OBJECTIONS TO INVESTED CAPITAL METHOD AS THE SOLE STANDARD

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The fundamental objection to the Treasury plan is that it lays down a sole standard called "invested capital" for determining excess profits in all cases. This standard was applied during the World War without success. As a measure of excess profits, invested capital is not a proper standard in a great many cases. It gives no recognition to the fact that many businesses have been conservatively capitalized or built up, especially the smaller ones, not mainly from capital but from good management, skill, development of goodwill, favorable locations, trade advantages, and other important factors of personal efficiency. As well stated by the late Professor Seligman, of Columbia University:

> Almost all large businesses have grown from humble beginnings and it is precisely in these humble beginnings that the percentage of the profits to the capital invested is apt to be the greatest.

COMMENTS ON INVESTED CAPITAL BY ECONOMISTS AND ADMINISTRATORS

Objections to the invested capital method have been voiced by the following economists and administrators:

Dr. T. S. Adams, an adviser to the Treasury and the Congress, during the war years said in relation to the difficulties of invested capital:

> It depends to a large extent upon the mere action of form in which the corporation is organized. It penalizes undercapitalized corporations as compared with overcapitalized corporations. It punishes conservative corporation finance and rewards stock watering. A large number of the third-rate corporations which the public charges with profiteering get off with comparatively small excess-profits taxes because they have been so generously capitalized.

Mr. Arthur Ballantine, Solicitor of Internal Revenue in 1918 and later Under Secretary of the Treasury, said:

> There is no question that the experience of the Government and taxpayers with the determination of invested capital was unsatisfactory and this basis should not be used again except as a last resort.

In a letter to the War Policies Commission by Bernard M. Baruch, dated April 12, 1935, he said:

> I propose * * * to take by special taxes, 100 percent of all profits and income in war above the average of the preceding 3 years of peace * * *. Taxes on new enterprises will have to be adjusted and worked out separately * * *. I do not propose to make * * * asset values any factor in determining the tax, or to repeat the partial futility of the World War excess-profits tax.

The War Policies Commission analysis of testimony, prepared by its executive secretary, Mr. Robert H. Montgomery, a recognized authority on taxation, said:

> The determination of what constituted invested capital was an insoluble problem during the continuance of the tax, and is still unsolved.

The Treasury proposal follows in principle the 1917 excess-profits-tax law, which was soon replaced by the Revenue Act of 1918. Under that proposal, the corporation was allowed an invested-capital credit in an amount equal to the same percentage of the invested-capital for the taxable year which the average amount of net income during the base period was of the invested capital for the pre-war period (but not less than 7 nor more than 9 percent of the invested capital for the taxable year). In commenting upon this, Professor Seligman said:

What constitutes invested capital, however, is so elusive as to be virtually impossible of computation.

The following comments on an excess-profits tax based solely upon invested capital were voiced by the following Secretaries of the Treasury:

Secretary Glass (Annual Report of the Treasury for 1919):

The Treasury's objections to the excess-profits tax, even as a war expedient, * * * have been repeatedly voiced before the committees of the Congress. * * * It encourages wasteful expenditure, puts a premium on overcapitalization, and a penalty on brains, energy, and enterprise, discourages new ventures, and confirms old ventures in their monopolies.

Secretary Houston (Annual Report of the Treasury, 1920):

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.

Secretary Mills (in response to a resolution of the Senate requesting recommendations as to the findings of the War Policies Commission for wartime taxation) stated that "the experience of the World War clearly demonstrated 'the invested-capital basis' to be impracticable of general application."

ANALYSIS OF INEQUITIES IN INVESTED CAPITAL

Some corporations were organized in periods of low values—others in periods of high values. Some have frequent turn-overs in their stock sales, others have not. Some corporations have been liberal in their dividend policies, others have not. All of these factors have a very disturbing effect if invested capital is applied as the sole yardstick for measuring excess profits. It works fairly in some cases and unjustly in others.

The mere definition of invested capital is such as to discriminate in favor of the corporation which has retained a greater part of its earnings as contrasted with the corporation which has a liberal dividend policy. Invested capital does not consist merely of cash paid in to the corporation. It includes the basis for income taxes of property paid in for stock or as paid-in surplus or contribution to capital, the accumulated earnings and profits of the corporation, and 50 percent of the borrowed capital.

Let us look at certain actual cases to see how the invested-capital concept benefits the corporation retaining its earnings.

