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WAR REVENUE ACT

JUNE 10, 1936.—Ordered to be printed with an illustration

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

REPORT

[To accompany H. R. 5529]

The Committee on Finance, to whom was referred the bill (H. R. 5529) to prevent profiteering in time of war and to equalize the burdens of war and thus provide for the national defense and promote peace, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The committee struck out title I of the bill and inserted a new title I. Such new title I and the reasons for its adoption are explained fully in the report of the subcommittee and such report is hereby incorporated in and made a part of this report.

[Subcommittee report]

The Subcommittee of the Senate Committee on Finance, to whom was referred the provisions of title I of H. R. 5529, known as the Emergency War Time Tax Act, having had this phase of the bill under consideration, report it back to the Senate Committee on Finance with recommendation that in lieu of title I as prepared and submitted by the Senate Munitions Committee, a substitute title I, drafted by the subcommittee, and accompanying this report, be considered by the Senate Finance Committee. It is recommended that the proposed substitute for title I be incorporated in the bill.

The subcommittee held hearings, participated in by sponsors of the bill, by representatives of the Treasury Department, and by the staff of the Joint Committee on Internal Revenue Taxation. A series of pertinent tax studies were undertaken, the substance of which was presented to the subcommittee. Ample factual data were developed and considered dealing with the main features of the bill and it is concluded that the substitute title I, prepared by this subcommittee, will carry out the objectives of a war revenue act as urged by the Special Senate Committee on Investigation of the Munitions Industry, and in addition, will afford a workable and practical tax system.

Title I of H. R. 5529 as submitted to this subcommittee constitutes a fiscal and economic measure of wide scope and importance. The objectives thereof, as stated by its sponsors and as reflected in testimony given before the Senate Munitions Committee, are primarily two, viz:

1. To take the profits out of war.
2. To provide means for paying for the war out of current taxes rather than through borrowings.

It consists of a comprehensive revenue act imposing drastic income and war-profits taxes and, in point of construction, comprises a superstructure built upon the framework of the 1934 Revenue Act.

Major Features of Title I, H. R. 5529, Emergency Wartime Tax Act

Section 11 increases the normal tax on individuals from 4 to 6 percent.

Section 25 decreases the present exemption for a single man from $1,000 to $500, and for a married man from $2,500 to $1,000. A credit of $100 for each dependent as against $400 in the existing law is proposed. The bill also eliminates the hitherto allowable 10 percent earned income credit. Under section 51 the filing of a joint return by husband and wife is made compulsory; also the respective husband or wife is made jointly liable for the full amount of tax due on the return but in an amount not to exceed the income reported by such spouse.

Section 12 (b) sets forth new drastic surtax rates beginning with 10 percent applicable to surtax net income between $3,000 and $5,000, and reaching to a surtax of 93 percent, applicable against surtax net income in excess of $20,000. The net effect of the proposed rates in the case of a married man is to limit the retention of income to $9,920 on a net income of $21,000, and to take in normal and surtaxes 99 percent of any excess.

Section 13 (a) imposes a graduated income tax on corporations as follows: 15 percent on net incomes not in excess of 2 percent of adjusted declared value; 25 percent on net incomes not in excess of 6 percent of adjusted declared value; and 100 percent on net incomes in excess of 6 percent of adjusted declared value.

This graduated scheme of excess profits tax levy will allow corporations to retain net income only to the extent of 4.7 percent of their adjusted declared value. In addition to these taxes, in the case of corporations, other than personal holding companies, adjudicated to have accumulated surplus improperly, section 102 (a) imposes a tax of 98 percent of the amount of the net income not in excess of $100,000, plus 100 percent of the remainder. These rates are in lieu of rates of 25 percent and 35 percent respectively, contained in the Revenue Act of 1934. In the case of personal holding companies, the rates have been changed from 20–30 percent to 98 percent of the amount of income not in excess of $100,000 and from 40–60 percent to 100 percent of the amount of income in excess of $100,000. In addition to the above corporate taxes, H. R. 5529 proposes also imposing a tax of 75 percent on so-called undistributed surplus determined by taxing that portion of the net income in excess of 2 percent of the adjusted declared value, after provision for taxes and dividends paid during

the year. By the provisions of section 141 (c), an additional tax of 2 percent is added to the rates imposed by section 13 (a), on railroad companies electing to file consolidated returns.

A penalty is imposed upon corporations equal to 10 percent of the amount by which the tax due for the fourth quarter exceeds one-fourth of the total amount of tax for the entire year unless the commissioner is satisfied that the excess is not due to retention of amounts properly apportionable to the first three-quarters of the taxable year (sec. 13 (i)). This feature is injected as a corollary to the provisions contained in section 52 covering the filing of quarterly returns by corporations, based on estimated figures for the first three-quarters and an actual determination of net income on an annual basis for the last quarter. The tax on corporations is predicated on a self-valuation of the corporate capital structure in lieu of invested capital as utilized in the War Revenue Acts of 1917 and 1918. The basic plan adopted is the mandatory use of the adjusted declared value as reported for 1934 for capital-stock tax purposes. The bill provides for reductions in valuations to be made by the commissioner only, but has no provision for upward revisions.

Under the provisions of section 22 (b) (3), gifts may have to be included in gross income.

Section 23. Deductions from gross income: Interest, repairs, promotional, public relation, and selling expenses are limited to a sum not larger than the average annual outlay for such purposes in the preceding 3-peacetime years. These are severe limitations and exclusions intended, as stated, to "iron out wrinkles in the present tax laws which are most conducive to tax evasion."

The right to a foreign tax credit which is provided for in section 131, Revenue Act of 1934, has been eliminated. Severe statutory restrictions have been placed in the bill with respect to allowances for depreciation and depletion. No provision, whatsoever, was made in title I for amortization allowances applicable against war facilities.

The proposed bill carries the same provisions, section 55, with respect to publicity of tax returns (pink slip) as were incorporated in the Revenue Act of 1934, though these were subsequently repealed (Public, No. 40, 74th Cong.).

Tax payments by corporations were made to fall due on the date upon which the return is due. In the case of individual taxpayers, provision was made for voluntary advance payments, and as an incentive for so doing the bill provides for interest, payable by the Government at the rate of 1 percent per month, with the limitation that in no event shall there be allowed interest in excess of $10,000 in any taxable year (sec. 56). Section 63 provides for the appointment by the Speaker of the House of Representatives of a general auditor, whose functions shall be to have access to all records in the Treasury Department or any other department or agency, relating to the tax imposed by this title and who shall have power to subpena witnesses, administer oaths, and, upon request by any Member of Congress, produce for the official use of such Member all details of any record relating to any tax imposed by this title.

