Volume ISBN: 0-870-14117-1

CHAPTER 8

Taxation of Corporations

BECAUSE the corporate form of organization predominates in our industrial system, a very large share of the commodities and services which make up the national product is created in enterprises operated by corporations. Similarly, a very large share of the money payments by which the bulk of the national income is distributed among individuals takes the form of corporate disbursements. Such disbursements include three categories of chief significance in the present analysis: (1) wages and salaries paid to employees, ranging from unskilled labor to managers, for their productive services; (2) interest paid to creditors for the use of their capital; and (3) dividends paid to owners for the use of their capital and for their assumption of the risks of enterprise. For numerous corporations, some disbursements in the second and third categories go to other corporations and therefore do not constitute a direct distribution of national income among individuals. But the bulk of corporate dividend and interest payments goes to individuals directly or reaches their possession indirectly through savings banks and other financial institutions. Manifestly, practically all disbursements of the first category, wages and salaries, go directly to individuals.

As Chapters 3 and 4 show, the main danger of an inflationary price advance arises because total civilian money incomes are likely to exceed greatly, during the war, the total value at constant prices of goods available for civilian purchase. While corporations spend a large share of the aggregate net income of civilians, the main share is spent by individuals from their income. A tax policy designed to combat inflation will therefore include provisions intended to restrict the income available for individual purchases. Various elements of the tax system, existing or contemplated, contribute to this end. Whatever the other tax devices possibly appropriate to this end, taxes on corporations are in some quarters regarded as peculiarly appropriate because they may be designed to reduce income, or prevent its expansion, *before* it reaches individuals.

In a practical sense, the possibilities in this direction are not as numerous as might be implied by listing the three main categories of corporate disbursements to individuals. A tax levied upon a corporation is unlikely to reduce, or prevent expansion of, its payments in the form of wages and salaries or of interest. A tax on corporate gross receipts, like an excise (see Ch. 9), tends to be shifted to buyers of corporate products, through higher prices. A tax on corporate profits is unlikely to restrict or reduce wage or interest payments in the short run period, such as would probably include the duration of a war, so long as that tax can be met amply out of profits. If the tax is very severe, however, it may tend to restrict wage or interest payments by making the expectation of gain (profit *after* taxes) so small in view of the risks that corporate management will refrain from employing labor and borrowing working capital to expand operations. Even such a severe tax is unlikely to restrict wage payments through a limitation of wage rates, for the labor market for management personnel, skilled labor, and perhaps unskilled labor is so tight that increases in wage rates are not easily resisted.[1]

A dominant aim of the war effort is to increase output, and public policy is unlikely to favor corporation taxes so severe as to restrict compensation of employees or payments of interest through limitation of new or expanded undertakings. Accordingly, the one important category of disbursements to individuals that taxes on corporations can practically be designed to restrict is the third, dividends. The possibilities of limiting, by means of corporation taxes, dividends to individuals, and therefore of limiting for those individuals who are dividend receivers the incomes available for use in civilian purchases, are very great: if corporate taxes were so severe as to prevent all dividend payments, the reduction in individual incomes would reach several billion dollars (even in 1939 net dividend payments were about $3.8 billion).[2] In actual practice, corporation taxes are unlikely to be so severe as to prevent all dividend payments, and a substantial fraction of corporate profits flows to individuals in the form of dividends. These dividends then become part of the taxable income of individuals, and on the average bear a high rate of individual income tax. This part of the income of such individuals is accordingly subject to double taxation and under the present law at high rates, once as net income in the hands of the corporation and once as income received by the individual. No other type of individual income is subject to two such heavy taxes, and this condition explains the frequent protest that the existing tax law discriminates heavily against individuals who own the equity capital of corporations. Further increases in tax rates on corporate profits will emphasize this discrimination.

In terms of the needs of the situation, as developed in Chapter 3, the fact that taxes on corporations can feasibly restrict in important degree only such incomes flowing to individuals as take the form of dividends is somewhat unfortunate. Dividends, unlike wages of labor and to a less extent compensation of managers and perhaps interest on corporate debt, go chiefly to individuals having large and middle bracket incomes rather than to those in the lower brackets. Chapter 3 shows that one of the main points of inflationary danger is in the middle range of the income scale, $1,750-10,000, the total excess of purchasing power being considerably smaller at the top. Restriction of dividends through corporation taxes is not precisely adapted to meeting the chief need mentioned in Chapter 3, although it would certainly contribute toward meeting the needs there set forth.

Direct taxes on corporations reduce or restrict the incomes of dividend recipients, out of which they might make civilian purchases, as well as absorb corporate income that might not be distributed as dividends but might instead remain in the possession of corporations and be spent for civilian goods.[3] In both respects, then, corporation taxes limit purchasing power for civilian goods, and the possible limitation is very great, reaching at its maximum the total net earnings of taxable corporations. For various practical reasons, the feasible absorption of civilian money incomes through corporation taxes falls short of total net earnings, after wage and interest payments and all other costs, of the corporate system; and, for various reasons of public policy, it may fall far short. Nevertheless, a very large part, perhaps nearly the entire wartime *expansion* in corporate net earnings, and the corresponding expansion in incomes of dividend recipients and of the retained income of corporations themselves, could be absorbed by a set of corporation taxes designed for this purpose. Much of the discussion below is directed to these possibilities.

First, however, we note that certain other taxes can be designed to limit employee compensation and interest payments and these other taxes are of the stoppage-at-the-source type (see Ch. 11 and 12). Although these are not taxes on corporations, corporations may be made the agents of the Treasury for their collection.

1 EXISTING CORPORATE TAXES

Taxes on corporations have already come to be the largest revenue producers in the federal tax system. The policy of Congress is clearly to use them extensively in the current emergency, and strong pressure exists for their conversion into the primary weapon of war finance. The weight of this pressure, the existence of a policy which satisfies in considerable degree the objective laid down, and the potential yield of the taxes involved, warrant detailed consideration of a program of this sort.

