SUMMARY OF H. R. 9827 "THE EXCESS PROFITS TAX ACT OF 1950" AS AGREED TO BY THE CONFEREES

PREPARED BY THE

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The bill provides for the raising of revenue by the levying of a corporate excess profits tax effective as of July 1, 1950, and a 2-percentage-point increase in the corporate surtax rate effective with respect to taxable years beginning on and after July 1, 1950.

It is estimated that the bill will produce about $3.3 billion annually when fully effective under the levels of corporate profits existing in the calendar year 1950 and between $4 billion and $5 billion under the levels of corporate profits which may reasonably be expected in the calendar year 1951. At the levels of corporate profits present in 1950, the 2-percentage-point increase in the corporate surtax rate will yield about $600 million annually. The balance of the $3.3 billion, or $2.7 billion is attributable to the excess profits tax.

At the levels of corporate profits present in 1950 about 70,000 corporations will pay an excess profits tax. The surtax rate increase will apply to these corporations and to 30,000 others which will not be liable for excess profits tax.

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

(*a*) *The corporate surtax.*—The bill increases the surtax rate under the regular corporate income tax by 2 percentage points with respect to taxable years beginning on and after July 1, 1950. Thus the total normal and surtax rate will be 47 percent for such taxable years. Since no increase is made in the corporate normal tax rate, the rate on income of $25,000 and less remains at 23 percent for 1950 and 25 percent for 1951 and subsequent years.

(*b*) *The excess profits tax.*—The bill imposes an additional excess profits tax rate of 30 percent which together with the regular corporate normal tax and surtax represents a total rate of 77 percent when fully effective. The combined rate of 77 percent on adjusted excess profits net income is comparable to the excess profits tax rate of 85½ percent at the end of World War II, that is, the 95-percent rate reduced by the 10-percent postwar refund.

Under the bill, the combined rate of the corporate income tax, including the 2% tax on consolidated returns, and the excess profits tax cannot exceed a 62-percent ceiling rate, applied to the corporation's excess profits net income. Under the World War II tax a similar ceiling limited the combined rate of the corporate income tax and excess profits tax to slightly more than 72 percent of the surtax net income after allowance for the postwar credit.

As in the case of the World War II tax, the taxpayer is given the choice of the higher of two alternative bases in determining what proportion, if any, of its income is to be subjected to excess profits tax. The primary credit is an average earnings credit, based on the average income for 3 out of the 4 years 1946 to 1949. The alternative is a credit based on a rate of return on invested capital. A similar choice was provided in the World War II law.

The excess profits tax is made effective in 1950 for calendar-year corporations by imposing for that year approximately one-half the tax which will apply in subsequent years. Thus, the excess profits tax rate applicable to these calendar-year corporations in 1950 is about 15 percent which, when combined with the corporate normal tax and surtax, will represent a total rate of about 57 percent. The excess profits tax does not apply to years ending prior to July 1, 1950. In the case of a corporation with a year beginning prior to and ending after July 1, 1950, the excess profits tax imposed will be a percentage of the 30-percent excess profits tax rate computed on the basis of the full year's income. The percentage is to be determined by dividing the number of days in the taxable year after June 30, 1950, by the total number of days in the taxable year. These rules are similar to those applied for 1950 to fiscal year corporations in making the changes in the corporate normal tax and surtax rates under the Revenue Act of 1950.

The bill provides that the excess profits tax shall terminate as of June 30, 1953. For corporations with years beginning before July 1, 1953, and ending after June 30, 1953, the same procedures will be used with respect to the termination of the tax as in the case of the initial imposition of the tax.

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

The excess profits tax is an additional tax over and above the other corporate income taxes. In general the excess profits tax is computed as follows:

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

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

(*c*). Third, the excess profits tax at the rate of 30 percent is imposed on this adjusted excess profits net income. This, when added to the aggregate normal and surtax of 47 percent produces a 77 percent rate on adjusted excess profits net income.

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

Substantially the same tax burdens are achieved under either method of computation, but under the approach in this bill the normal tax and surtax can be computed without regard to the excess profits tax, and subsequent adjustments in the excess profits credit will not require a recomputation of the normal and surtax. Also, the method used in the bill permits the unification of procedures for assessing and collecting the other income taxes and the excess profits tax. The income tax and the excess profits tax will be treated as one tax for the purpose of the computation of interest on refunds or deficiencies, the statute of limitations for assessment and refund purposes, the sending of 90-day letters, etc.

The consolidated return privilege is made available as in the World War II statute.

3. The minimum credit under the excess profits tax

The bill provides a minimum credit of $25,000. Any taxpayer which upon computing its excess profits tax credit under either the average earnings or invested capital method finds that its credit is less than $25,000 may raise its credit to this amount. In contrast to this the World War II law provided all taxpayers with a specific exemption of $10,000.

4. The average earnings credit under the excess profits tax

(*a*) *The selection of the base period and the percentage of earnings taken into account.*—Taxpayers using the calendar year have a base period under the bill consisting of the 4 years, 1946 through 1949. Such taxpayers will eliminate their poorest year in this base period, adjust the income of the remaining 3 years in a manner to be described below, and calculate from the adjusted income of these 3 years an average base period net income. This average is then reduced by 15 percent for the purposes of the average earnings credit. Alternative average base period net incomes which may be elected by qualified taxpayers under certain relief provisions described below are also reduced by 15 percent.

Taxpayers with fiscal years ending after December 31 but before April 1 will use as their base period the last four consecutive taxable years ending prior to April 1, 1950. They will follow the same procedure as calendar year taxpayers eliminating the poorest of the four taxable years falling within their base period.

