

EXCESS PROFITS TAX ACT OF 1950

REPORT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

TO ACCOMPANY

H. R. 9827

A BILL TO PROVIDE REVENUE BY IMPOSING A
CORPORATE EXCESS PROFITS TAX,
AND FOR OTHER PURPOSES



DECEMBER 18, 1950.—Ordered to be printed

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EXCESS PROFITS TAX ACT OF 1950

DECEMBER 18, 1950.—Ordered to be printed

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

REPORT

[To accompany H. R. 9827]

The Committee on Finance, to which was referred the bill (H. R. 9827) to provide revenue by imposing a corporate excess profits tax and for other purposes, having considered the same, reports favorably thereon with amendments and recommends that the bill, as amended, do pass.

I. GENERAL STATEMENT

Your committee's bill provides for the raising of revenue by the levying, collection, and payment of a corporate excess profits tax effective as of July 1, 1950, and for a 2-percentage point increase in the corporate income tax rate with respect to taxable years beginning on and after July 1, 1950. This bill is the second step in the financing of the vastly expanded military program resulting from hostilities in Korea and the critical international situation, and carries out the mandate imposed on the Committee on Finance by section 701 (a) of the Revenue Act of 1950, which provided as follows:

The House Committee on Ways and Means and the Senate Committee on Finance are hereby directed to report to the respective Houses of Congress a bill for raising revenue by the levying, collection, and payment of corporate excess profits taxes with retroactive effect to October 1, or July 1, 1950, said bill to originate as required by article I, section 7, of the Constitution. Said bill shall be reported as early as practicable during the Eighty-first Congress after November 15, 1950, if the Congress is in session in 1950 after such date; and if the Congress is not in session in 1950 after November 15, 1950, said bill shall be reported during the first session of the Eighty-second Congress, and as early as practicable during said session.

It is estimated that your committee's bill will produce about \$3,200,000,000 under the levels of corporate profits existing in the calendar year 1950 and between \$4,000,000,000 and \$5,000,000,000 under the levels of corporate profits which may reasonably be expected in the calendar year 1951. The comparable estimate for the House bill is

about \$3,000,000,000 under the levels of corporate profits existing in the calendar year 1950.

The substantial increases made since July in the military and related programs indicate that budgetary expenditures in the fiscal year 1952 will be very substantially above the current level of receipts. The lag in expenditures behind appropriations may well keep expenditures in the fiscal year 1951 close to the level of receipts which will be available after the passage of your committee's bill. However, further substantial increases in taxes must be made next year if receipts are even to approach the anticipated levels of expenditures.

The first step in increasing receipts to meet the expansion in expenditures was taken in the Revenue Act of 1950 when corporation and individual income taxes were increased to provide an estimated \$4,500,000,000 of additional annual revenue. Your committee's bill represents the second step. Additional revenues will, no doubt, be required next year.

One of the main advantages of an excess-profits tax in periods of large military expansion is that it selects for additional tax those corporations whose profits are higher than they probably would have been in the absence of hostilities and a large military budget. By limiting the average earnings credit to 85 percent of the base period earnings, your committee's bill will also reach some profits which have been sustained at the relatively high levels of the base period by the increased tempo of the defense economy. The 2-percentage point increase in the corporation income tax rate, however, will also give assurance that all corporations with incomes of \$25,000 and over will share, at least to some extent, in the additional tax burden resulting from the present emergencies.

Your committee believes that an excess-profits tax enacted at this time should be so framed as not to interfere unduly with the normal expansion of the industrial capacity of the Nation. Your committee's bill has attempted to alleviate most of the hardship cases under the excess-profits tax by providing automatic relief provisions. In addition your committee's bill provides an over-all limitation so that the income tax and excess-profits tax together will not take more than 60 percent of any taxpayer's income. This provision will aid substantially those taxpayers with inadequate credits where the automatic relief provisions are not available or are inadequate.

II. REVENUE ESTIMATES

It is estimated that your committee's bill will yield \$3,200,000,000 in a full year of operations with corporate profits at the level existing in the calendar year 1950. The House bill under similar assumptions as to corporate profits would have yielded about \$3,000,000,000. It is believed that with such a level of corporate profits an excess-profits tax would be imposed on about 70,000 corporations.

With the level of corporate profits which may reasonably be expected in the calendar year 1951, it is estimated that your committee's bill will yield between \$4,000,000,000 and \$5,000,000,000 in a full year of operation. On this basis about 80,000 corporations will be subject to excess-profits tax.

III. MAJOR PROVISIONS OF GENERAL APPLICATION

1. The rate, the base, and the years of application

Your committee's bill increases the surtax rate under the regular corporate income tax by 2 percentage points. Thus the total corporate income tax rate on income in excess of \$25,000 is to be 47 percent for years beginning on and after July 1, 1950. Since no increase is made in the corporate normal tax rate, the total tax rate on income of \$25,000 and less remains at 25 percent, the rate provided by present law for 1951 and subsequent years.

The House bill provided for no increase in the corporate surtax rate. Thus, the total corporate rate would have remained at 45 percent for 1951 and subsequent years. Your committee deemed it desirable to increase the income tax rate from 45 percent to 47 percent in order to provide more revenue and to give assurance that all corporations with incomes in excess of \$25,000 will share in the additional tax burdens it is necessary to impose on corporations at this time.

Your committee's bill also imposes an additional excess profits tax rate of 30 percent which together with the regular corporate normal tax and surtax represents a total rate of 77 percent when fully effective. This 30 percent additional tax on excess profits represents no change from the House bill. The combined rate of 77 percent on adjusted excess profits net income is comparable to the excess profits tax rate of 85½ percent at the end of World War II after allowance is made for the 10 percent postwar refund provided by that tax. However, the combined rate of the corporate income tax and the excess profits tax, under your committee's bill, cannot exceed 60 percent of the corporation's income. This 60 percent rate can be compared to the 67 percent ceiling on corporation surtax net income provided by the House bill. Your committee's bill provides a lower ceiling rate than the House bill because your committee realized that, despite its care in providing for relief in hardship cases, some corporations will have inadequate excess profits credits. Under the World War II tax a similar ceiling limited the combined rate of the corporate income tax and excess profits tax to slightly more than 72 percent after allowance for the postwar credit.

As in the case of the World War II tax, the taxpayer is given the choice under your committee's bill of the higher of two alternative bases in determining what proportion, if any, of its income is to be subjected to excess profits tax. The primary credit, that is, the credit likely to be generally used, is an average earnings credit, based on average income in the 4 years 1946 to 1949. The alternative is a credit based on a rate of return on "invested capital." A similar choice is presented in the House bill and was provided in the World War II tax.

Your committee conceives of this tax as primarily a tax on increased profits due to the outbreak of hostilities and to large military expenditures. This accounts for the primary emphasis upon the average earnings base. However, it is believed that a minimum rate of return, free of excess profits tax, should be allowed taxpayers who happened to have poor earning experience in the base period. Therefore, taxpayers are offered an invested capital credit as an alternative which

places a floor on the rate of return assured before the imposition of excess profits taxes.

In section 701 of the Revenue Act of 1950 the Senate required this committee to report out an excess profits tax effective as of July 1, 1950, or October 1, 1950. After consideration of these alternative effective dates, your committee has concluded that an excess profits tax should be effective as of July 1, 1950. This date is the same effective date as provided by the House bill. This is approximately the date of the outbreak of hostilities in Korea and antedates the substantial increase in corporate profits during the third and fourth quarters of 1950 which resulted from the wave of buying following the start of hostilities.

The excess-profits tax is made effective in 1950 for calendar-year corporations by imposing for that year one-half the additional taxes which will be imposed for subsequent years. Thus, the excess profits tax rate applicable to these calendar-year corporations in 1950 is 15 percent which, when combined with the corporate normal tax and surtax, will represent a total rate of 57 percent on those calendar-year corporations in 1950.

The excess profits tax does not apply to fiscal-year corporations with respect to years ending prior to July 1, 1950. In the case of a fiscal-year corporation with a year beginning prior to and ending after July 1, 1950, the excess profits tax imposed will be a percentage of the 30-percent excess profits tax rate computed on the basis of the full year's income. The percentage is to be determined on a pro rata basis by dividing the number of days in the fiscal year which are after June 30, 1950, by the total number of days in the fiscal year. These rules are similar to those applied for 1950 in making the changes in the corporate normal tax and surtax rates in the Revenue Act of 1950.

The 2-percentage-point increase in the regular corporate surtax rate is made effective under your committee's bill with respect to taxable years beginning on and after July 1, 1950. Thus the total normal tax and surtax rate for the calendar year 1950 remains at 42 percent. However, the total normal tax and surtax rate of 45 percent provided by the Revenue Act of 1950 is raised to 47 percent for taxable years beginning on or after July 1, 1950.

Your committee's bill provides that the excess profits tax shall terminate as of December 31, 1952. The House bill provided no-termination date. Your committee believes that a termination date of this type is desirable in order to assure the review of the excess profits tax in the near future. For fiscal-year corporations with years beginning before January 1, 1953, and ending after December 31, 1952, the same procedures will be used with respect to the termination of the tax as have previously been described in the case of the initial imposition of the excess profits tax for these corporations.

2. Relationship of the excess profits tax to the income tax

The excess profits tax provided by your committee's bill is computed as an additional tax over and above the other corporate income taxes. The consolidated return privilege is made available as in the World War II statute. In general the computation of the excess profits tax is as follows:

- (a) First, the income tax is imposed on the entire amount of taxable net income.

(b) Second, the normal tax net income, after certain adjustments, is reduced by the excess profits credit (that is, the portion of the corporation's income which for the purposes of this tax is considered normal) and any unused excess profits credit carried forward or back to the taxable year. The result is called the adjusted excess profits net income.

(c) Third, an additional tax at the rate of 30 percent is imposed on this adjusted excess profits net income. This, when added to the corporate income tax of 47 percent represents a 77 percent rate on adjusted excess profits net income.

This is the same approach as was used under the House bill. Under the World War II excess profits tax the so-called "two-basket" approach was followed. The corporate income tax was imposed only on income which not subject to the excess profits tax, and the excess profits tax (comparable to the 77 percent tax referred to above) was imposed on income in excess of the excess profits credit.

Substantially the same tax burdens are achieved under either type of computation, but the type used in your committee's bill and in the House bill is believed to be the simpler. Under this approach the other income taxes can be computed without regard to the excess profits tax, and subsequent adjustments in the excess profits credit will not require a recomputation of the other income taxes. Also this method permits the complete unification of procedures for assessing and collecting the other income taxes and the excess profits tax, which should reduce substantially the burden of administration and taxpayer compliance. Under the provisions of your committee's bill and the House bill the income tax and the excess profits tax will be treated as one tax for the purpose of the computation of interest on refunds or deficiencies, the statute of limitations, credit and refund, the sending of 90-day letters, etc.

3. The minimum credit under the excess profits tax

Your committee's bill and the House bill provide for a minimum credit of \$25,000. Any taxpayer which upon computing its excess profits tax credit under either the average earnings or invested capital method finds that its credit is less than \$25,000 may raise its credit to this amount. As distinguished from this procedure the World War II law provided all taxpayers with a specific exemption of \$10,000.

The minimum credit has a number of advantages over the specific exemption, although the primary purpose of both is the same; namely, to relieve small corporations from excess profits tax and to encourage their growth, to prevent small corporations from being discriminated against as compared to their unincorporated competitors, and to make it unnecessary for them to compute an excess profits tax. A minimum credit and specific exemption of the same size are equally effective in removing these small businesses from the application of an excess profits tax. However, because the benefits arising from a minimum credit are available only to small corporations, it is possible to provide a much larger minimum credit than specific exemption with no additional drain on revenues. A \$25,000 minimum credit, for example, is less expensive in terms of revenue than a \$10,000 specific exemption.

4. Average earnings credit under the excess profits tax

For taxpayers on a calendar-year basis the base period under your committee's bill is the 4-year interval 1946 to 1949. Taxpayers are

permitted to eliminate the poorest of the base-period years. The normal tax net income of the remaining years is then adjusted in a manner described subsequently and averaged. The resulting average base period net income is then reduced by 15 percent for the purposes of the credit. These provisions are the same as in the House bill.