The weapons that would probably be the bulwark of such a program already existed at the end of 1940. The tax system then in force included a long list of taxes on corporations, most of which can be neglected in the present connection. Three are simply devices intended to assist in enforcing the taxes imposed on personal incomes.[4] Three provide special formulae for applying the basic corporation income tax to particular cases,[5] and two impose levies on unusual revenues which appear under certain narrowly defined circumstances.[6] Of the other four taxes two are of overwhelming importance, the tax on corporate net income and the levy on excess profits which was established by the Second Revenue Act of 1940.

Far less important are the capital stock and declared-value excess profits taxes. Enacted to assist in financing the National Industrial Recovery Act of 1933, they have continued as a part of the federal revenue system in the face of vigorous protest. The opposition is readily understood upon even a cursory examination of the Act. One imposes a rate of $1.25 per thousand on the value of capital stock, but no attempt is really made to evaluate capital stock for this purpose. The statement of the taxpayer corporation concerning the amount of this item is accepted as final. The reasonableness of the statements is supposed to be assured by the second tax. Excess profits are calculated as a rate of return upon the declared value of capital stock used in the first measure.[7] The dilemma which confronts the taxpayer is largely responsible for the unpopularity of the declared-value taxes. If, in choosing the declared value, the corporation attempts to lighten the burden under one of these taxes it automatically incurs heavier liabilities under the other. The Treasury has recommended that this pair of taxes be repealed in 1942, and that the loss of revenue be made up through other corporate taxes.

The logical justification for them must run in terms of a payment for the privilege of doing business in the corporate form, but the connection between it and the bases used in these taxes is extremely remote. This, together with their relatively small yield,[8] their unpopularity, and the fact that they are characterized by a type of shrewdness beneath the dignity of a powerful government makes it doubtful that they could properly be elaborated to provide additional revenues for financing war. Hence the role of corporation taxes in a revenue program for the immediate future must be discussed primarily in terms of a levy on corporate net income, the excess profits tax introduced in 1940, and any new varieties of business taxation that can de developed to meet the needs of the existing emergency.

Tax on Corporate Net Income

The tax on corporate net income is the basic element in the entire existing structure. Set up in 1909 as a prelude to the enactment of a tax on personal income, it was carried over into the legislation of 1913 as an instrument for collecting at the source the normal tax upon the portion of individual income received as dividends, as well as the portion of corporate earnings left undistributed. As time went on, however, the sharp divergence between the rate on personal income and on corporate net income indicated that the tax on the latter was coming to be more and more a tax on corporate enterprise itself rather than a collection device to enforce the levy on personal income. This transition was thrown into sharp relief in 1936 when corporate dividends were for the first time included in the personal net income subject to normal tax. Congress was probably influenced to introduce the first significant divergence between the rate on corporate income and the normal rate on personal income because it recognized that failure to distribute corporate earnings offered a means of avoiding taxes, by all stockholders,[9] even though many stockholders intended no avoidance and were perhaps unaware of it. Another factor which has perhaps often favored advances in the rate is the ease, from a political and legislative viewpoint, with which a new demand upon corporate income can be made. In any case, once different rates had been set, restoration of the original relationship could never be easy. The historical development can be rationalized after the fact in logical terms by saying that the present corporate net income tax has come to be a special payment in return for the privilege of carrying on business within the framework of the laws and services provided by the federal government. These benefits are now taxed, however, only when enjoyed by a group of enterprisers operating as a corporate body. Partnerships and individual enterprises are subject to neither this nor other federal taxes imposed on corporations.

Under the legislation of 1940 the rates ranged from 14.85 per cent on corporate net income up to $5,000 to 24 per cent on that above $25,000. The yield for the fiscal year 1941 was $1.9 billion, the largest single item in federal revenues. The legislation of 1941 raised the effective rate to approximately 31 per cent for corporations having net incomes over $25,000. The form this raise took, the application of a surtax instead of a simple change in the normal rates, was shaped by a desire to avoid a premium that would otherwise accrue to corporate holders of certain federal securities exempt from the normal tax on corporations under the terms of the bond contract. The expected yield from the corporate net income tax as so altered for the fiscal year 1943 is $3.5 billion. It is higher than for preceding years both because of the rates and other provisions established by the Act of 1941 and because of the expansion of national income and the advance in prices.

Tax on Excess Profits

The second of the two major elements in the corporate tax system, the levy on excess profits enacted in 1940 (not to be confused with the declared-value excess profits tax mentioned above), is of an entirely different nature. It marks an attempt to reach not all earnings but merely those which in one sense or another are unusually large. They may be purely windfall gains depending on changing market conditions, or generally high profits based upon monopoly position, superior equipment, or managerial skill, or they may be earnings which are associated with some unusual occurrence such as the receipt of munitions orders or the mere existence of a war boom. Although it is by no means easy to single out one or more of these several varieties of unusual earnings for taxation, something can be done and the type of profits at which the tax is aimed will determine very largely the details of the legislation.

The excess profits tax has struck primarily at the fairly general increase in earnings resulting from the armament boom rather than the profits of munitions manufacturers as such on the one hand or generally high profits, which are presumably largely influenced by monopoly position, on the other. This conclusion is not at all self-evident from an inspection of the law itself; for, although the law is clearly broader in its scope than a tax on munitions profits would be, the prospective taxpayer is offered a choice between one formula, which is associated with the taxation of wartime profits, and a second, which is commonly used when high profits generally are the object of the legislation. The manner in which taxpayers have exercised their option, however, warrants the conclusion that this tax operates in fact as if it were imposed primarily upon wartime profits *per se*.

A tax aimed at the latter is ordinarily applied to the additional earnings which appear during the war and are above those present in a selected prewar period. The present federal levy permits the taxpayer corporation to calculate net income for excess profits tax purposes by comparing current earnings and those which result from the application of an extremely complex formula constructed around the income actually earned during 1936–39. These four years are known as the 'base period', and this method of calculation, as the 'base period income' formula. A levy built on these lines alone would be recognized immediately as a 'war profits' tax. Although it would not trench greatly upon unusually high profits due to monopoly position or long-standing superior management, it would strike at all wartime increases in profits, including windfalls not due to the war boom.