Section 112, the reorganization section, has been revised so as to make taxable all gains from reorganizations and exchanges but to disallow all losses therefrom.

Section 115 has been rewritten so as to tax distributions out of earnings or profits or increase in value of property accrued before March 1, 1913. The provisions with respect to capital gains in the Revenue Act of 1934, section 117, have been eliminated with the result that the entire gains are recognized for tax purposes no matter how long the period the capital assets were held. Capital losses, however, are recognized only to the extent of $2,000.

The penalties for evasion have been made more severe (sec. 145). The maximum fine has been increased from $10,000 to $100,000. There is an added liability for three times the amount of tax to be paid in cases of evasion or failure to "withhold."

Finally, the proposed bill, section 381, includes a tax in the nature of an excise tax on the issuance of stock dividends. The section requires that corporations pay $100 for each share or fraction of a share which they may issue as a stock dividend.

It is believed that the above brief summary suffices to indicate the basic points of divergence between the existing revenue law and the proposed war bill, the most vital of which are:

(1) The imposition of drastically increased rates of tax.

(2) Development of a concept of statutory net income materially different from that determined under the Revenue Act of 1934 by virtue of limitations on and prohibitions against the taking of certain business deductions.

(3) A serious disturbance of the provisions of existing law dealing with the manner of making returns, methods of payments of tax, reorganizations, capital gains, penalties.

(4) The imposition of an excess-profits tax based on adjusted declared value in lieu of a flat income tax on corporations.

An exhaustive analysis of questions of tax policy inherent in the proposed bill will not be attempted, but rather, there is set forth herein the scope of some of the fundamental difficulties and frictions which might ensue if the bill were enacted into law. The subcommittee deems the objectives of the war revenue bill both meritorious and desirable. It appears vital, however, that the proposed bill itself be analyzed from the viewpoint of whether or not, as drafted, there may not result such undesired effects as the curbing of the profit motive, the hindrance of war production, and the disorganization of tax administration.

Effects of Drastic Taxation on Economic Activities

A tax law devised to yield revenue sufficient to run a war, should, in addition, be constructed so as not to hinder the production of war materials nor curb the incentive for continuous economic activity. More than on any other occasion, in a time of war the marginal producer is as necessary as the low-cost large-scale producer. His productive activities must therefore be fostered and maintained. Faced with a condition of war, when the requirements of government financing are practically limitless, the question is not at what rate of tax will the Treasury obtain the necessary war revenue, but at what rate of tax shall a war revenue bill stop in order to assure a steady government income to satisfy the requirements of a constantly replenishing war chest. However, a government should not too freely utilize the power of drastic taxation, for its efforts may produce an adverse effect. The raising of revenue by imposing so-called maxi-

mum rates may clash with the conduct of business for a profit, and thus tend to disturb war production disastrously.

To preserve initiative and the desire to risk capital, as well as to assure war productivity, require that profits be not too ruthlessly diverted by taxation from their reemployment in normal business channels. As stated in Senate Munitions Committee Report 944 (pt. 2, p. 11), uninterrupted output in most fields of industry is essential and is—

> far more important than eliminating profiteering or preventing a heavy debt being passed on to postwar administrations. Consequently, if the absolute rate of any wartime tax is so severe as to discourage investment required for reconditioning idle plants, converting plants from nonessential to essential production, building new facilities, financing larger purchases of raw materials, and increased pay rolls * * * it cannot be permitted.

It is a well-accepted economic theory that we function largely under the impetus of the profit motive. The extent to which other motives such as patriotism or an appeal to a sense of social justice, equality of contribution and sacrifice may induce business endeavors to remain industrially active is highly problematical. Whether under a stress of war men might be motivated by a high moral purpose to support their government and concede to a levy approximating all of the profits above a certain low minimum, is a conjecture which should not be tested at a time of war in view of the dire consequences of failure.

It has been said that the conducting of large businesses is a matter of trusteeship for the stockholders. In other words, the preservation of the investment in the business becomes a duty touched with legal and social considerations. There is involved more than the willingness of any individual to forego profits for patriotic reasons.

If wartime tax rates are so heavy as to be stigmatized as unjust, there may result an increase in the devising of methods of avoidance which will have the effect of decreasing the revenue to the Government. An income tax while predicated on the ability-to-pay theory must be constructed so as to afford taxpayers the possibility of conforming with the provisions of the statute and of paying the required taxes without undue sacrifice. In preparing a war revenue bill, we are therefore faced with the practical necessity of drafting a tax law which should not have undesired adverse effects on economic groups and classes of our people. Large business enterprises should not be discouraged; incentive on the part of individuals to continue work should not be curtailed.

A close analysis of the drastic rate structure proposed in title I of H. R. 5529 has brought up in the minds of the members of the subcommittee the question of whether in a time of war, the profit motive will not be unduly strained and constitute a halting factor in providing the necessary wherewithal to carry out the "pay-as-you-fight" policy, suggested by the Senate Munitions Committee.

In line with the objectives of taking the profits out of war, and paying for a war currently insofar as it may be accomplished without undue economic disturbances, this subcommittee has prepared and recommends for acceptance schedules of rates applicable to individuals and corporations to be substituted for the proposed rates contained in title I of H. R. 5529.

Closing of Loopholes for Tax Avoidance

The sponsors of the bill have incorporated therein many provisions which in their opinion aim to thwart efforts at tax avoidance; also provisions which tend to curb the taking of what was termed by them as excessive and unreasonable deductions from gross income. Restrictions are thus placed on what are ordinarily termed sound accounting deductions in arriving at statutory net income, which may result in severe tax rates being applied to an amount considerably greater than actual net income.

Beginning with the enactment of the 1918 Revenue Act, Congress has, from time to time, injected provisions into the income-tax law designed to distribute the tax burden justly. It is no doubt with the same purpose in view that Congress is at present engaged in the preparation of the Revenue Act of 1936, primarily intending to create a basic form of taxation applicable to corporations which will result in a greater equality of tax burden as between corporations and individuals. Many loopholes for tax avoidance have been blocked. At the present time there may exist certain unsatisfactory situations which require careful study and experimentation. The subcommittee does not think it expedient that in a wartime bill all of the conjectures which may arise with respect to avoidances should be summarily dealt with and revised provisions enacted so as to effectively eliminate all possibilities of avoidance. After more detailed study, a gradual injection into the tax structure of new provisions can be accomplished, tending ultimately to attain an ideal tax law. The wholesale redrafting of provisions when the rate structures are so drastic as to constitute a pressure on business, and when the need for revenue could be no greater, might result in undue disturbances which not only may lessen the revenue yield, but what is more important in wartimes, may halt the production of war materials.