(a) *Selection of the base period and percent of earnings taken into account.*—Under the World War II law the base period was 1936 to 1939, and the credit was 95 percent of the average earnings in this period. It was necessary to substitute the period 1946 to 1949 for the 1936 to 1939 base in your committee's bill both because of the large number of businesses which have been started recently and because of the substantial changes which have occurred in the businesses currently in operation which were in existence in the period 1936 to 1939. The period 1946 to 1949 is the only recent 4-year nonwar period available. However, it is a period of unusual business prosperity which to a substantial degree was built on the deferred demands, the accumulated savings of World War II, and large postwar defense expenditures. Since this unprecedented level of business activity could hardly have been expected to continue permanently, the use of the income of the years 1946 through 1949, without adjustment, would produce a general overstatement of the taxpayers' earning capacity in the absence of hostilities in Korea or a large program of military expenditures. For this reason your committee believes that a 15-percent cut-back in average base period income is a moderate adjustment.

(b) *Counting deficit years as zero years.*—In addition to eliminating the poorest year in its base period, the taxpayer is permitted to count the earnings of any remaining deficit year as zero under both your committee's bill and the House bill. The comparable World War II adjustments were considerably less liberal. Under that law the earnings of the poorest year could be raised to 75 percent of the average of the other 3 years. This is only three-fourths of the upward revision which occurs in the selection of the best 3 out of 4 years. Moreover, there was no provision in the World War II law allowing additional deficit years to be counted as zero.

(c) *Capital additions during the latter base period years.*—Under your committee's bill and the House bill the average earnings credit may be increased for investments made late in the base period. Although no similar provision was contained in the World War II law, an adjustment of this character is needed to place corporations where investments were made late in the base period on a comparable basis with corporations where investments were made prior to, or in the early part of, the base period. Investments early in the base period are fully, or largely, reflected in the base period earnings, but investments made in the latter half of the base period would at best be only partially reflected in the base period earnings and may not affect those earnings at all.

For this reason the average earnings credit is increased to reflect one-half of the net additions to capital in 1948 and all of the net additions to capital in 1949. Under your committee's bill the average earnings credit is increased by 12 percent of such investments, irrespective of whether they take the form of equity capital, retained earnings, or

borrowed capital. This is the same rate of return allowed for net additions to capital in the years in which the excess profits tax is applicable and is the maximum rate of return allowed those using the invested capital base. This provision of your committee's bill differs from the comparable provision in the House bill only in the rate of return accorded borrowed capital. Under your committee's bill a 12-percent rate of return is provided for such capital. Under the House bill the credit was increased by 133 percent of the interest payable on the new funds. This change is in conformance with the change made by your committee in the rate of return on borrowed capital included in an invested capital credit. The reasons for this change are discussed below.

(d) *Fiscal-year corporations.*—Taxpayers using fiscal years ending after December 31 but before April 1 will use the last four taxable years ending prior to April 1, 1950, as their base period. The use of the corporation's actual taxable years is desirable in itself, and the inclusion of the first quarter of 1950 in the base period does not appear to be objectionable because profits in that quarter were not materially out of line. However, taxpayers whose fiscal years end after March 31 and before December 31 are required to use as their base period the 48 months beginning on January 1, 1946, and ending December 31, 1949. In these cases the use of the corporation's actual taxable years would involve either the exclusion of a portion of the calendar year 1949 and the inclusion of a corresponding part of 1945, or the inclusion of a portion of the calendar year 1950 which includes or borders upon the months affected by the hostilities in Korea. Therefore, such corporations are required to construct by proration four calendar years in order to compute their base period credit. For instance, for base period purposes, the 1946 income of a corporation with a taxable year ending November 30 will consist of eleven-twelfths of the income of the corporation's 1946 fiscal year and one-twelfth of its 1947 fiscal year. The income of the other base period years will have a similar composition. The 1949 income for base period purposes will consist of eleven-twelfths of the corporation's income in the 1949 fiscal year and one-twelfth of the income of its 1950 fiscal year. This will reduce to a minimum the effect of the Korean hostilities upon base period income. Similarly, a corporation having a fiscal year ending on May 31, will have a 1949 income consisting of five-twelfths of its 1949 fiscal year and seven-twelfths of its 1950 fiscal year. The provision of your committee's bill dealing with the base period of fiscal-year taxpayers is the same as under the House bill.

5. *Invested capital credit*

Under your committee's bill the excess-profits credit of a corporation computing its credit by reference to invested capital is the sum of the invested capital credit reduced by inadmissible assets plus the new capital credit. The invested capital of a corporation includes equity capital, retained earnings, and borrowed capital.

(a) *Rates of return on invested capital.*—The rates of return under your committee's bill for equity capital, retained earnings, and borrowed capital are shown in table 1.

TABLE 1.—Rates of return allowed on equity capital, retained earnings, and borrowed capital under your committee's bill and the World War II statute¹

Equity capital, retained earnings, and borrowed capital rate brackets	Rates under Finance Committee bill	Rates under World War II law
<i>(In millions)</i>		
Under \$5-----	12 percent-----	8 percent.
\$5 to \$10-----	10 percent-----	6 percent.
Over \$10-----	8 percent-----	5 percent.

¹ Under the World War II statute the capital in each bracket included only one-half of the borrowed capital.

As in the House bill, it is believed necessary to provide for more liberal rates of return than under the World War II law to allow for the general increase in rates of return on invested capital which has occurred since the pre-World War II period.

The rates of return allowed on equity capital and retained earnings are the same as those allowed under the House bill. The rates of return allowed on borrowed capital, however, differ from those provided in the House bill. Your committee's bill treats borrowed capital in the same manner as other forms of invested capital; that is, 100 percent of such capital is included along with the other forms of invested capital in computing the 12 percent, 10 percent, or 8 percent rate applicable. However, the interest payment on such borrowed capital is not allowed as a deduction in computing excess profits tax net income. This differs from the procedure followed under the World War II statute only in two respects. Under the World War II statute 50 percent, instead of 100 percent, was included with the other forms of invested capital, and one-half of the interest payments, instead of no interest payments, was allowed as a deduction in computing excess profits tax net income.

Under the House bill the rate of return on borrowed capital would have been computed entirely separately from other forms of invested capital. The rate of return would have been 133 percent of the interest rate payable on 100 percent of these borrowed funds. This would have been accomplished by allowing the full deduction of interest payments and by also increasing the invested capital credit by one-third of the interest payments. Under the House bill the minimum amount by which the credit would have been increased was 1 percent of the borrowed capital (limited to obligations with a term of 5 years or more), and the maximum by which it would have been increased was 3 percent of the total borrowed capital, without limitations on the interest deduction.

Your committee has shifted the method of computing the rate of return to be allowed on borrowed capital from that of the House bill because it was believed that, after corporate normal taxes and surtaxes are taken into consideration, the rate of return allowed under the House bill for borrowed capital will provide little incentive for a corporation to expand during the excess profits tax period by the use of borrowed capital.

(b) *Definition of equity capital and retained earnings.*—Under your committee's bill the invested capital of a corporation is generally determined by deducting from its total assets on its books at the end of the base period the total of its liabilities on its books at the same time, plus any "recent loss" adjustment. The determination of the date upon which a liability is incurred is to follow sound accounting principles and rules similar to those applicable in the computation of the taxpayer's earnings or profits. Except for cash, the term "assets" applies only to property having a basis for gain or loss upon sale or exchange. The value of the assets is determined in the case of all assets other than intangible assets by taking their "adjusted basis for gain."

The value of intangible assets under your committee's bill is determined without regard to the value of the property as of March 1, 1913. This represents a change from the House bill. Under the House bill the value of these assets was determined by taking their "adjusted basis for gain" which would have been the March 1, 1913, value where this was higher than cost. Your committee changed this because most of these assets, not being subject to depreciation, have not been valued as of March 1, 1913, and to do so would be quite difficult. Intangible assets are defined as "secret processes and formulae, good will, trademarks, trade brands, franchises, and other like property".

Your committee has also added a provision which excludes from invested capital the assets which are not held in good faith for the purposes of the business. The purpose of this limitation is to disallow in computing invested capital those assets which are not required in the business and which have the principal effect of reducing excess profits tax.

The recent loss adjustment referred to above, which is added to the net assets, is any net deficit in the period 1946 to 1949, or 1940 to 1949. The net deficit is the excess, if any, of operating losses over net income in the period. This provision is the same as in the House bill.

In addition to continuing the House provision relating to the computation of equity capital and retained earnings by deducting liabilities from assets, and adding the "recent loss adjustment," your committee's bill provides the taxpayer with the alternative of computing its invested capital under the so-called historical capital approach provided in the World War II statute. This alternative was not provided under the House bill. Under this historical capital approach, the equity capital and retained earnings represent the money and property previously paid in for stock or paid in for surplus plus the accumulated earnings and profits of the corporation as of the beginning of its taxable year. The major difference between this approach and that of the asset approach is the treatment of deficits. Under the historical capital approach a net deficit—that is, any deficit remaining after offsetting deficits of loss years against earnings of profitable years—does not decrease paid-in capital or paid-in surplus. Under the asset approach, also in this bill, a net deficit incurred prior to 1946 or 1940 (depending on which is more advantageous to the taxpayer) has the effect of reducing capital or surplus paid in prior to that date. However, a net deficit under the asset approach for the period since 1940 or 1946 reduces neither capital nor surplus paid in at any time, nor earnings and profits realized

prior to 1940 or 1946. Thus, under the asset approach, corporations with recent losses are treated more favorably than under the historical capital approach, while taxpayers with net deficits over the whole span of their existence are treated more favorably under the historical capital approach. Your committee recognized that it was desirable to provide favorable treatment for corporations with net deficits since 1940 or 1946 even though they had earnings prior to that time which would offset these deficits, since such corporations are likely to have a very unfavorable average earnings base and also are likely to find their invested capital base depleted as a result of these losses. For these reasons the provision of the House bill permitting corporations to use the asset approach was continued. However, it was also recognized that there were certain classes of corporations having losses over the entire span of their existence which would lose the advantage of adding back their net deficit merely because most of the losses were incurred prior to 1940. Furthermore, the asset approach is less favorable to corporations adopting percentage depletion. For this reason your committee also gives corporations the alternative of computing their capital under the historical capital approach.

In the case of insurance companies other than life, your committee amended the bill to provide that 50 percent of their reserves should be treated as borrowed capital in computing the invested capital base. Your committee also added a specific provision which provides for the inclusion of organization expenses in the case of these insurance companies in the computation of equity capital for purposes of computing their invested capital credit. A provision has also been added which permits face-amount certificate companies to include 50 percent of the mean of the amount of their reserves on their outstanding investment certificates.

(c) Definition of borrowed capital.—Borrowed capital, under your committee's bill, is indebtedness (but not including interest) which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, deed of trust, bank loan agreement, or conditional sales contract. This is substantially the same definition as appears in the House bill. However, your committee's bill limits the amount to be considered as borrowed capital to outstanding indebtedness "incurred in good faith for the purposes of the business." No such limitation was contained in the House bill although the report of the House committee indicated that it was intended to limit indebtedness treated as borrowed capital to indebtedness "employed in the trade or business." The definition of borrowed capital in both the House bill and your committee's bill is substantially the same as the definition appearing in the World War II statute except for the addition of conditional sales contracts and bank loan agreements. Conditional sales contracts are a form of borrowing which has been used extensively, and your committee believes that their omission from the definition of borrowed capital would work a hardship on taxpayers borrowing substantial amounts in this manner. The category of indebtedness evidenced by a bank loan agreement, added by your committee's bill, includes such indebtedness owing to a bank, and does not include the indebtedness of a bank to its depositors.

