labor records of potential contractors.\textsuperscript{132} And where competitive bids are submitted, the Comptroller General has ruled that violations of the labor policies enunciated by the Defense Commission are sufficient grounds for rejecting the lowest bid.\textsuperscript{133}

But whether social reforms will survive a direct conflict with industrial mobilization remains a question for the future. And other problems not contemplated by existing legislation and regulations will arise if the emergency long continues. Dislocations of the price system may require rigid controls. Provisions may be necessary to protect the financial and credit structure from the coming shock. Finally, the end of the emergency will bring problems of demobilizing an abnormally accelerated and over-expanded production economy.

III. THE EXCESS PROFITS TAX OF 1940

A defense program requires money as well as machines and men. Although business can legitimately be expected to contribute its share through taxes, too heavy a burden will hinder the forces of production. Yet the morale of labor, consumers, and prospective draftees cannot be preserved if it is felt that a national emergency is being turned to private profit.\textsuperscript{1} In response to these diverse demands there has emerged the Excess Profits Tax Act of 1940.\textsuperscript{2}


\textsuperscript{133} (1940) 9 U. S. L. Week 2231. But compliance with the Act cannot be made a condition precedent to payment of contract price. Comptroller General Dec., No. B-10575, July 8, 1940, (1940) 9 U. S. L. Week 2054.

Attorney-General Jackson's statement that an unappealed ruling of the NLRB would be binding upon officers letting defense contracts was later explained as meaning only that such officers, if they decide to deal with a violator of the Act, cannot say that there has been no violation on the ground that there has been no appeal. See (1940) 9 U. S. L. Week 2231.


2. Title II of the Second Revenue Act of 1940, Pub. L. No. 801, 76th Cong., 3d Sess. (Oct. 8, 1940), INT. REV. CODE §§ 710-52 (1939). Hereinafter, references to this Act will be made by section numbers in the Code. The former "Excess Profits Tax," complementing the capital stock tax, has been redesignated the "Declared Value Excess Profits Tax." SECOND REVENUE ACT OF 1940, § 506(a).

Title I of the Second Revenue Act of 1940 raises corporate tax rates to 24% when net incomes exceed $25,000; other increases in general tax rates were made by the Revenue Act of 1939, 53 STAT. 863, and the (first) Revenue Act of 1940, Pub. L. No. 656, 76th Cong., 3d Sess. (June 25, 1940).
Taxation of excess profits is a common wartime phenomenon. At least sixteen countries, including the United States, imposed such taxes during the last war; England, Canada, France, and Germany have adopted them in the present war. Although productive of revenue, an excess profits tax may reflect at least three other objectives. It may attempt simply to penalize high profits in the production of military supplies. Such a tax may be called a “war industries” tax. But defense preparation may stimulate a general business upswing; hence a tax might well be levied on all profits in excess of those received during a base period regarded as normal. Although the profits taxed by this method would be only roughly related to the defense program—they might, for example, be the harvest of previous plowing back of earnings—the assumption is made that all increases in profits directly or indirectly result from the defense preparation. Such a tax may properly be called a “war profits” tax. It may further be felt, however, that since the nation is expected to sacrifice in time of emergency, industrial profits during that period should be carefully limited. Hence, all profits above those reasonably necessary to ensure unimpeded productive activity might be heavily taxed. Such a tax may be called an “excessive profits” tax.

No single theory appears to have motivated the policy of the present Act. While the Presidential message proposing such legislation appears to have emphasized the need for a revenue measure based on the ability to pay, the House Committee stressed the need for preventing the rise of “war millionaires,” and the “substantial enrichment of already wealthy persons,” ap-
parently adopting in one breath both a “war profits” and an “excessive profits” theory. In view of the extremely hasty passage of the Act, theoretical unity was hardly to be expected.11

A. THE INCIDENCE OF THE TAX

Those Subject to the Tax.—The present Act taxes only corporate incomes.12 No necessary reason for such a restriction appears; excessive profits of partnerships or individuals are no less undesirable, and no less a result of wartime spending.13 But few partnerships and individual enterprises earn sufficient income to be taxable even were they included within the present Act,14 and their taxation would entail administrative difficulties.15 Another reason given for the restriction to corporations was that existing personal income tax rates result in heavy surtaxes on businesses not taxed as corporations.16 On the other hand, it has been suggested that the Excess Profits Tax may accentuate the existing tax discrimination against smaller corporations as compared with partnerships or individual enterprises of like size17—a discrimination not entirely warranted by the advantages of the corporate form.

This exemption of personal incomes may partially explain why certain types of corporations are not subject to the Excess Profits Tax.18 Thus

11. The speed which characterized the enactment of this law has been severely denounced as resulting in the “worst of all the so-called emergency measures.” 86 Cong. Rec., Sept. 13, 1940, at 18306. On July 1, 1940, President Roosevelt sent a message to Congress proposing a “steeply graduated excess profits tax” to apply to all individuals and corporations. The House, after numerous revisions, passed a corporate excess profits tax on Aug. 29, and the bill went to the Senate, where it was considerably modified and passed on Sept. 19. On Oct. 1, a compromise version was approved by both houses and the bill was signed by the President on Oct. 8.

12. Section 710. The excess profits tax provisions of 1918 and 1921 were likewise restricted to corporations. REVENUE ACTS OF 1918 AND 1921, § 301.

13. Thus the English and Canadian Acts, notes 4 and 5 supra, tax “business” income of individuals and partnerships.

14. Compare House Report, p. 3, stating that all but 70,000 out of 500,000 active corporations in the United States would be exempt from the tax solely by virtue of the $5,000 specific exemption.

15. See House Report, p. 2. The principal difficulty alluded to was the fact that all the assets of an individual entrepreneur or a partner are subject to the liabilities of the business, thus rendering impracticable the determination of the amount of capital invested. See Testimony of Under Secretary of the Treasury Sullivan, Hearings before Senate Committee on Finance on H. R. 10413, 76th Cong., 3d Sess. (1940) 118 (hereinafter referred to as Senate Hearings). These difficulties would arise only under the invested capital method [see pp. 291-292 infra], which may explain the successful taxation of partnerships in England and Canada. See TWENTIETH CENTURY FUND, TAXING THE PROBLEM (1937) 274.


17. See N. Y. Times, Nov. 3, 1940, § 3, p. 1, col. 5.

18. Specific exemptions are contained in § 727. Other exemptions not mentioned above include: (1) all corporations exempt from income tax; (2) foreign corporations
personal holding companies, already highly taxed, and certain types of investment companies are exempt. Personal service corporations—a class restricted by the requirement that 70% of the stockholders participate actively in the business and that capital be not a material income-producing factor—may elect to be taxed under special provisions analogous to the income tax on partnerships.

