

# **REVENUE TO DEFRAY WAR EXPENSES**

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## **HEARINGS AND BRIEFS**

**BEFORE THE**

### **COMMITTEE ON FINANCE**

### **UNITED STATES SENATE**

**SIXTY-FIFTH CONGRESS**

**FIRST SESSION**

**ON**

## **H. R. 4280**

**AN ACT TO PROVIDE REVENUE TO DEFRAY WAR EXPENSES  
AND FOR OTHER PURPOSES**

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Printed for the use of the Committee on Finance

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# REVENUE TO DEFRAID WAR EXPENSES.

## TITLE II. WAR EXCESS-PROFITS TAX.

BRIEF PRESENTED BY MR. ROBERT B. REED, OF NEW YORK CITY  
ON WAR EXCESS-PROFITS TAX.

### INTRODUCTORY.

This draft is intended to adapt to American conditions the underlying principles of the English act, under which it has been possible to levy first a 50 per cent, then a 60 per cent, and now an 80 per cent tax, and to raise \$700,000,000 last year, with an estimate of \$1,000,000,000 this year, all of it without substantial protest. No other similar system has, it is believed, produced any such result even approximately.

There are two essentials to the English plan:

(1) It deals with actualities, stripped of forms and fictions. It taxes the trade or business in rein, disregarding ownership and endeavors to reach the actual profits of an actual period.

(2) It gives necessary, even generous, latitude in administration and this latitude has been used to prevent injustice in particular cases, so that the tax falls only where it can be borne.

It is a striking fact that English business men speak frequently of the fairness and liberality of the English tax, while the Government shows a collection under it of \$700,000,000.

With our American system of organization, this method, once understood, seems even more necessary if not absolutely essential, if we wish to have in fact, not merely in name, a highly productive "war excess-profits tax." Only if we can get down to the basic realities and impose a tax on the business as such, can we deal fairly between different concerns, differently financed and capitalized and get the enormous sums obtainable under this anomalous "tax."

The fact must be emphasized that, whatever the name, no tax can get the bulk of real war or abnormal profits which either as drawn or as administered lays its burdens on and confiscates nonwar or normal profits.

Inequities in small taxes can be borne. In a 30-80 per cent tax they will not be borne.

Finally, such a tax so imposed and administered should produce two or three times what can be obtained by any other so-called excess-profits tax, i. e., an inflexible tax based on arbitrary standards. At half the new English rate of 80 per cent, this tax should produce in this country the \$1,000,000,000 estimated for the English tax.

One viewpoint that has influenced this proposal is that of war efficiency. Few things are more vital to the success of the present war than our capacity to finance it without dislocating and retarding

industry and production, also without creating opposition and division among our own people.

It seems essential that any excess-profits tax be enacted, administered, and paid in this spirit.

#### WAR EXCESS-PROFITS ACT.

SEC. 200. That when used in this title the term "corporation" shall include corporations, joint-stock companies or associations, and insurance companies; the term "United States" means only the States, the Territories of Alaska and Hawaii, and the District of Columbia; the term "taxable period" shall be a calendar year, commencing with the year nineteen hundred and seventeen, or may, under regulations to be made by the Secretary of the Treasury for such purpose, be a fiscal year, commencing with such part of the fiscal year ending in the calendar year nineteen hundred and seventeen as is included in such calendar year, or a part of a calendar or fiscal year where the trade or business commenced or is terminated or changes ownership during any such year; the term "prewar standard of income" shall mean the standard of income determined as provided in section two hundred and two or section two hundred and three.

SEC. 201. That, in addition to the taxes under existing laws, there shall be levied, assessed, collected, and paid for each taxable period under this title on the net profits or income derived by any corporation, partnership, or individual—

It is impossible to exclude individuals without destroying half the small corporations and partnerships of the country. This must be recognized by anyone familiar with such businesses—

from any trade or business carried on during such period subject to this title, a tax equal to — per centum (or "the following-named percentage") of the amount by which the net profits or income of such trade or business for such period shall exceed a sum equal for the period to a rate of \$5,000 a year plus the prewar standard of net profits or income, respectively, shall be determined as hereinafter provided.