Manifestly, the plugging of loopholes for tax avoidance is desirable, but what this subcommittee questions is the inopportunity of approach. At one of the hearings, held before the Senate Committee on Finance on April 2, 1936, at the request of the chairman of the subcommittee, when the question of injecting innovations in tax structure into a wartime revenue bill was under consideration, Mr. John T. Flynn, who was in charge of the committee which drafted title I of H. R. 5529, stated:

> We tried to tighten up the bill, but I think this committee may very well consider Mr. Parker's point, necessarily to leave these questions of depreciation and depletion and exhaustion and these salary and promotion charges out, and merely adopt the protective clauses of the bill of 1934 or 1935 if the committee chooses, and then as the years go by, 4 or 5 years—let us hope 10 or 20 years—before we are in war, as the Treasury Department perfects its tax provisions under the income-tax laws, let the bill get the benefit from time to time by amendment. (Hearings before Subcommittee of the Committee on Finance, 74th Cong., 2d sess., p. 53.)

In the substitute for title I, drafted by the subcommittee, certain provisions which in the opinion of the subcommittee constitute definite and direct problems resulting from war conditions, have been included. Such matters as amortization, allowances for losses in inventories, and adjustments for carry-over war contracts are provided for (see pp. 12 to 20, inclusive, for more detailed discussion).

Elimination of Suggested Administrative Changes

In addition to the many substantive changes resulting in revised manner for reporting income and the inclusion of items previously not treated as taxable there are contained under title I of H. R. 5529 several suggested changes in administrative provisions, the principal ones of which are:

1. Compulsory joint returns.
2. Filing of quarterly returns by corporations.
3. Advance tax payments by individuals.
4. The creation of the office of general auditor.
5. Severe penalties.

1. COMPULSORY JOINT RETURNS

Section 51 of the bill requires the income of husband and wife to be included in a single joint return, and the tax computed as though the income was the income of a single taxpayer. This provision is somewhat similar to a provision in the income-tax law of the State of Wisconsin which the Supreme Court of the United States held unconstitutional (*Hoeper* v. *Tax Commission*, 284 U. S. 206). Subsequent to this decision a subcommittee of the Ways and Means Committee of the House held special hearings on community-property income. (See Hearings before a subcommittee of the Committee on Ways and Means, 73d Cong., 2d sess. on H. R. 8396) with a view to amendment of the 1934 Revenue Act. In view of the doubtful constitutionality of this provision as expressed by testimony in these hearings, this subcommittee has eliminated the requirement for compulsory joint returns.

2. FILING OF QUARTERLY RETURNS BY CORPORATIONS

In the case of corporate taxpayers, quarterly returns are required under the bill based upon estimates for the first three quarters and actual results in the final quarter. The subcommittee recognizes the advantages to the Government resulting from an early collection of war revenue. However, several practical objections to this provision were pointed out by the experts.

In the first place, corporate taxpayers may be required to make income-tax payments for 2 taxable years in the first effective year of the War Revenue Act. This would impose such a drain upon the cash of corporations that war preparations may be greatly retarded. In the second place, it was pointed out that during the World War though the 1917 Revenue Act required payment of the entire tax at one time, Congress changed this policy in the 1918 act so as to permit four installments, principally because the Treasury Department was of the opinion that a single payment under the 1917 act placed too great a strain upon industry. Thirdly, in cases where industrial activity is seasonal, it is very difficult to estimate in advance with reasonable degree of accuracy the amount of income expected over the remainder of the year. Fourthly, in the case of small corporations, and to some extent large corporations, especially where large inventories are involved, it is not the practice to determine the result of

operations except at the end of the accounting period. Finally, from the viewpoint of administration, quarterly returns would impose substantial additional administrative burden upon the Treasury Department in the way of classifying, filing, and auditing of returns.

These objections in the opinion of the subcommittee outweigh the arguments advanced in support of quarterly returns, especially in view of the fact that experience of the Bureau over a period of years shows that a substantial proportion of the entire corporate tax under the existing law is paid upon filing of returns. In view of these objections, the subcommittee deems it advisable to continue the policy of existing law.

3. ADVANCE TAX PAYMENTS BY INDIVIDUALS

The bill provides for interest in the nature of discount allowed in the cases of voluntary advance payments by individuals, with a limitation that in no case should the interest allowed exceed $10,000 to any one person. It was pointed out to the subcommittee that while the 1917 act provided for voluntary advance payments somewhat similar to this provision, the Secretary of the Treasury recommended its elimination in the 1918 act because no substantial advance payments were made as a result of its being in force. In any event, a considerable amount of total tax due in excess of the first installment is paid upon the filing of returns. The subcommittee recommends elimination of this provision.

4. THE CREATION OF THE OFFICE OF GENERAL AUDITOR

The bill provides for a general auditor appointed by the Speaker of the House of Representatives, subject to approval by the Senate, with broad powers for investigation and examination of tax returns. In view of the fact that the Finance Committee of the Senate and the Ways and Means Committee of the House both have power to inquire into tax administration, and the further fact that the Joint Committee on Internal Revenue Taxation was created with special duties, some of which are here assigned to the general auditor, the subcommittee believes there is no need for the creation of a new, overlapping agency.

5. PENALTIES

The bill increases the maximum penalty for evasion from $10,000 in the present law to $100,000 and adds liability of three times the amount of the tax withheld or evaded. In the case of jeopardy assessments and extensions for filing returns, interest charges have also been doubled. While there may be some added incentive for evading tax in the period of war due to the fact that rates are higher than in peacetime, this factor alone does not seem sufficient ground for materially increasing the penalties of peacetime acts. Penalties and interest are amounts due in addition to the tax and constitute persuasive factors in inducing compliance with the law. The present provisions, in the view of the subcommittee, are adequate to reasonably assure compliance with the war tax measure.

Basis for Corporation Tax

As stated previously, the manner proposed in H. R. 5529, for taxing corporations is predicated on the allowance of a reasonable return on adjusted declared value and subjecting the balance of the net income to severe graduated rates reaching 100 percent on the amount in excess of 6 percent of the adjusted declared value.

At the hearings before this subcommittee consideration was given to other methods for taxing corporations among which was the plan in effect during the last war, i. e., the plan involving the use of invested capital.

It is to be noted that recognized tax experts, as well as Internal Revenue Bureau officials avoid recommending invested capital as a basis for wartime taxation. Dr. Thomas S. Adams, who acted in an advisory capacity to the Treasury Department and committees of Congress for many years, in an article appearing in the Quarterly Journal of Economics, May 1921, pages 371 and 372, stated:

> The intricacy of the excess-profits tax is such that it is hardly an exaggeration to say that it takes more time to teach an accountant to master its mysteries than the average accountant can be retained in the service after he has attained such mastery. * * * Ten years would be a radically short time required in which to bring the taxpayers and the administrative authorities of the country to a point where the excess-profits tax could be reasonably well enforced.