Method of Imposition of the Tax.—The determination of the amount of excess profits tax payable involves several computations. First there must be determined the “excess profits net income” upon which the calculation is based. To determine how much of this amount is “excess” and subject to tax as “adjusted excess profits net income,” there must be deducted from “excess profits net income” first, a specific exemption of $5000, and second, an “excess profits credit,” representing the income regarded as reasonable. In limited cases a carryover of unused excess profits credit from the preceding year is allowed.

The adjusted excess profits net income thus determined is taxed at rates graduated from 25% to 50%. These rates, instead of being applied on a relative basis such as ratio of profits to capital or ratio of current to previous earnings, are based on absolute dollar amounts of excess profits. Perhaps this rate structure stems from a desire to minimize the burdens on small not having an office or place of business in the United States; (3) domestic corporations 95% of whose income is derived from sources outside the United States.

19. Such companies were given special tax treatment under the Revenue Act of 1937 because they were regarded simply as a method of avoiding taxes by putting personal income in corporate form. See Paul, Background of the Revenue Act of 1937 (1937) 5 U. Chi. L. Rev. 41.


21. Section 752. Similar provisions for special taxation under both excess profits and income taxes were contained in the Revenue Acts of 1918 and 1921, §§ 200, 218(d), 300. The definition of personal service corporation in these Acts has been adopted in almost identical words in the present Act.


23. Section 710(b)(1). The Senate version of the bill raised the exemption to $10,000, but in conference the House proposal of $5,000 was restored. H. R. Rep. No. 3002, 76th Cong., 3d Sess. (1940) 44 (hereinafter referred to as Conference Report).

24. Section 710(b)(3). This carryover is applicable only where the corporation has a normal tax net income not over $25,000.

25. These rates, imposed on top of an income tax rate of 24%, are comparable with the World War rates, which were graduated from 20% to 60% on top of an income tax of 12%. Revenue Act of 1918, § 201. However, the World War Acts were based upon invested capital alone, and hence the credits thereunder were materially less in many instances. The current English Act levies a 100% tax on earnings in excess of those received during the base period. Finance Act (No. 2) of 1940, 3 and 4 Geo. VI, c. 29, § 26. The Canadian Act imposes a 75% tax on earnings above those received in the base period. (Canada) Stats. of 1940, c. 32, § 3.
EXCESS PROFITS TAX

corporations. While it imposes the heaviest tax on those profits which by
their size alone are most likely to arouse popular indignation, it may be
argued that the controlling consideration should not be the amount of profits,
but the degree to which they exceed those regarded as appropriate for the
business in question. 26

The Determination of Excess Profits Net Income.—Although excess
profits net income is essentially the same as net taxable income for income
tax purposes, 27 certain items of income are not subjected to this tax, and
certain income tax deductions are not allowed. 28 Whatever the legislative
origin of these somewhat haphazard adjustments, they seem in considerable
part consistent with the special objectives of an excess profits tax.

Under any theory of excess profits taxation it would seem that the attempt
should be to tax the excess of that income which results from the productive
activity of the corporation, and to disregard items which are unusual and
nonrecurrent. This may be the explanation of the non-recognition of long-
term capital gains and losses, 29 of net gains from the sale of depreciable
property held over eighteen months, 30 and of income from the retirement or
discharge of indebtedness outstanding for more than eighteen months. 31
Losses on the two latter items are still allowed as deductions. A possible
explanation might be the seeming unfairness of taxing a corporation on
“excess” earnings when those earnings are offset by losses; under this theory,
however, long-term transactions of all types should be allowed to offset each
other and only the net loss should be deductible. Another reason for the

26. See Minority Report, p. 7. The rates proposed by the Senate Committee were
based on both dollar amounts and percentage over credit. Conference Report, p. 42.
The application to corporations of a graduated tax based on dollar amounts seems
inappropriate, since the tax is not imposed on units of comparable size. See Colm,
Conflicting Theories of Corporate Income Taxation (1940) 7 LAW. & CONTEMP. PROB.
280, 282. The present corporate income tax imposes a flat 24% on all incomes over
$25,000, although it is graduated by dollar amounts for smaller incomes.

27. See Int. Rev. Code § 13(a)(2) (1939). The tax throughout builds upon the in-
come tax structure; thus all provisions of the income tax law are applicable under this
Act and the terms used have the same meaning herein as under the income tax, §§ 728,
729.

28. Section 711(a). For the most part, the same adjustments are provided for
whether the taxpayer chooses the invested capital or average earnings method. See
pp. 291-297 infra. Additional adjustments for taxpayers on the invested capital
method are: (1) only 50% of interest paid is deductible (This is a corollary of the
inclusion of 50% of borrowed capital in invested capital); (2) interest on tax exempt
Government bonds may be included if the security is included in invested capital; (3)
all dividends received are deducted, not merely those from domestic corporations.

29. The taxation of capital gains and losses is now controlled by Int. Rev. Code
§ 117 (1939).

30. Depreciable property is defined in U. S. Treas. Reg. 103, § 19.23(E)-2.

31. If the issuance was at a premium, the accrued amortization of the premium for
the part of the year preceding discharge is still income; the unamortized premium,
however, is excluded from income.
allowance of the deduction for expenses and loss on retirement of indebtedness might be to provide some stimulus to improvements in financial structure through bond retirement at a premium.

The failure to make similar adjustments for short-term capital gains and losses may derive not only from the fact that economically the gain or loss is realized during a period proximate to the taxable year, but also from their special treatment under the income tax, based on the assumption that they are likely to be speculative. Since profitable speculations in property will probably be a result of a wartime rise in prices, taxation of these gains may be justified as an attempt to prevent “profiteering.” Similar reasoning, however, would in most cases be inapplicable to short-term gains or losses on the sale of depreciable property, or to income or loss from the short-term retirement of indebtedness.

B. Bases for Determining “Excess”

After the determination of excess profits net income there remains the computation of the credit to be allowed in order to arrive at the amount of income which is actually taxed as “excess.” The present Act is unique in giving the taxpayer an annual choice between two methods: one based

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32. It will thus be desirable for the taxpayer to hold his property over 18 months if a gain on sale is probable. Conversely, if a corporation has been making excess profits and has short-term capital goods that can be sold at a loss, it will be desirable for it to do so at once, within the limitations imposed by § 117(d).

33. For income tax purposes, at least two distinctions are drawn between long-term and short-term transactions: (1) deductions for unlimited long-term capital losses are allowed, but short-term losses are allowed only to the extent of short-term gains [Int. Rev. Code § 117(b) (1939)]; (2) in the case of a taxpayer other than a corporation, the percentages of the capital gains or losses to be regarded for tax purposes, differ with the length of time the property is held [Int. Rev. Code § 117(b) (1939)].