But the 1941 statute also permits the taxpayer to compute excess profits net income by a second and very different formula: the invested capital method. He may compute 'excess profits' by comparing current earnings with an amount which is roughly 8 per cent on the investment (as peculiarly defined in the Act) in the corporation. An excess of this sort may appear because of a war boom, a windfall or unusual conditions of some other nature, or a monopoly situation or other competitive advantage that produces currently an unusually high yield on the investment.

About two-thirds of the firms reporting in the year following enactment of the statute chose the base period income rather than the invested capital method, and those applying the latter reported only one-fifth of the total excess profits upon which the tax was based.[10] The conclusion can be drawn that the legislation of 1940 set up an excess profits tax which turned out in practice to be primarily a levy on wartime profits. Firms which had unusually low earnings during the base period or which are not old enough to possess the evidence upon which base period income might be calculated chose the alternative method.

Under the Act of 1940 excess profits as calculated by the formula the enterprise chose were subjected to a rate schedule ranging from 25 to 50 per cent; under the Act of 1941 the rates range from 35 to 60 per cent. The range in rates is not based upon the relation between earnings and assets, as one might expect in a tax of this sort, but upon the absolute excess profits, the maximum rate applying to the amount over $500,000. The estimated yield from this tax for the fiscal year 1943 is $2.7 billion.

2 POSSIBLE CHANGES IN CORPORATE TAXES

As noted above, the group of corporation taxes as a whole is playing a major role in financing the armament program. The estimated yield under the Act of 1941 for the entire group of corporate taxes for the fiscal year ending June 1943 is $6.7 billion, which accounts for 38 per cent of the revenue produced by the entire federal tax program. In contrast, the yield from corporation taxes in the fiscal year ended June 1939, the last before the actual outbreak of hostilities in Europe, was $1.3 billion, which was only 23 per cent of the total tax revenue collected by the federal government in that year.

Nevertheless, this growth in the relative contribution of corporation taxes has not prevented prominent individuals and organizations from noting that corporate profits *before* taxes have expanded more rapidly than national income. Expressing intense dissatisfaction with current policies, they urge that taxes on corporations be raised substantially, frequently supporting their position by pointing out the relatively more prominent role these taxes played in federal finance during World War I.[11] A set of basic issues presents itself for consideration. One concerns the form of the excess profits tax: is it to be continued as predominantly a war profits tax or is it to be converted into a tax on high profits generally? At the hearings on the Revenue Bill of 1941 the Treasury made a determined effort to eliminate the option to compute excess profits by the base period income method. This change would have meant the conversion of a *de facto* war profits tax into a levy on high profits generally, but it failed.

Another basic issue concerns the rates imposed under the excess profits tax: will the additional revenue yielded under the 1941 rates because of expanding national income and rising prices be sufficient, or should the rates be advanced still further? If the rates are advanced, should they be designed to maintain corporation taxes, i.e., the excess profits tax together with the tax on corporate net income and other corporate levies, in their present percentage position in the revenue system, or should their relative importance be increased or decreased?

Before examining these questions, we note the presumption favoring the continuance of the two major elements in the corporate tax structure. The fundamental objective of war finance, namely, to curtail civilian spending, is discussed above in its bearing on corporation taxes. If new attempts to promote social reform of a broad character through taxation are relegated by the government to a minor role for the duration, continuance of existing taxes, so long as they do not interfere drastically with the regulation of a wartime economy, is the natural and easy course, and changes are likely to be determined mainly by their contribution to such regulation.

The levy on corporate net income has the sanction of long usage and is constructed on the base best calculated to throw the main burden upon the shareholders whom most citizens regard as the primary recipients of the governmental benefits supposedly justifying taxation of this sort. While the rates under the Act of 1941 are relatively high, those prevailing for several years have been substantial and business has not only become accustomed to taxation in this form but also probably adjusted itself largely to them. Such adjustment has gone forward progressively, and the raising of large sums by means of this tax has encountered relatively few objections.

An excess profits tax designed to tap wartime profits is also widely commended. Indeed, if such a tax were not in force, it would be politically desirable to impose one. 'Excess profits' are synonymous in most citizens' minds with unnecessarily large profits, which in time of stress are apt to be regarded as the fruits of 'profiteering'. If popular acquiescence in a war finance program is to be retained, the public must be assured that action is being taken to keep the misfortunes of the nation from becoming the source of unusual gains to particular business enterprises. An excess profits tax seems to the public mind eminently suited to recapturing such income when it does appear; and, since most people do not raise the further question of the technique by which profits that are 'excess' are to be separated from those which are not, the intellectual difficulties that confront the expert who attempts to construct an excess profits tax are avoided by the ordinary citizen. Under these circumstances, popular and legislative approval of something labeled an 'excess profits' tax is fairly easy to obtain.

In addition to satisfying this demand on the part of the voting public, an excess profits tax may lead to a less insistent direction of trade union policy toward higher wage rates. If 'excess profits' go untaxed, a much more persuasive case can be made for general advances in wage rates. Since the latter are highly inflationary, the case for excess profits taxation is significantly strengthened.

Finally, in any boom a great many profits accrue which are unnecessary in the sense that they would not have to be paid in order to get the work of a capitalist society done. This is probably more apt to be true in a war boom than in a more ordinary one, because during a war motives other than the search for profits play an unusually significant role in determining business decisions. An excess profits tax may be used to absorb much or all of these unnecessary profits.