Secretary of the Treasury David F. Houston in his annual report for the fiscal year 1920, in urging the repeal of the excess-profits tax said:

> The tax does not attain in practice the theoretical end at which it aims. It discriminates against conservatively financed corporations and in favor of those whose capitalization is exaggerated; indeed, many overcapitalized corporations escape with unduly small contributions. It is exceedingly complex in its application and difficult of administration, despite the fact that it is limited to one class of business concerns, corporations.

While the subcommittee recognizes that invested capital has merit as a basis for taxation in a war period, especially from a standpoint of tax yield, the difficulties of administration and the complex problems which will be encountered in attempting to draft a provision that would meet pointed objections to its use constitute sufficient grounds for its rejection.

Also, there were presented the results of a study of the possible effects of taxing corporations based upon the use of adjusted declared value. The information presented consisted of a table of a representative group of 14 large corporations and their subsidiaries showing the relation which the adjusted declared value bore to book value and market value of the stock. Notwithstanding the findings of the Senate Munitions Committee, contained in report 944, part 2, page 26, that declared values as determined by corporations were unduly high, the facts for the group studied indicated that adjusted declared values reported were in the aggregate 84.88 percent of the book values and 81.13 percent of the market values for the stock.

The group covered $4,090,118,737 declared value out of a total declared value for all corporations of $91,508,121,290 for 1934. This same group during the prosperous year 1929 reported approximately 7½ percent of all income returned by corporations. For 1934 it returned 4½ percent of the total. The table is as follows:

Corporation	Adjusted declared value (1934)	Book value, Dec. 31, 1933	Market value of stock Dec. 31, 1933	Ratio of declared value to book value	Ratio of declared value to market value
1	$8,260,000	$14,888,765	$20,833,147	55.41	39.60
2	5,000,000	26,923,727	5,614,343	18.57	91.79
3	22,231,000	10,395,063	37,438,612	213.86	59.37
4	583,911,000	237,310,136	605,186,302	227.09	96.48
5	260,385,000	478,600,000	110,931,132	55.11	237.80
6	40,000,000	36,122,720	86,360,000	110.73	46.31
7	20,401,000	22,639,392	11,403,359	90.11	178.90
8	14,826,000	26,246,077	22,826,397	56.48	64.95
9	349,556,000	500,141,424	1,180,825,945	69.89	29.60
10	1,013,909,737	871,497,357	1,684,339,246	116.34	60.19
11	224,000,000	119,656,258	334,103,231	187.20	67.04
12	34,000,000	45,851,059	23,617,511	74.15	143.96
13	150,000,000	490,434.325	179,336,126	30.58	83.64
14	1,363,654,000	1,937,475,000	738,031,867	69.05	184.76
Total	4,090,118,737	4,818,195,503	5,040,817,218	84.88	81.13

It will be seen from the above that while the aggregate ratios of declared values to book values and to market values for the 14 corporations studied were 84.88 and 81.13 percent, respectively, there were gross divergences as between the separate units, in one case the ratio of declared value to book value being 18.57 percent, while in another 227.09 percent.

The unreliability of the use of the adjusted declared value as a basis is perhaps more apparent from the fact that declared values represent amounts which were reported by corporations predominately with the view of tax saving rather than as an expression of true value. From the standpoint of the corporations filing returns, this was necessary in view of the fact that under the 1934 Revenue Act there is imposed an excess-profits tax which is determined by use of the adjusted declared value. If earnings for the year happened to be low and the corporation was not subject to excess-profits tax, it was to the interest of such corporation to report a small adjusted declared value. By so doing, it could save itself from the imposition of a high capital stock tax, which too, is based upon the use of an adjusted declared value for the capital stock.

One of the major points urged by the Senate Munitions Committee in favor of the use of the adjusted declared value was that in the event of war, the trend of existing taxation could be followed with merely a revision in the severity of the rates of the excess-profits tax without changing the basis itself. With the present possibility of the complete elimination of both the capital-stock tax and excess-profits tax in the proposed Revenue Act of 1936, now under consideration in the United States Senate, whatever advantage may have been inherent in the use of the adjusted declared value will be extinguished.

The subcommittee, mindful of the changed situation, herein recommends that the plan for taxing corporations as contained in

H. R. 12395 is one which can be made adaptable to war conditions. Its adoption in a war revenue act will give it the advantage of an accumulation of tax experience in the interim between the present and the date of any prospective war. A detailed discussion of corporate rates suggested by this subcommittee applicable in war times is contained on pages 14 and 15.

Estimated Yield

When dealing with a drastic rate structure the matter of estimating yields resulting from reported income for tax purposes becomes decidedly doubtful. It is dependent upon many variables. There are factors of inflation, as a possible consequence of war activity; secondly, there may result a substantial curtailment of production by virtue of adverse effect on profit motive since the Government takes so large a share of the income; and lastly, there may arise difficulties in connection with administering new and radical provisions producing understatements of income and protracted litigation.

While it may be urged as proper to put upon the statute books a war revenue act prior to our country being in a state of war, it is nevertheless true that it is impossible to determine in advance of a war what revenue would be required. Obviously, a war with a weak country would cost far less than a war with a strong country or a group of countries. Furthermore, a prolonged war would require much greater financing than a war of short duration. If a war-revenue law is to be effective it must anticipate a revenue yield sufficient to cope with all eventualities, and therefore, provision in such a bill should be made for a high revenue yield. This brings us to the question of whether the consideration of maximum revenue yield should predominate the consideration of the preservation of the economic welfare of the country. Is it economically healthy and socially desirable that the bulk of the income made by individuals and corporations, except for an exempted minimum for living expenses and a 3 or 4 percent return to corporations be diverted into Government channels?

While it is not to be gainsaid that the most important thing in connection with a war is to win such war, legislation pertaining thereto must, however, be framed so as not to assume that from a fiscal standpoint "to win the war" means ignoring basic principles of public finance, as well as factors tending to the preservation of the economic well-being of the Nation.

Having in mind the above considerations, this subcommittee recommends a rate structure for individuals and corporations which, while not going to the maximum figures adopted in the original title I of H. R. 5529, does reach levels which were decided upon as being rates which effectively recapture war profits and which result in a yield to the Treasury sufficient to constitute compliance with the principle that means should be provided to pay for a war out of current taxes (see chart Comparison of Rates, marked "Exhibit A").

For comparative purposes, the Treasury Department was requested to furnish estimated revenue from the war rates as proposed

for individuals as well as corporations, based on 1928 income. The estimates given were:

	Individuals (in millions)	Corporations (in millions) [1]
H. R. 5529	9,783	
As proposed by this subcommittee	7,866	
Total		

[1] Not available at time of printing.