35. Other adjustments, which serve to lessen excess profits net income are made: (1) 100% of dividends received is excluded, instead of the 85% credit given by the corporation income tax. Int. Rev. Code § 26(b) (1939). The income out of which dividends were paid has already been subject to excess profits taxation. In the case of a taxpayer adopting the invested capital method, this applies to dividends from all corporations other than foreign personal holding companies; if the taxpayer adopts the average earnings method he may exclude only dividends from domestic corporations. If the dividends from foreign corporations are abnormal, relief may be possible under § 720. See Conference Report, p. 46. (2) Income from the recovery of taxes paid under the AAA, and income from the recovery of a debt charged off as worthless in a taxable year prior to 1940 is excluded. Since these items are treated as income in order to correct deductions allowed or allowable in previous years, during which no excess profits tax was applicable, their exclusion seems proper; (3) Income taxes paid may be deducted. The penalty tax imposed by Int. Rev. Code § 102 (1939) is not deductible.


37. Section 712(a). The option is taken “at the election of the taxpayer made in its return during the taxable year.” Certain foreign corporations, corporations delinquent in filing their returns, and domestic corporations organized after Jan. 1, 1940 must
on average earnings during a base period, and thus suited to the taxation of "war profits"; the other based on a percentage of invested capital for the current year, and therefore suited to the taxation of "excessive profits."^38

By giving this option the Act carries out neither theory of excess profits taxation.^39

The Invested Capital Method.—A credit of 8% of the amount of the invested capital in the current taxable year may be taken. Invested capital is the sum of equity capital and 50% of borrowed capital.^41 Equity capital consists essentially of money and property^42 paid in for stock or as paid-in surplus or contributions to capital, and accumulated earnings and profits^43 as of the beginning of the taxable year. The amount thus determined must use the invested capital method. §712. Corporations organized after the end of the base period obviously cannot use the average earnings method. But this reason does not explain the denial of this option to corporations filing late returns. This restriction is apparently additional evidence of Congressional opposition to the average earnings method. See note 62 infra.

38. Section 712. A third method suggested during the course of Congressional debate was the use of the "payroll to profit" ratio. See 85 Cong. Rec., Sept. 13, 1940, at 18,402. However, the fact that this ratio varies greatly in different industries makes this alternative unsuitable.

39. See p. 286 supra. In effect, the act taxes only those "war profits" which are not also "excessive profits."

40. Sections 714-720.

41. This sum must be reduced by the amount of inadmissible assets. See p. 295 infra.

42. Under the instant Act, credit seems to be given for the full amount of "intangibles" as well as "tangibles," which are paid in for stock. Consequently, the numerous questions arising under the previous excess profits acts where intangibles (consisting of patents, trademarks, etc.) were admitted only to a limited extent, will be eliminated. For a comparison of the invested capital provisions of the Revenue Acts of 1917, 1918 and 1921, see Holmes, Federal Income Tax (1923 ed.) 1241, 1244.

43. For purposes of determining whether a dividend is out of earnings, the amount of earnings and profits on the corporation's books is not determinative and probably not even prima facie evidence of the earnings and profits which will be allowed. See 1 Paul and Mertens, Law of Federal Income Taxation (1934) 343. Gains and losses are generally brought into the earnings and profits account only to the extent to which they are recognized for income tax purposes. U. S. Treas. Reg. 101, Art. 1153. Cf. Paul, Ascertainment of "Earnings of Profits" for the Purposes of Determining Taxability of Corporate Distributions (1937) 51 Harv. L. Rev. 40.

44. Certain other items will affect invested capital. Capital will be increased by the gain and reduced by the loss incurred on a tax-free liquidation. §§718(a)(5), 718(b)(4). Capital is reduced by the amount of earnings and profits of a transferor corporation which under the rule of Comm'r v. Sansome, 60 F. (2d) 931 (C. C. A. 2d, 1932), cert. denied, 287 U. S. 667 (1932), would be treated as earnings and profits of the transferee. §718(b)(3); see Conference Report, p. 49.

The World War Acts had similar provisions. Revenue Acts of 1918 and 1921, §326(a). The method adopted has the advantages that it eliminates the possibility of tax avoidance by inflation of book values. See Minority Report, p. 12. The need for annual valuations of assets is eliminated insofar as the determination of equity capital
be reduced to allow for dividend distributions. In order to account for changes made during the year, the computation is made by averaging the amounts of invested capital for each day of the taxable year.\(^4\)

The significant feature of this method of determining equity capital is that it considers only money and property moving between the corporation and its shareholders.\(^4\) Purchases of property will not directly affect equity capital unless the corporation issues stock in consideration therefor.

Appreciation in the value of the property will not affect invested capital, despite the resultant increase in earning power of the corporation.\(^4\) But where the property has been sold at a profit and the gain taxed as income, that gain may be reflected in invested capital through an increase in accumulated earnings. Hence, where property has appreciated in value, it would seem possible to take advantage of that appreciation by transferring the property to another corporation for its stock, provided the transfer is not a tax free exchange under the income tax.\(^4\) Since property paid in is included in invested capital at an amount equal to the unadjusted basis used in the income tax for determining loss upon sale or exchange,\(^4\) the

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is concerned, but the provisions relating to inadmissibles [see p. 295 infra] require the determination for each day of the adjusted basis of all assets held on that day. It is to be hoped that the Commissioner's regulations [see §720(b)] will provide a simple procedure for making this determination.

45. In order to relieve the hardship of daily computation, the Commissioner is empowered to allow the taxpayer to use another basis provided the resulting invested capital will not differ by more than $1,000 from an invested capital determined on a daily basis. §715. But to ascertain whether or not there is the $1,000 difference, the corporation may be obliged to compute its daily invested capital.

46. The inclusion of accumulated earnings and profits in invested capital is not necessarily inconsistent with this statement. To the extent that income has been received, it is money or property available for distribution to stockholders. While the corporation may legitimately refuse so to distribute earnings, the retention of those earnings may be regarded as an involuntary reinvestment by the stockholders.

47. This was equally true under the World War Acts. La Belle Iron Works v. United States, 256 U. S. 377 (1921). For criticism of this refusal to include appreciation in property see McCamic, *Appreciation in Value as Invested Capital under the Excess Profits Law* (1920) 30 Yale L. J. 239; Adams, *Should the Excess Profits Tax be Repealed?* (1921) 35 Q. J. Econ. 363, 378.