(d) Admissible and inadmissible assets.—Under the World War II statute the capital to which the various rates of return were applied

to determine the invested capital credit was reduced for certain so-called inadmissible assets. These assets were excluded because the income realized from them was not subject to excess profits tax. Stock in a corporation was an inadmissible asset because dividends received on such stock were not includible in excess profits tax net income. State and local government obligations and partially tax-exempt Federal obligations were also treated as inadmissibles because interest received on them was not includible in excess profits tax net income. However, in the case of these obligations the taxpayer had the option to treat them as admissible assets if it included in its excess profits tax net income the interest received on these obligations.

The House bill makes no major change in admissible and inadmissible assets except to deny the option to treat State and local government obligations and partially tax-exempt Federal obligations as admissible assets. The granting of this option gives an undue advantage to holders of these obligations. The interest rate payable on such obligations is quite generally around 2 percent to 3 percent. To allow rates of return of 8 percent to 12 percent, the rates provided for invested capital, gives the holders of these obligations an opportunity to apply the excess of the rate of return allowed over the rate of return received on these obligations to income on other assets. Your committee's bill makes no significant change in this provision of the House bill.

6. Net capital changes in the tax years

Under your committee's bill, both the taxpayer using the average earnings credit and the taxpayer using the invested capital credit, if the latter is computed under the asset approach, are allowed to increase their credit for net additions to investments since 1949. Additions to invested capital in the case of the average earnings taxpayer and in the case of the invested capital taxpayer computing its equity capital and retained earnings under the asset approach are allowed a flat rate of return of 12 percent. The taxpayer computing its invested capital base under the historical capital approach adds any net capital additions in the tax period to the invested capital which it had at the end of 1949 and receives a rate of return on these net capital additions of 12 percent, 10 percent, or 8 percent, depending upon its rate bracket.

Reductions in invested capital in the tax period, under your committee's bill, are permitted to decrease prior additions in the tax period at the same rate at which these increases were previously made. Thus, in the case of the average earnings taxpayer and the invested capital taxpayer using the asset approach the excess profits credit is reduced by 12 percent of any reductions which offset additions previously made in the tax period. In the case of the invested capital taxpayer using the historical capital approach, the rate of return by which the excess profits tax is reduced depends upon its top invested capital rate bracket which may be 12 percent, 10 percent, or 8 percent. Any reductions in excess of the additions in the tax years decrease the credit of both types of invested capital taxpayers and also average earnings taxpayers. For all invested capital taxpayers the rates of return used in connection with any such reductions are the rates used in building up their invested capital credit initially. For the average earnings taxpayer, the rate of return used is 12 percent in the case of these additional reductions.

The provisions of your committee's bill, described above, differ from those of the House bill in two important respects. First, under your committee's bill borrowed capital receives the same rate of return as other forms of invested capital while under the House bill its rate of return depends on the interest rate at which it was borrowed. Second, the invested capital taxpayer using the historical asset approach is not given the flat 12-percent rate of return with respect to additions made during the tax years but rather is required to use the rate of return it last used in computing its invested capital credit. Both of these changes in your committee's bill arise from changes made in the method of computing the invested capital credit and have been previously discussed.

The World War II statute was much less generous than either your committee's bill or the House bill, and also was inconsistent in the allowance for additions to capital in excess profits tax years. In the case of the average earnings taxpayer no allowance was made for investments in the tax years if they took the form of borrowed capital or accumulations of retained earnings. An increase in its credit was allowed at an 8-percent rate of return if the additions took the form of paid-in capital or paid-in surplus and a 6-percent rate of return was used for reductions of these types.

In the case of the invested capital taxpayer the World War II statute provided that retained earnings and borrowed capital be included in the ordinary computation of invested capital at the regular rates for such capital. Additions to paid-in capital or paid-in surplus were also included in the credit at the ordinary rates but as a special incentive they were included at 125 percent of their value. This had the same effect as providing for them a 10-percent, 7½-percent, or 6¼-percent rate of return, depending on the invested capital bracket of the corporation.

Your committee believes that the more generous provisions provided in this bill are necessary since the emergency may be of long duration requiring substantial increases in productive facilities.

7. Net income in the taxable year

(a) *General.*—The net income used in the excess profits tax is an adjusted version of the net income to which the 25-percent corporate normal tax is applied. Chief among the adjustments is an exclusion of capital gains and losses, both long- and short-term. This exclusion is based upon the sporadic character of the receipts. The World War II law excluded only long-term gains and losses. Logic requires the exclusion of short-term gains and losses as well.

Although casualty losses are also sporadic they are not excluded because they are likely to have a serious effect upon the corporation's taxpaying capacity in the year of the loss. For similar reasons net losses on the sale or exchange of assets used in a trade or business falling within the scope of section 117 (j) of the Code are not excluded from the excess profits tax net income under the committee's bill although they were excluded under the House bill.

Like the World War II law, the committee's bill excludes certain other types of sporadic income, such as—

1. Income arising out of the retirement or repurchase at less than the issue price of bonds, and other evidences of indebtedness, outstanding for more than 6 months;

2. Income arising from the recovery of bad debts in cases where no deduction has been claimed in a year for which an excess profits tax was imposed under the World War II law or would be imposed under this bill; and

3. Refunds of taxes paid under the Agricultural Adjustment Act of 1933.

The committee's bill excludes so much of the taxpayer's interest deduction as represents interest on the indebtedness included in the taxpayer's borrowed capital if it uses the invested capital basis. Interest reductions were allowed in full in the House bill. The difference reflects the change in the treatment of borrowed capital under the invested capital credit. The disallowance of the interest deduction in the Finance Committee bill is consistent with the inclusion of 100 percent of borrowed capital in the taxpayer's invested capital base.

The net income of the excess profits tax year is also corrected by the elimination of deductions arising out of the retirement at a premium of bonds and other evidences of indebtedness outstanding for more than 6 months. Such an adjustment was allowed under the World War II law, but only in the correction of the base period net income. Under the bill the adjustment is also made in the income of the tax period.

As in the World War II-law, the net income of life insurance companies is adjusted for contributions to policyholders' reserves so as to conform income for excess profits tax purposes with income used for the corporate normal and surtaxes. If the company computes its excess profits credit on the invested capital basis, the adjustment for contributions to policyholders' reserves is reduced by 50 percent because half such reserves are included in borrowed capital used in calculating the invested capital credit.

Taxpayers in certain extractive industries are permitted to exclude a portion of their income from "excess output," as under the World War II legislation, as well as amounts received as incentive payments to encourage exploration, development, and mining for defense purposes.

The bill follows the precedent of the World War II law in allowing a full 100 percent credit for dividends received from domestic corporations. While the World War II law also allowed a full credit for dividends in kind, the bill restricts the credit for such dividends to the adjusted basis of the distributed property in the hands of the distributing corporation. This conforms the treatment of dividends in kind under the excess profits tax with that under the corporate normal and surtaxes as revised by section 122 of the Revenue Act of 1950.

The bill contains a provision allowing the correction of the net income of the excess profits tax years for other abnormalities. This provision is similar to section 721 of the World War II law. Generally, income appearing in particular excess profits tax years is reallocated under this provision if it is attributable to events that occurred or work that was done in other years. Such an adjustment is made only if the income of the class deemed to be abnormal received in the taxable year is more than 115 percent of the average amount of the income of the same class received during the four previous taxable years. In

appropriate cases such an excess will be attributed to other years under regulations to be prescribed by the Secretary of the Treasury.

Adjustments of this type are limited to income arising out of—

1. A claim, award, judgment, or decree;
2. Exploration, discovery, or prospecting which extended over a period of more than 12 months;
3. The sale of patents, formulas, or processes developed over a period of more than 12 months; or
4. Income which is includible in the taxable year rather than another year by reason of a change in the taxpayer's method of accounting.

The equivalent provision in the World War II law (sec. 721) also permitted adjustments with reference to certain other types of income, particularly that resulting from the sale of tangible property arising out of research and development which extended over a period of more than 12 months. This provision in the old law was a potential loophole of major dimensions. Because there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (sec. 722), and because the need for a reallocation of such income seemed to be materially less than for the other classes of income described above, the bill omits this item from the list of abnormal types of income for which a reallocation can be made.

The bill also contains a number of other provisions designed to adjust the excess profits tax net income of specific classes of taxpayers.

(b) *Installment basis taxpayers.*—The bill permits taxpayers using the installment basis method of accounting for income tax purposes to elect to report their income on an accrual basis for the excess profits tax. Under the House bill this election is open only to taxpayers receiving income from installment sales. The Finance Committee bill also permits such an election in the case of taxpayers whose principal business consists of the purchasing of installment sales obligations.

Under the installment basis method of accounting, income arises when the payments made under the contracts are received. In the absence of the election provided in this bill, many taxpayers using this method would probably be required to pay unusually large taxes during the first years of the excess profits tax period because the receipt of payments arising out of sales in earlier years will exceed substantially the volume of new business. This is expected to occur because the volume of installment purchases was very heavy in 1948, 1949, and 1950, and is expected to diminish sharply in 1951 and subsequent years as a result of the application of controls to installment purchases and the development of scarcities among the commodities ordinarily sold by the installment method. A similar result would obtain in the case of taxpayers whose principal business consists of purchasing installment sales obligations.

The election provided under the bill permits such taxpayers to exclude from the excess profits net income of the taxable years payments arising out of sales made during the years in which the tax did not apply. Such an election when made is irrevocable and applies to all subsequent taxable years to which the excess profits tax is applicable.

(c) *Long-term contracts.*—A similar election is provided for taxpayers who receive payments under long-term contracts and who, under the completed contract method, account for such receipts as income for the year in which the contract is completed. The bill permits such taxpayers to elect to report their income from long-term contracts under the percentage of completion method of accounting for the purpose of the excess profits tax. This election when made is also irrevocable and applies to subsequent taxable years.

(d) *Long-term leases.*—A special adjustment is provided in the case of long-term leases which require the lessee to pay a stated rental to the lessor free of tax. Such leases are found in the railroad industry and were usually entered into many years ago when taxes were not as important an item as now. Under such leases an increase in taxes automatically raises the income before taxes received by the lessor corporation and may serve as the basis for the imposition of an excess profits tax, which the lessee will be obligated to assume. To eliminate the resulting hardship the bill provides that the amount of tax paid by the lessee be excluded from the income of the lessor corporation, and that no deduction be allowed to the lessee.

As under the House bill, this adjustment is available only in the case of a lease for a term of more than 20 years. The committee's bill also provides that an agreement for the lease of railroad properties shall be considered to be a lease for such term as the total number of years during which the lease may be renewed and continued automatically.

To qualify for this adjustment it is necessary that the lease be entered into prior to December 1, 1950.

(e) *Bad debt reserves of banks.*—Banks which have elected to use the reserve method of accounting for bad debts for income tax purposes substitute for excess profits tax purposes a deduction for debts which became worthless in whole or in part within the taxable year. This is desirable because the banks which elected to use the reserve method for income tax purposes beginning in 1947 have for the most part accumulated reserves that equal or approach the maximum allowable under the existing rulings. In view of this situation and because of the probability that losses from bad debts will be comparatively low during the excess profits tax years it is likely that the deductions under the reserve method will be abnormally low during the excess profits tax period. The deduction of such losses as they occur will provide a more equitable result.

(f) *Blocked income.*—Special rules are provided under the bill for the treatment of "blocked income" arising prior to 1951. These rules are discussed below.

3. *Net income in the base period*

The calculation of excess profits by a comparison between base period income and the income of the taxable year requires the removal of abnormalities not only from the income of the taxable year but from the income of the base period years as well. Many of the provisions in the bill for adjusting the income of base period years are similar to those used in the taxable years. Among these are the exclusion of gains and losses from the sale or exchange of both long- and short-term capital assets, and income arising from the retirement or repur-

chase at less than the issue price of bonds and other evidences of indebtedness outstanding for more than 6 months.

However, gains and losses from the sale or exchange of assets used in the trade or business (sec. 117 (j) assets) are excluded from the taxpayer's base period net income, as under the House bill, even though they are not excluded in the determination of income in the excess profits tax years. The exclusion of such gains and losses in the base period years is justified because it is desired to obtain a "normal" earnings experience for the taxpayer. Since such gains and losses are apt to be sporadic and frequently are sizable, their inclusion would distort the taxpayer's base period net income. On the other hand the exclusion of such items from the income of the excess profits tax years would lead to the disallowance of substantial losses which, because of the high rate imposed, might prove to be a serious embarrassment to a hard-pressed taxpayer.