As stated at the hearings before the subcommittee on April 10, 1936 (pt. 4, p. 144), the selection of the year 1928 was decided upon because it was considered to "most nearly represent industrial activity and the production of business profits comparable with a war year, assuming this country should be involved in a war within the next 2 or 3 years."

New and Revised Provisions in Subcommittee Substitute for Title I

In view of the objections as presented herein, which the subcommittee has to the proposed title I of H. R. 5529, it has been decided legislatively expedient to draft a substitute for title I. From the standpoint of construction it follows the provisions of existing law with respect to individuals and adopts the plan for taxing corporations as now under consideration in the proposed Revenue Act of 1936. As a result of the subcommittee's determination as to the existence of special problems incident to war conditions and the necessity for special statutory consideration therefor, there have been included in the substitute draft several new provisions. Certain other provisions have been revised. The matters included consist of provisions relating to:

1. Tax rates and exemptions—individuals.
2. Tax rates—corporations.
3. Carry-over Government contracts.
4. Loss in inventory by virtue of price decline due to war cessation.
5. Depletion.
6. Amortization of war facilities.
7. Tax determination in first return under two different laws.
8. Filing of bond incident to appeal.

1. TAX RATES AND EXEMPTIONS—INDIVIDUALS

Exemption.—The personal exemptions have been set at $800 and $1,600 in the case of single and married persons, respectively. In the case of dependents the credit is fixed at $250 (sec. 24(b)). The subcommittee fully recognizes that during a war period the cost of living may be substantially increased over peacetime. The urgent need for revenue, however, makes it advisable to place the exemption at such a point as will leave free of tax an amount that approximates the cost of the necessities of life.

Rates of tax.—Section 11 of the proposed substitute provides for a normal tax of 10 percent. Section 12 includes a schedule of surtax rates beginning with 6 percent on the first thousand dollars in excess of the exemption and $1,000, and reaching a maximum of 80 percent

on surtax net income in excess of $50,000. The rates applicable to each surtax bracket, the tax resulting from the application of these rates to the income falling within the brackets, and the total surtax on incomes reaching the maximum of each bracket is as follows:

Surtax net income	Rate	Bracket (Surtax)	Total (Surtax)
On first $1,000	0	0	0
$1,000 to $2,000	6	60	60
$2,000 to $3,000	9	90	150
$3,000 to $4,000	12	120	270
$4,000 to $6,000	15	300	570
$6,000 to $8,000	18	360	930
$8,000 to $10,000	21	420	1,350
$10,000 to $14,000	25	1,000	2,350
$14,000 to $18,000	30	1,200	3,550
$18,000 to $24,000	40	2,400	5,950
$24,000 to $30,000	50	3,000	8,950
$30,000 to $40,000	60	6,000	14,950
$40,000 to $50,000	70	7,000	21,950
Over $50,000	80		

The comparative tax load and percentage of net income taken in tax under the proposed substitute as compared with title I, H. R. 5529, and the present law are as follows:

Married person, no dependents

Net income	Tax			Percentage of tax to net income		
	Proposed substitute	Title I, H. R. 5529	Revenue Act, 1935	Proposed substitute	Title I, H. R. 5529	Revenue Act, 1935
$1,000	$0	$0	$0			
$1,500	0	30	0		2.60	
$2,000	40	60	0	0.2	3.00	
$2,500	90	90	0	3.6	3.60	
$3,000	164	120	8	5.4	4.00	0.03
$3,500	244	150	26	6.9	4.28	.07
$4,000	336	180	44	8.4	4.50	1.10
$4,500	431	260	62	9.57	5.77	1.40
$5,000	538	340	80	10.76	6.80	1.60
$6,000	770	500	116	12.83	8.33	1.90
$7,000	1,020	860	172	14.57	12.28	2.50
$8,000	1,282	1,320	248	16.02	16.50	3.10
$9,000	1,564	1,880	320	17.06	20.88	3.70
$10,000	1,854	2,610	415	18.54	26.40	4.20
$12,000	2,490	4,160	602	20.75	34.66	5.00
$14,000	3,190	5,680	809	22.78	40.57	5.80
$16,000	3,910	7,200	1,044	24.43	45.00	6.50
$18,000	4,710	8,720	1,299	26.16	48.44	7.20
$20,000	5,530	10,240	1,589	27.65	51.20	7.90
$25,000	8,050	14,960	2,690	32.20	59.84	10.90
$30,000	10,990	19,910	3,569	36.63	66.36	11.80
$40,000	17,830	29,810	5,979	44.57	74.52	14.90
$50,000	25,670	39,710	8,869	51.34	79.42	17.70
$60,000	34,510	49,610	12,329	57.51	82.62	20.50
$70,000	43,510	59,510	16,549	62.15	85.01	23.60
$80,000	52,510	69,410	21,269	65.63	86.76	26.60
$100,000	70,510	89,210	32,469	70.51	89.21	32.50
$200,000	160,510	188,210	95,344	80.25	94.10	47.70
$500,000	430,510	485,210	304,144	86.10	97.04	60.80
$1,000,000	880,510	980,210	679,044	88.05	98.02	67.90

The revised rate structure as framed by this subcommittee is designed to achieve the following broad objectives:

1. To impose a maximum tax load without however seriously interfering with the continued existence of the profit motive.

2. The application to the lower income brackets of effective tax rates having a relation to, but somewhat lower than British rates in corresponding brackets.

3. Establish a smooth tax curve free, as far as possible, from sharp differences in rates as between various brackets.

The first objective, it is believed, is in harmony with the expressed view of the Finance Committee that the profit motive should not be destroyed (Subcommittee Hearings, pt. 3, p. 73).

In the case of nonresident alien individuals, a flat rate of 10 percent is proposed by H. R. 12395, which rate is increased to 20 percent in the subcommittee revised rate structure. The personal exemption as to such taxpayers is applicable only against compensation for personal services.