Corporation X, a closely held corporation, has retained approximately 85 percent of its earnings during its corporate history. With a fixed capital of less than 17 million dollars, it is able by reason of the retention of this large surplus, to establish an invested capital of approximately 617 million dollars. Under existing law, this will result in an invested-capital credit of approximately 49 million dollars, which will not only eliminate any excess profits tax liability for the calendar year 1940 but will also permit it to carry over into the next year an unused credit of approximately 22 million dollars to be offset against its 1941 excess profits net income. On the other hand, corporation Y, whose stock is widely held, and which has a fixed capital of 620 million dollars, retained only 450 million dollars of surplus over its corporate history. Y corporation has, therefore, distributed approximately 70 percent of its earnings as compared to a 15-percent distribution of its competitor, the X corporation. Y corporation is required to pay a large excess-profits tax, and, therefore, has no unused credit carry-over. Another competitor of the X corporation, corporation Z has reduced its surplus, through dividend distributions of approximately 63 percent of its aggregate earnings. Its fixed capital is approximately 52 million dollars and its accumulated earnings approximately 116 million dollars. This corporation can, therefore, only establish an invested capital of 168 million dollars as compared with its competitor X corporation's invested capital of 617 million dollars. If this corporation had adopted the policy of its competitor and distributed only 15 percent of its earnings, its invested capital would have been approximately 320 million dollars. The only relief available to corporations Y and Z from this competitive situation is through the use of the average-earnings basis. Clearly, it should not be the policy of the Government to penalize corporations, which through liberal dividend distributions, have brought in additional revenues to the Government. But this is exactly the result of the Treasury proposal, which gives much more favored treatment to the corporation whose policy in the past has been to retain a large part of its earnings.

It is claimed that by using for invested capital purposes the basis of property for income-tax purposes, many of the difficulties of determining the value of property as of a fixed date, possibly far in the past, are avoided, since the records of the Bureau and the income-tax returns filed by the taxpayer can reasonably be expected to reveal the data necessary for the determination of the basis of property paid in to a great majority of corporations. But this is not necessarily true. In many cases, the basis of property has been determined only through compromises or lump-sum settlements of the entire income-tax liability. It is very doubtful whether such determinations will be permitted to stand for invested capital purposes. Therefore, it will still be necessary to determine the value of the property in many cases.

There are also numerous inequities arising from the use of the income-tax basis for property. Where property was transferred to a corporation prior to 1913, its basis will be the value at the date of the transfer. This is also true with respect to property transferred to corporations during the low tax years, 1913 to 1916, inclusive. Nontaxable transfers under the Revenue Act of 1928 are given an entirely different basis rule from that of identical nontaxable transfers occurring under the revenue acts of subsequent years. For example, if property was transferred to a corporation in 1929 in a tax-free exchange pursuant to a reorganization, its basis would be its value at the time of the transfer, unless an interest of 80 percent or more remained in the same persons or any of them. On the other hand, if the property was transferred in a tax-free exchange pursuant to a reorganization in 1934, its basis would be its cost to the transferor if an interest of 50 percent or more remained in the same persons or any of them. In other words, corporations which reorganized under the Revenue Act of 1928 will have a higher basis of property, for invested capital purposes, than those which were organized under the later acts. Moreover, many transfers of property which were once regarded as nontaxable exchanges have subsequently been held to be taxable exchanges for income-tax purposes. Therefore, the basis of the property exchanged in such cases will be its fair market value at the date of the exchange. Thus retroactive valuations may still be required in a great many cases.

The unfortunate and discriminatory effect of using invested capital as a sole standard is shown by the following actual case.

Corporation X reorganized in 1904. Through such reorganization, it was permitted to include in its invested capital, good will in the amount of 163 million dollars. It also further decreased its invested capital by 32 million dollars through the liquidation of subsidiaries. In 1911, by virtue of a decision by the Supreme Court, corporation X was compelled to transfer 56 million dollars of its good will to other companies, leaving in invested capital 140 million of good will. Company Y, on the other hand, which was organized in 1901, with practically the same assets as X Corporation, was compelled to reflect in its invested capital, good will in the amount of only 1 million dollars although it was admitted that its good will had almost as much actual value as that of X corporation. This was due in a large measure to the fact that the good will of Y company had not been originally acquired for stock but had been built up through the history of the corporation. These two corporations in 1940 had practically the same volume of business, net income and assets, except for good will. If the Treasury's proposal of compelling excess profits to be determined solely by the standard of invested capital is applied, company Y will be compelled to adopt an invested capital of approximately 160 million dollars as compared to 314 million for corporation X. This unfair result will be avoided through the use of the optional basis of average earnings.