Deductions for premiums paid and expenses involved in the retirement of bonds and other evidences of indebtedness outstanding for more than 6 months are eliminated from the income of the base period years as from the income of the taxable year. Provision is made for the elimination of the deduction based on the repayment of processing taxes to vendees, which parallels the adjustment for processing tax refunds in the income of the excess profits tax year.

A 100-percent credit for dividends received is allowed in computing the net income of the base-period year and the rule applied to dividends in kind is the same as that now used under the corporate normal and surtaxes.

In addition the bill contains a general provision applying to claims, awards, and judgments against the taxpayer, intangible drilling and development costs of oil or gas wells, development costs in the case of mines, casualty losses, and deductions of other classes subject to regulations prescribed by the Secretary. For any class of such abnormal deductions, the amount in excess of 115 percent of the average amount of deductions of such class for the four previous taxable years is to be eliminated under regulations prescribed by the Secretary, provided that in the base-period year the deductions of the class disallowed exceed 5 percent of the average excess profits net income for all the taxpayer's base-period years computed without the disallowance of any class of deduction under this provision. For the purposes of the latter limitation, a deficit in any of these years is counted as zero.

This provision is similar to the corresponding portion of the World War II law except that the latter eliminated only the excess over 125 percent of the average of the deductions for the four previous taxable years, and did not include the 5-percent limitation described above.

The bill, like the World War II law, does not permit the disallowance of such abnormal deductions unless the taxpayer establishes that the increase in the deduction is not (a) a cause or a consequence of either (1) an increase in the taxpayer's gross income in its base period or (2) a decrease in the amount of some other deduction in its base period, which increase or decrease is substantial in relation to the amount of the increase in the deductions of such class, or (b) a consequence of a change at any time in the type, manner of operation, size, or condition of the business engaged in by the taxpayer.

The bill also follows the precedent of the World War II law in limiting the amount of the deductions disallowed to the excess over the deductions of the same class in the taxpayer's excess profits tax year.

The income of the base-period years is adjusted to conform to that of the taxable years in the case of taxpayers who elect to change from the installment basis to the accrual method of accounting, or to substitute the percentage of completion method for the completed contract method of accounting for payments under long-term contracts. The base-period income of lessees which are obligated to pay the tax due on the payment to a lessor under a long-term contract is adjusted in the base period to conform with the tax period. Banks using the reserve method of accounting for bad debts during the base period substitute deductions for debts which became worthless in whole or in part within those years for the larger deductions made to establish such reserves.

Life insurance companies deduct their contributions to policyholder's reserves in computing their base period net income as in computing the income of their excess profits tax years.

In addition to the forgoing provisions which follow, in general outline the corresponding provisions of the House bill, the Finance Committee bill permits an adjustment of the assessments paid by banks during the base period to the Federal Deposit Insurance Corporation. Public Law 797 of the Eighty-first Congress, second session, recognized that the assessments paid in prior years had resulted in the accumulation of a sufficient reserve and made provision for a credit which would be counted against the gross assessments due in later years. This credit is computed by reference to the operating experience of the FDIC in the preceding year. As a result of its use, the FDIC assessments actually payable in the excess profits tax years probably will be much less than those paid in the base period years. Under the committee's bill the deduction for FDIC assessments in the taxpayer's base period years will be reduced proportionally with the credit allowed against the FDIC assessment in the excess profits tax year.

9. General relief

(a) *Provisions of World War II law.*—Section 722, the general relief provision of the World War II law, was designed to aid hardship cases by providing such corporations with a substitute, or constructive average, base period net income. Section 722 dealt with three principal classes of cases—(1) corporations which had suffered some adversity during their base period, (2) corporations which had made changes during the base period resulting in an increase in their profit potentials, and (3) corporations which were not in existence during the base period and, therefore, had no base period net income at all.

In each instance the section provided that a hypothetical base period earnings credit be "tailor made" for the particular taxpayer and that certain assumptions be made in connection with the case. Each case was a problem in research, and the legal or tax result generally was intertwined with complicated accounting and economic problems. Almost every factor which had any influence on the particular business was pertinent to the case and the time and expense involved in reconstructing the average base period earnings credit were tremendous.

These complex relief provisions of the World War II law have resulted in extended delay in the settlement of relief claims which discriminated against taxpayers who had neither the time nor the financial resources necessary for the establishment of their cases. Moreover, the determination of what the taxpayer's base period income would have been in the absence of the claimed abnormality was largely a matter of subjective judgment, and a great deal of complaint has arisen on this account. Hence this bill reduces to a minimum the amount of administrative discretion involved in the adjustment of the hardship cases which may be expected to arise under an excess profits tax.

(b) *Reduction in hardship cases under the bill.*—Since corporations in general had a high level of profits during the past 4 years, and since the bill is more liberal in a number of major respects than the World War II law, the number of hardship cases which will arise should be substantially less than if the old law were reenacted under current conditions.

Provisions of the bill which may be expected to reduce the need for relief are (1) the substitution of a \$25,000 minimum credit for the \$10,000 specific exemption of the prior law; (2) the option granted the taxpayer to eliminate the worst year in its base period for the purpose of computing its average base period net income; (3) the treatment of a deficit in any remaining base period year as zero for the purpose of computing the average base period net income; (4) the substitution of a 5-year carry-forward and a 1-year carry-back of the unused excess profits credit and net operating losses for the 2-year carry-forward and the 2-year carry-back used under the World War II law; (5) the privilege of carrying over to 1950 and 1951 operating losses incurred during the base period which have not been utilized to offset the income of other years; (6) the increase of the average base period net income for capital additions during the latter part of the base period; (7) the adjustment of the average base period net income for capital additions after the base period with a broader application and higher rates than the equivalent provision of the World War II law; and (8) the provision that the combined rate of the corporate income tax and the excess profits tax cannot exceed 60 percent of the corporation's income.

(c) *General relief provisions in the bill.*—The bill provides automatic formulas for each of the most important types of cases which arose under section 722 of the World War II law. These formulas permit an objective computation of the amount of relief granted in each case, thus avoiding the practice of making the extent of the relief dependent upon an attempted analysis of all the varying factors in the individual case with the resulting uncertainty, delays, and disparity of treatment among taxpayers which characterized the application of the general relief provisions of the World War II law.

(i) *Abnormalities during the base period*

Section 722 (b) (1) and (2) of the prior law provided relief when the income of the taxpayer's base period years was substantially abnormal because of a physical interruption to production, such as a fire, strike, or flood, or because of a depression in the business of the taxpayer resulting from temporary economic circumstances unusual in the

case of the taxpayer, such as a severe price war. Your committee's bill provides relief in these same areas. However, the bill does not retain that part of section 722 (b) (2) which provided relief in cases where the business of the taxpayer was depressed because the industry of which the taxpayer was a member was depressed due to temporary economic events unusual to such industry. Provision is made in another portion of the bill for the relief of taxpayers whose industry was depressed during the base period.

If an abnormality existed in the taxpayer's lowest year of earnings during the base period, this year will be eliminated automatically from the average base period net income computation. However, if an abnormality occurs in one of the remaining periods of 12 months or less in the base period, the taxpayer may, if it was in business at the beginning of its base period, substitute for its actual excess profits net income for the period of the abnormality an amount determined by multiplying its total assets for the last day of the period of the abnormality by the rate of return for its industry for that period. This formula provides relief without introducing the difficult task of proving what the taxpayer's earnings would have been in the abnormal period had the abnormality not existed.

If an abnormality is present in more than one of the three best years in the taxpayer's base period, a different formula is used. In such cases, a substitute average base period net income is computed by multiplying the average of the amounts of the taxpayer's total assets on the last day of each of its base period years preceding its first excess profits tax taxable year by the base period rate of return for the taxpayer's industry.

The substitute average base period net income described above would be available only if the taxpayer's average base period net income in the event of the substitution exceeded 110 percent of the taxpayer's average base period net income computed without adjustment for the abnormality. Similarly, a substitute excess profits net income may be used for a single abnormal year only if it exceeds 110 percent of the taxpayer's excess profits net income for that year computed without such substitution. Such a limitation is desirable in order to avoid burdening the administration of the tax with trivial claims.

Taxpayers having abnormalities in more than one of their best 3 years may not adjust their substitute average base period net income for changes in capital during the last 2 years of the base period, since their substitute income is not dependent primarily upon their own earnings record. However, the taxpayer which has only one abnormal year remaining after the elimination of its worst year, and, therefore, which uses an average base period net income computed largely from its own earnings record, may claim the adjustment for capital additions, provided the year of the abnormality is 1946 or 1947, and may claim an adjustment for capital additions in 1949 where the year of the abnormality is 1948.

The House bill used a somewhat different formula which allowed the taxpayer to substitute for the actual income of the year or years of the abnormality an amount which bore the same relation to the taxpayer's earnings in its "normal" years during the base period as an earnings index for the taxpayer's industry in that year bore to the aggregate of the industry indexes in the taxpayer's normal years.

The House formula could not be applied unless one of the taxpayer's base period years was free of abnormality. Moreover, the substituted amounts might be inappropriate if the year to year changes in the taxpayer's earnings during the base period were not similar to the changes in the index of the taxpayer's industry. Finally, the system of indexes used under the House bill was somewhat complex.

The formulas contained in the Finance Committee's bill are simpler since they merely apply an industry average rate of return to the taxpayer's total assets. The possibility of erratic results arising out of the difference between the year to year changes in the taxpayer's profits and those of his industry is eliminated, and relief is available even in the case where each of the taxpayer's base period years contains an abnormality.

The industry rates of return used under this and other provisions of the bill will be determined and proclaimed by the Secretary of the Treasury. For this purpose the Nation's industry will be grouped into the 64 classes shown in appendix A. This is a slightly modified version of a classification developed by the Bureau of the Budget for general use in the Federal Government, and the description of the classes appears in the Standard Industrial Classification Manual prepared by the Bureau's Division of Statistical Standards.

The computation will be based on data regularly compiled from income tax returns by the Treasury Department in preparing the Statistics of Income.

The industry rate of return for an individual year will be computed by dividing the sum of the aggregate net income and the aggregate interest deduction shown on the income tax returns filed by the corporations in the industry by the aggregate total assets of such corporations as of the close of the taxable year for which the returns were filed. Since interest is added to net income in the calculation of the rate of return which the taxpayer applies to his assets, the amount of interest accrued by the taxpayer during a single year of abnormality is subtracted in determining his substituted income of that year. Similarly, when the taxpayer uses a substituted average base period net income it makes an appropriate adjustment to eliminate 1 year's interest.

The industry base period rates of return will be computed by aggregating the net income and the interest deductions reported by the corporations in the industry during the 4-year period 1946 through 1949 and dividing by the aggregate of the sum of the total assets of these corporations for the 4 years in question.

Since it will not be possible to assemble immediately the data necessary for computing the final rates of return for the last year or years in the base period, or for the entire base period, provision is made in the bill for the calculation of tentative rates of return. These are to be proclaimed prior to March 1, 1951, and will be used until the final rates have been proclaimed. The final rates will, of course, supersede the tentative rates and applications for adjustments based on the latter will be redetermined when the final rates are available.

The taxpayer adjusting only one of his three best years will use the rate of return for the industry to which is attributable the largest amount of its gross receipts in that year. The taxpayer using the industry rate of return for the entire base period will use the rate for

the industry accounting for the largest amount of the taxpayer's gross receipts in the appropriate period.

Fiscal year taxpayers adjusting a taxable year beginning in 1945 and ending in 1946 will use the rate of return for the taxpayer's industry classification for the calendar year 1946. Those adjusting a taxable year beginning in 1949 and ending in 1950 will use the rate of return for the calendar year 1949. In other cases fiscal year taxpayers will use the index for the calendar year in which falls the greater number of days in such taxable year.