A somewhat different procedure is followed in the case of taxpayers whose fiscal years end after March 31 and before December 31 Such taxpayers are required to use 36 months out of the 48-month period beginning on January 1, 1946, and ending on December 31, 1949. In determining the 36-month period they must eliminate the worst of the following: (*a*) Any one of the three taxable years falling completely within the period January 1, 1946, through December 31, 1949; (*b*) the portions in the base period of their two taxable years which fall only partially within the period January 1, 1946, through December 31, 1949; or (*c*) one of the portions of these two taxable years falling partially within this period plus enough months in the adjoining taxable year in the period to make up a total of 12 months within the period.

Under the World War II law the corresponding credit was 95 percent of the taxpayer's average earnings in the period 1936 through 1939. Also, under the World War II law the earnings of the poorest of the 4 years could be raised to 75 percent of the average of the other 3 years, but the earnings of no year could be eliminated.

(*b*) *Counting deficit years as zero years.*—In addition to eliminating the poorest year in its base period, the taxpayer counts the earnings of any remaining deficit year as zero. Under the World War II law there was no corresponding provision.

(*c*) *Capital additions during the latter base period years.*—The average earnings credit is increased under the bill to reflect one-half of the net additions to capital in 1948 and all of the net additions to capital in 1949. The increase is 12 percent of such investment. If they take the form of equity capital or retained earnings, 100 percent of such investments are counted. In the case of borrowed capital only three-fourths of such investments are counted. The 12-percent rate is the same rate of return allowed for net additions to capital in the years in which the excess profits tax is applicable and is the maximum rate of return allowed those using the invested capital base. There was no comparable provision under the World War II law.

5. Invested capital credit

Under the bill the excess profits credit of a corporation using the invested capital method is the sum of its invested capital credit (reduced by an amount bearing the same relationship to the credit as its inadmissible assets bear to its total assets) and its new capital credit. The invested capital credit of a corporation includes equity capital, retained earnings, and borrowed capital.

(*a*) *Rates of return on invested capital.*—The same rates of return are allowed under the bill for equity capital, retained earnings, and borrowed capital. In the case of equity capital and retained earnings the rates of return are applied to the full amount of such investments. In the case of borrowed capital the rates are applied to three-fourths of such investments, and one-quarter of the interest payments are deductible in the current tax year in computing income subject to excess profits tax. Under the World War II law the full amount of the investment was taken into consideration in the case of equity capital and retained earnings, but the rates of return were applied to only one-half of the borrowed capital, and one-half of the interest payments were deductible in computing income subject to excess profits tax.

Table 1 shows the rates of return allowed on invested capital under the bill and the World War II law.

TABLE 1.—*Rates of return allowed on equity capital, retained earnings, and borrowed capital under H. R. 9827 and the World War II statute* [1]

Equity capital, retained earnings, and borrowed capital [1] rate brackets	Rates under H. R. 9827	Rates under World War II law
	Percent	*Percent*
Under $5,000,000	12	8
$5,000,000 to $10,000,000	10	6
Over $10,000,000	8	5

Under the bill the capital in each bracket includes ¾ of the borrowed capital and under the World War II law it included ½ of the borrowed capital.

Table 2 shows, for funds borrowed at specified interest rates, the effective rates of return allowed on the total borrowed capital under the bill and the World War II statute, giving effect to the deduction of one-fourth of the interest payments under this bill and one-half of the interest payments allowed in the case of the World War II statute.

TABLE 2.—*Comparison of the effective rates of return allowed on borrowed capital in each asset bracket under the bill and the World War II law (including the effect of interest deductions)*

Selected interest rates	Effective rates under the bill for funds in the bracket—			Effective rates under the World War II law for funds in the bracket—		
	Under $5,000,000	$5,000,000 to $10,000,000	Over $10,000,000	Under $5,000,000	$5,000,000 to $10,000,000	Over $10,000,000
	Percent	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
2 percent	9½	8	6½	5	4	3½
3 percent	9¾	8¼	6¾	5½	4½	4
4 percent	10	8½	7	6	5	4½
5 percent	10¼	8¾	7¼	6½	5½	5
6 percent	10½	9	7½	7	6	5½
7 percent	10¾	9¼	7¾	7½	6½	6
8 percent	11	9½	8	8	7	6½

(*b*) *Definition of equity capital and retained earnings.*—Under the bill the equity capital and retained earnings of a corporation are generally determined by deducting from its total assets on its books at the end of the base period the sum of the liabilities on its books at the same time, plus any "recent loss" adjustment.

The value of the assets is determined, in the case of all assets other than intangible assets, by taking their "adjusted basis for gain," which is their cost or March 1, 1913, value, whichever is higher, plus or minus subsequent adjustments in basis. The value of intangible assets is determined without regard to the value of the property as of March 1, 1913. Intangible assets are defined as "secret processes and formulae, good will, trade-marks, trade brands, franchises, and other like property."

Assets which are not held in good faith for the purposes of the business are excluded in computing invested capital.

The "recent loss" adjustment referred to above, which is added to the net assets, is the net deficit, if any, in the period 1946 to 1949, or 1940 to 1949, whichever is the greater. The net deficit is the excess, if any, of operating losses over net income in the period.