With corporate taxation as established under the Act of 1941, the weight of the excess profits tax upon earning power must be considered together with the burden under the net income tax, and note must be taken of the order in which the two taxes are computed. Much attention has recently been given, as corporate taxes have become heavier, to the concept of the 'marginal rate of tax': for practical purposes, the tax on the last portion of profits actually earned, or the tax which would apply to an additional dollar of profits. Suppose a corporation has earnings such that it is taxed in the highest brackets under both the excess profits and the income tax provisions, the top bracket rates under the Act of 1941 being normal tax, 24; surtax, 7; excess profits tax, 60. If its earnings increased $1.00, the corporation would pay on that dollar 60 cents in excess profits tax; and the remaining 40 cents would be subject to the normal tax and the surtax at 31 per cent, or 12.4 cents. The total tax on that dollar would be 72.4 cents, and the marginal rate of tax 72.4 per cent. The net profit from that dollar after tax is 27.6 cents; and this is what the corporation would gain in compensation for taking whatever risks and calling upon its executives and other employees for whatever extra efforts might be involved in producing the additional dollar of 'profits before taxes'. In the short run, and the short-run effects predominate in wartime, the decisions to assume additional risks and put forth additional effort would presumably be made in the light of this expectation as to profits after taxes. The higher the total tax on marginal profits, the smaller the net profit after tax from the marginal earnings; the smaller, in other words, the final reward of the corporation for a given effort and risk-assumption. Conceivably under the boom conditions largely prevailing in wartime, many enterprises may find the effort and risk incident to producing an additional dollar of earnings smaller than in peacetime; and, so far as this is true, less of the additional dollar may need be left free after taxes in order to call forth the additional productive activity. Precise determination of the facts is difficult or impossible. We emphasize merely the qualitative principle: the marginal tax burden should not be so heavy as to remove the encouragement afforded by expectation of profit after taxes to the maximum productive activity vital to the war effort.

Since a considerable portion of the profits realized during a boom of this sort may be unnecessary in this sense, since a substantial levy on excess profits removes an argument union leaders could use in negotiating for higher wages, and since this form of taxation is calculated to placate the general public's fear of 'profiteering', a case for imposing an excess profits tax can easily be made now. Acceptance of this conclusion brings up the form of the present levy. As pointed out above, the tax under the Act of 1941 is in fact a levy on 'war profits' rather than on 'high profits'. This distinction is important, especially since the wisdom of the choice Congress made has been questioned repeatedly by the Treasury, which has proposed the elimination of the corporation's option to use the average prewar profits as a base for calculating excess profits and the compulsory use by all corporations of the invested capital base. By this seemingly technical maneuver the basic philosophy of the existing law would be reversed, and the law would be transformed into one taxing high profits similar to that in force during World War I.

Although excellent authority can be brought to bear in support of the Treasury recommendation, the proposal admits of the interpretation that the government desires to convert the tax from a temporary wartime basis to a permanent source of revenue and of business regulation, and is in fact interpreted in this fashion in certain quarters. The Treasury's 1941 proposal, implying a tax on unusually high profits irrespective of their source, was not pushed in the House hearings on the 1942 revenue bill. Some profits always seem to be unusually large, even in peacetime; therefore, a case can always be made for a high profits tax, a conclusion stressed by the outstanding American advocate of this particular form of excess profits taxation.[12]

The main reasons which can be adduced for the proposal to engineer this drastic shift in the nature of the present tax are a desire to reach profits of an allegedly monopoly character, or profits not necessary as a means of calling forth output, and to tax more effectively enterprises that had unusually high earnings during the base income period used under the present law. The chief economic objection to the proposed shift in the type of tax is the difficulty encountered in distinguishing between monopoly profits, which are widely regarded as an excellent object of special taxation, and other high profits, which must be permitted in many cases in order to get the work of a capitalist society done. An excess profits tax constructed along the lines of the Treasury's 1941 recommendation would boil down to a levy on incomes in excess of a more or less arbitrarily chosen rate of return on a more or less arbitrarily defined capital investment. Very real danger exists that a levy of this sort would strike at the payments necessary to call forth business enterprise, especially the form of enterprise that represents a gamble against fairly long odds, although war-order business may, in numerous cases, be free from some of the risks ordinary enterprise runs.

Moreover, while a case might be made for a special attack on monopoly profits, if they could be recognized and determined, during more normal times, certain economic and political considerations can be advanced against attempting such action during the emergency. The proposal to levy a tax on 'high profits' *per se* will arouse opposition that is not present when the measure in question is apparently aimed merely at the unusual gains arising during a war boom. A tax of the latter sort not only seems less likely to touch on socially necessary payments but also may reasonably be expected to vanish with the boom conditions that explain its existence. The fact that the excess profits tax, a 'high profits' tax, of World War I was repealed in the early 'twenties may not inspire confidence that a similar law would be repealed after this war. Hence business men probably react less violently to a levy of the 'war profits' type than to a tax on high incomes the logic of which leads to an expectation that it will become a permanent feature of the federal tax system. Since the wholehearted cooperation of business is vital during a national emergency, a strong argument based on both political and economic grounds can be made to continue the excess profits tax in its present form. Congress has recognized this in rejecting the Treasury's suggestion, pressed especially during the 1941 hearings, that the option to calculate excess profits by the base period income formula be withdrawn.

This argument does not mean that the present law is perfect, nor does it support the base period income as the sole appropriate method of calculating excess profits. It can be argued to excellent effect that this technique is in any event incomplete and will of necessity be replaced by the invested capital method if the tax is long retained in its present form. Changes in the capital used in a business subsequent to the years which form the basis for the comparison between net incomes would require a corresponding alteration in the calculation of normal and excess earnings if substantial and illogical discrimination among firms were to be avoided. The lengthening of the interval between the base period and current earnings would increase the number of companies which choose to calculate normal profits in terms of invested capital, and a distinct tendency would exist, through exercise of the option, for the latter to supplant base period earnings as a method of calculating normal profits. Therefore, unless the base period itself is altered, any reasonably constructed excess profits tax (on excess over base period earnings) will, if the option is permitted, tend to become a high profits tax (on excess above normal return on invested capital) over a long period. However, many years would have to elapse before this automatic conversion would be fully or even largely achieved. From the foregoing argument comes a strong case for correcting the base period income for changes in invested capital and this is in fact done under the present statute.

