation having excess profits amounting to 10 percent on invested capital, providing the absolute amounts of excess profits were the same.

Profits cannot be divided sharply into those that are excessive and those that are not. Excessiveness is a matter of degree and the tax rate should be graduated according to the degrees of excessiveness, not simply according to the amount of excess profits. A proper rate structure for an excess-profits tax would graduate the rate according to the ratio of profit to invested capital. Under the rate structure as it now stands, many corporations with extremely excessive profits will pay much more moderate taxes than other corporations with only moderate excess profits.

(6) THE BILL IS TERRIFICALLY COMPLICATED

The bill is very complicated and will cause taxpayers who cannot spend any considerable time in learning to understand it a great deal of worry and expense. Some of the complications of the bill were undoubtedly introduced for the purpose of making it more equitable. If the complications had succeeded in making this a reasonably equitable measure, it would, of course, be preferable to a simple but inequitable bill. As has been pointed out, however, the bill is not equitable and accordingly the complications are inexcusable.

A substantial portion of the bill is devoted to tax-free reorganizations and exchanges, a subject which will be of no concern to the majority of corporations. By far the most difficult sections of the bill are in this part. They are necessary in any bill in which base-period experience is used to determine the standard of normal profits. The complications of the tax-free exchange and reorganization sections can be almost completely eliminated if the use of base-period experience is abandoned. Thus, in the case of an invested-capital approach using a flat percentage as a norm, only transactions occurring during the taxable year need be taken into account. These can be handled with comparatively simple provisions.

A further complicating element in the bill is the provision for permissive consolidated returns. Permissive consolidated returns will give corporations the option of using such returns when it is to their advantage to do so and not to use them when it is to their advantage

not to do so. It gives great aggregations of wealth an unfair advantage over smaller corporations with simpler structures.

(7) THERE IS AN APPARENT LACK OF CONCERN FOR RAISING REVENUE

Appropriations and contract authorizations for the defense program are in excess of $15,300,000,000. The excess-profits tax under this bill will yield only about $115,000,000 for 1940. The costs of administration and compliance will all have to be borne and the revenue will be small. Administrative and compliance costs will represent a large proportion of the revenue yield. These costs are somewhat inflexible and would be a much smaller percentage if larger revenues were collected. More serious is the defective tax structure which is created under the bill. If the rates must be raised at a later date to obtain more revenue, the inequities previously recounted will become all the more severe.

It should be emphatically stated that increasing the revenue yield of this bill by adding a flat rate to the normal corporation tax solves none of the problems raised by this bill. It simply camouflages the negligible yield derived from the excess-profits tax. The normal corporation-tax rate can be increased at any time Congress desires to do so. It bears no relation whatsoever to an excess-profits tax.

An excess-profits tax could be an excellent method of raising money with relatively little harm to business. The excess-profits taxes imposed on corporations during the years 1917 through 1921 produced about $7,000,000,000 of revenue. On the whole, that revenue was obtained from corporations which could best afford to pay the taxes, namely, corporations that made large returns on their invested capital. Businessmen have been complaining for years about the high corporate income taxes. If additional revenue is now raised by increasing the rates on all corporations, the rate of return in lines of business which are barely earning enough to keep going may be reduced to the point that they will de driven out of business. No such result follows from the taking of excess profits from prosperous businesses which are making high returns on their capital. Accordingly, far more money can be raised with much less harmful effect on business if the revenue is taken from those concerns whose business is most prosperous. That should be the function of a real excess-profits tax.

PART II. THEORIES OF EXCESS-PROFITS TAXATION

The two optional methods of computing tax liability under H. R. 10413 represent two distinctly different theories of excess-profits taxation. Each is intended in tax theory to function alone and to accomplish basically different purposes under separate sets of circumstances. The combination of the two theories in this bill with the avowed purpose of alleviating hardships that result under one or the other method is no more logical than combining a sales tax with an income tax and giving the taxpayer the option of paying either of the two because the incidence of one or the other falls too heavily on him. It is true that the option that might be afforded under either of these alternative methods would relieve inequities otherwise borne by the taxpayer, but it is equally true that numerous new inequities

are introduced and loopholes provided. The option that is intended to relieve one taxpayer of an unjust burden will in other cases relieve taxpayers of just burdens. It is decidedly preferable to perfect one method and make all taxpayers subject to that one.