2. TAX RATES, CORPORATIONS

Section 13 of substitute title I imposes a tax on corporations at rates graduated according to the percentage of net income retained and reaching a maximum of 77 percent in cases where no distribution is made. In the interest of simplicity the subcommittee had adopted a single rate schedule applicable to corporations instead of separate schedules for corporations of $10,000 net income or less as provided in H. R. 12395. The effective rates of tax in the proposed substitute title I as compared to H. R. 12395 in the case of corporations having net income in excess of $10,000 are as follows:

Percent of undistributed net income to adjusted net income		Rate of tax	
H. R. 12395	Proposed substitute	H. R. 12395	Proposed substitute
Percent	*Percent*	*Percent*	*Percent*
5	5	2	30
10	10	4	37.5
15	15	6.5	50
20	20	9	65
23	23	10.8	77
30	23	15	77
35	23	20	77
40	23	25	77
45	23	30	77
50	23	35	77
55	23	40	77
57.5	23	42.5	77

A similar table of certain brackets compiled from schedule II (A), H. R. 12395, and schedule I (A), of the proposed substitute based upon the percentage of adjusted net income which has been distributed as dividends, shows the following comparison:

Percentage which dividend is of adjusted net income	Effective rate of tax on adjusted net income		Percentage which dividend is of adjusted net income	Effective rate of tax on adjusted net income	
	H. R. 12395	Proposed substitute		H. R. 12395	Proposed substitute
	Percent	*Percent*		*Percent*	*Percent*
5 percent	40	73	50 percent	17.5	39.285
10 percent	37.5	69	60 percent	13.125	33
15 percent	35	65	70 percent	9.375	25.714
20 percent	32.5	61.25	80 percent	6.000	17.142
25 percent	30	57.50	90 percent	2.857	8.571
30 percent	27.5	53.75	100 percent	None	None
40 percent	22.5	46.428			

Wherever H. R. 12395 provided for flat rates of 15 and 22½ percent for corporations, the subcommittee has increased such rates to 25 and 40 percent in order that such corporations may be taxed at rates comparable to the increased rates fixed in the case of other corporations. The rate of tax in section 102 has been fixed at 25 percent. Such a rate in addition to the severe corporate rates otherwise imposed constitutes sufficient safeguards against unreasonable accumulation.

3. CARRY-OVER GOVERNMENT CONTRACTS

Section 18 provides for taxing at wartime rates, all income derived from Government war contracts, even though the income may not be realized until after the close of the war.

Under this provision, taxpayers who derive such net income in excess of $10,000, will be required to pay tax at the rates in substitute title I regardless of when received. This, in the opinion of the subcommittee, is necessary in order to carry through one of the principal objectives of H. R. 5529, that is, to take the profits out of war. In order, therefore, that such contractor should carry his just share of the war burden, he should be required to return to the Treasury the wartime tax and not the lower peacetime tax on the profit arising from such contracts. Thus, the war-tax rates follow such profits and the subcommittee so recommends.

4. LOSS IN INVENTORY BY VIRTUE OF PRICE DECLINE DUE TO WAR CESSATION

Subsection 23 (s) (1) of the substitute title I provides for deduction in the last taxable year the War Revenue Act is in effect, of losses sustained from any material decline (not due to temporary fluctuations) of the value of inventory or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year. In order that taxpayers may have the benefit of this deduction, provision is made for claims in abatement conditioned upon the filing of a bond to assure collection of any tax that may be due upon final adjustment of the loss.

Subsection 23 (s) (2) further provides that if no such claim is filed, but losses of this character are sustained within 1 year after the date upon which the last return under the act is due, such losses may be deducted from the net income of the last taxable year under this act.

The necessity for the above relief provision is apparent from the knowledge that upon the termination of war many business organizations will find themselves with large inventories on hand and may face the possibility of a price decline. As it is desired to encourage production during the war, the eventuality of having on hand a large amount of goods which will have to be sold at prices lower than anticipated is thus protected. The section as drafted will also serve the purpose of accelerating sales during the war period as the purchaser knowing that the seller may obtain adjustment or a rebate in the event of price decline will not hesitate to buy and request such rebate if at the end of war variations in prices warrant same.

5. DEPLETION

The depletion rates fixed in section 114 of the substitute draft reduces to one-half the allowances provided in existing law. In all

cases where the present law qualifies that in no event shall the allowance exceed 50 percent of the net income change has been made to a percentage not to exceed 25. The depletion rates as fixed in the present law and as proposed by this subcommittee are as follows:

	Percentage of gross income from the property	
	Present law	Proposed substitute
Oil and gas	27½	13⅓
Metal mines	15	7½
Coal	5	2½
Sulphur	23	11½

The subcommittee recognizes that stimulation of the natural resources industries to increase their output during war is of extreme importance. On the other hand, data presented during the hearings show conclusively that many concerns have been allowed aggregate depletion in excess of cost or other basis. It is believed that no undue hardship will result by virtue of the reduction of the annual allowance to the one-half permitted under the present law, especially in view of the fact that taxpayers purchasing new properties during wartime may still elect to take depletion on the basis of cost. Furthermore, it is important to add that under a wartime act taxpayers will be permitted, as they are under existing law, to deduct currently actual expenditures incurred in developing and operating their properties.

6. AMORTIZATION OF WAR FACILITIES

Need for amortization.—In title I of H. R. 5529, there is no provision for amortizing the cost of such wartime industrial construction and expansion as may be necessary for the successful prosecution of the war. The Senate Munitions Committee recommended (S. Rept. No. 944, pt. 2, p. 34) that no amortization of war facilities be allowed but instead that governmental loans be authorized for such construction as may be found necessary and which cannot otherwise be financed. The Munitions Committee makes the further observation, however, that if no allowance is made for the amortization of such new construction there may be anticipated a considerable insistence that such construction be paid for by outright governmental subsidy, and concludes the subject of amortization with the following:

> Most expansion is financed by borrowed capital and the mere fact that the lender is the United States will not remove the demand for assurance against loss of the amount invested in assets which may prove valueless upon the conclusion of the war. Consequently, it must be realized that the reasons causing the normal demand for alleviation of governmental burdens on industry upon a return to peace * * * will make it inevitable that strong pressure will be exerted for the reduction, by compromise or otherwise, of any Government wartime construction loans outstanding when the war ends. For similar reasons it is likely that substantial amounts of any such loans as are not reduced or compromised will be defaulted. Finally, it is to be noted that under either a subsidy or a loan plan the Federal Government will, following the termination of the war, own extensive

plants and equipment, the usefulness and value of which as a whole will be conjectural. To the extent that these plants and equipment are made up of integral parts of various private corporations, their value will be less than the general level of wartime construction. As to the plant and equipment which the Government has acquired, the choice will be between Government operation and sale for little, if any, better than salvage prices.

A review of that portion of the above-mentioned report dealing with amortization seems to indicate that the Munitions Committee had reached the conclusion that the Government, in any event, would be obliged to bear a very large part, if not substantially all, of the cost of such wartime construction, and that, this being the case, the cost to the Government probably could be more easily and more efficiently controlled through the medium of direct loans than by the allowance of amortization in connection with income taxes.

This subcommittee having jurisdiction only of title I, income tax, makes no comment or recommendation with respect to title V, war finance control.