The troublesome question of incentives, troublesome because its solution involves a balancing among the attitudes of various groups in the community, arises in connection with the form of the excess profits tax. If *no* excess profits tax existed in wartime, the damage to the incentives of most individuals, including many business men, might easily be so great as to outweigh any possible stimulus, through absence of restriction on the rate of profit, to such business men as might be in a position to share in the enlarged earnings of especially favored corporations; and the war effort might accordingly be seriously impaired. But, once the excess profits tax exists, failure to give it the form of a high profits tax will probably not greatly weaken incentives of individuals in general, although a few may be disappointed because the war is not used as an occasion for achieving what they regard as a long run reform in governmental control over the distribution of industrial rewards. On the other hand, giving the tax the form of a high profits tax would probably work havoc on the incentives of many business men, including some not in a position to share in war profits. They may see in such a tax a promise of a policy to be retained after the war, and fear accordingly that the peacetime tax system will limit or prevent the high rates of earnings which encourage them to take the business gamble against loss. Such high rates are by no means common among enterprises, and are rarely maintained for long intervals; instead they are usually unexpected, but the *chance* that they may be realized is one of the most powerful factors in calling forth management effort. This chance, that successful management may occasionally demonstrate its capacity by reporting high profits while the mass of managers succeed in reporting merely moderate profits or report losses, is an essential element of the free enterprise system.

The present law also departs from a pure added profits tax in order to avoid the discriminatory burdens the latter would impose on firms whose earnings during the base period were unusually low; for instance, because a depression affected their industry or area but was not general.[13] Such cases are covered by the option to use the invested capital method, and this relief recognizes that no period can be 'normal' for all industry.[14]

As a matter of fact, only one major logical gap appears in the excess profits provisions of the present law. A corporation that has made high, perhaps unusually high profits, during the base period may escape to a substantial degree from the scope of the excess profits tax under the current option to compute by the base period income method. This is unfortunate if, in view of the arguments of preceding paragraphs, such high profits are in truth economically unnecessary, and the exclusive use of the invested capital method would admittedly remedy this defect. Many of these cases of high base period profits probably do not exist, because 1936–39, which now constitutes the base period, was in general a period of low or moderate corporate earnings.

Nevertheless, political pressure to bring these favored corporations more effectively under the excess profits tax may lead to consideration of some compromise device accomplishing at least part of this objective. The suggestion has been made that a practical means would be to require every corporation to calculate its excess profits on *both* the average base period earnings and the invested capital formulas, and compute the tax on the average of the two. A plan of this sort dodges the theoretical issues, treating the matter merely as one in which, as neither solution is recognized to have been convincingly established, a straight average may prove more equitable than a rigid insistence on either and would at the same time remove an option the taxpayer corporation would naturally choose to its advantage.

The mass of technical problems arising in the construction, administration, collection, and payment of an excess profits tax need not be mentioned here. However, as it is common knowledge that they are unusually acute as compared with, say, a tax on corporate net income, a presumption is set up in favor of the latter in raising additional revenue from corporations. This is especially true in view of the axiomatic proposition that in taxation administrative difficulties and rates tend to increase together.

The foregoing indicates that to continue the main elements of the existing system of corporation taxes is easy to accept, but the expansion of these measures in order to increase the total yield of corporation taxes raises a troublesome issue concerning the balance among the various elements of the entire tax structure.*

* COMMENT BY A MEMBER OF THE CONFERENCE ON RESEARCH IN FISCAL POLICY:

In saying that "the continuance of the main elements of the existing system of corporation taxes is easy to accept" and in commenting on some defects of that system, it seems to me that the Committee should not have ignored the ill effects of the present treatment of borrowed capital and interest thereon, and the lack of integration between the personal and corporation income taxes.

Profits of an enterprise conducted by a corporation, if distributed as interest, are taxed once—to the bondholders. Those distributed as dividends are taxed twice—first, to the corporation on the gross sum out of which dividends must come, and then to the stockholders on the remnant they receive. This system puts a premium on debt financing, which becomes greater as tax rates increase and is now almost compelling.

The absurdity of the system is illustrated by the fact that under the law now in force it is often possible for companies to increase their net income after taxes by borrowing, even if the proceeds produce no income. Again, one of the major benefits from incorporation is limitation of liability; yet the more this privilege is availed of, the smaller becomes the excise tax levied on business conducted in corporate form. In such ways unsound capital structures are encouraged, with the result that later a demand for special relief to debt-ridden companies is created which as a practical matter cannot be ignored, and further discrimination against sound finance results.

It is a strange commentary on our system of Government that the Interstate Commerce Commission and the Securities and Exchange Commission should under the direction of Congress be engaged in efforts to improve the capital structure of corporations by the creation of equity capital and the reduction of debt, and at the same time the Treasury, which should be even more interested in this objective, should be following a policy which must discourage or penalize its attainment.

Surely none who are studying the problems of the war or the post-war period can fail to be gravely concerned over the effects of the present policy. The manner of dealing with it would require careful study. The English scheme suggests one solution. If a less radical change is sought, it would probably be desirable to deal differently with various classes of companies, such as railroads, utilities, finance companies, real estate companies, et cetera, and also to make distinctions between companies whose securities are widely distributed, those closely held, and pure holding companies. The treatment of corporations as homogeneous for the purpose of an excise tax not integrated with the personal tax has long seemed to me illogical and unsound.

George O. May

From the viewpoint of a principal objective of a war finance program, to curtail consumer incomes, these taxes are seriously deficient in several respects. As noted above, levies on corporate net income and excess profits by themselves fail to reach the bulk of consumer income, which is received in the form of wages and salaries. They are concentrated upon the types of income from which relatively large percentages are saved. Moreover, if this unfortunate limitation of corporate taxes is avoided by shifting the basis from net income to gross receipts, the economic effects will be changed from those associated with a levy falling primarily on shareholders to those obtained under a general tax on sales. The main arguments concerning the sales tax, and suggestions of better ways to reduce consumer spending, the basic task, are set forth in Chapter 9. Another defect of the present corporate taxes is their failure to reach even business income generally. Their expansion means greater discrimination in favor of such unincorporated business as is not owned by high bracket individual taxpayers, and fails to reach incomes of unincorporated business which also tend to increase consumer spending.