Since the rates of return are computed on the basis of "total assets," the taxpayer using such rates will apply them to its "total assets." The latter means the sum of the cash and property other than cash or inadmissible assets used by the taxpayer for a bona fide business purpose. Such property is to be valued at its adjusted basis for determining gain on sale or exchange except that in the case of certain intangible property the basis shall be determined without reference to the value on March 1, 1913.

The taxpayer desiring to adjust its base period net income under these provisions will make an application with its return, or file a claim for refund within the period of limitations applicable to claims for refund, or file an application to offset a deficiency proposed against it. If a taxpayer files a petition with the Tax Court for redetermination of a deficiency, such application must be filed not later than the date of the filing of the original petition. The purpose of requiring the taxpayer to file an application or make a claim is to provide the Treasury Department with full and timely knowledge of the taxpayer's grounds for relief. This replaces a provision contained in the House bill which would have deferred a percentage of the adjustment in the tax claimed by the taxpayer on the basis of the abnormality.

The definitions of total assets, gross receipts, industry classification, and base period rate of return described above are generally similar under the formulas developed for other hardship cases. The taxpayer's claim for adjustment under those provisions will be made in the same manner and will be subject to the same special rule concerning the statute of limitations which applies when an adjustment is made for abnormal years.

(ii) New products or services introduced in the base period

Corporations which commenced business before the base period and made substantial changes in their products or services during the last 36 months of the base period may elect a substitute base period net income. This provision is intended to replace the "new products" adjustment authorized under section 722 (b) (4) of the World War II law. Corporations which commenced business after the beginning of the base period are not eligible under this provision, but may qualify for a substitute net income under the "new corporation" rules described below.

The concept of a change in product or service was developed under the World War II law and it is believed that the experience thereunder was generally satisfactory.

To qualify for relief under the "new product" provision the change in products or services must have been "substantial" in the sense that

by the end of the third year (or earlier) following the year in which the products or services were introduced, the gross income from such products must aggregate to more than 40 percent of the taxpayer's gross income in that year. The House bill used a test of 33 percent of the taxpayer's net income. Witnesses appearing at your committee's hearings pointed out the difficulties involved in the allocation of net income to particular products and services. Hence a test using gross rather than net income has been substituted.

To qualify for relief under this provision the taxpayer must also demonstrate that its net income in any one of the taxable years in which it has met the percentage of gross income test was in excess of 125 percent of the average excess profits net income during the base period year or years preceding the first change in product or service used in qualifying under the "gross income" test.

The taxpayer who qualifies under the afore-mentioned test prior to January 1, 1950, may use a substitute average base period net income computed by multiplying its total assets for the last day of its last pre-excess profits tax year or of the earliest year in which the taxpayer qualifies for relief, whichever day is later by the base period rate of return in its industry and adjusting for 1 year's interest. If the year in which the taxpayer first meets these tests ends after the base period, the substitute average base period net income is computed by multiplying the total assets for the last day of such taxable year by the base period rate of return for the taxpayer's industry classification.

A taxpayer who obtains relief under the new product provision may obtain an adjustment for new capital additions in the tax period only in those years which follow the year in which the taxpayer qualifies for relief under the new product provision but is given no adjustment for capital additions in the base period.

It is intended that, where a taxpayer establishes that it has made several substantial changes in products or services during the last 36 months of its base period, the aggregate effect of such changes may be considered in determining whether the eligibility requirements of the section are met. The gross income and net income tests can be met in a particular year by considering all such substantial changes which were made during the three preceding years.

(iii) Increase in capacity during the base period

A corporation which commenced business before its base period and made substantial changes in its capacity during the last 36 months of the base period may also elect a substitute average base period net income. This provision is intended to replace the equivalent portion of section 722 (b) (4) of the World War II law.

To qualify for relief the taxpayer must have added to its facilities in a manner which—

(a) resulted in an increase of 100 percent or more in its productive capacity, *or*

(b) resulted in an increase of 50 percent or more in its productive capacity *and* the adjusted basis of the taxpayer's total facilities after the addition or replacement exceeds by 50 percent or more the adjusted basis of the taxpayer's total facilities prior to such addition or replacement, *or*

(c) the unadjusted basis of the taxpayer's total facilities after such addition or replacement exceeded by 100 percent or more the unadjusted basis of the taxpayer's total facilities prior to such addition or replacement.

These tests must be complied with prior to the end of the taxpayer's base period.

For the purpose of these tests the term "facilities" means real property and tangible depreciable property held by the taxpayer for a bona fide business purpose.

These tests will confine relief to taxpayers whose capacity has undergone a change which is sufficiently great to make its base period earnings experience a poor basis for evaluating its earnings during the excess profits tax period.

Taxpayers who qualify under one of the afore-mentioned tests may elect to use an average base period net income calculated by multiplying the base period rate of return for the taxpayer's industry classification by the taxpayer's total assets for the last day in its last pre-excess profits tax year. Since the alternative net income is computed on the basis of the assets as of the close of the base period, no adjustment need be made for capital additions during the base period. Since the rate of return of the taxpayer's industry classification is calculated by adding the sum of the net profits and the interest paid during the base period years and dividing by the total assets of the industry in those years, the alternative average base period net income is reduced by an amount equal to the total interest paid or accrued by the taxpayer in the final year of its base period.

There was no equivalent provision in the House bill, but numerous witnesses who appeared before the committee pointed out the need for an adjustment based on substantial changes in capacity and stressed the discrimination which would result if an alternative basis were provided in the new product cases while no adjustment was made for substantial changes in capacity.

(iv) Depressed industries

The bill provides a substitute average base period net income in cases where the taxpayer's industry was depressed during the base period. The World War II law contained section 722 (b) (3) (A) which permitted the reconstruction of an hypothetical base period income when the taxpayer could show that the industry of which it was a part was depressed during the base period. Relief was available only when the depression was characteristic of the entire industry to which the taxpayer belonged, and this is also true of the provision contained in this bill.

The House bill made no special provision for relief for depressed industries, and it was brought to the attention of the committee that because of this omission some vital industries would have a very poor base period earnings record. Moreover, in many cases the individual firms in these industries would have an inadequate invested capital credit. Hence it appeared desirable to make special provision for the depressed industry cases.

The existence of a depression in the taxpayer's industry during the base period is to be determined by comparing the industry's average rate of return during the years 1946 through 1949 with its average rate of return during the period 1936 through 1949.

Under the bill a depressed industry is one in which the average rate of return on total assets during the years 1946 through 1949 is less than 60 percent of the average rate of return for the industry over the period 1936 through 1949. It is believed that this entrance test will confine the application of the provision to taxpayers in industries whose base period earnings were substantially below normal.

Taxpayers in such industries are permitted to use a substitute average base period net income computed by multiplying their average total assets during the base period by 80 percent of the depressed industry's average rate of return during the period 1936 through 1949.

The special alternative average base period net income for taxpayers in depressed industries is, of course, available on an elective basis.

For purposes of the depressed industry test, taxpayers will be classified in general conformity to the three-digit classification of industries used by the Treasury Department in compiling its Statistics of Income data for the years 1938 through 1947, using such combinations of subgroups as the Secretary determines are necessary to provide reasonably comparable data over the period 1936 through 1949. The taxpayer's industry classification will be the one from which it derives the majority of its gross receipts.

Since the rate of return of the taxpayer's industry classification is calculated by adding the sum of the net profits and the interest paid during the base period years and dividing by the total assets of the industry in those years, the alternative average base period net income is reduced for the average yearly interest paid or accrued by the taxpayer.

The depressed industry formula also provides relief for the type of case covered under 722 (b) (3) (B) of the World War II law. These are cases in which the industry is characterized by sporadic and intermittent periods of high profits and such profits fail to appear in the base period. Hence the industry rate of return in the base period years may be expected to fall well below its long-term average. The House bill did not provide relief in cases of this type.

(v) Other types of abnormalities in the base period

Section 722 of the World War II law also permitted the reconstruction of the taxpayer's base period experience on the basis of (a) changes in management or methods of operation (722 (b) (4)), (b) changes in the ratio of debt capital to other capital (722 (b) (4)) and (c) cases where a taxpayer acquired, prior to the end of the base period, all or part of the assets of a competitor with a resulting elimination or diminishment of the competition of the competitor (722 (b) (4)). No specific formulas are provided for such cases under the committee's bill or under the House bill.

The construction of a relief formula for cases involving changes in management or methods of operation involves extreme technical difficulties, since the existence of changes of this type does not itself prove that the character or earning capacity of the business has been altered materially. The determination of the effect of such changes proved extremely difficult under the World War II law and involved the very type of subjective judgments which are being avoided in this bill. When changes of this type actually do result in substantially increased earnings, the effects usually appear comparatively quickly

and as a result will be reflected in the average base period income of the taxpayer without special adjustment. Moreover, if such changes are accompanied by the introduction of new products or a change in plant capacity, relief is available under specific formulas contained in the bill.

Your committee has not included in this bill a relief formula based on the changes during the base period in the ratio of debt capital to other capital. At the time such relief was enacted as a part of the old section 722 (b) (4), it was thought that there would be a substantial number of such cases because the base period, 1936-39, was characterized in part by recovery from a severe economic depression. This situation was not a characteristic of the base period, 1946-49, used in this bill. Moreover, your committee has been informed that a comparatively insignificant number of cases arose under the prior provision.

A reduction in debt in relation to other capital is accompanied either by a net increase in capital or a net decrease in capital with a resultant contraction in operations. In the former case, that of an addition to capital, another portion of the bill provides for an adjustment to base-period earnings to the extent that such additions were made in the latter part of the base period. With respect to the latter case, an actual contraction in operations, your committee is unable to discover any adequate reason for granting relief.

Your committee has not provided a special relief adjustment in the case of an acquisition by the taxpayer before the end of the base period of all or part of the assets of a competitor which resulted in the elimination or diminishment of the competition of the competitor. It is believed that an accurate evaluation, based on fact rather than opinion, of the extent to which earnings are affected by such a change in the competitive relations of any particular industry is virtually impossible. Moreover, if an acquisition of this type does in fact result in increased earnings to the taxpayer in the base period such earnings will be reflected in its average base period net income. If the acquisition is accompanied by an addition to capital during the latter part of the base period or a change in product or capacity, the bill provides specific relief formulas. To the extent the acquisition is not accompanied by an addition to capital but is merely the result of a shift in assets no valid claim for relief exists.

10. Alternative basis for new corporations

Unlike the World War II law, the present bill combines the relief treatment for new corporations which commenced business during the base period with those which commenced business subsequent to the base period. In both cases an alternative average base period net income is provided which will make it unnecessary for the taxpayer to reconstruct a hypothetical base period experience as he did under section 722 of the World War II law.

Except in the case of an acquiring corporation, which is dealt with in part II of the bill, and certain ineligible corporations, an alternative average base period net income is provided for a corporation which commenced business at any time after the beginning of its base period. The alternative is computed by applying the average base period rate of return for the taxpayer's industry classification to the amount of

the taxpayer's total assets. If the taxpayer's first three taxable years ended in the base period, the industry rate of return is applied to the taxpayer's total assets on the last day of the base period. This alternative net income may then be adjusted for retained earnings or net capital additions or reductions subsequent to the close of the base period. When the taxpayer's first, second, or third taxable year ends after the base period, the credit is determined for each of these years by applying the industry average base period rate of return to the taxpayer's total assets for each of such years. The credit for subsequent years is determined in a similar manner on the basis of total assets at the close of the taxpayer's third year or its last preexcess profits tax year, whichever is later. A new corporation also receives an adjustment for subsequent capital additions in the tax period.

Since the rate of return of the taxpayer's industry classification is calculated by adding the sum of the net profits and the interest paid during the base period years and dividing by the total assets of the industry in those years, the alternative average base period net income is reduced for 1 year's interest paid or accrued by the taxpayer.

This adjustment is, of course, available to the taxpayer at his election and provides a "floor" based on the average earnings experience of the taxpayer's industry during the base period.