In addition to permitting the taxpayer to compute its equity capital and retained earnings by the asset method described above, the bill provides the taxpayer with the alternative of computing its invested capital under the so-called historical capital approach used in the World War II statute. Under the historical capital approach, the equity capital and retained earnings represent the money and property previously paid in for stock or paid in for surplus plus the accumulated earnings and profits of the corporation as of the beginning of its taxable year. A major difference between this approach and the asset approach is in the treatment of deficits. Under the historical capital approach a net deficit—that is, any deficit remaining after offsetting deficits of loss years against earnings of profitable years—does not decrease paid-in capital or paid-in surplus. Under the asset approach a net deficit incurred prior to 1946 or 1940 has the effect of reducing capital or surplus paid in prior to that date. However, under the asset approach a net deficit incurred for the period 1940 to 1949 or 1946 to 1949 reduces neither capital nor surplus paid in at any time, nor earnings and profits realized prior to 1940 or 1946. Thus in this respect the asset approach is more favorable to corporations with recent losses, while the historical capital approach is more favorable to corporations with net deficits over the whole span of their existence. However, under the historical capital approach (but not under the asset approach) a net deficit in the base period which has not been utilized for carry-back purposes can be carried forward to reduce the excess profits net income for 1950 and 1951. On the other hand, under the asset approach new capital additions in the tax period are provided for at a flat 12-percent rate of return, while under the historical capital approach new capital additions in the tax period are provided for at a rate of return of 12 percent, 10 percent, or 8 percent, depending on the asset bracket of the corporation.

The bill provides in the case of insurance companies, other than mutual and other than life or marine, that equity capital and retained earnings shall include 50 percent of reserves required by law (except those constituting borrowed capital). In the case of mutual insurance companies (other than life or marine) the bill provides that equity capital and retained earnings include surplus as well as 50 percent of reserves required by law. The organization expenses of these insurance companies are included in the computation of equity capital for purposes of the invested capital credit.

In arriving at the equity capital and retained earnings of a bank under the asset approach the bill defines liabilities as excluding reserves for bad debts. Since liabilities are deducted from total assets in arriving at equity capital and retained earnings, the exclusion of reserves for bad debts from liabilities has the effect of increasing the equity capital credit.

(*c*) *Definition of borrowed capital.*—Borrowed capital is indebtedness (not including interest) which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, deed of trust, bank loan agreement, or conditional sales contract. However, the amount to be considered as borrowed capital is limited to outstanding indebtedness "incurred in good faith for the purposes of the business." The definition of borrowed capital is substantially the same as the definition appearing in the World War II statute except for the addition of conditional sales contracts and bank loan agreements. The latter include indebtedness to a bank, but do not include the indebtedness of a bank to its depositors.

In the case of insurance companies 66⅔ percent of the unearned premiums are to be treated as borrowed capital. In the case of a life insurance company 66⅔ percent of the adjusted reserves and 66⅔ percent of the reserves on certain annuity contracts are to be treated as borrowed capital. Since 75 percent of borrowed capital is taken into account in computing the rate of return on invested capital, treating 66⅔ percent of these unearned premiums or reserves on annuity contracts as borrowed capital means that 50 percent of them are taken into account in computing the invested capital credit.

In the case of a face-amount certificate company 66⅔ percent of the reserves on its outstanding investment certificates are treated as borrowed capital. As in the case of insurance companies, this means that 50 percent of these certificates will be taken into account in computing the invested capital credit.

(*d*) *Admissible and inadmissible assets.*—The World War II statute had the effect of reducing the capital, to which the various rates of return were applied in order to determine the invested capital credit, by the so-called inadmissible assets. These included stock in a corporation and State and local government and partially tax-exempt Federal obligations. However, in the case of such Government obligations the taxpayer had the option to treat them as admissible assets if it included in its excess profits tax net income the interest received on them.

The bill makes no major change in the World War II treatment of admissible and inadmissible assets except to deny the option to treat State and local government and partially tax-exempt Federal obligations as admissible assets.

6. Net capital changes in the tax years

Under the bill, both the taxpayer using the average earnings credit and the taxpayer using the invested capital credit, if the latter is computed under the asset approach, are allowed to increase their credit by a flat 12 percent of the net additions to their investment since 1949. However, in the case of net additions taking the form of borrowed capital only 75 percent of the additional investment is taken into account in applying the 12-percent rate of return. The taxpayer computing its invested capital base under the historical capital approach receives a rate of return on net capital additions in the tax period of 12 percent, 10 percent, or 8 percent, depending upon its rate bracket.

Reductions in invested capital in the tax period decrease prior additions in the tax period at the same rate allowed on the increases. Thus, in the case of the average earnings taxpayer and the invested capital taxpayer using the asset approach the excess profits credit is reduced by 12 percent of any reductions which offset additions previously made in the tax period. In the case of the invested capital taxpayer using the historical capital approach, the rate of return by which the excess profits tax is reduced depends upon its top invested capital rate bracket, which may be 12 percent, 10 percent, or 8 percent. Any reductions in excess of the additions in the tax years decrease the credit of all invested capital taxpayers by the rates of return used in building up their credit initially. For the average earnings taxpayer, the rate of return applied to such net capital reductions is 12 percent.

In the case of the average earnings taxpayer no allowance was made under the World War II statute for investments in the tax years if they took the form of borrowed capital or accumulations of retained earnings. An increase in the credit was allowed at an 8-percent rate of return if the additions took the form of paid-in capital or paid-in surplus and a 6-percent rate of return was used for reductions of these types.

In the case of the invested capital taxpayer the World War II statute included retained earnings and borrowed capital in the ordinary computation of invested capital at the regular rates for such capital. Additions to paid-in capital or paid-in surplus were also included in the credit at the ordinary rates but as a special incentive they were included at 125 percent of their value.

7. Excess profits net income in the taxable year

(*a*) *General.*—The net income used in the excess profits tax is an adjusted version of the net income to which the 25-percent corporate normal tax is applied. Chief among the adjustments is an exclusion of capital gains and losses, both long- and short-term, from the sale or exchange of capital assets. The World War II law excluded only long-term gains and losses.