Despite these defects, large additional revenue will probably be raised from the corporation taxes. The chief reason is political and springs from the logic that makes the appearance of an excess profits tax inevitable during a war: the war incentives of the mass of citizens are likely to be injured if they believe or suspect that an inadequate share of the total burden is laid upon corporations which seem to profit from the war. When a large contribution is being demanded from the lower income classes, especially when the taxes imposed on wages themselves are increased (e.g., in the social security system it is proposed to increase the levies on payrolls), it will be extremely difficult if not impossible to head off further business taxes which are presumed to fall primarily on the middle and upper income brackets. Moreover, this reasoning will probably lead in the direction of a tax on excess profits rather than on corporate net income, despite the relative administrative advantages in the latter tax, for excess profits are regarded by the public as reflecting largely advantages gained from exploiting the necessity of the nation.

The basic practical question of policy concerns, in fact, the direction in which the new burdens will be imposed. Should the additional revenue to be raised through corporate taxes be from the levy on corporate net income or on excess profits? [15] As noted above, the former has a great advantage from an administrative viewpoint. Although 'net income' is difficult enough to define, 'excess profits' are even more vague, a fact which complicates the task of those who draft as well as those, in enterprises and in government, who attempt to interpret the legislation. In addition, the levy on corporate net income has a substantially broader scope in that it would reach the incomes of more corporations, and hence would be a better, though far from perfectly effective, instrument for reducing private spending. Hence, a presumption is in favor of the net income tax as the source of most of the additional revenue corporation taxes may be called upon to produce. On the other hand, excess profits taxation seems to very many citizens more equitable in the present circumstances, and is far more salable from a political point of view.

If political pressure and economic reasons favoring excess profits taxation are so strong that a more severe application is undertaken, an advance in the rates and a tightening up of the details of the present law seem capable of increasing substantially the yield. Two suggestions are calculated to mitigate somewhat the unfortunate consequences of an unduly severe levy on excess profits. One is the device used in Great Britain during World War I of imposing a tax on the average income of several years. When the war ends and losses take the place of excess profits in some instances, a moving average will bring a revision of the tax due, and refunds can be made in cases of unusual distress. Such a scheme is easy to justify from the viewpoint of both equity and fiscal policy. But it is so cumbersome from an administrative viewpoint, and invites so much public hostility to frequent and perhaps large tax refunds, that it does not seem feasible for the United States. An alternative is to levy a portion of the tax due in the form of blocked accounts or to collect a forced loan evidenced by nontransferable government securities.[16] This, like the averaging device, would contribute to greater equity and would reduce the depressing effect on business initiative that rates of 70 per cent or higher are almost certain to exert.[17]

Finally, note may be taken of the suggestion that the excess profits tax on corporations be supplemented by a levy which falls on the additions that appear during the war in other types of income.[18] The incomes of numerous unincorporated businesses, as well as of individuals, such as earnings from personal services or rents, may expand with the war boom and are sometimes regarded as therefore including an element of 'excess earnings'. If a tax of this sort were imposed, a main objection—that excess profits taxation reaches merely a small fraction of the incomes enlarged by the war effort—to heavy reliance on corporate taxation would disappear, for such a tax would strike enlarged consumer incomes on a wide front. Moreover, such a tax on the increment in earnings of an individual would probably be less burdensome to taxpayers than an equally productive tax on individual income in general. Attractive as this suggestion is at first glance, the administrative task raises serious doubts concerning its wisdom, because the 'added income' tax requires a comparison between wartime and prewar incomes of individuals rather than of corporations, and because most individuals were excluded from our federal income tax before this war. Moreover, the arguments against the tax on excess profits as compared with that on corporation net incomes can be applied here.

3 REVENUE YIELD OF ILLUSTRATIVE RATE CHANGES

If we are driven to the conclusion that political and economic reasons force additional corporate taxation, what further revenue can be expected? If we look to Great Britain for a precedent, we find a 50 per cent rate on corporate net income, with, however, a corresponding offset against individual income tax, and 100 per cent rate on excess profits, one-fifth of the latter to be rebated under certain conditions after the war.

The logic of the above considerations runs counter to such high rates. Extremely heavy taxes on corporate earnings have too small a scope to achieve the essential curtailment of general civilian purchasing, and may cripple the vital war incentives of business men. Moreover, any sudden and heavy addition to the tax burden, whether in the whole system of taxes or in one type such as taxes on corporations, might so exaggerate the economic difficulties of adaptation to new burdens that the advantages of the heavier levies would be partly offset. Even in the crisis of war, a too swift increase in tax burdens may defeat its purpose.

Under the 1941 law, the excess profits tax, with bracket rates of 35 to 60 per cent, is estimated to yield $2.7 billion for the fiscal year 1943. The corporate income tax, including normal tax bracket rates of 15 to 19 per cent for corporations with net incomes not exceeding $25,000 and a flat rate of 24 per cent for other corporations, and including a surtax with bracket rates of 6 and 7 per cent, is estimated to yield $3.5 billion. In view of these expectations, the main factors which, together with the rates imposed, determine the yield of the taxes may be estimated approximately as follows (in billions of dollars): net income of corporations having taxable income, 13.7; excess profits credit, 8.3; income subject to excess profits tax, 5.4. These rough estimates are for a full business year.[19] Under the 1941 Act the excess profits tax, if any is due, is deducted from the net income before the rates for the normal tax and the surtax are applied.

Let us next consider possible yields from the application to the above basic figures of various flat rates, selected here for illustration of the possibilities, not as suggestions concerning the appropriate rates to be adopted, for the excess profits tax, the normal tax, and the surtax. Flat rates are used throughout because the computations are simpler, and indeed could not be made without supplementing the above basic figures by figures on the number of corporations having net incomes of various sizes (separately shown for the excess profits tax and the income tax computations)—information which is not available and could be estimated only by elaborate calculations.

Whether the rates should be flat or graduated is a controversial question of policy. Under the Act of 1941 all three sets of rates—the normal tax, the surtax, and the excess profits tax—were graduated. The graduation of the two elements (normal tax and surtax) of the corporate income tax applies only for very small net incomes, those not exceeding $25,000; and may perhaps be fairly regarded as designed to grant tax concessions to 'small' corporations or to penalize 'large' corporations. Whatever may be said concerning the wisdom of such a grant—such as that the government wishes to offer a special incentive, in the form of a higher rate of profit after tax, to small enterprises, or wishes to protect small enterprises from financial embarrassment—the present law is not precisely fitted to such a purpose. A different argument sometimes advanced in favor of graduating the corporate income tax is that it imposes the tax burden in accordance with 'ability to pay'. While the so-called principle of ability to pay is widely recognized as the basis for imposing graduated taxes on individual incomes, the same reasoning can by no means be carried over to taxation of corporations. The 'ability' of a corporation to pay taxes or to make any other expenditures does not depend solely upon its *net income* but is controlled also by its size and various other factors. For example, a small corporation with a net income of $50,000 may be more 'able' to pay a tax of $20,000 than a larger corporation with a net income of $100,000.