While entirely sympathetic with the objectives sought to be accomplished by the Munitions Committee with respect to the handling of this difficult question, this subcommittee, after full consideration and for the reasons hereinafter stated, recommend that provision be made in the war revenue bill for the amortization of wartime construction which may be essential to the successful prosecution of the war. Experiences of the World War supports the view that a direct loan method is more expensive than provision for amortization.

While exact figures are not available to show the total loss in revenue sustained by the Government through the allowance of amortization during the last war, it has been estimated that the total amount of amortization claimed by taxpayers was approximately $1,000,000,000, against which the Government allowed approximately $600,000,000, or about 60 percent. Assuming a tax of approximately 70 percent, the actual cost in revenue by allowance for amortization was approximately $400,000,000, or 40 percent of the cost of wartime construction.

Under the plan proposed by the Munitions Committee to provide for all such wartime construction by direct loans or subsidies, the total cost would be the starting point from which to determine the Government's ultimate loss. Settlement of canceled contracts and the loss sustained by the Government from the sale of surplus property at the close of the World War seems to indicate a much greater loss to the Government by the direct-loan or subsidy plan than by provision for amortization. Aside from the percentage of loss on amounts loaned, the urge to get industry on a war basis will tend to result in the granting of many unwise loans extending over a broader field of industrial activity than would result from provision for amortization. apart from being undesirable as a fiscal policy, the direct-loan method would require the outlay by the Government of vast sums of money which the tax structure would not then have provided and which would be immediately available only by bond issues, much of which would, of course, be absorbed by the industries whose plants were to be expanded. It would thus appear that the direct-loan method would tend to further increase inflation, the avoidance of which is one of the primary objectives of this bill.

A reasonable degree of certainty as to the outcome is generally essential to the employment of private capital in any venture. It seems likely that industries will be loath to risk their private capital for wartime construction, due to the uncertainty as to the probable duration of the war and the peacetime value of the plant or equipment, if there is no assurance given that the cost of such construction may be amortized.

Further, the direct-loan method alone will tend to retard war preparations. Experiences of the War Finance Corporation, the National Industrial Recovery Administration, the Reconstruction Finance Corporation, and other governmental agencies of a similar character indicate money cannot be made available for war plants without considerable delay. In war, time consumed in getting under way is far more important than loss in revenue that might result from possible abuse of administration.

This subcommittee is of the opinion that a large part of the cost of wartime construction can and will be financed by the industries involved without delay if they are assured, with a reasonable degree of certainty, that they will be enabled to recover their cost through the allowance of amortization in connection with their taxes and that this method will result in less loss to the Government than under the direct-loan plan.

There was presented to the subcommittee the many problems arising under the 1918 and 1921 acts, some of which appear to have influenced the Munitions Committee in its decision on this subject. The subcommittee has written an entirely new provision based upon the experiences of the war revenue acts, embodying such additional features as will reasonably assure a practical and workable plan.

Provisions of amortization section, section 23 (m).—This subsection provides for the allowance of a reasonable deduction for amortization of the cost borne by the taxpayer of buildings, machinery, equipment, or other depreciable facilities only when contracted for and constructed, erected, installed by the taxpayer on or after the effective date of the act, for the production of articles essential to the prosecution of the war, and of vessels contracted for and constructed by or for the taxpayer after the effective date of the act for the transportation of articles or men essential to the prosecution of the war. Facilities contracted for prior to the effective date of the act are eliminated. The allowance is inclusive of all depreciation during the amortization period on property subject to amortization, but is exclusive of other allowances in computing net income.

In order that business may be assured of special treatment before making expenditures and to simplify administration, the President is required to designate an agency which shall authorize projects coming within the scope of this provision. This subsection has been restricted to facilities which are depreciable in character.

The provision is also limited to taxpayers who acquire facilities for producing articles essential to the prosecution of the war, and the determination of compliance with this requirement is placed in the hands of such agency as the President designates. In order that the taxpayer may have a substantial benefit currently, provision is made for annual deductions of 12½ percent of cost until the aggregate

allowances are 50 percent of the cost of the facilities or vessels after which no further tentative allowance shall be made. The subsection also provides that after the act ceases to be effective the returns filed during the amortization allowance period may be reexamined and the tax for the year or years affected redetermined. The amount of any deficiency in tax so determined may be assessed and collected at any time, subject to the right of appeal to the Board of Tax Appeals, but without regard to the statute of limitations on assessment and collection. Overpayments of tax, if any, are to be credited or refunded to the taxpayer in accordance with the provisions of section 322 of the bill. There is a further provision that the deduction to be finally allowed shall be measured by the conditions prevailing during a period of not more than 3 years after the date upon which the act ceases to be effective.

Summarizing the above, it will be seen that the amortization subsection will accomplish the following principal objectives:

(1) To determine in advance whether any project for wartime construction of a facility or vessel shall be amortized.

(2) To allow amortization only as to construction actually begun after the declaration of war for the production of articles or commodities essential to the prosecution of the war.

(3) To deny amortization of the cost of construction of projects either begun or contracted for prior to the declaration of war and designed to meet peacetime needs.

(4) To deny amortization of the cost of facilities in existence prior to the declaration of war but which are thereafter transferred to new owners, where no amortization would be allowable in the absence of such transfer.

(5) To allow amortization only in connection with depreciable property.

(6) To provide a definite period of 3 years after the termination of the war to be used as a yardstick in determining the amount of amortization ultimately to be allowed.

In conclusion, it is assumed, of course, that in the event of war, the Government will exercise strict control over all industrial construction and that no manufacturer will be able to construct any plant or to obtain materials and supplies for such construction without first having his project approved by a governmental board or commission established for that purpose. Depending upon the stress of conditions existing at the time of application for permit, such agency conceivably may authorize many construction projects designed for the production of commodities not strictly essential to the prosecution of the war. If the applicant for the construction permit should claim the right to amortization with respect to his project, such agency will determine that question at that time by requiring the applicant to establish to the satisfaction of the agency that the article or commodity to be produced is "essential to the prosecution of the war." The decision of such agency will be conclusive of the question whether such project shall be entitled to amortization. The amount of amortization ultimately to be allowed will be left for determination by the Bureau of Internal Revenue. This method has several distinct advantages, one of them being that

the Government, through the control agency, will be able to require and obtain complete information with respect to the applicant's existing facilities at the time of application for permit. Under the 1918 and 1921 Revenue Acts the Government was obliged to obtain all such information, after the termination of the war, when it was to the interest of taxpayers to interpret their valuation records and claims in the light of post-war conditions so as to obtain a maximum allowance of amortization.