The invested capital rule also discriminates against corporations organized or reorganized in the periods of low values. Compare, for example, a corporation organized in 1929 with a corporation organized in 1931. The identical assets may have been turned in to each corporation. Yet such assets may be reflected in invested capital in one corporation at many times the value it will have in computing the invested capital of the other corporation. In the summary of the testimony before the War Policy Commission, House Document No. 271, it is stated in reference to invested capital that, "In some cases mere accidents of incorporation in one year, instead of one year later, meant savings in taxes of millions of dollars." A corporation reorganized shortly before the World War would have a higher basis than if there had been no such reorganization.

The invested capital method gives no recognition to the amount which the present owners of the corporation paid for their stock. It is well recognized that there has been a large turn-over in the stock of many American corporations. The present owners in many instances acquired such stock on the basis of the earning record of the corporation at the time of purchase. To conclude that they have realized excess profits on the basis of what the original owners paid for the stock seems contrary to equity and justice. For example, it was pointed out in the testimony of Mr. Clay Williams that stock of the Reynolds Tobacco Co., which represented a contribution by the original stockholders of $15 a share was purchased by subsequent shareholders at prices ranging from $26.50 a share to $66.50 a share. By using the invested-capital method, the excess-profits tax would be measured not on the basis of a reasonable return on the investment of the present stockholders but on the basis of the purchase price to the original stockholders.

Another difficulty about the Treasury proposal is that it would not only subject to the excess-profits tax corporations whose incomes in the taxable year were in excess of their base period earnings but also would subject to the excess-profits tax the earnings of corporations in the taxable year which were less than the earnings in the base period. The following illustrations are taken from the House Ways and Means Committee hearings reporting the testimony of Mr. A. F. Matthisen:

The Cream of Wheat Co. earned in the base period an average of 35.1 percent of its invested capital. In 1940 it earned 32.5 percent. Under existing law, it would pay no excess-profits tax. Under the Treasury proposal, because its credit is limited to 10 percent of its invested capital in the base period, it would have been required to pay an excess-profits tax. The same is true of Parke, Davis & Co. That corporation, according to the testimony, earned an average of 24.6 percent in the base period. During 1940, its earnings declined to 21.3 percent. If its earnings in 1941 were over 10 percent of its invested capital, the Treasury would subject them to an excess-profits tax.

INVESTED CAPITAL CREDIT

The average earnings basis is recognized by all as the proper basis for taxing war or defense profits. It was pointed out by Mr. Sullivan that only 5 out of the 12 large integrated steel companies will pay any excess profit for 1940, although steel companies in general received huge amounts of defense orders. However, this defect is not due to the earnings basis but to the invested capital basis. It is true that many of the heavily capitalized companies through the allowance of the 8 percent invested capital credit are receiving a larger tax-free return than they earned for many years on their invested capital. This defect can be cured only by making adjustments in the invested capital credit, and not by eliminating the average earnings basis.

The following table illustrates how some of these corporations, through the invested capital method, are not paying their proper share of defense profits:

[In millions]

	A	B	C	D	E
Invested capital	1, 531	2, 580	570	187	83
Invested-capital credit	122	206	46	15	7
Average-earnings credit	44	161	18	3	4
1940 excess-profits taxable income	106	217	58	10	6
Approximate 1940 excess-profits tax	0	5	6	0	0
Excess carry-over	17	0	0	5	1

In the case of A corporation, it will be noted that not only will it not pay any excess-profits tax for 1940, due to its large invested capital credit of $122,000,000, but it will also have an excess carry-over of $17,000,000 which it may apply in reduction of its excess-profits net income for 1941.

The D corporation will also not pay any excess-profits tax for 1940, due to its large invested capital credit of $15,000,000 and will have a carry-over of $5,000,000 to apply against its excess-profits net income for 1941. This is also true with respect to E corporation which will not pay any excess-profits tax for 1940 and will have a carry-over of $1,000,000 to apply against its excess-profits tax net income for 1941. The B corporation, because of its enormous invested capital, will be entitled to an invested capital credit based on the 8 percent of $206,000,000. This corporation will naturally take the invested capital credit although it had healthy earnings during the base period, its earnings credit amounting to $161,000,000.

Most of the inequities discussed would result from making invested capital the sole standard for computing excess profits. Many corporations, if given the right to continue to use the average-earnings basis, will be relieved of many of the hardships and inequities which have been referred to. Congress, of course, has substantial reason for continuing the use of the invested capital standard as a relief measure. It is necessary to provide a yardstick for those corporations which had no base-period income or those which were operating on a subnormal basis in the base period. However, the relief should not be such as to give taxpayers too large an exemption of profits attributable to the defense program.

FOREIGN EXPERIENCE

The average-earnings basis is the ideal method to bring into the Treasury the profits arising from the defense program. With a sufficiently high rate, it will prevent war millionaires. The excess-profits tax in Great Britain during the World War was the outgrowth of the public demand to prevent profiteering out of the war. Since labor has particular aversion to working to create profits for others, it was an assurance to the workers that their efforts to speed up production would not be reflected in profits to the owners of the plants.