The tax is placed on the income derived from the "trade or business" as defined in section 208. This imposes the tax as an expense of the business? It (1) follows the English plan as most practicable and convenient, (2) avoids any question of character of taxpayer or ownership or other artificial difficulty, (3) determines prewar income regardless of change of ownership, (4) ignores, when necessary, the division of parts of a business into separate entities, and (5) emphasizes under section 203 (b) the actual value of trade and business assets as basis of computation.

The graduated exemption meets a very real need to get the higher tax where the rate of profits is truly abnormal. The doubled or tripled rate on the "increased percentage" would, if adopted, put the burden of the tax on the concerns getting higher prices for a given profit and make it possible to retain a lower rate on concerns benefiting naturally from an increased business activity without raising prices.

(May add:

"The percentage of such tax shall be as follows: — per centum on the excess of such net income up to amount equal to — per centum of the normal income; on the excess over — per centum up to — per centum of the normal income; on the excess over — per centum up to — per centum of the normal income; on the excess over — per centum up to — per centum of the normal income; on the excess over — per centum up to — per centum of the normal income; on the excess over — per centum of the normal income.)

(May also add the following:

"Provided, That if any part of such taxable excess as so determined is found to be due to an increase in the percentage of earned income to gross business over the percentage prevailing in the prewar period as determined under section two hundred

and two (c) or section two hundred and four (e), then as to such part of such taxable excess as is due to such increased percentage the rate of tax shall be twice the rate above prescribed, and as to the balance of such excess the rate shall be as above prescribed.")

Sec. 202. (a) If the net profits or income of such trade or business either for the five calendar years of nineteen hundred and ten, nineteen hundred and eleven, nineteen hundred and twelve, nineteen hundred and thirteen, and nineteen hundred and fourteen, or for five fiscal years ending in said calendar years can be satisfactorily determined from the prior tax returns or from the books of such trade or business or by any other satisfactory evidence to be specified by regulations to be made by the Secretary of the Treasury, the prewar standard of income of such trade or business shall be prima facie determined by first determining the standard of income of each of such years, making allowance for any increase or decrease of capital or other material factors as provided in subsection (b) and then excluding from consideration the two of such years showing respectively the highest and lowest standard of income, and then taking the average of the standard of income thereof of the three remaining years.

#### This is the German basis:

If the prewar standard of income of such trade or business can not be satisfactorily determined as above provided, or if in the opinion of the Commissioner of Internal Revenue it can be more readily and satisfactorily determined as below stated and if such trade or business was carried on for at least ten months prior to the year 1914, then the prewar standard of income of such trade or business shall be prima facie determined by the average standard of income of such trade or business, making allowance for any increase or decrease of capital as aforesaid, during a period or periods between January first, nineteen hundred and eleven, and December thirty-first, nineteen hundred and fifteen—

The English basis, more elastic and selective. The 1913-1914 period is intended to fit in with individual and partnership accounts made for basis of income tax—

such period or periods to be selected by the taxpayer and agreed to by the Commissioner of Internal Revenue, or, in the absence of such selection and agreement, to be fixed by such commissioner as the period or periods most likely to evidence the normal income thereof prior to nineteen hundred and sixteen, and in any event to include at least either two calendar or fiscal years or the complete period from March first, nineteen hundred and thirteen, to December thirteenth, nineteen hundred and fifteen, inclusive.

If such trade or business was not carried on for at least ten months prior to 1914, but was carried on for any period prior to 1917, which, in the judgment of the Commissioner of Internal Revenue, subject to regulations to be made by the Secretary of the Treasury, makes it possible to satisfactorily determine a prewar standard of income for such period, and also if in any case under this section, in the judgment of such commissioner, subject to such regulations, any other prewar year or years or period than those above specified would better evidence the normal income thereof, the Commissioner of Internal Revenue, subject to such regulations, may designate or fix any such year or years or period and determine the prewar standard of income by reference thereto in the manner above provided. The period taken for such computation is referred to in this title as the prewar period.

(b) The standard income of such year or period (part of the prewar period) shall be determined from the net income, which shall be computed in the manner provided with respect to the net income of corporations under the act of August fifth, nineteen hundred and nine, and the act of October third, nineteen hundred and thirteen, and the returns filed under such acts by any corporation carrying on any such trade or business shall be taken as prima facie evidence of such net income therein. In computing such standard of income under subsection (a), however, allowance shall be made for any increase or decrease of capital from the first day of any prewar period to the first day of the taxable period, by adding to or subtracting from, as the case may be, the net income of such prewar year or period an amount equal to the prewar trade percentage, determined under section two hundred and three (b), on such increased or decreased capital.