The reasoning concerning the graduation of the excess profits tax according to the amount of such profits is similar, though the 1941 Act carries the graduation to a much higher level of income ($500,000) and has a wider range of rates. The 'ability' of a corporation to pay an excess profits tax cannot be known merely from its excess-profits net income in any one year, but is controlled also by its size and other factors. A tax concession for small companies, if such is intended by the lower bracket rates, is not achieved by a graduation in terms of net income, as defined either for income tax or for excess profits tax purposes. If consideration of the incentives of managers or owners is decisive in the choice between graduated and flat excess profits tax rates, consideration must be given to the marginal rate of taxation, discussed above. No clear reason appears for believing that the marginal rate can be set higher for large companies than for small, or for companies with large earnings than for those with small, if the maximum productive activity of all enterprise is to be realized.

The calculations in this chapter are based on flat rates, because no satisfactory basis for estimating graduated rates is available, but the revenue may be regarded as equally obtainable by such scales of graduated rates as would be equivalent to average rates identical with the flat rates here used. This would mean, for example, that substitution of graduated rates for a flat excess profits tax rate of 60 per cent would, in order that the revenue yield be the same, need to have a top rate running well above and a bottom rate below 60 per cent. As a matter of fact, preliminary and partial evidence indicates that the graduated excess profits tax rates under the Act of 1940, ranging from 25 to 50 per cent, yielded the revenue which a flat rate of about 41 per cent would have yielded.

In the calculations of Table 17 the normal tax rate is taken at its present maximum level, because the arguments which

TABLE 17

Rough Estimates of Revenue from Illustrative Rates of Corporate Taxes (for a full year having net income characteristics at about the average of 1941–42)
(all rates are percentages, money figures in millions of dollars)

Section A

Excess profits tax, at alternative flat (or average) rates, on income (after excess profits credit) of $5,400 million, estimated as subject to excess profits tax; and estimate of corresponding income subject to income tax, and normal tax thereon

RATE	EXCESS PROFITS TAX REVENUE	INCOME SUBJECT TO INCOME TAX	NORMAL TAX REVENUE (at 24%)
60	3,240	10,460	2,510
70	3,780	9,920	2,381
75	4,050	9,650	2,316
80	4,320	9,380	2,251

Section B

Surtax revenue at alternative flat (or average) rates applied to taxable income shown in column 3 of Section A

Income subject to income tax	10,460	9,920	9,650	9,380
SURTAX RATE	SURTAX REVENUE			
11	1,151	1,091	1,062	1,032
16	1,674	1,587	1,544	1,501
21	2,197	2,083	2,027	1,970
26	2,720	2,597	2,509	2,439
31	3,243	3,075	2,992	2,908

Section C

Total revenue from selected combinations of the various alternatives, including the normal tax of 24 per cent. Figures in parentheses are the percentages of total net income, $13.7 billion, taken by taxes

Excess profits rate	60	75
SURTAX RATE	REVENUE	
16	7,424 (54)	7,910 (58)
31	8,993 (65½)	9,358 (68½)

led to calling the increases in the corporation income tax under the Act of 1941 'surtaxes' are likely to continue to control legislative action. The illustrative combinations of Section C of the table show estimated revenues ranging from about $7.4 to $9.4 billion, and these represent respectively 54 and 68½ per cent of the estimated total net income ($13.7 billion) subject to tax. Correspondingly, taxable net income after tax ranges from $6.3 to $4.3 billion.[20]

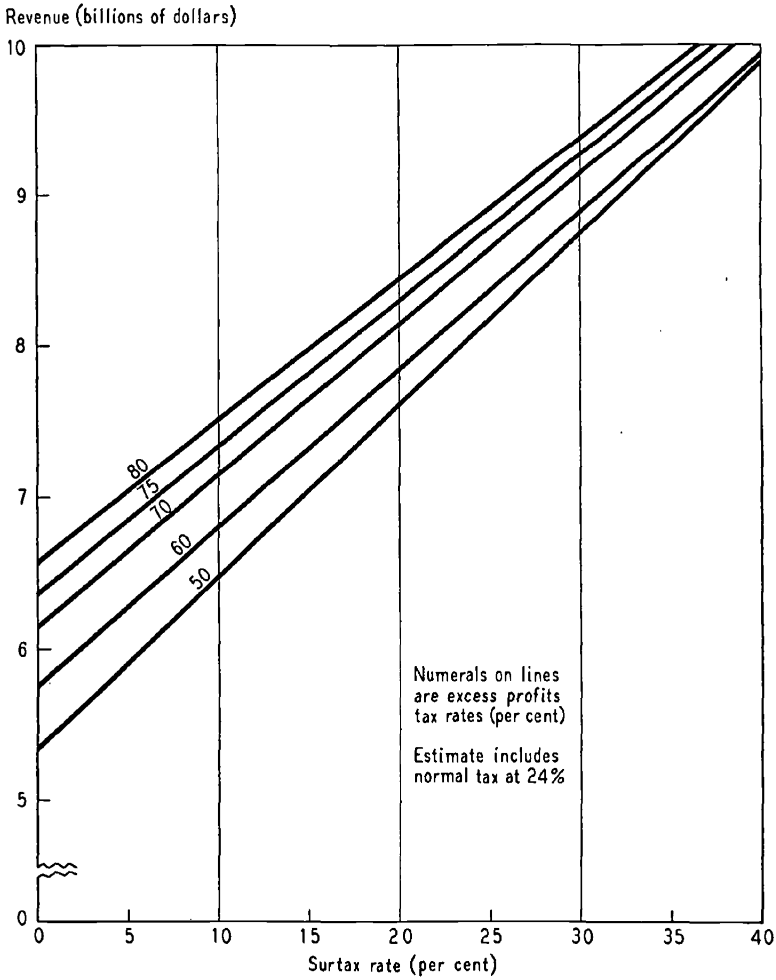
As already noted, these estimates are merely approximate; because certain information essential to calculating the effects of various tax rates is unavailable, they must be recognized as subject to considerable margins of error. Despite their roughness, no doubt can exist as to their relative magnitudes. The highest revenue figure in Section C represents an increase, over revenue estimated for the fiscal year 1943 under the 1941 Act, of about $3.2 billion.