48. See INT. REV. CODE §112 (1939).

49. Section 718(a)(2). The unadjusted basis for determining loss is normally the cost to the transferee. INT. REV. CODE §113(a) (1939). This will be the fair market value of the stock given in exchange for the property where such a value is ascertainable. Seymour Mfg. Co., 19 B. T. A. 1280 (1930); see Ida I. McKinney, 32 B. T. A. 459, 456 (1935), aff'd, 87 F. (2d) 811, (C. C. A. 10th, 1937); 2 PAUL AND MERTENS, *Law of Federal Income Taxation* (1934) 271. Where, however, the fair market value of the stock cannot be ascertained, the unadjusted basis of the property received by the corporation is the fair market value of such property. Gillette Rubber Co., 31 B. T. A. 483 (1934); Record Petroleum Corp., 32 B. T. A. 1270 (1935). Where the property was acquired in a tax-free exchange, the basis is the cost to the transferor. INT. REV. CODE §§113(a) (6), 113(a) (7), 113(a) (8) (1939).
feree would acquire an invested capital credit equal to the value of the stock transferred, or if that were not ascertainable, equal to the value of the assets received. The transferor, of course, would realize taxable gain on the difference between the cost to it of the property and the value of the stock received therefor, but this gain would be capable of becoming part of the accumulated earnings and profits for subsequent years. The World War acts provided that a transferee corporation could include the property in its invested capital at no more than the amount at which it was included by the transferor, if the transferor owned more than 50% of the transferee's stock.\(^\text{50}\)

The effect of the present income tax provisions relating to tax free exchanges would be similar, but since their applicability is largely restricted to transfers where there is at least 80% control,\(^\text{51}\) the possibility of the type of transaction described is greater under the present Act.

Any method of computation based on amount invested must take into consideration dividend distributions to shareholders; where the money or property so distributed has previously been included in invested capital, it is necessary to reduce invested capital by the amount distributed.\(^\text{52}\) No reduction is needed, however, where the distribution is out of current earnings and profits, as they have not yet been included in invested capital. Since distributions made in previous years out of earnings and profits will automatically have reduced the accumulated earnings and profits account for subsequent years, no further adjustment is necessary.

By making these deductions for dividends distributed, and by including accumulated earnings and profits in invested capital, the Act encourages the retention of earnings by corporations using the invested capital method, and discourages distribution to stockholders.\(^\text{53}\) To some extent this may provide

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The World War Acts included property at its "value" at the time of the transfer. \textit{Revenue Acts of 1918 and 1921}, § 326(a). The statement that the present Act eliminates the difficulties that arose under the World War acts [see Minority Report, p. 11] seems only partially true, since in many cases it will be necessary to value the property as of the date paid in, and in others such valuation would not have been difficult. However, the fact that the determination of basis is a familiar process, and one which it may be necessary to go through under the income tax, will facilitate administration.


51. See the definitions of "reorganization" and "control" in \textit{Int. Rev. Code} §§ 112(g), 112(h) (1939). § 113(a)(8)(B) appears to impose no requirement of control.

52. Section 718(b) provides for the deduction from invested capital of dividends paid in the current year out of other than earnings and profits of that year, and of dividends paid in prior years out of other than earnings and profits.

53. Since capital reductions effected by dividend distributions are computed on a daily basis, the delaying of distribution of dividends derived from other than current earnings and profits is encouraged. Section 718(c)(2) provides that a dividend declared within the first 60 days of a taxable year shall be deemed to have been declared in the previous year. This provision prevents the augmentation of the accumulated earnings and profits account by the amount of this dividend; but its effect may be avoided by delaying distribution until the 60-day period has lapsed.
an added incentive to plant expansion; but the danger seems real that corporations, especially if they believe the tax to be of a temporary nature, will build up large accumulations of idle money.

Stock dividends cause further problems. Although many stock dividends represent taxable income to the recipient, they represent to the corporation merely a capitalization of its surplus, which in no way reduces its assets or its earning power. Hence the Act does not permit a reduction of invested capital because of stock distributions. One way of reaching the same result might have been to treat a taxable stock dividend as a distribution of money or property to shareholders, who immediately return it to the corporation in payment for stock. The Act specifically rejects this theory, and instead provides that stock dividends out of earnings and profits other than those of the current taxable year shall be added to invested capital, and that stock dividends from other sources shall not be treated as "distributions." Thus, by excluding certain stock dividends from the operation of the rules applicable to dividends in general, and by restoring to invested capital in all other cases the amounts deducted under those rules or the amounts by which accumulated earnings and profits had been reduced as a result of the dividends, the Act allows stock dividends to have no effect on invested capital.

The inclusion in invested capital of 50% of borrowed capital may be justified by the increased risk to which stockholders' investments are subjected by the incurring of obligations prior to their own. Congress appears to have been motivated by a desire to aid small businesses which might find it difficult to obtain needed money by issuing stock. It is probable that the restriction to 50% reflected a fear that the relatively simple processes by

55. Section 718(c) (1).
56. Sections 718(a) (3), 718(c) (1). The statutory language is that dividends which "are considered distributions of earnings and profits" shall be added to invested capital. To the extent that a stock dividend is taxable under the income tax, it is considered to reduce the earnings and profits available for subsequent dividend distribution; a non-taxable stock dividend does not so reduce earnings and profits. Int. Rev. Code § 115(h) (1939); see August Horrmann, 34 B. T. A. 1178, 1183, 1184 (1936). The distinction adopted by this Act is, therefore, that between taxable and non-taxable stock dividends.
57. Section 719. While the statutory definition includes most debts evidenced by writing, a mere written contract probably would not be acceptable as evidence of indebtedness. Surrey, Invested Capital, address before the Trade & Commerce Ass'n, Oct. 21, 1940. However, this restriction on the use of a contract can easily be avoided by resort to a post dated check, which, being a bill of exchange, satisfies the statutory definition.
58. See Senate Report, p. 2. The House bill attempted further to favor small corporations by including varying percentages of borrowed capital, depending on the size of the corporation.
which debt, especially inter-company debt, might be incurred would furnish
a ready means of tax avoidance. The effect of such transactions might be
negated by application of the doctrine of Gregory v. Helvering so as to
allow the inclusion in invested capital of only that portion of the borrowed
capital which is actually needed and employed in the business. But the
difficulties of determining how much was so needed and employed would
make it probable that only the most obvious attempts to avoid the tax would
thus be thwarted.

After adding one-half of borrowed capital to equity capital one further
adjustment must be made. Since dividends from other corporations are not
included in excess profits net income, it seems fair to deduct that proportion
of invested capital which such stock bears to the total corporate assets.
A similar deduction is made for tax-exempt securities, except that at the
taxpayer's option such securities may be included in invested capital, and
the income therefrom subjected to tax.

The Average Earnings Method.—The alternative method of computing
excess profits credit is based on 95% of the average earnings during a base
period from 1936 through 1939. In order to obtain a proper basis for compa-
nison, items of income or loss which are not anticipated or which do not
result from current business operations should be disregarded in computing
income. Furthermore, the same adjustments should be made in the base
period years as in the current taxable year. The Act wholly satisfies neither
objective. It is true that the adjustments made in determining current taxable

59. Shoup, The Excess Profits Tax, unpublished address delivered before the 33d
Annual Tax Conference, National Tax Association, Sept. 12, 1940. Another reason for
the restriction to 50% may be that the interest paid on such obligations is allowed as a
deduction under the income tax.