Casualty losses, losses on abandonment, and the excess of losses over gains from involuntary conversions and the sale or exchange of property used in the trade or business (117 (j) losses) are allowed as deductions in computing excess profits net income. The excess of gains over losses (117 (j) gains) are not included in excess profits net income since they are treated as gains from the sale or exchange of capital assets.

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

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

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

(3) refunds of taxes paid under the Agricultural Adjustment Act of 1933.

The bill excludes 75 percent of the portion of the taxpayer's interest deduction which represents interest on the indebtedness included in the taxpayer's borrowed capital if it uses the invested capital basis. This is consistent with the inclusion of 75 percent of borrowed capital in the taxpayer's invested capital base.

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

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

Taxpayers in certain extractive industries are permitted to exclude a portion of their income from "excess output," in a manner somewhat similar to that provided under the World War II legislation. Amounts received as incentive payments to encourage exploration, development, and mining for defense purposes are excluded both for the purposes of the excess profits tax and the corporate normal tax and surtax.

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

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

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

(1) a claim, award, judgment, or decree;

(2) exploration, discovery, or prospecting which extended over a period of more than 12 months;

(3) the sale of patents, formulas, or processes developed over a period of more than 12 months; and

(4) income which is includible in the taxable year rather than another year by reason of a change in the taxpayer's method of accounting; or

(5) income of other classes permitted under regulations prescribed by the Secretary.

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

(*b*) *Installment basis taxpayers.*—The bill permits taxpayers using the installment basis method of accounting for income tax purposes to elect to report their income on an accrual basis for the excess profits tax. This election is available to taxpayers whose principal business consists of installment sales or the purchasing of installment sales obligations. Such an election when made is irrevocable and applies to all subsequent taxable years to which the excess profits tax is applicable.

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

(*d*) *Long-term leases.*—A special adjustment is provided in the case of long-term leases which require the lessee to pay a stated rental to the lessor free of tax. Under such leases an increase in taxes automatically raises the income before taxes of the lessor corporation and may serve as the basis for the imposition of an excess profits tax, which the lessee will be obligated to assume. The bill provides that in appropriate cases the amount of income or excess profits tax paid by the lessee is excluded from the income of the lessor corporation, and that no deduction is allowed to the lessee. This treatment is available only in the case of a lease for a term of more than 20 years. However, an agreement for the lease of railroad properties is considered to be a lease for the total number of years during which the lease may be renewed or continued.

To qualify for such treatment it is necessary that the initial lease be entered into prior to December 1, 1950.

(*e*) *Bad debt reserves of banks.*—Banks which have elected to use the reserve method of accounting for bad debts for income tax purposes will substitute for excess profits tax purposes a deduction for debts which became worthless in whole or in part within the taxable year.

(*f*) *Blocked income.*—Special rules are provided under the bill for the treatment of "blocked income" arising prior to 1951. These rules are discussed in paragraph 16 (f) below.

8. Excess profits net income in the base period

Many of the provisions in the bill for removing abnormalities from the income of the base period years are similar to those used in the taxable years. Among these are the exclusion of gains and losses from the sale or exchange of both long- and short-term capital assets, and income arising from the retirement or repurchase at less than the issue price of bonds and other evidences of indebtedness outstanding for more than 6 months.

However, net gains and losses from the sale or exchange of assets used in the trade or business (sec. 117 (j) assets) are excluded from the taxpayer's base period excess profits net income even though, when such losses exceed such gains, the excess is not excluded from the determination of income in the excess profits tax years.

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

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

In addition, the bill contains a general provision applying to claims, awards, and judgments against the taxpayer, intangible drilling and development costs of oil or gas wells, development costs in the case of mines, casualty losses, and deductions of other classes subject to regulations prescribed by the Secretary. Generally for any class of such abnormal deductions, the amount in excess of 115 percent of the average amount of deductions of such class for the four previous taxable years is to be eliminated under regulations prescribed by the Secretary, provided that in the base period year the deductions of the class disallowed exceed 5 percent of the average excess profits net income for all the taxpayer's base period years computed without the disallowance of any class of deduction under this provision. For the purposes of the latter limitation, a deficit in any of these years is counted as zero. An exception is made in the bill which excludes from the scope of the 115-percent limitation described above deductions in prior years arising out of the same extraordinary event which accounted for the deduction in the taxable year. The World War II law eliminated only the excess over 125 percent of the average of the deductions for the four previous taxable years, and did not include the 5-percent limitation described above.

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

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

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

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

Banks are permitted to reduce their deductions for assessments paid to the Federal Deposit Insurance Corporation during the base period years proportionately with the reductions which occur in the taxable year as a result of the credits allowed under Public Law 797 of the Eighty-first Congress, second session.

9. General relief provisions

The bill provides relief in most of the important cases which were covered under section 722, the general relief provision of the World War II law. However, under section 722 a hypothetical base period earnings credit had to be "tailor-made" for the individual taxpayer on the basis of almost all the factors which influenced the taxpayer's business during its base period years. Hence a great deal of judgment was necessarily involved in the processing of the relief claims arising under section 722. The bill provides relief by a set of formulas, thus reducing the area of administrative discretion to a minimum.

(*a*) *Abnormalities during the base period.*—Section 722 (b) (1) and (2) of the World War II law provided relief when the income of the taxpayer's base period years was substantially abnormal because of a physical interruption to production, such as a fire, strike, or flood, or because of a depression in the business of the taxpayer resulting from temporary economic circumstances unusual in the case of the taxpayer, such as a severe price war. The bill contains two formulas which provide relief in these same areas.