The so-called earnings method of computing excess profits is predicated on the theory that earnings during the taxable year which are in excess of earnings during the base period are wholly due to some circumstances (such as a war, a defense program, etc.) which are intended to be taxed specially. Whatever validity there is in this method is based on the assumption that the base period is normal and that the increases, if any, are really due to the factor which is intended to be taxed. This type of tax operates only as a temporary tax, under the same principles as a "windfall" tax.

The so-called invested capital method measures excess profits with reference to the return on invested capital. Unless it provides for a variable credit based on the taxpayer's previous profit experience (as contained in the bill passed by the House of Representatives) no knowledge of past earnings is necessary. The sole standard of excessiveness of profits is the rate of return on invested capital as compared with a fixed standard, for example, 8 percent in the La Follette amendment. An excess profits tax imposed on this basis is not limited to operate during a short-term emergency. It is advanced by some tax experts as a desirable permanent reform in the corporate tax structure and is in fact so used by some foreign countries.

OPINION OF EXPERTS

Dr. Alfred G. Buehler, professor of public finance at the University of Pennsylvania, writing in a recent issue of Law and Contemporary Problems (vol. 7, No. 2, spring 1940, p. 300) in an article entitled "The Taxation of Corporate Excess Profits in Peace and War Times" concludes that:

> Economists appear to be agreed that it is more logical to employ a tax based upon the rate of return rather than a tax based upon the excess of profits over those in a given period.

The same principle has been supported by the findings of a research staff of the Twentieth Century Fund, Inc., which group under the directorship of Dr. Carl Shoup, of Columbia University, published its survey of taxation in the United States in the publication Facing the Tax Problem. It is interesting to note also that a current publication of the National Economy League, representing a conservative viewpoint on United States public finance, contains this comment in the conclusion of a discussion on taxing excess profits:

> The "percent of invested capital method" of defining excess profits is theoretically preferable to the "standard return" method, since it reaches all profits above a specified ratio and permits tax rates to be graduated according to profits rates.

BASIC ARGUMENTS

The chief arguments in behalf of a permanent excess-profits tax based on invested capital are (1) it is an economically sound tax geared to the principle of ability to pay; (2) it yields considerable revenue without disrupting the economic system; (3) it acts as a regulatory measure in controlling monopoly profits and windfall gains;

(4) it recaptures for Government and thereby for the public part of the excessive benefits that certain governmental services may normally bestow upon some business firms but not upon others.

PAST EXPERIENCE WITH EXCESS-PROFITS TAXATION: AT PEACE AND IN WAR, AT HOME, AND ABROAD

American experience with an excess-profits tax dates back to 1863 when the State of Georgia enacted such a tax to provide for war pensions. It was imposed on earnings in excess of 8 percent of the capital stock, at rates varying from 5 to 25 percent of the amount of the excess. The first experience of the Federal Government with the tax was at the time of the World War. More than 15 other countries adopted the tax at about that time, including Australia, Austria, Britain, Belgium, Canada, Denmark, France, Germany, Greece, Italy, Japan, the Netherlands, Norway, Russia, Sweden, Spain, and Switzerland.

The role of the tax in peacetimes has been more limited. It is interesting to note, however, that Hungary, Japan, Ireland, Colombia, and Mexico have been utilizing the tax as a normal means of raising revenue. More recently, with the outbreak of the present war in Europe and just prior to it, France, Germany, England, and Canada adopted stiff excess-profits taxes.

The allegation has been frequently made that all other countries are using the "earnings method" as a basis for measuring excess profits. That statement is not true. The facts are that several countries at present use the "invested capital method." Furthermore, it is significant that Australia which during the World War relied on the earnings method, is basing its present excess-profits tax on invested capital.

The German law imposed early in 1939 is based on the average-earnings method, but the French law, imposed shortly thereafter, was on an invested-capital basis, with special provisions for profits accruing from government contracts and armaments. The severity of the French tax is evident from the rates imposed September 1, 1939: An exemption of 2 percent on invested capital; a 25-percent tax on profits in excess of 2 percent of invested capital, but less than 8 percent on invested capital; a 100-percent tax on all profits above an 8-percent return.

The present excess-profits tax of England defines excess profits in relation to the earnings in the base period: New corporations and additions to the capital of old corporations are taxed on the invested-capital basis, with the first 8 percent of return being exempt. The valuation of capital investment is regulated by rather complex rules. Britain in the World War allowed the taxpayer a credit of either 6 percent of capital or an amount equal to the average earnings in any 2 of 3 base years.