60. 293 U. S. 465 (1935).

61. Section 720. See note 28 supra. Special provision is also made to reduce the
amount of inadmissibles wherever the inadmissible is sold and a short-term capital gain,
which does figure in excess profits net income is realized. §720(c).

62. The allowance of only 95% can probably be explained by Congressional opposi-
tion to the average earnings option. Indeed the House version provided for a 4.1% pen-
alty provision and a 5% higher excess profits tax rate on those corporations not
electing the invested capital method. See Conference Report, p. 42.

63. It has been suggested that the period of 1924 through 1927 is more suitable
for a base period inasmuch as it is a more normal period than the depression years of
1936 through 1939. Brief of American Institute of Accounting Presented to Committe
on Internal Revenue Taxation, J. Acc'Tcy, Sept. 1940, 245. But many corporations
subject to the Excess Profits Tax would not have been in existence during that period.

The present Canadian Excess Profits Tax employs a base period of 1936 through
1939 in ascertaining "normal" or "standard" profits. (Canada) Stats of 1940, 2d Sess.,
c. 32, §2(1)(h). Under the current English Excess Profits Tax, varying one or two
year base periods are employed. Finance (No. 2) Act of 1939, Part III, 2 and 3 Geo VI,
c. 109, §13.
year income are repeated in the determination of base period income. But deductions for certain abnormal losses—e.g., casualty, theft, or judgments paid—are disallowed in the base period only. And abnormal gains are not excluded during the base period, although, in determining current taxable year income, windfalls such as judgments recovered can be spread over several years. Thus the taxpayer is favored at every turn.

The income for the four base years must be averaged. If deficits have been incurred, the income for the year of the largest deficit was incurred is taken at zero, although other deficits are included in the average. This provision, a compromise from the Senate provision allowing a choice of three of the four years, may be simply a reflection of doubt as to the ability to select a wholly satisfactory base period.

Changes in the size of a corporation during or after the base period—which are automatically reflected in the taxpayers' credit under the invested capital method—present difficulties in applying the average earnings method. Whether such changes occurred during or after the base period, comparison with earnings prior to such alteration is meaningless.

Determination of hypothetical base period earnings had the corporation then had its present size would be the ideal method; but this is seldom possible. Hence arbitrary figures are adopted, and the credit is adjusted by adding 8% of the net capital additions or deducting 6% of the net capital reductions which have occurred since the end of the base period. One objection to this method is that it fails to take account of changes in invested capital during the base period, which serve to render earnings prior to such change inaccurate as a comparative. Moreover, it seems inconsistent to regard earnings over 8% from a part of a corporation's property as "excess," while

64. See p. 289 supra. Thus, income tax paid for the year in question is deductible [§ 711(b)(1)(A)]; dividends on stock of domestic corporations are deductible [§ 711(b)(1)(I)]; income from discharge of obligations outstanding for over 18 months is deductible [§ 711(b)(1)(C)]; a share of the deduction taken for repayment of processing tax to vendees is disallowed [§ 711(b)(1)(F)]; long-term capital gains and losses are excluded [§ 711(b)(1)(B)], though the sections of the present Act dealing with the worthlessness of securities [§§ 23(g)(2), 23(k)(2)] and § 117 are treated as having been part of the applicable revenue act, so that a common system of treatment is possible [§ 711(b)(2)]; net gains from depreciable property held over 18 months is excluded [§ 711(b)(1)(B)]. Not excluded from base period income, however, is income from the recovery of a previously discharged bad debt.

65. Section 711(b)(1)(E).
66. Section 721.
67. Section 713(b)(4). In no event can the average base period net income be less than zero. § 713(b)(6).
68. Conference Report, p. 48. The Senate provision was probably stimulated by the feeling that one year during the base period might be an unduly abnormal year, and should not, therefore, be permitted to upset the computation. Cooper, Excess Profits Net Income, address before Trade & Commerce Ass'n, N. Y. C., Oct. 21, 1940.
69. Special provision is made, however, for certain tax-free exchanges. See § 751.
permitting higher earnings from the remainder of its property.70 Both of these criticisms would be obviated if the same rate of earning were allowed on present invested capital as was earned on the base period invested capital.71 But the 8% provision may be justified by the possibility that extensive capital expansion by corporations with favorable base period earnings, possibly accompanied by entry into fields of activity completely unrelated to that engaged in during the base period, might free large profits from the excess profits tax, with resultant impairment of both revenue and morale.

The method of determining the amount of net capital additions or reductions roughly approximates that used to determine invested capital.72 However, no consideration is given to accumulations of earnings or to changes in borrowed capital. The reason for including these in invested capital but not regarding them as capital additions under the average earnings method is not apparent.

C. Problems Involving Several Corporations

**Mergers and Consolidations.** — Supplement A to the Act provides that in combinations of corporations through exchanges of property for stock,73 credits for resulting increases in invested capital are not set at 8% but are arrived at by a special method. This Supplement deals with the acquisition by an “acquiring corporation,” actually or constructively74 in existence at the beginning of its base period, of property of another corporation, designated the “component corporation,” which was similarly in existence. The average earnings credit of the corporation resulting from a consolidation, or enlarged by a merger, is the sum of the credits of the participating cor-

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70. Somewhat analogous is the provision giving to domestic corporations not in existence throughout the base period a constructive income for the period during which they were not in existence, equal to 8% of their invested capital as of the first taxable year after the base period. §713(b)(5).

71. The House bill adopted such a method of determining credit, operative within a 5% minimum and 10% maximum return on invested capital. See Conference Report, p. 48. The Revenue Act of 1917 had a similar provision (§207), using the pre-war period of 1911, 1912, and 1913, and employing a 7% minimum and a 9% maximum.

72. Section 713. The net capital addition or net capital reduction for a given year is the difference between the aggregates of daily additions and of daily reductions. Daily additions or reductions are all additions or reductions made between the end of the taxpayer's base period and the day in question.

73. These are prescribed in §740(a). *Cf. Revenue Act of 1918*, §330; Revenue Act of 1917, §204. Included are transactions which come within the reorganization and liquidation provisions postponing recognition of gain or loss for income tax purposes. *Cf. Int. Rev. Code* §§112(b)(6), 112(g) (1939). Consequently, many of the problems presented by the definition have arisen under the income tax. Comparable provisions of the English and Canadian acts are relatively brief and unspecific. Finance (No. 2) Act, 1939, 2 & 3 Geo. VI, c. 109, §16, amended by Finance Act, 1940, 3 & 4 Geo. VI, c. 29, §38; Excess Profits Tax Act of 1940, (Canada) *Stats. of 1940*, 2d Sess., c. 32, §4(2).