This seems to be the accurate way to establish a correct prewar standard. It gives each of the prewar years an equal capital and

brings them into correct relation to each other for the purpose of selection. See note under 203 (b).

Allowance may also be made, under regulations to be made by the Secretary of the Treasury, for any other changes in the character of such trade or business or in its conduct or ownership, so that the standard of income of each prewar period or year shall represent as nearly as may be the income which such trade or business as capitalized, carried on and owned in the taxable period, would have earned in such prewar year or period.

(May add if necessary to make special rule for special cases:)

"Allowance may also be made, under such regulations for any special circumstance or condition which has operated in the prewar period to make the net profits or income of such period abnormally low or abnormally high, so that the same can not, in the judgment of the Commissioner of Internal Revenue, be properly taken as a normal profit or income earned under normal conditions in such trade or business. Excessive competition with reduced prices or the absence of competition with increased prices in any trade or business may be deemed a special condition under this subsection.

"(c) The Commissioner of Internal Revenue, under regulations to be made by the Secretary of the Treasury, shall also require from every corporation, partnership, or individual whose prewar standard of income has been determined under this section a statement in a form to be prescribed by such regulations showing the average percentage which the profits or earned income of such trade or business in the prewar period under subsection (a) normally bore to the gross business thereof during such period, designating as such gross business such factor in the business as is most commonly used for such purpose and is best adapted to such determination, and the like percentage of such profits or earned income to such gross business in the taxable period. The difference between such percentages shall represent the increased percentage of the taxable period, and such increased percentage of the gross business of such taxable period shall be deemed to be the amount by which the excess of net profits or income of the taxable period over such profits or income of the prewar period is due to such increased percentage."

Sec. 203. (a) If such trade or business was not carried on for at least ten months prior to nineteen hundred and thirteen or for such a period prior to nineteen hundred and seventeen as in the judgment of the Commissioner of Internal Revenue makes it possible to satisfactorily determine a fair and just prewar standard of income under section two hundred and two, or, if for any reasons, including a change in the character of such trade or business since the war, the prewar standard can not fairly be determined under section two hundred and two, then the prewar standard of income shall be prima facie deemed to be the prewar trade percentage of the actual value of the assets employed in producing the income of the taxable period, plus the prewar income from personal service and good will or other assets, if any, estimated and determined under subsection (c). Such prewar trade percentage may be applied to such trade or business as a whole or to the parts thereof, if different percentages are applicable to any such parts.

(b) The Secretary of the Treasury may, upon such evidence, statistics, and expert opinion, as he may deem reliable, determine and declare by Treasury order as to any named class of trade or business or as to any subdivision of any such class, the percentage which the yearly earned income thereof normally bore prior to January first, nineteen hundred and fifteen, to the value of the assets employed in producing such incomes.

It is recognized that there should be no tax based on a flat legislation declaration of a fair income. What is here proposed is a finding of the fact best adapted as a prewar standard to apply to any new business. Only by a fair approximation of actual percentage earnings can the prewar standard be fairly applied as between (1) a prewar trade with no decrease of capital, (2) a prewar trade which has increased its capital, and (3) a new trade with new capital. The proposal to use a percentage of prewar income to present net income seems much less desirable. Though a prewar normal basis may be fairly approximated by selection, the variations of a single year (1917) would make a normal percentage impossible and unfair. A will be

taxed in effect on the big profits of B and C, and C will escape his just share. Practically every man below the level will claim individual relief. The standard here proposed will be general and though mathematically difficult it is practically possible to declare a fair basis which will be accepted and can be applied automatically and fairly in each case.

He shall select for such purposes such period or periods and such instances and factors as will in his judgment give the correct normal percentage of earned income on capital assets for any such class or subdivision thereof. He shall exclude from consideration any income found to be produced in given cases by factors other than capital including the personal services and good will of partnerships and individual businesses or from other assets, if any, the fair value of which is declared in such Treasury order to be indeterminable, as to any such class or subdivision and which have been excluded in the consideration of the value of assets. He shall also exclude from a consideration interest paid on indebtedness representing a part of the normal capital assets employed in producing such income, and all items, such as interest received on idle funds or investments and taxes paid which are not normally a part of such trade or business.