The percentages in Section C indicate the severity of the different combinations, and these degrees of severity have some bearing, though less direct than the marginal rates, on whether a particular combination of corporation taxes will seriously hurt the incentives of managers and owners of corporations. The balance between the excess profits and the income tax burden also bears upon incentives: adding to the one burden and lightening the other, while leaving total revenue fixed, may weaken the incentives of one group of business managers and investors while fortifying the incentives of others. Moreover, the weight of the burden, or rather the supposed lack of burden, on corporations may affect greatly the incentives of other groups. Measures imposing corporation taxes, as well as other burdens imposed necessarily during the war, will reflect a balancing of conflicting interests of various groups in the community.

Although all the money figures in Table 17 are carried out to several digits, the bases for the estimates do not warrant any such precision, and the procedure was followed only because it shows more clearly the arithmetic involved and reveals correctly the direction of change in total revenue in passing from one combination of rates to a somewhat different combination. For all practical purposes such final figures

CHART 7

Total Estimated Revenue, for 1941–42 Income Levels, of Excess Profits Tax Rates, Surtax Rates on Net Income, and a Normal Tax of 24 Per Cent



as those in Section C should be stated only to the nearest tenth of a billion (for example, 7.4, 7.9); even then the accuracy of the right-hand digit may be seriously questioned.

Column 3 of Section A is the difference between the estimated base figure, $13.7 billion, and column 2. Certain peculiarities of the legal provisions concerning the income and the excess profits taxes, as well as certain other technical difficulties may mean that this manner of estimating 'income subject to income tax' is considerably in error, but the figures are believed satisfactory for such a rough estimate as is here being made. The revenues in Section C can be supplemented, for various combinations of excess profits tax and surtax rates, by reading directly from Chart 7.

NOTES

[1] Note is here taken of the possibility that heavier corporation taxes might to some extent reduce the demand, or weaken the argument supporting such demand, for increases in rates of wages or other employee compensation. This point is discussed below.

[2] To what extent such incomes would be used for civilian purchases is open to question; see Ch. 10.

[3] Whether such funds would in fact be spent by corporations largely to buy civilian goods is highly doubtful under present circumstances, because goods such as corporations purchase are in short supply and because of other restraints on corporate capital expansion; see Ch. 5.

[4] The surtaxes on personal holding companies and on corporations improperly accumulating surplus, and the tax on foreign personal holding companies.

[5] The taxes on mutual investment companies, on resident foreign corporations, and on non-resident foreign corporations.

[6] The taxes on unjust enrichment, imposed in order to recapture revenue left in the hands of businesses acting as collection agents for the levies formerly imposed under the AAA program, when these taxes were declared unconstitutional, and a recapture clause, embodied in the so-called Vinson Act of 1940, limiting profits on defense orders.

[7] Specifically the rate imposed is 6.6 per cent on net income (before other federal taxes) which is more than 10 but not more than 15 per cent of the declared value, and 13.2 per cent on income that exceeds 15 per cent of the declared value.

[8] In 1941 the declared value excess profits tax produced only $26,000,000; the declared value capital stock tax, $167,000,000.

[9] Except those exempt from income tax, such as educational and charitable institutions, and individuals with incomes less than the allowable deductions and credits.

[10] Testimony of John Sullivan, Assistant Secretary of the Treasury, *Hearings,* Senate Committee on Finance, 1941, Part 1, p. 47.

[11] E.g., M. S. Eccles, R. M. LaFollette, and certain C.I.O. leaders.

[12] Carl Shoup, The Taxation of Excess Profits, *Political Science Quarterly,* LV, 535-55; LVI, 84-106, 226-49.

[13] For instance, the experience of the railroads, the coal industry, flour milling, mining, lumber, and, to some extent, machinery production 1936–39 (*Hearings,* Senate Committee on Finance, Revenue Revision of 1941, pp. 220-32, 509, 522, 648, 694, 816, 894).

[14] The same argument implies a question concerning the wisdom of the special 10 per cent levy on added income to be applied when the invested capital method is used, which was present in the House bill in 1941 but rejected by the Senate.

[15] We give no attention here to the effects of the change in the Act of 1941, by which the *order* of computing the two taxes is altered. Computing the excess profits tax first and the corporate net income tax on the residue of income increases the yield of the first at the expense of the second, and also has certain less obvious consequences. The arguments for or against reverting to the former procedure are not considered here.

[16] A plan of the blocked-accounts type was included in the Treasury's recommendations to the Ways and Means Committee in March 1942 (*Hearings,* unrevised, Part 1, p. 6).

[17] Hicks and others, *Taxation of War Wealth* (Clarendon Press, Oxford, England, 1941), Ch. I.

[18] The issues involved in this form of taxation are discussed at length in *ibid.,* Ch. IV.

[19] Such a full year is approximately the average of the calendar years 1941 and 1942, tax liabilities on each of which contribute in roughly equal proportions to taxes collected in the fiscal year 1943; but this average may not be a close approximation because of the many corporations reporting on a fiscal (not a calendar) year basis. The figures in the text above are, moreover, only rough estimates, because the full information upon which close estimates could be made has not been published and may indeed not be available.

[20] These last figures are *not* the amounts available for dividends and additions to surplus for taxable corporations. To get those amounts, these figures should be raised by the receipts of tax-exempt interest and by the tax-free portion of intercorporate dividends received by these taxable corporations as a group from nontaxable corporations (those showing deficits in the sense of the tax law definitions).