7. TAX DETERMINATION IN FIRST RETURN UNDER TWO DIFFERENT LAWS

Section 48 of the proposed substitute provides for computing the tax in cases where the effective date of the act does not coincide with the beginning of the taxable year. Under this provision the tax is first computed under the provisions of the act existing prior to the effective date of this act, and then under the provisions of this act. The final tax imposed for the period is found by taking the sum of the same proportion of the tax computed under the prior act as the number of months of the accounting period prior to the effective date of this act is to 12 months, and the same proportion of the tax computed under this Act as the number of months following within the accounting period from the effective date of this act is to 12 months. This provision is necessary in order to carry out the policy of the subcommittee to tax at war rates the income which arises during the period of the war.

8. FILING OF BOND INCIDENT TO APPEAL

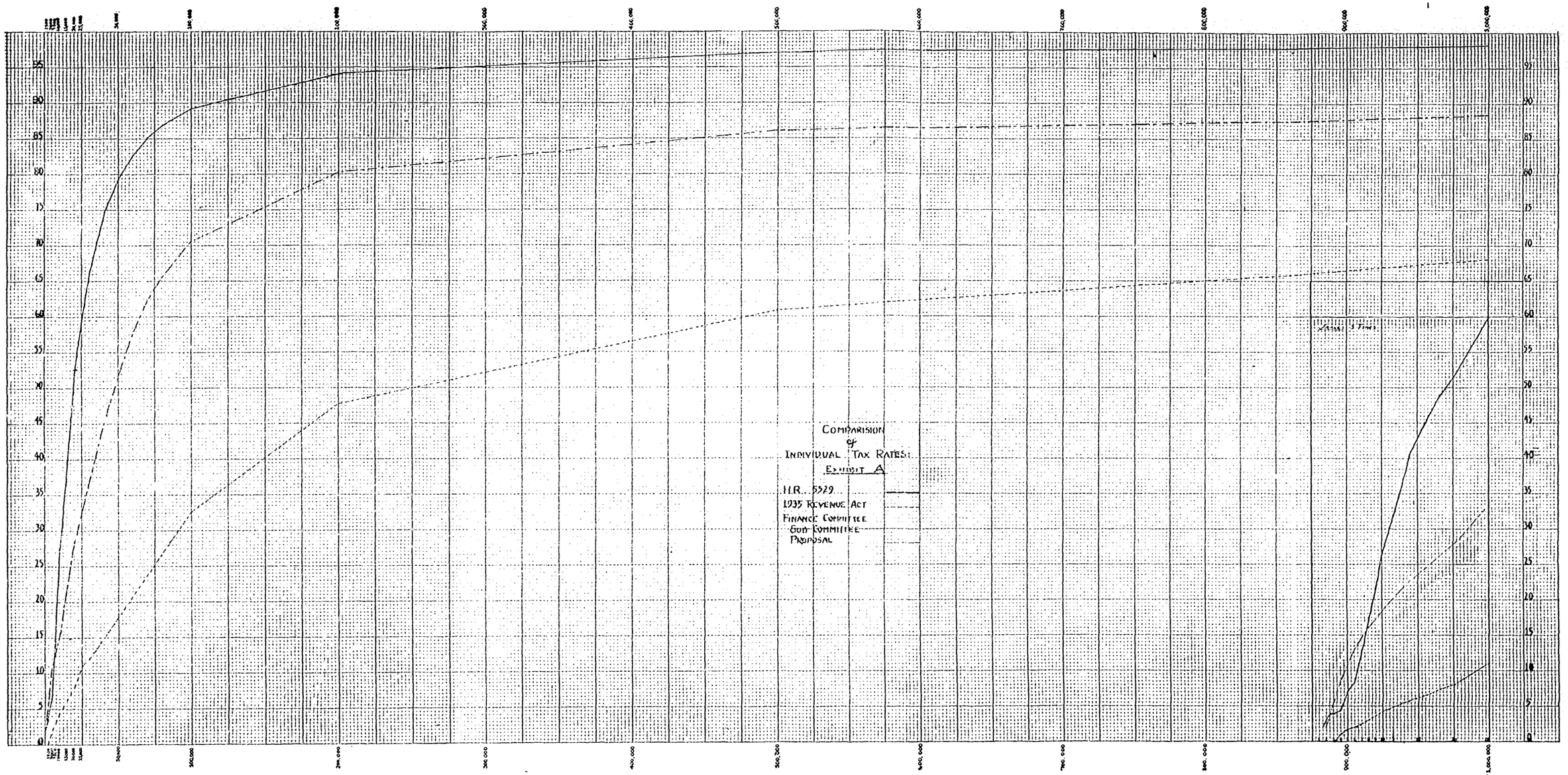
The present law gives the taxpayer the right to have reviewed by the United States Board of Tax Appeals any deficiency found by the commissioner. The subcommittee continues this policy for the proposed substitute, but requires (section 48) that, as a condition precedent to the filing of a petition, a bond be given, acceptable to the Commissioner of Internal Revenue, to assure payment of the deficiency as finally determined.

Taxpayers prior to the Revenue Act of 1924 were prohibited by the provisions of section 3224 of the Revised Statutes from enjoining collection of tax by suit. Because of apparent hardship occasioned by incorrect assessment, this policy was changed so as to permit review by the United States Board of Tax Appeals before final assessment (House of Representatives, 68th Cong., 1st sess., Rept. No. 179). Because of the urgent need for revenue, the subcommittee recognizes the importance of early determinations during a war period and the handicaps to the Government in attempting to collect tax in the period of readjustment following the close of the war. On the other hand, because of the severe rates provided in substitute title I, the subcommittee believes taxpayers should be fully protected from the extreme hardships that would result from incorrect assessments of tax. The provision adopted, it is believed, continues the present policy of protecting taxpayers from erroneous assessment, and at the same time, saves the Government from losses of revenue due to the changed financial condition subsequent to appeal. The provision has the added advantage over the present policy in that the filing of bond will have a tendency to discourage frivolous appeals designed to delay the assessment of the tax.

Amendments to Title III

The committee struck out section 512 of title III of the bill and made two clarifying amendments in sections 502 and 505. Title III of the bill deals with war resources control and in general gives the President wide powers to regulate and control commodities and commodity exchanges. Section 512 provided that the effective date of this title shall be upon the declaration by Congress that a state of war exists between the United States and any foreign power and that the existence of such state of war creates a grave national emergency, or upon the declaration by Congress that a grave national emergency has arisen owing to the imminence of declaration of war or owing to the existence of a state of war between two foreign powers.

This committee felt that the effective date of title III should be the same as that of the other titles of the bill and has accomplished this end by striking out section 512, so that the effective date of this title will be governed by section 806 which provides that the act will become effective only upon the declaration by Congress that a state of war exists between the United States and a foreign government and that the existence of such state of war creates a grave national emergency.



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