The eliminations seem necessary to any real standard. They are intended to supply a guide and principle rather than a fixed rule. A standard based on equities and individual accidents would not be sound.

The percentage so determined and declared is referred to in this title as the prewar trade percentage and in the absence of any such determination shall be presumed to be 8 per cent in any such trade or business.

(c) In applying such prewar trade percentage as a standard of earned income on capital assets on any taxable trade or business carried on by a partnership or individual, there shall be added to and be included in the prewar standard of income under subsection (a), a fair, just, and equitable allowance for the income which would have been normally produced in the prewar period by the factors other than capital, including the personal services and good will of the partners or individual owner or by other assets, if any, the fair value of which has been declared in such Treasury order under subsection (a) to be indeterminable. Reference may be had for this purpose to the earning value of such or similar services, good will, or other assets employed in the prewar period in like or similar trades or businesses.

A rough standard, better than absolute discretion.

(d) In the case of any trade or business carried on by a corporation having any assets the fair values of which has been declared in such Treasury order under section (a) to be indeterminable, the income such assets would have produced in the prewar period shall be determined as accurately as may be and added to and included in the prewar standard of income as provided in subsection (c).

May also add:

"(e) The Secretary of the Treasury shall, upon such evidence, statistics, and expert opinion as he may deem reliable, determine and declare by Treasury order as to any named class of trade or business, or as to any subdivision of any such class, the percentage which the earned income thereof prior to January first, nineteen hundred and fifteen, normally bore to the gross business thereof, designating as such gross business such factor in the business as is most commonly used for that purpose and is best adapted to such determination. He shall also by regulation provide for the determination in each taxable period of the percentage in any taxable trade or business which such earned income bears to such gross business. The difference between such percentage of the prewar period and of the taxable period shall represent the increased percentage of the taxable period, and such increased percentage of the gross business of the taxable year shall be deemed to be the amount by which the excess in the net profit or income of such taxable period over such profits or income of the prewar period is due to such increased percentage."

SEC. 201. (a) If in the judgment of the Commissioner of Internal Revenue the prewar standard of income of trade or business can not fairly be determined with approximate accuracy under either of the foregoing sections or would, if applied, operate unfairly or prejudicially to the public needs during the war either because

of the relation of such trade or business to the needs of war or because it belongs to a class of trade or business so recently developed that prewar standard of income can be satisfactorily determined as above provided, or because it is a new trade or business the predominating earning factor of which is not capital or not assets the fair value of which is determinable, then, he may, under regulations to be made by the Secretary of the Treasury, fix and determine a fair, just, and equitable method or basis for the computation of the prewar standard of income therein.

May add:

"And also for the determination of the increased percentage of earned income to gross business therein."

(b) The Secretary of the Treasury shall by regulation determine and declare the percentage which the net income of any class of trade or business or any subdivision of a class normally bore prior to January first, nineteen hundred and fifteen, to any named factor therein, or he may determine and declare any other general factor by reference to which the prewar standard of income in any such class or subdivision may be fairly determined, or he may modify the application of section two hundred and two or section two hundred and three to any such class or subdivision and such percentage or other factor or modification may be applied under subsection (a) to determine such prewar standard of income of a taxable trade or business.

SEC. 205. In the case of trades or businesses peculiarly related to the needs of the war, whether or not carried on in the prewar period, the Secretary of the Treasury may, by Treasury order, determine and declare a percentage which the yearly earned income thereof during the period of the war should bear to the value of the assets employed in producing such income (computed as provided in subsection (a) of section two hundred and three) before the excess of such income shall be subject to taxation hereunder, in order that the employment of capital in such trade or business and the efficient prosecution thereof may be encouraged, and such percentage so declared shall be substituted for the prewar trade percentage under subsection (a) of section two hundred and three and subsection (b) of section two hundred and two, and the standard of income so determined shall be known as the during-war standard of income, applicable to such trade or business and be substituted for the prewar standard of income under section two hundred and one.

See English act, section 42. In this class of necessary discrimination the term "prewar standard of income" is a misnomer and misleading.

May add:

"Similarly a during-war standard percentage of earned income to gross business may be determined for any such class of trade or business, the increase above which in the taxable period shall be substituted for the increased percentage under sections two hundred and two (c) and two hundred and three (c)."