The provision contained in the Finance Committee bill differs from that found in the House bill primarily because of the denial of the new corporation adjustment in certain cases where taxpayers might transfer assets between corporations in order to obtain the benefit of the industry average rate of return available to new corporations.

11. Alternative basis for growing corporations

Recognizing that the excess profits credit based either on the average income of the best 3 years in the base period or on invested capital may not be satisfactory for corporations experiencing an unusually rapid growth during the base period, the Finance Committee bill, like the House bill, provides an alternative average base period net income for such taxpayers. This alternative is available only to a corporation which commenced business before the beginning of its base period. Corporations commencing business at a later date are provided for under the "new corporations" alternative described above.

The House bill provided that growing corporations might compute their average base period net income from the income of the last 24 or the last 12 months in the base period, whichever is higher. The Finance Committee bill contains a third alternative consisting of an amount determined on the basis of 40 percent of the taxpayer's earnings in 1950 and 50 percent of the taxpayer's earnings in 1949.

The theory upon which the alternative credit for growing business is based is that by the end of the base period taxpayers who have been in business since 1945 will have reached or be approaching maturity. This logic clearly justifies the development of an alternative average base period net income from the experience of the final year in the base period, 1949. The House report indicates that the option to use instead an average based on 1948 and 1949 resulted from recognition of the fact that in many industries the 1949 earnings were substantially lower than those for 1948. Testimony at the hearings of this committee brought out the fact that in some cases corporations which were ob-

viously experiencing substantial growth during the base period did not reach a profitable status until 1950 and, therefore, could not obtain a real benefit under the House provision. Hence, the option permitting the taxpayer to develop an average base period net income from his experience in the years 1949 and 1950 was added, but since the committee recognized that the 1950 earnings might be inflated by the business boom which occurred during 1950 the taxpayer is required to discount its 1950 earnings experience by 20 percent.

Under the Finance Committee bill, as under the House bill, the alternative based on growth is available only if the taxpayer had total assets of not more than \$20,000,000 at the beginning of its base period. This restriction is designed to exclude from the benefits of the growth provision large corporations whose earnings experience does not justify additional relief on account of growth.

A floor amendment will be offered to provide further liberalization as to the qualification for determining growth under this provision.

The committee bill has added to the limitation based on size the proviso that, when the taxpayer is one of a group of corporations meeting the test of affiliation provided in section 141 of the Internal Revenue Code, the assets of the taxpayer shall be added to those of the other "affiliated" corporations for the purpose of the limitation in question. Corporations which are "affiliated" in this manner are eligible to file consolidated returns, and the aggregation of their assets for the purpose of this test is necessary in order to prevent discrimination against affiliated corporations which elect to file consolidated returns.

In addition to meeting the assets test described above, a corporation desiring to use the alternative based on growth must qualify under a test designed to limit the benefits of the provision to corporations experiencing a degree of growth during the base period substantially in excess of the growth of industry in general. For this purpose two indices are used: Payrolls and gross receipts. If the taxpayer's total payroll for the last half of the base period is 130 percent or more of its total payroll during the first half of the base period, it can qualify as a growing corporation. However, a taxpayer who fails to meet the payroll test may qualify if its gross receipts for the last half of its base period are 150 percent or more of its gross receipts for the first half of its base period. The use of the alternative gross receipts test is justified by the fact that a corporation may increase its physical volume of production materially by introducing additional equipment and new operating procedures which do not involve a corresponding increase in its labor force. The percentages used in the payroll and gross receipts tests are sufficiently large so that only those taxpayers will be able to qualify whose business has grown substantially more rapidly than the average during the base period years.

The World War II law contained a much more general adjustment for growth in the base period. The so-called growth formula used under that law permitted the taxpayer to use as an alternative credit computed by adding to the average income of the last half of the base period 50 percent of the difference between the average income for the first and second halves of the base period, subject to the limitation that the alternative credit could not exceed the net

income of the highest taxable year in the base period. While this formula may have been useful as a device for providing relief for corporations experiencing unusually rapid growth under the conditions which existed from 1936 through 1939, the application of the formula in the years 1946 through 1949 would benefit many taxpayers whose growth was no more than average and would result in the widespread use of the year 1948 as the sole basis for the calculation of the base-period income credit. The alternative bases provided in this bill will bring relief only to corporations which can qualify under tests which indicate clearly that the corporation was growing substantially more rapidly than business in general.

12. Carry-overs of net operating losses and unused excess profits credits

The bill permits the use of the net operating loss carry-back and carry-forward in calculating the net income of an excess profits tax year. With the exceptions discussed below the same rule is used as under the corporate normal tax and surtax, that is, the carry-back is limited to 1 year and amounts not so absorbed are carried forward until exhausted over a period of not more than 5 years. This compares with a carry-back of 2 years and a carry-forward of 2 years used under the World War II law after 1942. Thus the averaging period under the bill will be 7 years as compared with 5 years under the previous law. The change will reduce materially the discrimination that might arise against corporations experiencing unusual fluctuations in income during the excess profits tax period and cuts down the need for the reallocation of income between individual excess profits tax years.

Generally, a net operating loss in the base period can be carried forward to the excess profits tax period under the formula described above. This follows the provision in the House bill. However, it was pointed out at your committee's hearings that in some cases taxpayers incurring substantial operating losses in the early years of the base period have not been able to offset such losses against the earnings of prior years. They would thus be unable to carry them forward into the excess profits tax period because the change from a 2-year carry-forward to a 5-year carry-forward was not made until 1950. Therefore, the committee's bill provides, at the election of any taxpayer using the base period credit, for the carry-forward to the years 1950 and 1951 of losses during the base period which have not otherwise been offset against the income of later years.

The net operating loss carry-over or carry-back is not used for computing the excess profits tax net income of the taxpayer in its base period years. Since all taxpayers are permitted to select the best 3 out of a possible 4 years in their base period, and since a number of taxpayers are permitted to base their credit on the experience of one or two of their base period years, the application of the loss carry-over would be undesirable because it would reduce the income of the years which have been selected as an appropriate test of the taxpayer's normal earning power by adjustment for losses in the other years, including years outside the base period itself.

Like the World War II law this bill provides for a carry-back and carry-forward of an unused excess profits credit. The carry-back is for 1 year and the carry-forward for 5, thus producing the same 7-year averaging period used under the net operating loss carry-over for

both income and excess profits tax purposes. The unused excess profits tax credit adjustment under the World War II law was limited to a carry-back of 2 years and a carry-forward of 2 years, thus producing an averaging period of 5 years which conformed to the net operating loss carry-over provisions of that law.

For a taxable year beginning before July 1, 1950, and ending after June 30, 1950, the unused excess profits credit is the same percentage of such credit, computed as if all of such year were subject to the excess profits tax, which the number of days in the taxable year after June 30, 1950, bears to the total number of days in the year.

The bill provides that any unused portion of the \$25,000 minimum credit shall not be counted for purposes of the unused excess-profits carry-over.

An unused excess-profits credit cannot be carried back from a period after a corporation has distributed substantially all of its assets.

IV. OTHER IMPORTANT PROVISIONS

1. *Minimum credit for certain regulated industries*

Your committee's bill provides a minimum excess profits tax credit which is available for taxpayers in certain specified types of regulated industries. This credit is an alternative to the average earnings credit and the invested capital credit for such taxpayers.

In general, this minimum credit consists of 6 percent or 7 percent of the sum of the equity capital, retained earnings, borrowed capital, the corporate normal tax and surtax payable by the corporation for the taxable year in question, less interest payable on the borrowed capital. Equity capital and retained earnings of the regulated industries availing themselves of this alternative credit are reduced by the so-called inadmissible assets (discussed elsewhere in this report). However, the normal tax and surtax under your committee's bill are not reduced by inadmissible assets.

The 6-percent rate of return is available to regulated industries supplying the following types of services or products:

- (a) electric energy,
- (b) gas,
- (c) water,
- (d) transportation on an intrastate, suburban, municipal, or interurban electric railroad, trolley system, or bus system, or
- (e) transportation by trucks or busses,

where the rates charged by such corporations are subject to regulation by a governmental body.

The 6-percent rate of return is also available to a regulated industry supplying the following types of services or products:

- (a) transportation of oil or other petroleum products or gas by pipeline if the corporation is subject to the jurisdiction of the Interstate Commerce Commission or the Federal Power Commission, and
- (b) railroads regulated by the Interstate Commerce Commission.

(c) transportation by water subject to the jurisdiction of the Interstate Commerce Commission or the Federal Maritime Board under the Intercoastal Shipping Act of 1933.

The 7-percent rate of return is available to regulated industries supplying the following types of services or products:

(a) telephone and telegraph services where the rates charged are subject to regulation by a governmental body, or

(b) air transportation subject to the jurisdiction of the Civil Aeronautics Board.

In the case of interstate trucking, busses and railroads, and in the case of air transportation the equity capital and retained earnings on which the rate of return is computed under this alternative credit is the same as that of an ordinary corporation determining the value of its assets under the "asset approach." In the case of all other regulated industries receiving the benefits of this provision where the corporate books of account are maintained in accordance with systems prescribed by a regulatory body or maintained in accordance with the uniform systems prescribed by the Federal Power Commission or the National Association of Railway and Utilities Commissioners, the equity capital and retained earnings are the sum of the average outstanding common and preferred capital stock accounts and the capital surplus and earned surplus accounts as shown on the corporation's books.

The use of this alternative credit, in addition to being limited to corporations supplying the types of services or products described above, is limited to corporations deriving 80 percent or more of their gross income from regulated sources. Where a public utility supplies services or products in one or more "interconnected and coordinated" systems and where the regulation to which the corporation is subject in part of its operating territory in effect controls rates in the unregulated territory, and these rates are as favorable to the users in the unregulated territories as the rates in the regulated territory, the whole "interconnected and coordinated" system or systems are considered to be regulated.

Since only some of the members of an affiliated group eligible to file a consolidated return may be regulated industries to which the special alternative credit is available, your committee found it necessary to specify in the bill how consolidated returns should be handled in such cases. In the case described above the regulated industries which are eligible for the minimum credit may be split-off and one consolidated return may be filed for one of the groups. If, however, all the members of the affiliated group in such a case file a single consolidated return, none of the regulated industries involved may claim the special minimum credit.

Although maintaining the basic structure of the alternative credit provided in the House bill for regulated industries, your committee has revised the House provision considerably as the result of testimony on this provision of witnesses appearing in the committee hearings. Probably the most important change is that raising the rate of return allowed airlines from 5 percent to 7 percent, that allowed telephone and telegraph services from 6 percent to 7 percent, and that allowed railroads from 5 percent to 6 percent. Your committee believes that this revision of rates is more nearly in line with the rates provided by the respective regulating agencies than the rates provided by the House bill. Another major change from the House bill is that providing that most of the utilities may compute their equity capital and retained

earnings in the manner provided by their regulating bodies rather than by the means provided for ordinary corporations using the invested capital base. Your committee believes that it is desirable to allow corporations to compute their rate of return in this manner since this is a basis on which their rate of return is computed for regulatory purposes by other governmental bodies and also because these corporations are more familiar with this type of computation.

Your committee also found that in some States regulation of utilities is delegated to local authorities with the result that some utilities are regulated in urban but not rural areas. Nevertheless, in these cases the rates charged in the regulated areas generally determine the rates in the unregulated areas. This accounts for the fact that your committee has changed the House bill to provide that utilities of this type are to be considered regulated utilities for the purposes of this alternative credit. In other cases utilities carry on one or more of the regulated services described previously but also carry on some subsidiary activity which is not subject to regulation. For example, an electric utility may well carry on a small coal-mining operation along with the supplying of electrical energy. It was to provide for such cases that your committee changed the House bill to grant the minimum credit to industries where the regulated services represent 80 percent or more of the total gross receipts of such a company.