The Canadian law enacted last year allowed an option between a tax based on invested capital and one based on average earnings. Rates under the invested-capital method were graduated from a 10-percent tax on profits above a 5-percent exemption to a 60-percent tax on profits in excess of 25 percent of the investment. The tax failed to raise the revenues desired and on June 24 of this year a decision was made to eliminate one of the options. The new law (con-

ceded to be an emergency measure to raise the most possible revenue from the war expenditures) levies a 75-percent tax on all profits in excess of average profits during the last 4 years.

A minimum excess-profits tax of 12 percent upon profits (before credit) is also imposed.

The Canadian experience indicates that an optional law will not work satisfactorily. It is true that Canada chose the earnings method when one option was eliminated, but apparently recognition was made of the fact that such a tax could only be a temporary tax. It may be inferred that the other option would ultimately be adopted if the tax were continued for any considerable length of time.

REFUTATION OF ARGUMENTS AGAINST INVESTED CAPITAL METHOD

It is often asserted that the necessity for determining invested capital results in an excessive burden upon the administrative machinery and imposes undue hardship upon taxpayers because of the complexities involved in ascertaining invested capital. The experience under the wartime revenue acts is often cited in support of this contention.

It should be pointed out that the alleged complexities of the invested capital method are no less under the committee amendments than under my amendment which uses invested capital as the sole measure of excess profits. Under the committee amendments it will be necessary for almost every taxpayer to determine its invested capital in order to ascertain which of the two alternative methods—invested capital or average earnings—is to its advantage. In fact, the Committee proposes to supplement all the alleged complexities of invested capital with the further complexities necessitated by the use of base period experience under the average-earnings method. Whether or not my amendment is adopted, practically every corporation subject to excess-profits tax will still have to compute its invested capital.

In any event, the complexities involved in determining invested capital have always been exaggerated. The assertion that complexities will occur is traceable to the wartime revenue acts. These acts permitted the value of property paid in for stock at the time paid in to determine invested capital. This dependence upon valuation caused extensive litigation and much delay in the final ascertainment of tax liabilities. My amendment, however, like the committee amendment, uses the tax cost of property paid in to the corporation for the purpose of determining the invested capital of the corporation. The figures respecting the tax cost of property must always be ascertained for income-tax purposes and consequently in most instances are already available both to the Bureau of Internal Revenue and to the taxpayer. These figures once ascertained remain constant. Current adjustments to invested capital can easily be computed. Moreover, as most of the current adjustments relate to the earnings of the business involved and as such earnings must also be ascertained for income-tax purposes, no complexity will arise on this score.

It has been asserted that use of the invested capital method will perpetuate for excess-profits-tax purposes all of the evils of watered stock and inflated valuations of property and will give a tax advantage to those corporations which have in the past pursued such practices. This assertion is unfounded. The invested capital of a

corporation under my amendment does not depend upon the value at which the corporation's property is carried on its books. Consequently, the corporation which issued its stock for the properties of other corporations and which placed those properties on its books at an excessive valuation will not obtain any tax benefit from such excessive valuation since the valuation is immaterial for the computation of invested capital for tax purposes. As stated above, the controlling figure for excess-profits purposes is the tax cost of property paid in for stock and not its value on the books of the corporation which acquired the property. Moreover, it must be observed that the only property which figures in the computation of invested capital for tax purposes is property received in return for corporate stock issued to acquire such property.

The purchase or sale of property by a corporation has no effect upon its invested capital for tax purposes, so that if a corporation buys property at an inflated price its invested capital will not be increased thereby. The following illustrates the dependence of invested capital upon the tax cost of property paid in for stock rather than its value: Corporation A issues 500,000 shares of stock for the properties of corporation B. It values these shares and these properties at $5,000,000. Actually, the stockholders of corporation B had invested only $2,000,000 of capital and earnings in corporation B. The increase in corporation A's invested capital by reason of this acquisition of property will be $2,000,000 and not $5,000,000.

The invested capital method of computing excess profits thus seeks to determine as fairly as possible the actual dollars invested by the shareholders in the business and remaining at risk in the business. It is only on actual money actually risked that invested capital is based.

The same observations may be made with respect to the argument that an excess-profits tax based upon invested capital unduly penalizes the corporation using conservative accounting practices and writing down its properties in the light of changing business conditions. Since invested capital is based only upon what was originally paid into the business plus the earnings remaining at risk in the business, subsequent write-downs on the corporate books have no effect upon invested capital.