If an abnormality existed in the taxpayer's lowest year of earnings during the base period, this year will be eliminated automatically from the average base period net income computation. However, if an abnormality occurred in one of the remaining periods of 12 months or less in the base period, the taxpayer may, if it was in business at the beginning of its base period, substitute for its actual excess profits net income for the period of the abnormality an amount determined by multiplying its total assets for the last day of the period of the abnormality by the rate of return for its industry for that period.

If an abnormality is present in more than one of the three 12-month periods in the taxpayer's base period, a different formula is used. In such cases, a substitute average base period net income is computed by multiplying the average of the amounts of the taxpayer's total assets on the last day of each of its base period years by the base period rate of return for the taxpayer's industry.

The substitute average base period net income described above is available only if the taxpayer's average base period net income in the event of the substitution exceeds 110 percent of the taxpayer's average base period net income computed without adjustment for the abnormality. Similarly, a substitute excess profits net income may be used for a single abnormal year only if it exceeds 110 percent of the taxpayer's excess profits net income for that year computed without such substitution.

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

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

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

The industry rate of return for an individual year will be computed by dividing the sum of the aggregate net income and the aggregate interest deduction shown on the income tax returns filed by the corporations in the industry by the aggregate total assets of such corporations as of the close of the taxable year for which the returns were filed. Since interest is added to net income in the calculation of the rate of return which the taxpayer applies to his assets, the amount of interest accrued by the taxpayer during a single year of abnormality is subtracted in determining his substituted income of that year. A similar adjustment is made in other cases where the industry rate of return for a single year is applied.

The industry base period rates of return will be computed by aggregating the net income and the interest deductions reported by the corporations in the industry during the 4-year period 1946 through 1949 and dividing by the aggregate of the sum of the total assets of these corporations for the 4 years in question. In this and other cases where the taxpayer computes a substitute average base period net income with its industry average base period rate of return the taxpayer makes an appropriate adjustment to eliminate 1 year's interest.

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

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

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

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

The taxpayer desiring to adjust its base period net income under these provisions will make an application with its return, or file a claim for refund within the period of limitations applicable to claims for refund, or file an application to offset a deficiency proposed against it. If a taxpayer files a petition with the Tax Court for redetermination of a deficiency, such application must be filed not later than the date of the filing of the original petition.

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

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

To qualify for relief under the "new product" provision the change in products or services must have been "substantial" in the sense that by the end of the third year (or earlier) following the year in which the products or services were introduced, the gross income from such products must aggregate to more than 40 percent of the taxpayer's gross income or 33 percent of the taxpayer's net income in that year. The taxpayer must also demonstrate that its net income in any one of the taxable years in which it has met the percentage of gross or net income test was in excess of 125 percent of the average excess profits net income during the base period year or years preceding the first change in product or service used in qualifying under the gross or net income test.

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

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

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

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

To qualify for relief under the "change in capacity" formula the taxpayer must have added to its facilities in a manner which—

(1) resulted in an increase of 100 percent or more in its productive capacity; *or*

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

more the adjusted basis of the taxpayer's total facilities prior to such addition or replacement; *or*

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

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

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

Taxpayers which qualify under one of the afore-mentioned tests may elect to use an average base period net income calculated by multiplying the base period rate of return for the taxpayer's industry classification by the taxpayer's total assets for the last day in its last pre-excess profits tax year. Since the alternative net income is computed on the basis of the assets as of the close of the base period, no adjustment is made for capital additions during the base period.

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

The existence of a depression in the taxpayer's industry during the base period is to be determined by comparing the industry's average rate of return during the years 1946 through 1948 with its average rate of return during the period 1938 through 1948. Under the bill a depressed industry is one in which the industry average rate of return on total assets during the years 1946 through 1948 is less than 63 percent of its average rate of return over the period 1938 through 1948.

Taxpayers in "depressed" industries are permitted to use a substitute average base period net income computed by multiplying their average total assets during the base period by 80 percent of the depressed industry's average rate of return during the period 1938 through 1948.

For purposes of the depressed industry test, taxpayers will be classified in general conformity to the three-digit classification of industries used by the Treasury Department in compiling its Statistics of Income data for the years 1938 through 1947, using such combinations of subgroups as the Secretary determines are necessary to provide reasonably comparable data over the period 1938 through 1948. This classification is substantially more detailed than that shown in appendix A which is used in other relief provisions contained in this bill. The taxpayer's industry subclassification will be the one from which it derives the majority of its gross receipts.

The depressed industry formula also provides relief for the type of case covered under 722 (b) (3) (B) of the World War II law. These are cases in which the industry is characterized by sporadic and intermittent periods of high profits and such profits fail to appear in the base period. Hence the industry rate of return in the base period years may be expected to fall well below its long-term average since the latter will probably include one or more of the high profit periods.

10. Alternative basis for new corporations

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

Except in the case of a new corporation which acquires the assets of an old corporation (dealt with in pt. II of the bill) and certain ineligible corporations, an alternative average base period net income is provided for a corporation which commenced business at any time after the beginning of its base period. The alternative is computed by applying the average base period rate of return for the taxpayer's industry classification to the amount of the taxpayer's total assets. If the taxpayer's first three taxable years ended in the base period, the industry rate of return is applied to the taxpayer's total assets on the last day of the year preceding its first excess profits tax year. This alternative net income may then be adjusted for retained earnings or net capital additions or reductions subsequent to the close of the base period. When the taxpayer's first, second, or third taxable year ends after the base period, the credit is determined for each of these years by applying the industry average base period rate of return to the taxpayer's assets for each of such years. The credit for subsequent years is determined in a similar manner on the basis of the assets at the close of the taxpayer's third year. A new corporation receives an adjustment for capital additions in the tax period when made more than 3 years after it commences business.