SEC. 206. (a) The net income of the taxable period shall be determined as prescribed with respect to the net income of a corporation under Title I of the act of September eighth, nineteen hundred and sixteen, but there shall be no limitation with respect to the amount of interest paid deductible from gross income and all taxes assessed or paid under Title I of the act of September eighth, nineteen hundred and sixteen, shall be excluded: *Provided also*, That credit shall be allowed pro rata on any tax imposed under this title for any similar tax imposed upon any corporation, the dividends from which are included in the computation of such net income.

(b) When the prewar standard of income is determined by reference to the prewar trade percentage the Secretary of the Treasury may, by regulation, provide for such modification of the method of determining the net income of the taxable period either by eliminating the factors eliminated in determining such prewar trade percentage or otherwise as may be necessary to prevent the unfair application of such determination in any particular case.

The fairer basis would be to ignore funded debt and form of capital. But Treasury officials can probably adapt income tax returns with substantial fairness.

(c) The Secretary of the Treasury may also, if in his judgment necessary to the relative fairness of the tax imposed by this title, provide by regulation for the similar modification of the method of determining such net income and the prewar standard of income, so that the tax imposed on trades or business is subject to section two hundred and two, may be substantially fair in relation to the tax imposed on trade and businesses subject of section two hundred and three.



SEC. 207. The net income of the taxable period and the excess thereof having been computed as provided in this title, not exceeding one-half of the excess income otherwise taxable, may be deducted from the income of any taxable period to offset a less than prewar standard of income during the next preceding three calendar or fiscal years to the extent necessary to bring up the income of those years to a prewar standard of income basis computed under this title.

**See English law, fourth schedule, Part I, 7.**

SEC. 208. Every trade or business carried on in the United States or owned or carried on elsewhere by persons ordinarily resident in the United States, whether continuously carried on or not, shall be subject to this title, excepting unless carried on by a corporation—

(a) Agriculture in the United States;

(b) A profession the profits of which are mainly dependent on personal qualifications and require no capital expenditure or only capital expenditure of a comparatively small amount;

(c) Any Federal, State, or municipal office or public or private employment, but including the business of any person taking commissions and of any agent other than a commercial traveller or an agent whose compensation consists wholly or fixed salary, and also excepting however carried on;

(d) Any trade or business, a corporation carrying on which is exempted from income tax under title I of the act of September eighth, nineteen hundred and sixteen;

(e) Railroad or other public utilities, the rates or charges of which are subject to regulation by any governmental authority, unless in the case of any such railroad or public utility not subject to regulation by the Interstate Commerce Commission, it is made to appear that the net income thereof computed as provided in subsection (b) of section two hundred and three, exceeds eight per centum of the value of the assets employed therein, in which case it shall be subject to this title.

SEC. 209. In any trade or business which is owned or carried on by a corporation whose directors, not exceeding twelve, have together a four-fifths interest therein, such corporation shall for the purpose of this title be treated as a partnership of which such directors are the partners.

**English (1916) act, section 49, 1.**

SEC. 210. The Secretary of the Treasury shall have power if in his judgment desirable, to create a board of referees, the chairman of which shall be a member of the Federal Trade Commission designated by the chairman of such commission for such duty, and the other two named by the Secretary of the Treasury, and to include an experienced public accountant. Such board if created shall prepare for approval and promulgation by the Secretary of the Treasury all regulations and Treasury orders under this title, and upon the application of any taxpayer may review any ruling or decision of the Commissioner of Internal Revenue hereunder.

**English law, section —.** The necessarily great administrative power given by the act requires, it is believed, the supervision of a quasi-legislative judicial body connected with but in principle separate from the collecting department of the Treasury.

SEC. 211. No corporation or person shall enter into any artificial or fictitious transaction or operation for the purpose of avoiding any tax under this title, and if it shall be made to appear in any case that any such transaction or operation, or the carrying on of one trade or business by two or more concerns subject to a common ownership or stock control, would have the effect of reducing the amount of any tax hereunder, such tax shall be assessed and imposed as though such transaction or operation had not been entered into or as though such trade or business constituted a single trade or business subject to a single ownership or control.

**English act, section —, fourth schedule, Part I, 5, 6.**