Finally, it is often asserted that use of the invested capital method is unduly advantageous to the very large corporation having a substantial amount of capital in the business. To the extent that this criticism of the invested capital method has any merit, it is equally applicable to the committee amendment. No large corporation with extensive invested capital will pay any less tax under my amendment than it will pay under the committee amendment. In many instances such corporations will pay more tax under my amendment than under the committee amendment.

With respect to the merits of the argument, figures show that large corporations tend to earn a higher percentage of return upon their invested capital than do small corporations. Thus, it can fairly be said that the invested capital method is less advantageous to large corporations as a class than to small corporations as a class. To the extent that a large corporation consistently earns more than 8 percent upon its invested capital it is unduly favored under the committee amendments. In fact, it can fairly be said that those large corporations which are now and have been in the past consistently rich and

prosperous are precisely those corporations which secure the greatest advantage and pay the least tax under the committee amendments.

Moreover, any proper comparison respecting the effect of an excess-profits tax can only be made in terms of each separate industry, rather than in terms of a representative corporation in one industry with a representative corporation in a completely different industry. The real question is whether an excess-profits tax affects substantially alike all the corporations which are engaged in the steel industry, and not whether it affects a corporation in the steel industry differently than a corporation in the merchandise field. By and large, within an industry the ratio of earnings to capital is relatively the same for each corporation in the industry, whereas it may differ from industry to industry. Within each industry, therefore, the invested capital method treats corporations substantially alike, since the single standard of the relation of earnings to invested capital is utilized. But the committee amendment, by using both the standard of absolute earnings and the standard of the relation of earnings to invested capital has an unequal competitive effect upon corporations within each industry. As is shown above, moreover, it unduly favors the intrenched corporation over a growing or newly established corporation in the same industry.

Any possible advantage secured by the large corporation under the invested capital method is mitigated under my amendment by allowing every corporation the same dollar amount as a specific exemption. In other words, by exempting from excess-profits tax 8 percent of invested capital plus $5,000, a corporation having an invested capital of only $100,000 may earn free of excess-profits tax $13,000 or 13 percent of its invested capital. A corporation having an invested capital of $10,000,000, on the other hand, may earn free of excess-profits tax $805,000 or only 8.05 percent of its invested capital.

Part III. Major Differences Between the La Follette Amendment and Titles I and II of the Committee Amendments to H. R. 10413

The proposed amendment strikes out all of titles I and II of the committee's amendment to H. R. 10413. No changes are proposed in titles III, IV, or V, relating to amortization deductions, suspension of the Vinson-Trammell Act, and miscellaneous amendments to the Internal Revenue Code. The two most essential points of difference are (1) the elimination of increases in the normal corporation income tax, and (2) as respects the excess-profits tax, the elimination of the average-earnings method of computing excess profits. Under the amendment the invested-capital method is the exclusive method of determining excess profits. One consistent theory of taxation is embodied in the provisions of the amendment and all corporations subject to taxation thereunder would pay taxes according to one standard, without options.

My amendment is patterned after the one which was adopted by the Senate 41 to 31 (but deleted in conference) during the debate on the First Revenue Act of 1940 last June. The new amendment, however, is improved in many respects to embody technical improvements contained in the invested capital method worked out by experts of the Treasury Department. As respects the method of computing

invested capital, my amendment is similar in almost every detail to the method of ascertaining invested capital under the committee amendment. The 8 percent credit allowed on such invested capital is also the same under my amendment and the committee amendment.

The amendment is comparatively simple: 20 pages substituted for 60. Unlike the invested capital method contained in the House bill, which allowed a variable standard for "normal" profits, based on experience during a base period, this amendment contains a fixed exemption of 8 percent on invested capital plus $5,000. The fixed 8 percent places all competitors on the same footing regardless of past experience. The flat $5,000 exemption benefits the growing concern or the small corporation, which could actually earn 25 to 30 percent on invested capital without any additional tax.

My amendment is purely and simply an excess-profits tax. No provision is contained for hiking normal corporate income-tax rates. At most, only 70,000 corporations—about 1 out of every 7—would be liable for taxes under this amendment. These 70,000 would be the most prosperous and the most able to pay of all corporations. The incidence of my amendment is in bold contrast with the Finance Committee bill; their provision for an increased 3.1 percent normal tax rate shifts the burden to all corporations that have any income, many of them facing bankruptcy or struggling for their very existence.