The new corporation treatment is denied in certain cases where taxpayers might transfer assets between corporations in order to obtain the benefit of the industry average rate of return available to new corporations.

11. Alternative basis for growing corporations

The bill provides an alternative average base period net income for a corporation which commenced business before the beginning of its base period and experienced an unusually rapid growth during its base period. This alternative is not available to a corporation commencing business at a later date which may qualify for relief under the new corporation formula described above.

The alternative average base period net income for growing corporations is a substitute for the so-called growth formula used in the World War II law which permitted all taxpayers to calculate their base period credit by adding to the average income of the last half of the base period 50 percent of the difference between the average income of the first and second halves of the base period, subject to the limitation that the alternative credit could not exceed the net income of the highest taxable year in the base period. The use of the World War II growth formula in the present bill would have resulted in the widespread use of the income of the year 1948 as the sole basis for calculating the average base period net income.

There are two alternative sets of tests provided in this bill for establishing the existence of unusually rapid growth during the base period. One set of tests, designated here as "test A," permits a corporation to qualify if its total payroll for the last half of its base period is 130 percent or more of its total payroll for the first half of its base period, or alternatively if its gross receipts during the last half of its base period are 150 percent or more of its gross receipts for the first half of its base period. It is important to note that an alternative average base period net income is available to a taxpayer who qualifies under test A only if the taxpayer's total assets at the beginning of the base period are not more than $20,000,000. For the purpose of this test the assets of a group of corporations which are privileged to file a consolidated return are aggregated whether or not a consolidated return is actually filed.

A taxpayer may also qualify as a "growth" company if it meets test B, which requires compliance with all of the following:

(1) The taxpayer's net sales for the period January 1 through June 30, 1950, when multiplied by 2 are 150 percent or more of its average net sales in the calendar years 1946 and 1947.

(2) Forty percent or more of the taxpayer's net sales for the calendar year 1950 are attributable to a product or class of products "not generally available to the general public" prior to January 1, 1946. For this purpose "a product or class of products" includes articles of which the product or class of products is a principal component and articles which are themselves a component of such product or class of products.

(3) The taxpayer's net sales attributable to such product or class of products in the calendar year 1946 are 5 percent or less than such net sales in 1949.

A corporation which qualifies under test B may obtain an alternative average base period net income even if its total assets at the beginning of the base period are more than $20,000,000.

A calendar year corporation which qualifies under either test A or test B may compute an alternative average base period net income on the basis of—

(1) its income in the years 1948 and 1949;

(2) its income in the year 1949; or

(3) one-half of its income in 1949 and 40 percent of its income in 1950.

Corresponding provisions are made for the fiscal year taxpayers.

Still another alternative is available to certain taxpayers which qualify under test B and whose excess profits net income for 1949 was not more than 25 percent of their income for 1948. Such taxpayers, if using the calendar year, may compute their alternative average base period net income on the basis of one-half their income in 1948 and 40 percent of their income in 1950. Corresponding provisions are made for fiscal year taxpayers.

12. Carry-overs of net operating loss and unused excess profits credit

The bill permits the use of the net operating loss carry-back and carry-forward in calculating the net income of an excess profits tax year. With the exceptions discussed below the same rule is used as under the corporate normal tax and surtax; that is, the carry-back is limited to 1 year and amounts not so absorbed are carried forward until exhausted over a period of not more than 5 years. This compares with a carry-back of 2 years and a carry-forward of 2 years used under the World War II law after 1942. Thus the averaging period under the bill will be 7 years as compared with 5 years under the previous law.

The bill also permits a taxpayer, other than an invested capital taxpayer using the "asset" approach, to elect to carry forward to the years 1950 and 1951 the total of the operating losses in the base period reduced by the losses carried back to years prior to the base period and by the income of the base period years.

The net operating loss carry-over or carry-back is not used for computing the excess profits tax net income of the base period years.

Like the World War II law this bill provides for a carry-back and carry-forward of an unused excess profits credit. The carry-back is for 1 year and the carry-forward for 5, thus producing the same 7-year averaging period as under the net operating loss carry-over. The unused excess profits tax credit adjustment under the World War II law was limited to a carry-back of 2 years and a carry-forward of 2 years which conformed to the net operating loss carry-over provisions of that law.

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

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

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

13. Minimum credi for certain regulated industries.

The bill provides a minimum excess profits tax credit which is available to taxpayers in certain specified types of regulated industries. This credit is an alternative to the average earnings credit and the invested capital credit for such taxpayers and is not subject to the 15 percent reduction generally applied to the average earnings credit.

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

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

(1) electric energy;
(2) gas;
(3) water;
(4) sewage disposal;
(5) transportation on an intrastate, suburban, municipal, or interurban electric railroad, trolley system, or bus system; or
(6) transportation by trucks or busses;

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

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

(1) transportation of oil or other petroleum products (including shale oil) or gas by pipeline if the corporation is subject to the jurisdiction of the Interstate Commerce Commission or the Federal Power Commission;

(2) transportation by railroads regulated by the Interstate Commerce Commission; and

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

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

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

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

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

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

Since only some of the members of an affiliated group eligible to file a consolidated return may be regulated companies to which the special alternative credit is available, the bill specifies how consolidated returns should be handled in such cases. The regulated companies which are eligible for the minimum credit may be split-off and a consolidated return may be filed for them as a group, but if all the members of such an affiliated group file a single consolidated return, none of the regulated companies involved may claim the special minimum credit.