74. An acquiring corporation is considered to have been in existence at the beginning of its base period if any of its components was in existence on that date. §740(f).
To make an exact estimate of the normal income of such taxpayer, however, it might appear necessary to determine what the experience of the combined properties during the base years would have been if the combination had occurred at the beginning of that period — an experience which may differ from a total of the separate experiences of the properties during this period. But the impossibility of making such determination has apparently compelled the underlying assumption in Supplement A that the normal return on the combined properties is simply the sum of the separate normal returns.

The chief line of demarcation between the mutually exclusive spheres of Supplement A and the provision setting the increase in credit at 8% of acquired assets is the requirement that for Supplement A to apply, "substantially all the properties" of the component be acquired. To avoid its application, therefore, the exchange may be arranged so that less than "substantially all" of the component's assets are obtained. And it might be argued that the limitation on Supplement A is unnecessary in that a percentage of the component's total credit might have been allowed, equal to the percentage of the component's total property which is acquired. But the inaccuracies which might result from variations in earning power between portions of the component's property may justify the restriction of Supplement A to transfers of substantially all of the component's property.

For excess profits tax purposes, it is advantageous to come within the scope of Supplement A if one of the participants has a high current return but a comparatively low credit, while the other has a relatively high credit and is currently receiving a low return or suffering a loss. Moreover, if the transaction comes within Supplement A, it will be an exchange on which

75. This is roughly the result of the formula in §742(a), (b), (c). Where an acquirer (or a component which is itself an acquirer) was not in actual existence at the beginning of its base period; its credit is computed without regard to either income nor losses for the period preceding the date on which it became an acquirer. §740(f)-(1), (2). Since the income subsequent to this date is apparently spread over the four base years, the resulting figure is no indication of the normal income of the taxpayer. The failure to take account of a corporation's base period experience prior to its becoming an acquirer seems unjustified, especially in view of the fact that where Supplement A is inapplicable a corporation not in existence during part of the base period is given a constructive income. Cf. §713(b) (5).

Moreover, if the taxpayer becomes an acquirer within the current taxable year, it can include only a percentage of its components' income equal to the ratio of the number of days after the exchange to the total number of days in that year. §742(f) (4). Administrative convenience may justify this assumption that the component's income is spread evenly over its taxable year.

76. Section 740(a). The construction received by a similar requirement under the income tax indicated that "substantially all" may mean as little as 85%. Western Industries Co. v. Helvering, 82 F. (2d) 461 (App. D. C. 1936).

77. The English Act in a similar situation provides for such allocation of capital, profits and losses as may appear just to the Commissioners. Finance (No. 2) Act, 1939, 2 & 3 Geo. VI, c. 109, §16(5), amended by Finance Act, 1940, 3 & 4 Geo. VI, c. 29, §38.
the recognition of gain for income tax purposes is postponed.\textsuperscript{78} The effect, however, of a combination is to restrict the taxpayer to a single deduction of $5,000\textsuperscript{79} instead of two such deductions. And if the participants are each receiving excess profits, the combination causes an amalgamation of such profits and perhaps a projection of the total into a higher rate bracket than was applicable prior to combination.

In addition, the fact that Supplement A precludes the use of the invested capital method as to acquired assets operates to the disadvantage of the acquirer when it desires to continue to use the average earnings method after acquiring the assets of a component that has earned less than 8% during the base period. This disadvantage is even more pronounced when combination is sought with a component which has sustained an average net loss during the base period, since such deficits must be subtracted from the acquirer’s credit.\textsuperscript{80}

In one type of transactions covered by Supplement A\textsuperscript{81} there is no requirement that after an exchange the component be dissolved or compelled to compute its credit on the invested capital plan. A parent corporation, which has earned more than 8% in its base period, may strip itself of all its assets by a transfer to a subsidiary which had been in existence throughout the former’s base period, so that only the corporate shell remains. Under Supplement A the subsidiary is allowed the parent’s base period credit. Since the parent is permitted to continue its existence, it would appear to retain its old credit.\textsuperscript{82} If the parent then acquires new assets of any kind, and continues doing business, it will apparently be able to apply against income produced by those assets not only the credit properly pertaining to them,\textsuperscript{83} but its old credit in addition.\textsuperscript{84} That the parent continues to receive approximately its old return indirectly from the subsidiary in the form of dividends can hardly justify retention of its old credit, for these dividends are not included in the parent’s excess profits income. These maneuvers may be thwarted, however, by judicial construction of the Act to require dissolution of the parent or by liberal application of the doctrine of \textit{Gregory v. Helvering}.\textsuperscript{85}

\textit{Consolidated Returns.}—Filing a consolidated return affords many of the tax advantages (and disadvantages) of merger. But the privilege to file a

\textsuperscript{78} See note 73 supra.
\textsuperscript{79} Cf. § 710(b) (1).
\textsuperscript{80} Cf. § 742(a) (3). This effect is eliminated under extremely restricted circumstances. § 742(a).
\textsuperscript{81} Section 740(a) (1) (A).
\textsuperscript{82} Cf. Minority Report, p. 4.
\textsuperscript{83} Section 713(a) (1).
\textsuperscript{84} Cf. Haig and Holmes, \textit{The Taxation of Excess Profits in Great Britain}, Am. Econ. Rev. Supp., Dec., 1920, p. 149. But this might reduce the highest bracket amounts of the parent and subsidiary. See p. 301 et seq. This disadvantage may be minimized by obtaining control of less than 90 per cent of the stock of a subsidiary which has not previously had its highest bracket amount reduced.
\textsuperscript{85} 293 U. S. 465 (1935).
consolidated return is limited to an "affiliated group" of corporations in which 95% of each class of stock of each member is owned directly by one or more other members and 95% of each class of stock of at least one member is owned directly by a common parent.

The use of consolidated returns is justified when corporations are thus closely allied, since they compose but a single business unit and should be taxed as such. Similar provisions in earlier statutes generally worked to the advantage of the taxpayer in that they permitted the elimination of inter-company profits and the offsetting of one member's profits against another's losses. But the advantage of filing a consolidated return under the Excess Profits Tax is not so clear. It is true that a group of corporations may obtain in the current taxable year a lower total income than would be the case if each filed a separate return. If, however, the Commissioner, under his power to regulate, requires the corporations using the average earnings method to recomputing on a comparable basis their returns for the base years, the resultant lowering of the base period credit would tend to offset the advantage of lower consolidated earnings in the taxable year. Consequently,

86. Section 730. This includes corporations which have been members of the affiliated group at any time during the taxable year. If a corporation is a member of the group for a fractional part of the year, the consolidated return is to include the income of such corporation for such part of the year as it was a member of the group.