The British war-profits duty during the first World War was levied on all business profits in excess of the profits in a base period or upon a certain percentage of the invested capital, whichever method favored the taxpayer. The tax was imposed at a flat rate, which originally was 50 percent, then was increased to 80 per cent, later dropped to 40 percent, and finally increased to 60 percent. In the year 1919–20, its yield amounted to 289 million pounds, or $1,400,000,000. In referring to this tax, Dr. Haig in his monograph said: "In the past 5 years, the British Treasury has received approximately one-fourth of its total revenues from the tax on excess profits, nearly 1 billion pounds in all. This enormous sum has been collected with surprisingly slight economic disturbance."

The British World War tax, as applied to corporations, closely resembles the present United States tax. Among the important differences, are the following:

(1) The British allowed the taxpayers electing the average-earnings basis to choose 2 out of 3 years for their base period. We require the taxpayers to use all the years of the base period, except the largest deficit year which can be counted as zero.

(2) The British allowed an invested capital credit of 6 percent for old capital and 8 percent for new capital. This credit could be increased by the board of referees if it was shown that the circumstances surrounding the class of business made it economically necessary for the corporation to receive an abnormally large return on its invested capital, such as risk, or deferred yield on nonproductive capital. We allow an invested capital credit of 8 percent.

(3) The British made no allowance for borrowed capital as a factor in computing invested capital. We allow 50 percent of borrowed capital to be treated as invested capital.

(4) The British imposed a flat rate on the excess-profits net income. We provide for some graduation in dollar amounts to take care of the small corporation.

(5) The British did not allow in computing their excess-profits-tax net income any deduction for the normal income tax. The excess-profits tax was allowed under their law as a deduction in computing the income subject to the normal rate. We allow the normal income tax to be deducted in computing the excess-profits tax net income.

The present British tax applies the average earnings base to corporations organized before July 2, 1936. A minimum base-period profit is prescribed, with relief provisions where the rate of profit on volume of business in the base period was less than might have reasonably been expected. Corporations organized after July 1, 1936, are required to compute their profits tax on the basis of the invested-capital method. The invested-capital credit is 8 percent of the invested capital, except that in case of a director-controlled company the rate is 10 percent of the invested capital. However, no deduction is allowed for directors' remuneration in the case of a director-controlled company. Borrowed capital is not permitted to be reflected in invested capital. Since invested capital is confined to new corporations, the difficulties of determining invested capital are largely avoided. No deduction is allowed in computing the excess-profits net income for the corporate normal tax, but the excess-profits tax is allowed as a deduction in computing the income subject to the corporate normal tax. The tax is imposed at a flat rate of 100 percent.

However, 20 percent of the amount collected will constitute a post-war credit to be refunded after the war. This will serve as a backlog of purchasing power, which will help companies to make the transition from a war economy to peacetime conditions. It is estimated that this tax will yield 210 million pounds in 1942 when it is first coming into full effect. This amounts to approximately 1 billion dollars.

Canada during the World War, adopted an excess-profits tax based solely upon invested capital. This was abandoned in the current law in favor of an average-earnings basis. Invested capital is applied by the board of referees as a standard in adjusting relief cases. Under the Canadian law, the board of referees is permitted to grant relief on a basis different than invested capital in the case of new corporations and depressed businesses if satisfied that the invested-capital basis will result in unjustifiable hardship, extreme discrimination, or jeopardize the continued existence of the business.

The tax in Canada is imposed at a flat rate of 75 percent. A minimum excess profits tax of 12 percent of the net income is imposed, which, under a pending proposal, is to be increased to 22 percent. While their base period is the same as ours, the years, 1936 to 1939, inclusive, the Canadian law is more liberal in its treatment. For example, under the Canadian law, all deficit years in the base period are counted as zero. Under our law, only the year of the highest deficit is counted as zero. Under the Canadian law a corporation is given the choice of its 3 best years in the base period if the profits of the fourth base period year were less than 50 percentum of the average of the profits of the other 3 base-period years.

Under the Canadian law, the normal corporate tax is not allowed in full as a deduction in computing excess-profits-tax net income. Only such part of the normal tax is allowed as applies to the income subject to the excess profits tax. The result is the same as the British practice. Under our law, the entire normal tax is allowed as a deduction in computing the excess profits tax.

Neither France nor Germany imposed an excess-profits tax based upon invested capital. Germany, which recently abandoned its excess profits tax, computed the excess profits according to the average earnings basis while the tax was in effect. Australia is apparently the only country which now adopts the invested capital method as a basis for determining excess profits.

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