The effect of this minimum credit is to give assurance that an excess profits tax will not be imposed on the specified regulated industries until after they earn a rate of return of 6 percent or 7 percent after paying corporate normal taxes and surtaxes (including the 2 percent additional tax for consolidated returns). Your committee believes that this is appropriate in view of the fact that the profits of these industries in the base period years were held down well below the profits earned by unregulated industries. Moreover, there is considerable evidence that rate adjustments for these industries lagged considerably behind increases in their costs of doing business. Your committee also believes that where industries are regulated by governmental bodies providing only a fair rate of return it is undesirable to consider profits allowed by such regulatory bodies as excessive for purposes of an excess profits tax, especially where the corporations are held to a relatively low rate of return. However, it should be clear that in establishing the rates of return provided by this minimum credit your committee is not in any way attempting to set a rate of return which would be proper for regulative purposes but only is concerned with the problem of establishing uniformity for purposes of determining income which should be subjected to excess profits tax.

2. Exemption of strategic minerals from the excess profits tax

An exemption is provided under your committee's bill for domestic corporations mining "strategic" minerals with respect to the income attributable to such mining in the United States.

"Strategic" minerals as used in this provision include antimony, chromite, manganese, nickel, platinum (including the platinum group metals), quicksilver, sheet mica, tantalum, tin, tungsten, vanadium, fluorspar, flake graphite, vermiculite, long-fiber asbestos in the form of amosite, chrysolite or crocidolite, beryl, cobalt, columbite, corundum, diamonds, kyanite (if equivalent in grade to Indian kyanite), molybdenum, monazite, quartz crystals, and uranium. In addition "stra-

tegic" minerals include any other minerals which the agency created to carry out the duties under section 303 (a) of the Defense Production Act of 1950 certifies as being essential to the defense effort of the United States and as not being normally produced in appreciable quantities in the United States.

This provision is the same as that in the House bill except that molybdenum has been added to the list of exempt minerals by your committee because of its strategic importance to defense production.

The World War II statute provided for the exemption of antimony, chromite, manganese, nickel, platinum, quicksilver, sheet mica, tantalum, tin, tungsten, fluorspar, flake graphite, vermiculite, and vanadium. The additional minerals exempted by the House bill were included after consultation with the National Security Resources Board.

The House bill also provided for the exemption of certain "critical" minerals. "Critical" minerals under the House bill were described as minerals which the agency administering the Defense Production Act of 1950 certifies as essential to the defense effort and which are mined from—

(1) Mineral properties developed and brought into production after June 25, 1950, or

(2) Mineral properties not in production on June 25 but in production prior to that date, or

(3) Mineral properties from which during the period 1946 to 1949 the income was less than the deductions.

Your committee's bill includes no provision for the exemption of any critical minerals, because it is believed that marginal producers of critical minerals, with which the House bill was primarily concerned, can better be provided an incentive to produce by provision for subsidies or bonus payments. Moreover, the provision described below dealing with the exemption of a portion of the income from the so-called excess output of mining properties will provide substantial relief for these critical minerals.

3. Exempt income from certain mining and timber operations and from natural gas properties

Your committee's bill, like the House bill, continues the relief which was provided by section 735 of the World War II statute with respect to certain mining, timber, and natural gas properties. The relief under this provision is provided by exempting from excess profits tax a certain portion of the current income from these properties. Generally this portion is determined by multiplying the normal unit profit during the normal period 1946 to June 30, 1950 (1936 to 1939 in the case of the World War II statute) by a specified proportion of current production in excess of normal output during the base period. In the case of coal and iron mines, timber properties, and natural gas properties, the exempt portion is determined by multiplying current excess production by one-half of the current net income per unit.

The World War II statute also contained a provision providing partial exemption for coal and iron mines and timber properties not in operation during the base period. One-sixth of the net income in the current taxable year of these properties was exempt from excess profits tax. The House bill continued this provision without change. Your committee's bill makes several changes in this provi-

sion. The exemption from excess-profits tax for properties coming under the provision is increased from one-sixth to one-third of the net income from such property in order to provide a greater incentive for the opening up of new properties. Natural gas and metal mining properties not in operation during the normal period (the taxable years included in the period January 1, 1946, to June 30, 1950) also are given the benefits of this provision in order to place them in a similar tax position with competitive properties in operation during the base period. Metal mining properties in operation in the normal period but having an aggregate loss for this period are also given the relief provided by this provision.

The House bill contained a provision which duplicated section 735 (c) of the World War II law. The effect was to exempt from the excess profits tax certain bonus payments made by agencies of the United States Government for the production of minerals and timber in excess of a specified quota or for the recovery of mineral products from mine tailings in certain specified cases. The language used in the House bill obviously reflects the system of incentive payments used during World War II. Since the methods of stimulating the extractive industries during the current emergency have not yet been spelled out, the committee's bill substitutes a provision which is couched in much more general language. The provision referred to is section 433 (a) (1) (P), which exempts amounts paid to the taxpayer by the United States or any of its agencies for the encouragement of exploration, development, or the mining of critical and strategical minerals or metals. This exemption is applicable whether the payment is made by grant or loan and whether or not it is repayable.

4. Foreign corporations and income from abroad

(a) *Resident and nonresident foreign corporations.*—For income-tax purposes foreign corporations are divided into two groups: Resident and nonresident foreign corporations. Nonresident foreign corporations are subject to income tax only on certain income derived from sources within the United States. This income is taxed at a uniform rate of 30 percent without deductions. Resident foreign corporations are subject to income taxes upon all income derived from sources within the United States at the rates applicable to domestic corporations.

The 30-percent gross income tax on nonresident foreign corporations is imposed rather than the ordinary corporate income tax since the jurisdiction of the United States over such corporations is limited to the sources of their income which are within the United States. The lack of jurisdiction over the corporation itself not only precludes the imposition of a tax upon the net income of nonresident foreign corporations but also the imposition of an excess profits tax. Therefore, your committee's bill, like the House bill, follows the precedent of the World War II statute and specifically exempts such corporations.

Resident foreign corporations are subject to the excess profits tax under your committee's bill and the House bill as under the World War II statute. If such corporations were nonresident foreign corporations during any of the base period years, only the invested capital credit is available to them. This was also the case under the World War II statute.

(b) *Corporations deriving most of their income from United States possessions.*—Although section 251 corporations—that is, corporations deriving a large portion of their income from sources within the possessions of the United States—are domestic corporations, they, like resident foreign corporations, are subject to Federal taxation only upon income derived from sources within the United States. Therefore, your committee's bill like the House bill follows the precedent of the World War II statute and gives these corporations the same excess profits tax treatment as resident foreign corporations.

(c) *Western Hemisphere trade and similar corporations.*—The World War II statute provided an exemption for a domestic corporation where 95 percent or more of its income over the last 3 years was derived from sources outside the United States, and where 50 percent or more of its gross income was derived from the active conduct of a trade or business. Although not limited to Western Hemisphere trade corporations, any such corporation, not filing a consolidated return with another domestic corporation, was effectively exempted from excess profits tax under this provision. Your committee's bill like the House bill continues this exemption. This is consistent with the preferential treatment conferred on Western Hemisphere trade corporations under income tax law.

Your committee's bill has also amended the provision relating to the filing of consolidated returns to provide groups of affiliated corporations with the opportunity to make a new decision as to whether or not they desire to file a consolidated return with respect to taxable years ending after June 30, 1950. While this provision is not limited to affiliated groups including a Western Hemisphere trade corporation, its primary effect will be to give such groups an opportunity to file a separate return for their Western Hemisphere trade corporation, and thus receive an exemption from the excess profits tax with respect to the income of such a corporation.

(d) *Dividends received from foreign corporations.*—Under World War II law, dividends received from foreign corporations by domestic corporations were included in the excess profits tax net income of average-earnings taxpayers both for the base and tax period. On the other hand, they were not included in the excess profits net income of invested capital taxpayers in the tax period but the stock in the foreign corporation was excluded from invested capital. The inclusion of dividends from foreign corporations in the excess profits tax net income of the average earnings taxpayer tends to discourage the return of this income to the United States, even though business purposes might dictate such a transfer. Your committee believes that both the average earnings credit taxpayer and the invested capital taxpayer should be treated the same. Accordingly foreign dividends are excluded from excess profits net income in the tax period in both cases. In addition, such dividends are excluded from the base period income of the average earnings taxpayer, and the foreign stock is excluded from invested capital in the case of the taxpayer computing his tax in this manner.

(e) *Foreign tax credit.*—Under your committee's bill, as under the World War II statute, domestic corporations operating branches abroad are subject to excess profits tax on the income derived from such branches in the year in which it is earned. However, any taxes

paid a foreign country with respect to such foreign operations which is in excess of the tax credit allowed by the United States for purposes of the normal tax and surtax is allowed as a credit against excess profits tax subject to certain limitations. The tax treatment accorded branches is the same as that provided by the House bill and the World War II statute.

(f) *Blocked income.*—Taxpayers deriving income from sources within a foreign country are permitted under the bill to exclude such portion of the income as would, but for monetary, exchange, or other restrictions imposed by the foreign country, have been includible in the gross income of the taxpayer prior to its first excess profits tax year. Because of the practice of foreign nations in past years to impose restrictions on the conversion of foreign earnings into dollars, income properly attributable to the base period years would be included in net income for excess profits tax purposes in the event that such income becomes convertible into dollars. Your committee believes that it would be unfair to subject such past profits to excess profits tax.

The Secretary is directed to prescribe rules for a reasonable allocation of the blocked income which arose prior to the end of the base period in cases where specific identification cannot be made.

A special rule is provided for the reallocation of income which arose during the first excess profits tax year but became “unblocked” in later years. Such an adjustment is necessary because of a difference in the amount of tax imposed.

Deductions properly allocable to income which is excluded under this provision are not allowed.

The “blocked income” provision was added to the bill by a floor amendment in the House. With the exception of the clarifying amendment permitting the Secretary to establish rules for the allocation of income in doubtful cases, the provision in the committee bill conforms with the floor amendment.

5. Optional exemption for certain air mail subsidies in the case of airlines

Airlines, under your committee’s bill, may exclude airmail subsidies paid by the Federal Government if the airlines have no adjusted excess profits tax net income when these airmail subsidies are not taken into consideration. It has been pointed out that a 7-percent rate of return on total assets, which is the rate provided for airlines under the minimum credit for regulated industries, is substantially below the rate of return allowed by the Civil Aeronautics Board in the case of overseas airlines. The exclusion of air-mail subsidies as described above was a part of the World War II statute. Therefore, your committee has restored this World War II provision. The House bill contains no such provision.

6. Personal service corporations

The World War II law provided that personal-service corporations could elect to be exempted from the excess profits tax if the stockholders of such corporations agreed to take up as part of their income for individual-income-tax purposes the pro rata share of the undistributed profits of the personal-service corporations. This did not, however, exempt a personal-service corporation from the corporate

normal tax or surtax. A personal-service corporation was defined as a corporation whose income was to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and who are the owners of at least 70 percent of the stock of the corporation. Your committee's bill, like the House bill, retains this provision of the World War II statute unchanged.

7. Merchant Marine Act

(a) *Corporations completing contracts under this act.*—Under section 505 of the Merchant Marine Act, 1936, as amended, if any contracting party in its taxable year completes one or more contracts or subcontracts for the construction of a vessel under this act, it is required to pay to the Maritime Board any profit in excess of 10 percent of the total contract prices of the contracts and subcontracts. These profits paid to the Maritime Board, together with all other receipts of the Board, are placed in a revolving construction fund and are available for further ship construction.

As a general rule under your committee's bill the amount received by the contracting party and recaptured by the Maritime Board will be excluded in computing the excess profits tax. An alternative computation requires the taxpayers to increase their excess profits net income and normal tax net income by the amount of the payments to the Maritime Board. The tax computed upon this basis is then reduced by the amount of such payments, and the remainder constitutes the tax which is to be paid, if it is less than the tax computed under the first method. This tax treatment is the same as that accorded by the House bill and the World War II statute.