As far as revenue yield is concerned, the amendment proposed would raise about $400,000,000 net. This amount exceeds by more than $100,000,000 the yield of the Finance Committee proposal during the first year (despite the 3.1 percent normal tax increase proposed by the committee). In future years, further increased corporate incomes would yield considerably more revenues under my amendment than under the Finance Committee bill. A 15-percent increase in corporate income would mean only a somewhat commensurate increase under the committee bill, while the same increase would mean approximately a 50-percent increase in yield or more under my amendment.

The use of a fixed percentage (8 percent) rather than a variable percentage has other advantages in addition to preserving competitive equality. When prior experience is removed from consideration in imposing the tax, no complicated administrative problems arise in connection with reorganizations and exchanges during the base period. Obviated, too, are the problems arising out of unclosed income returns for prior years. Some tax cases are subjects of controversy that remain in the courts for many years in the process of final settlement. Further taxes directly dependent upon a final determination of these returns—as would be the case if base period experience is taken into account—would cause manifold administrative difficulties.

Previous mention has been made in part I of the evils inherent in the average earnings method of computing excess profits and of the evils introduced in combining optional methods of computing tax liability. Needless to say, they are obviated by this amendment.

TAX RATE STRUCUTRE

The maximum rate imposed on excess profits under my amendment is no higher than the maximum rate imposed in the committee proposal, 50 percent of the excess profits in the highest bracket. The minimum rate in the lowest bracket subject to tax is actually lower

in my amendment: A 20-percent rate rather than 25 percent. The greater simplicity afforded by three brackets of taxation in my amendment is in effect more equitable than six brackets of taxation in the committee proposal, because the brackets in the amendment are based on percentage relationships to invested capital rather than absolute amounts of dollars. In other words, excessiveness of profit is measured and taxed under the amendment—not the absolute amounts of dollars.

A simple rate structure based on a percentage basis is readily adaptable, without inequity, to further increases in the rates should this become necessary at a later date. The inequity of the rate structure in the committee proposal would be aggravated by an increase in the rates.

CHANGES FROM THE PREVIOUS EXCESS-PROFITS AMENDMENT

The previous excess-profits amendment, adopted by the Senate last June, has been improved by the following changes:

1. *Minor changes in exemption and rates.*—The flat exemption has been increased from $3,000 to $5,000. The 8-percent credit on invested capital remains the same. The amount of $3,000 was the flat exemption contained in the 1917–21 acts. Examination of available statistics seems to indicate that $5,000 is wholly ample. As previously stated, only one out of every seven corporations would be taxed by this bill. To place the exemption higher than $5,000 is to overlook the fact that varying degrees of ability to pay exist among small corporations. The new amendment differs from the old in that three brackets of taxation are provided: 25 percent on the excess profits not in excess of 7 percent of the invested capital; 40 percent on the remainder up to 15 percent on invested capital; and 50 percent on all excess profits not taxed under the first two brackets. These rates are slightly higher than the rates imposed under the two brackets of the original excess-profits amendment—to compensate for the greater exemption allowed in the new amendment.

2. *Changes in terminology and method.*—Technical improvement of the original amendment has been made by accepting certain definitions and methods of computing invested capital, as provided in the House bill by the Treasury experts, i. e., the computation and definition of average invested capital, daily invested capital, equity invested capital, borrowed capital, etc. In addition, interest on Federal obligations which may under the terms of such obligations be subjected to excess profits is so taxed and interest on other governmental obligations is included in income if its taxpayer exercises an option to treat such obligations as admissible assets. The method of computing excess profits net income is the same under my amendment and the Committee amendment.

3. *Inclusion of borrowed capital.*—The new amendment includes borrowed invested capital to the same extent that it is included in the Finance Committee proposal: 50 percent of the outstanding indebtedness which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust.

4. *Amortization provisions.*—Provisions with reference to amortization, included in the original amendment, have been entirely excluded because the subject is covered in title III of the committee amendment which is not affected by my amendment, which is a substitute for titles I and II.

5. *Consolidated returns.*—Mandatory consolidated returns required under the original amendment have been omitted from the new amendment on the theory that refinements in the bill with reference to exchanges and reorganizations have made consolidated returns unnecessary and actually inequitable in some cases. Permissive use of consolidated returns (not allowed under the amendment) would reduce the revenue yield of the bill considerably, and, except in certain instances where corporations are separately incorporated through no desire of their own, it is logical to require groups of corporations which obtain the legal privileges of separate incorporation to assume the corresponding tax liabilities of separate incorporation.