Provisions allowing consolidated returns are found in both the English and Canadian excess profits taxes. 3 & 4 Geo. VI, c. 29, § 28 (1940); (Canada) Stats. of 1940, 2d Sess., c. 32, § 10.

88. See Haig, Federal Income Tax (1921) 190, 195; Ivins, Affiliated Corporations (1926) 4 Tax Mag. 131; Klein, Federal Income Taxation (1929) 1053-55; Montgomery, Federal Income Tax (1935-1936) 678-79; Note (1932) 32 Col. L. Rev. 513. The mandatory consolidated return provisions of the 1918 Act were intended to prevent tax avoidance, but in the large majority of cases resulted in greatly reduced taxes. See Klein, Federal Income Taxation (1929) 1052.

89. See Minority Report, p. 16: "... refinements in the bill with reference to exchanges and reorganizations have made consolidated returns unnecessary and actually inequitable in some cases."

90. Section 730(b) gives the Commissioner broad powers of regulation, and § 730(a) conditions the filing of a consolidated return on a consent to all such regulations promulgated prior to the last day for filing returns. Such a consent provision first appeared in the Revenue Act of 1928. This delegation of power "to prescribe regulations legislative in character" has been upheld. See Ilfeld Co. v. Hernandez, 292 U. S. 62, 65 (1934).
since the rate of tax on excess profits increases with the total dollar amount of the excess, it may prove undesirable to consolidate earnings.\(^1\)

In computing the excess profits credit by the invested capital method, stock held in another corporation must be deducted from equity invested capital.\(^2\) Hence a consolidated return would produce the same invested capital as would the sum of a set of separate returns. But inter-company debts are not excluded from invested capital. Assuming that the Treasury Regulations will require elimination of inter-company debt holdings in a consolidated return, a group of companies may by filing separate returns report a higher invested capital than they might by filing a consolidated return.\(^3\) There are, moreover, real possibilities within an affiliated group for the circular creation of debts which would increase invested capital. The loss of these possibilities in a consolidated return might make use of such a return considerably less attractive.

The Use of the Highest Bracket Amount.—As has been indicated, the fact that the rates are based on dollar amounts has decreased the desirability to the taxpayer, of mergers and consolidations and of filing consolidated returns. In an effort to invoke lower rates, a corporation might split itself in a manner not affecting the substance of its interest,\(^4\) but dividing its excess profits among the resulting units so that the several parts of those profits would come within lower rate brackets than would have applied to the total of such profits. The aggregate of the tax on the parts would be less than the tax on the total. In view of the continuity of the transferor corporation's interest, the tax reduction so achieved seems unjustified. It was to such a situation that Supplement B to the Act was directed.\(^5\)

The net effect of Supplement B in conjunction with Section 710 is to take the several parts of the former total of excess profits and project them into a rate bracket which would have been applicable to the total, so that the sum of the taxes on the several parts is not less than that which would have been the tax on the total. To restore the excess profits tax situation which preceded the split-up, the device of altering the "highest bracket amount" is employed. The highest bracket amount of a corporation is defined as that sum in the rate structure at and above which the highest rate becomes applicable (normally \$500,000).\(^6\) But when a corporation engages in a split-up, Supplement B may operate to reduce its highest bracket amount to a figure

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91. See N. Y. Times, Oct. 13, 1940, p. 51, col. 5. Note also that the Act permits only one specific exemption of \$5,000 to the affiliated group.
92. Section 720.
93. It is doubtful whether treasury regulations could exclude inter-company debt holdings where separate returns are filed inasmuch as § 720 seems to apply only to stock.
95. Senate Report, p. 20. The scope of Supplement B is defined by § 750(a).
96. Section 750(e) provides that it is \$500,000 or the highest bracket amount computed under § 752.
less than $500,000. Each of the bracket amounts in the rate structure below the top bracket is then reduced, under Section 710, proportionately to the reduction in the highest bracket amount. But the rate applicable to any one of the new brackets is the rate applicable to the bracket it displaced. These provisions concerning determination of highest bracket amounts affect only the rate structure, and bear no relation to the computation of the adjusted excess profits net income on which the rate structure operates.

Exchanges which produce split-ups usually affect bracket amounts to a greater extent if the transferor retains or acquires "control" of the transferee than if this element of control is absent. "Control" is defined as "at least 90 per centum of the total combined voting power of all classes of stock entitled to vote and at least 90 per centum of the total value" of the transferee's entire stock. If the transferor possesses such control, Section 752 of Supplement B may decrease the highest bracket amount of the transferee, as well as that of the transferor. Thus interests of the transferee's minority shareholders are adversely affected because of the actions of the transferor. The definition of control apparently indicates a Congressional judgment that this result is undesirable where the minority interests represent more than 10% of the stock. This definition, however, requires the transferor to own a greater per cent of the transferee's stock than is required by the income tax as a condition precedent to postponement of recognition of gain or loss.

97. Absence of control means that "... immediately after the exchange no transferor or its shareholders, or both, upon the exchange are in control of the transferee, and ... the shareholders of the transferee immediately preceding the exchange are not in control of the transferee immediately after the exchange..." § 752(b) (3), (c) (3).

Where all the participants enter the transaction with highest bracket amounts of $500,000, and the element of "control" in the transferor is absent, these bracket amounts remain unchanged. Cf. §§ 752(b) (1), (3), (c) (1), (3). Thus the transaction is treated in the same manner as a sale or exchange between unrelated participants. However, if "control" is lacking, and any of the participants enter the transaction with highest bracket amounts less than $500,000, there may be an alteration in these amounts. *Ibid.* Wherever the element of "control" is present, there must result an alteration in the highest bracket amounts. §§ 752(b) (2), (c) (2), (c) (4).

98. See note 97 *supra*. If the transferee receives excess profits both from property originally held and from newly acquired property, the bracket applicable to the sum of these profits may be higher than those brackets applicable to the separate parts. Therefore, at first impression, it may seem that where there has been an addition to the transferee's property, this factor should be taken into consideration when the highest bracket amount is being determined. But it is possible that without a reduction in the transferee's highest bracket amount, the exchange will result in an impairment of governmental revenue—e.g., if the transferee has a large credit with low current income whereas the transferor was in the converse position. While the reduction of this amount may result in the payment to the Government of more than it deserves, to determine whether this is so requires an examination of each case; the practical difficulties involved in such a procedure is patent.
on certain transactions.\textsuperscript{100} A transferor is therefore able to retain or acquire a percentage of stock great enough to obtain the benefits of operating control and of the postponement of income tax, and yet small enough to avoid the impact of the control provisions of Section 752 on the highest bracket amount.