(b) *Tax treatment of shippers' funds authorized under the act.*—Under titles V and VII of the Merchant Marine Act, certain statutory reserve and construction funds are authorized wherein shippers are required or permitted to make deposits of vessel earnings and certain gains from the requisitioning, sinking, or other disposition of vessels. These deposits are intended to provide for the replacement of American merchant vessels and to insure performance of certain contractual obligations under agreements with the Maritime Administration and other agencies of the Government. Under the House bill, these funds are not included in the shippers' invested capital credits or their average earnings bases. Since these funds belong to the shippers, your committee believes that it is inequitable to exclude them in the computation of their excess profits credits. Therefore, your committee's bill has amended the House bill to provide that deposits of this type (other than capital gains) made during the base period shall be included in the taxpayer's income to the extent that they exceed the deposits by each such taxpayer in the current taxable year. In the case of the invested capital credit, your committee's bill provides that all of these deposits made by any taxpayer prior to its current taxable year shall be included in computing its invested capital credit in the same manner as retained earnings of the ordinary corporation using the invested capital credit. However, the invested capital credit with respect to such additions is to be reduced to the extent that the additional credit is offset by additional deposits during the current taxable year.

8. Special provisions relating to the excess profits tax credit for railroad corporations

The House bill provides that where substantially all of the properties of one railroad have been leased to another railroad prior to July 1, 1950, under a lease for more than 20 years, which requires the lessee railroad to pay the Federal income taxes of the lessor railroad, the excess profits tax credit may be "equitably apportioned" between the corporations pursuant to an agreement between the corporations which is approved by the Secretary of the Treasury. Your committee's bill has retained this provision but amended it to provide the same treatment for leases where the leases are automatically renewed and where the whole term, including the renewal period, exceeds 20 years. Where such leases have been first entered into prior to December 31, 1950 (changed from July 1, 1950, in the House bill), they are to be considered as having been entered into prior to such date even though renewed after such date. Your committee's bill also makes the benefits of this provision available where more than one lessee is involved.

Your committee has added another provision to the bill providing that the invested capital credit of a railroad (formerly a lessor) shall include the fair value of betterments and additions made by a lessee railroad to property of the lessor railroad if the lease has been canceled.

9. Recomputation of the earnings credit in the case of corporate reorganizations

In the case of certain corporate reorganizations during the base period or subsequent to the base period, the experience of the corporation prior to the reorganization may be aggregated for purposes of determining excess profits credits based on earnings. This is provided for in part II of the excess profits tax subchapter. In general the reorganizations dealt with in part II are the type with respect to which gain or loss is not recognized. In addition to the general type of case where substantially all the assets of one corporation are taken over by another corporation, part II provides rules for the recomputation of base period net income in the case where substantially all the assets of a partnership or a sole proprietorship are acquired by a corporation and in cases where only part of the assets of the partnership are placed in a corporation or where only part of the assets of the corporation are split off into a new corporation.

Your committee's amendment of part II makes it clear that part II also covers those corporate reorganizations under section 112 (g) (1) (D) which are commonly known as split-ups, where the assets of a corporation are split up among two or more new corporations followed by the liquidation of the corporation originally transferring the assets. The inclusion by your committee in the definition of this type of transaction in section 461 (a) of a reference to section 112 (b) (4) is sufficiently broad to cover this type of a case, as well as the case where the transferring corporation, following a transfer in a reorganization of only a part of its properties in exchange for the stock of the acquiring corporation, retains that stock as its own. Your committee's amendment also changes the above definition so as to exclude transfers of assets by a corporation which is exempt from income tax under section 101 of the code.

The House bill provided that a corporation did not meet the definition of an acquiring corporation within the meaning of part II even though it acquired substantially all the properties of another corporation and the sole consideration for the transfer was voting stock in the corporation which acquired the properties unless the corporation transferring the assets was forthwith completely liquidated in pursuance of the plan under which the acquisition was made. Your committee's amendment of part II drops the requirements that the corporation transferring the properties be forthwith liquidated.

In general, if all the properties of the corporation are taken over by another corporation in an exchange to which part II is applicable, the old corporation is no longer entitled to use its business experience prior to the exchange for purposes of computing average base period net income. Instead, the corporation which acquires the properties may use the experience of the corporation which gave them up if this will result in a lower tax for the acquiring corporation. In a case where only part of the assets of a corporation go over to a new corporation in an exchange in which gain or loss is not recognized, the old corporation loses that portion of its base period experience which is allocable to the assets it loses in the exchange, and the acquiring corporation may utilize such experience in computing its average base period net income.

Where a corporation computes its excess profits tax credit simply on the basis of its excess profits net income during the base period, the effect on part II is to provide that, after the corporation acquires assets in an exchange described in part II, it shall recompute its excess profits net income for each month of the base period prior to the exchange by combining its own earnings experience during those months with the earnings experience of the corporation whose assets it acquired. If the corporation whose assets were acquired was not in existence during a month in the base period in which the acquiring corporation was in existence, then the recomputation described above is made by combining the earnings of the acquiring corporation with 1 percent of the equity capital of the corporation whose assets were acquired (after adjustment for inadmissible assets).

In addition to providing rules for the recomputation of excess profits net income for purposes of the earnings credit, part II also provides for the recomputation of excess profits net income and the attribution of payroll, gross receipts, and total assets in the case of the alternative earnings credit based on growth. It provides rules for the recomputation of excess profits net income and rules for the determination of average base period net income in the case of part II transactions involving corporations with base period abnormalities. It also provides rules for the computation of average base period net income in the case of part II transactions involving corporations which have had changes in the products or services furnished during the base period, corporations which have had increases in capacity for production or operation during the base period, new corporations, and corporations which were members of depressed industries during the base period. Your committee's amendment has added the provisions dealing with base period abnormalities, changes in products or services, increases in capacity, and depressed industries, and it has also revised the treatment in the House bill with respect to the growth

alternative and with respect to new corporations. In one particular, the treatment of acquiring corporations in part II transactions with respect to the growth alternative has been revised so as to make it clear that a corporation which is created incident to a part II transaction is not denied the growth alternative by reason of being a new corporation.

In the case of the type of exchange described in part II in which the assets of one corporation are split among two corporations the base period earnings experience of the one corporation prior to the exchange is allocated among the corporations in business after the exchange in proportion to the fair market value of the assets of the old corporation which are held by each of the corporations after the exchange. The House bill permitted allocation of the earnings experience in different proportion if all the parties to the reorganization agreed to the different allocation and the Secretary consented to it. Your committee's amendment of part II clarifies the allocation provisions by permitting the determination of the fair market value of the properties involved and the determination of the division of such value among the parties by agreement between the parties to the transaction with the Secretary's consent and by permitting, in lieu of an allocation based on fair market value, an allocation based on the earnings experience of the assets transferred where the parties to the transaction agree to the allocation and it is established to the satisfaction of the Secretary that the allocation fairly represents an identifiable earnings experience of each group of assets transferred or retained. Your committee's amendment retains the provision of the House bill that the allocation as among the component corporation and any acquiring corporations shall not exceed 100 percent of the excess profits net income (or average base period net income) of the corporation whose assets are transferred, but your committee's amendment provides an exception to this rule in the case where part of the assets of a partnership were transferred to a component corporation or corporations in a part II exchange which occurred before December 1, 1950. In such a case the earnings experience of the assets transferred may be used in the determination of excess profits net income by the acquiring corporation even though this earnings experience may represent an amount in excess of the net income of the partnership while it held the assets, if it is established to the satisfaction of the Secretary that such an allocation represents an identifiable earnings experience of such transferred assets.

In order to prevent double counting of base period earnings experience in applying the recomputation rules provided by part II, the Secretary is authorized to issue regulations providing for reduction of the average base period net income of the taxpayer and adjustments of transferred capital additions and reductions to the extent necessary in cases where, in general, the taxpayer acquired stock in a component corporation for other than its own stock. This provision is carried over from the World War II law and serves to prevent a taxpayer using assets which have had a base period earnings experience in its hands from purchasing stock of a corporation holding other assets which have similarly had a base period earnings experience and subsequently acquiring that latter experience by reason of a part II transaction. The situations where the possibility of double counting

may arise are complex. Certain cases have been brought to the attention of your committee where, despite the complexity of the facts, it would appear that double counting was not involved. In view of the difficulty of this question, however, the matter can only be determined in accordance with regulations.

Your committee's amendment extends the principle of carrying over to an acquiring corporation the experience of a component corporation during the base period by providing that, in the case of part II transactions before December 1, 1950, abnormal income received in the tax period which is attributable to a year of the component corporation during or prior to the base period shall be treated in the same manner as though the business of the component during such period had been the business of the acquiring corporation.

Adjustment is provided for both net capital additions during the last 2 years of the base period and net capital additions and reductions after the close of the base period in the case of parties to an exchange described in part II. Your committee's amendment revises the provisions of the House bill dealing with net capital additions and net capital reductions in the case of part II transactions so as to conform them with the other amendments of your committee dealing with the treatment of capital additions and reductions of taxpayers using the earnings credit. The amendment also revises the treatment of the base period capital conditions in the case of part II transactions so as to provide more specific rules and so as to conform with the amendments dealing with the treatment of base period capital additions of earnings credit taxpayers in general.

10. Basis for computation of the invested-capital credit after inter-corporate liquidations

Part III of the excess profits tax subchapter provides rules for the determination of the invested capital in the case of certain exchanges and liquidations. These rules correspond to those provided by supplement C of the World War II law.

(No section-by-section analysis of the bill is presented.)

APPENDIX A

Major groups, standard industrial classification

<i>Industry group</i>	<i>Major group number</i>
Agriculture, forestry, and fisheries:	
Farms and agricultural services, hunting, trapping.....	01 and 07
Forestry.....	08
Fisheries.....	09
Mining:	
Metal mining.....	10
Anthracite mining.....	11
Bituminous coal and lignite mining.....	12
Crude petroleum and natural gas extraction.....	13
Nonmetallic minerals except fuels.....	14
Contract construction:	
General contractors.....	15 and 16
Special trade contractors.....	17
Manufacturing:	
Ordnance and accessories.....	19
Food and kindred products.....	20
Tobacco manufactures.....	21
Textile mill products.....	22
Apparel and other finished products made from fabrics.....	23
Lumber and wood products.....	24
Furniture and fixtures.....	25
Paper and allied products.....	26
Printing, publishing, and allied industries.....	27
Chemicals and allied products.....	28
Products of petroleum and coal.....	29
Rubber products.....	30
Leather and leather products.....	31
Stone, clay, and glass products.....	32
Primary metal industries and fabricated metal products (except ordnance, machinery, and transportation equipment).....	33 and 34
Machinery (except electrical).....	35
Electrical machinery, equipment, and supplies.....	36
Transportation equipment.....	37
Miscellaneous manufacturing industries including professional, scientific, and controlling instruments; photographic and optical goods; watches and clocks.....	38 and 39
Transportation, communications, and other public utilities:	
Railroads.....	40
Local and interurban railways and bus lines.....	41
Trucking and warehousing.....	42
Highway transportation not elsewhere classified.....	43
Water transportation.....	44
Transportation by air.....	45
Pipeline transportation.....	46
Services incidental to transportation.....	47
Telecommunications.....	48
Utilities and sanitary services.....	49
Wholesale trade.....	50 and 51
Retail trade:	
Building materials and farm equipment.....	52
General merchandise.....	53
Food.....	54
Automotive dealers and gasoline service stations.....	55
Apparel and accessories.....	56
Furniture, home furnishings, and equipment.....	57
Eating and drinking places.....	58
Miscellaneous retail stores.....	59

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Major groups, standard industrial classification

<i>Industry group</i>	<i>Major group number</i>
Finance, insurance, and real estate:	
Banking -----	60
Credit agencies other than banks -----	61
Security and commodity brokers, dealers, exchanges, and services -----	62
Insurance carriers -----	63
Insurance agents, brokers, and service -----	64
Real estate -----	65
Holding and other investment companies -----	67
Services:	
Hotels, rooming houses, camps, and other lodging places -----	70
Personal services -----	72
Miscellaneous business services -----	73
Automobile repair services and garages -----	75
Miscellaneous repair services -----	76
Radio broadcasting, including facsimile broadcasting, and television --	77
Motion pictures -----	78
Amusement and recreation services except motion pictures -----	79
Other services -----	80, 81, 82, 84, 86, 89