14. Exemption of strategic minerals

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

"Strategic" minerals as used in this provision include antimony, chromite, manganese, nickel, platinum (including the platinum group metals), quicksilver, sheet mica, tantalum, tin, tungsten, vanadium, fluorspar, flake graphite, vermiculite, perlite, long-fiber asbestos in the form of amosite, chrysolite or crocidolite, beryl, cobalt, columbite, corundum, diamonds, kyanite (if equivalent in grade to Indian kyanite), molybdenum, monazite, quartz crystals, and uranium. In addition "strategic" minerals include any other minerals which the agency created to carry out the duties under section 303 (a) of the Defense Production Act of 1950 certifies as being essential to the defense effort of the United States and as not being normally produced in appreciable quantities in the United States.

The World War II statute provided for the exemption of antimony, chromite, manganese, nickel, platinum, quicksilver, sheet mica, tantalum, tin, tungsten, fluorspar, flake graphite, vermiculite, and vanadium.

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

The bill continues the relief which was provided by section 735 of the World War II statute with respect to certain mineral mining, timber, and natural gas properties. For this purpose the term "mineral" includes the following: ores of the metals, coal, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gravel, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand, shell, silica, slate, soapstone, soda, sulphur, and talc. This list is the same as under the World War II provision with the exception that "shell" was not included in that provision. The relief under this provision is provided by exempting from excess profits tax a certain portion of the current income from these properties. Generally this portion is determined by multiplying the normal unit profit during the normal period 1946 to June 30, 1950 (1936 to 1939 in the case of the World War II statute) by a specified proportion of current production in excess of normal output during the base period. The provision in the bill differs from the World War II version in that a taxpayer is given the option to aggregate his mining properties for this purpose.

In the case of coal and iron mines, timber properties, and natural gas properties, a World War II provision determined the exempt portion by multiplying current excess production by one-half of the current net income per unit. Such a provision is contained in the bill but is extended to apply to all metal mines.

The World War II statute also contained a provision providing partial exemption for coal and iron mines and timber properties not in operation during the base period. One-sixth of the net income in the current taxable year of these properties was exempt from excess profits tax. The corresponding provision in this bill differs in a number of respects. The exemption from excess profits tax for properties coming under the provision is increased from one-sixth to one-third of the net income from such property. Natural gas and metal mining properties not in operation during the normal period (the taxable years included in the period January 1, 1946, to June 30, 1950) are given the benefits of this provision as also are metal mining properties in operation in the normal period but having an aggregate loss for this period.

The bill exempts from both income and excess profits taxes amounts paid to the taxpayer by the United States or any of its agencies or instrumentalities for the encouragement of exploration, development, or the mining of critical and strategic minerals or metals.

16. Foreign corporations and income from abroad

(*a*) *Foreign corporations*.—The bill imposes an excess profits tax on foreign corporations only if they are engaged in trade or business within the United States and the foreign corporations subject to excess profits tax are taxable only on income derived from sources within the United States. If such corporations were engaged in trade or business within the United States during all of their taxable years in the base period, they are entitled to use either the average earnings credit or the invested capital credit. If they were not engaged in trade or business within the United States during the entire base period, they are entitled to use only the invested capital credit. In computing the average earnings credit for corporations eligible to use this credit, only income derived from sources within the United States is taken into consideration. In computing the invested capital credit only United States assets and liabilities are taken into consideration. Where the Secretary of the Treasury determines that these assets and liabilities cannot satisfactorily be segregated from the other assets and liabilities of the corporation, the equity capital and retained earnings of the corporation, for purposes of the excess profits tax, are to be the same proportion of the total equity capital and retained earnings of the corporation as its net income derived from sources within the United States is of its total net income. Borrowed capital in such cases is also determined from the relationship of net income from sources within the United States to the total net income of the corporation. The treatment provided under the bill for foreign corporations is substantially the same as provided by the World War II statute.

(*b*) *Corporations deriving most of their income from United States possessions*.—Domestic corporations to which section 251 of the Internal Revenue Code is applicable—that is, corporations deriving a large portion of their income from sources within the possessions of the United States—are subject to excess profits tax on only so much of their income as is derived from sources within the United States. They are given the same treatment under the excess profits tax as foreign corporations engaged in trade or business within the United States during a tax year but not all of their base period years. This is the same treatment accorded under the World War II law.

(*c*) *Western Hemisphere trade and similar corporations*.—The World War II statute provided an exemption for Western Hemisphere trade and other domestic corporations where 95 percent or more of their income over the last 3 years was derived from sources outside the United States, and where 50 percent or more of their gross income was derived from the active conduct of a trade or business. The bill continues this exemption.

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

(*d*) *Dividends received from foreign corporations.*—Under the World War II law, dividends received from foreign corporations by domestic corporations were included in the excess profits tax net income of average-earnings taxpayers both for the base period and the tax period. On the other hand, they were not included in the excess profits net income of invested capital taxpayers in the tax period and the stock in the foreign corporation was excluded from invested capital. Under the bill foreign dividends are excluded from excess profits net income in the tax period in the case of both the average earnings and the invested capital taxpayer. In addition, such dividends are excluded from the base period income of the average-earnings taxpayer, and the stock in a foreign corporation is excluded from invested capital in the case of the taxpayer computing his tax in this manner.

(*e*) *Foreign tax credit.*—Under the bill, as under the World War II statute, domestic corporations operating branches abroad are subject to excess profits tax on the income derived from such branches in the year in which it is earned. However, any tax paid a foreign country with respect to such foreign operations which is in excess of the tax credit allowed by the United States for purposes of the normal tax and surtax is allowed as a credit against excess profits tax subject to certain limitations. The tax treatment accorded branches is the same as that provided by the World War II statute.