6. *Reorganizations and exchange of stock.*—As in the committee bill, provision is made for certain tax-free exchanges. Compared with the committee bill, however, the language in the amendment is simple. This is possible because one consistent theory of taxation is followed and because exchanges during the base period need not be taken into account. Special provisions are also made for corporations completing contracts under the Merchant Marine Act of 1936.

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Comparisons of tax liability incurred under various plans of computing excess profits

Specific conditions			General characteristics	Tax liability	
Item	Base period	Tax year		Method	Amount
Corporation 1:					
Invested capital	$833,333	$833,333	A moderate-sized corporation which has earned more during the taxable year than the base period but still at a moderate rate of profit.	Earnings method[1]	$115
Net income	50,000	60,000		Invested capital[2]	0
Percent of invested capital	6.0	7.2		Invested capital[3]	0
				La Follette amendment	0
Corporation 2:					
Invested capital	555,555	555,555	Also a moderate-sized corporation. Same net income as corporation 1 is earned on a smaller amount of capital (a higher rate of return). Larger income is had than during base period, but percentage earned on invested capital is still relatively low.	Earnings method[1]	115
Net income	50,000	60,000		Invested capital[2]	115
Percent of invested capital	9	10.8		Invested capital[3]	0
				La Follette amendment	0
Corporation 3:					
Invested capital	166,666	166,666	An extremely prosperous corporation both during the base period and taxable year. Tax year also substantially better than the base period.	Earnings method[1]	115
Net income	50,000	60,000		Invested capital[2]	6,738
Percent of invested capital	30	36		Invested capital[3]	6,238
				La Follette amendment	10,313
Corporation 4:					
Invested capital	16,666,666	16,666,666	A large corporation that has had a very moderate return during the base period and the taxable year, though some improvement in the latter.	Earnings method[1]	33,180
Net income	1,000,000	1,200,000		Invested capital[2]	31,847
Percent of invested capital	6	7.2		Invested capital[3]	0
				La Follette amendment	0
Corporation 5:					
Invested capital	11,111,111	11,111,111	A smaller corporation than corporation 4, though identical income is earned and hence a higher return on invested capital. Same dollar improvement in income of taxable year compared with base year.	Earnings method[1]	33,180
Net income	1,000,000	1,200,000		Invested capital[2]	33,180
Percent on invested capital	9	10.8		Invested capital[3]	14,109
				La Follette amendment	13,828

See footnotes at end of table.

Comparisons of tax liability incurred under various plans of computing excess profits—Continued

Specific conditions			General characteristics	Tax liability	
Item	Base period	Tax year		Method	Amount
Corporation 6:					
Invested capital	$3, 333, 333	$3, 333, 333	An extremely prosperous corporation both during the base period and the taxable year. Tax year also substantially better than previous base period.	Earnings method [1]	$33, 180
Net income	1, 000, 000	1, 200, 000		Invested capital [2]	259, 434
Percent on invested capital.	30	36		Invested capital [3]	290, 267
				La Follette amendment.	253, 767
Corporation 7:					
Invested capital	5, 000, 000	5, 000, 000	A corporation which earns vory substantial profits during the taxable year though the profits during the base period were not unusually high.	Earning method [1]	334, 750
Net income	500, 000	1, 500, 000		Invested capital [2]	334, 750
Percent on invested capital.	10	30		Invested capital [3]	342, 250
				La Follette amendment.	263, 250
Corporation 8:					
Invested capital	5, 000, 000	5, 000, 000	A prosperous corporation in identical position as corporation 7 during the taxable year, but with a prosperous experience during the base period.	Earnings method [1]	44, 100
Net income	1, 250, 000	1, 500, 000		Invested capital [2]	294, 750
Percent on invested capital.	25	30		Invested capital [3]	342, 250
				La Follette amendment.	263, 250

[1] Earnings method: As approved by Finance Committee; without the 4.1 percent penalty tax.
[2] Invested capital: The variable exemption invested capital method contained in the bill as passed by the House (exemption of $5,000 plus 5 to 10 percent) but with rates based on the 25 to 50 percent rates approved by Finance Committee.
[3] Invested capital: Finance Committee recommendation of flat 8 percent plus $10,000, but taxed at same rates as above: 25 to 50 percent on absolute amounts.