The usual effect of the highest bracket amount device may well be merely a rough approximation of the situation before the split-up.\textsuperscript{101} The maze of formulae and computations involved in the operation of this device would appear unnecessary if the rates were graduated on a percentage ratio\textsuperscript{102} rather than on absolute dollar amounts; there would then be eliminated the chief incentive for engaging in the transaction at which the highest bracket amount sections are aimed.

D. Relief Provisions

Hardships will inevitably result from the application of a complex and hastily enacted statute imposing a fairly high tax by methods largely untested by experience. Although the alternative methods for determining excess profits credits and the elimination of burdensome aspects of former Acts\textsuperscript{103} have reduced the possibilities of hardship, provision for relief in individual cases was an evident necessity.\textsuperscript{104}

Some provisions were a clear response to specific cases which had been brought to the attention of Congress.\textsuperscript{105} Section 721 provides for the spreading over several years of specified abnormalities in income,\textsuperscript{106} and Section 723 provides a special method for determining equity invested capital where the usual formula cannot be used.\textsuperscript{107} To provide for cases not foreseen at the

\textsuperscript{100} Int. Rev. Code, § 112(h) (1939).

\textsuperscript{101} Cf. note 102 supra.

\textsuperscript{102} For the discussion of the rate structure, see p. 000 supra.

\textsuperscript{103} For example, two sources of administrative difficulty under the 1918 and 1921 Acts were the exclusion of borrowed capital, and the limitations on the inclusion of intangibles in determining invested capital. The inclusion of fifty per cent. of borrowed capital and of tangibles and intangibles without limitations reduces the possibilities of hardships.

\textsuperscript{104} Comparable provisions were included in the 1918 Act and appear in the present English and Canadian statutes. Revenue Act of 1918, §§ 327, 328, 3 & 4 Geo. 6, c. 29, § 27 (1940); (Canada) Stats. of 1940, 2d Sess., c. 32, §§ 4, 5.

\textsuperscript{105} World war experience and the hearings and debates were two main sources of information. See Joint Hearings, p. 330 (income from a contract the performance of which required several years); Senate Hearings, p. 223 (income arising out of a tax claim); Id. at 221, 272-273, 479-480, 491-492 (income from a contract the performance of which required several years); Id. at 468-475 (change in taxpayer's accounting method).

\textsuperscript{106} E.g., where it is unusual for the taxpayer to derive any such income or where the amount derived is unusual. It is uncertain whether the fact that the taxpayer has received abnormal income of a similar nature during one of the base years is sufficient to make this section inapplicable.

\textsuperscript{107} E.g., where the records have been lost or destroyed by which the corporation's equity invested capital would be determined.
time of enactment, Section 722 contains a blanket provision giving the Commissioner authority "to make such adjustments as may be necessary to adjust abnormalities affecting income or capital." The very general language of the provision and the fact that further study is to be given to the problem indicates that Congress will attempt to make specific provision for as many cases as possible and that the Commissioner is unlikely to exercise his powers until that time. At present, however, not only is the Commissioner given broad discretion to determine the occasions for the exercise of his powers of relief, but no procedure has been set up to guide his action.

In view of this broad grant of discretion, the extent to which the Commissioner's decisions will be reviewed becomes important. Specific provision is made for review by the Board of Tax Appeals of his decisions under Section 722. While no such provision is made in Sections 721 or 723 the Board will undoubtedly be held to have power to review the Commissioner's decisions. Under the authority of Williamsport Wire Rope Co. v. United States, however, it seems that in the absence of fraud or gross abuse by the Commissioner of his discretion, the taxpayer will be denied further appeal to the federal courts.

The present need for revenue is manifest. While the World War excess profits taxes furnished one-fourth of all ordinary receipts of the Government, the estimated yield of the present Act is at most one-twentieth of the anticipated annual revenue. Even allowing for substantial increases

108. See Conference Report, p. 52. It has been indicated that this revision will be made in time to affect the tax returns for the calendar year 1940. See 86 Cong. Rec., October 1, 1940, at 19499.
109. For the administrative difficulties in the procedure used under the World War Acts, see Joint Hearings, p. 95.
110. See Magill, Finality of Determinations of the Commissioner of Internal Revenue (1928) 28 Col. L. Rev. 563, (1930) 30 Col. L. Rev. 147. A special board of review independent of the Treasury Department to handle cases arising under the relief sections has been suggested. See Senate Hearings, pp. 24-28.
113. A further problem might arise as to the constitutionality of § 722 in view of the delegation of unlimited authority to the Commissioner. Since these provisions are intended to aid the taxpayer, this question is not likely to be raised. See Ballantine, Some Constitutional Aspects of the Excess Profits Tax (1920) 29 Yale L. J. 625, 637.
115. The net yield anticipated for the excess profits tax in fiscal 1940 is from $155,100,000 to $245,000,000. 86 Cong. Rec., Oct. 1, 1940, at 19407. But it has been predicted that taxable income will increase from 15 to 18% for 1941. See Senate Hearings, p. 200, the net yield might be increased to $400,000,000 or $450,000,000. The yield expected from the first Revenue Act of 1940 is about $1,000,000,000. H. R. Rep. No. 2114, 76th Cong., 3d Sess. (1940) 2. Current total anticipated receipts are $6,367,000,000 and
in profits in subsequent years, the return from the tax is likely to be unimpressive.

One way of increasing revenue yields would be to eliminate the taxpayer's opportunity to select from two methods of computation the one which will result in the lower tax. This change might also increase the Act's effectiveness in reducing profits of a size likely to arouse public indignation. Yet adoption of either method alone would introduce inequalities. The invested capital formula ignores the fact that the percentage of earnings from capital varies with the risk involved. The average earnings method, on the other hand, penalizes young corporations which were establishing themselves during the base period and have just begun to operate on a profit.

The emphasis of the present Act, a mild response to the demand for an excess profits tax, is upon the avoidance of hardship to the taxpayer. But if revenue needs increase or the public becomes restive at the size of corporate profits, revision of the Act seems inevitable.

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expenditures $12,058,000,000. Statement of Secretary Morgenthau, Joint Hearings, p. 18. Of this deficit $3,100,000,000 may be directly attributed to defense expenditures.

By reducing the earnings available for dividend distribution and by encouraging retention of earnings, the Excess Profits Tax may substantially reduce personal income tax yields. See Joint Hearings, p. 105. The figures given above take this into consideration in determining the net yield.

116. See Joint Hearings, p. 78.

117. See Adams, Excess Profits Tax in 5 ENCYC. SOC. SCI. (1937) 664, 666; Buehler, The Taxation of Corporate Excess Profits in Peace and War Times (1940) 7 LAW AND CONTEMP. PROB. 290, 299.

118. See Minority Report, pp. 4-7; Senate Hearings, pp. 231-238.