(*f*) *Blocked income.*—Taxpayers deriving income from sources within a foreign country are permitted under the bill to exclude such portion of the income as would, but for monetary, exchange, or other restrictions imposed by the foreign country, have been includible in the gross income of the taxpayer prior to its first excess profits tax year.

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

A special rule is provided for the reallocation of income which arose during the first excess profits tax year but became "unblocked" in later years.

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

17. Exemption for certain air-mail subsidies

As under the World War II law, airlines may exclude air-mail subsidies paid by the Federal Government if the airlines have no adjusted excess profits tax net income when these air-mail subsidies are not taken into consideration.

18. Personal service corporations

The World War II law provided that personal service corporations could elect to be exempted from the excess profits tax if the stockholders of such corporations agreed to take up as part of their income for individual income tax purposes the pro rata share of the undistributed profits of the personal service corporations. This did not, however, exempt a personal service corporation from the corporate normal tax or surtax. A personal service corporation was defined as a corporation whose income was to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and who are the owners of at least 70 percent of the stock of the corporation. The bill retains this provision of the World War II statute.

19. Corporations completing contracts under the Merchant Marine Act

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

Under the bill the amount received by the contracting party and recaptured by the Maritime Board first will be excluded in computing the excess profits tax. An alternative computation requires the taxpayers to increase their excess profits net income by the amount of the payments to the Maritime Board. The tax computed upon this basis is then reduced by the amount of such payments, and the remainder constitutes the tax which is to be paid, if it is less than the tax computed under the first method.

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

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

The bill provides that the invested capital credit of a railroad which was formerly a lessor shall include the fair value of betterments and additions made by a lessee railroad to property of the lessor railroad if the lease has been canceled.

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

In the case of certain corporate reorganizations during the base period or subsequent to the base period, the experience of the corporations prior to the reorganization may be aggregated for purposes of determining excess profits credits based on earnings. This is provided for in part II of the excess profits tax subchapter in this bill.

The reorganizations dealt with in part II are the type with respect to which gain or loss is not recognized. In addition to the general type of case where substantially all the assets of one corporation are taken over by another corporation, part II provides rules for the recomputation of base period net income in the case where substantially all the assets of a partnership or a sole proprietorship are acquired by a corporation and in cases where only part of the assets of the partnership are placed in a corporation or where only part of the assets of the corporation are split off into a new corporation.

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

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

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

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

A corporation which is created incident to a part II transaction is not denied the growth alternative by reason of being a new corporation.

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

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

In the case of part II transactions on or before December 31, 1950, abnormal income received in the tax period which is attributable to a year of the component corporation during or prior to the base period is treated in the same manner as though the business of the component during such period had been the business of the acquiring corporation.

Adjustment is provided for both net capital additions during the last 2 years of the base period and net capital additions and reductions after the close of the base period in the case of parties to an exchange described in part II.

22 Basis for computation of the invested-capital credit after intercorporate liquidations.

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

APPENDIX A

Industry Classification to be used in connection with certain General Relief Provisions

Industry group	*Major group No.*
Agriculture, forestry, and fisheries:	
Farms and agricultural services, hunting, trapping	01, 07
Forestry	08
Fisheries	09
Mining:	
Metal mining	10
Anthracite mining	11
Bituminous coal and lignite mining	12
Crude petroleum and natural gas extraction	13
Nonmetallic minerals except fuels	14
Contract construction:	
General contractors	15, 16
Special trade contractors	17
Manufacturing:	
Ordnance and accessories	19
Food and kindred products	20
Tobacco manufactures	21
Textile mill products	22
Apparel and other finished products made from fabrics	23
Lumber and wood products	24
Furniture and fixtures	25
Paper and allied products	26
Printing, publishing, and allied industries	27
Chemicals and allied products	28
Products of petroleum and coal	29
Rubber products	30
Leather and leather products	31
Stone, clay, and glass products	32
Primary metal industries and fabricated metal products (except ordnance, machinery, and transportation equipment)	33, 34
Machinery (except electrical)	35
Electrical machinery, equipment, and supplies	36
Transportation equipment	37
Miscellaneous manufacturing industries including professional, scientific, and controlling instruments; photographic and optical goods; watches and clocks	38, 39
Transportation, communications, and other public utilities:	
Railroads	40
Local and interurban railways and bus lines	41
Trucking and warehousing	42
Highway transportation not elsewhere classified	43
Water transportation	44
Transportation by air	45
Pipeline transportation	46
Services incidental to transportation	47
Telecommunications	48
Utilities and sanitary services	49
Wholesale trade	50, 51
Retail trade:	
Building materials and farm equipment	52
General merchandise	53
Food	54
Automotive dealers and gasoline service stations	55
Apparel and accessories	56
Furniture, home furnishings, and equipment	57
Eating and drinking places	58
Miscellaneous retail stores	59

Industry Classification to be used in connection with certain General Relief Provisions—Continued

Industry group	*Major group No.*
Finance, insurance, and real estate:	
Banking	60
Credit agencies other than banks	61
Security and commodity brokers, dealers, exchanges, and services	62
Insurance carriers	63
Insurance agents, brokers, and service	64
Real estate	65
Holding and other investment companies	67
Services:	
Hotels, rooming houses, camps, and other lodging places	70
Personal services	72
Miscellaneous business services	73
Automobile repair services and garages	75
Miscellaneous repair services	76
Radio broadcasting, including facsimile broadcasting, and television	77
Motion pictures	78
Amusement and recreation services except motion pictures	79
Other services	80, 81, 82, 84, 86, 89