

STATEMENT OF JOHN L. SULLIVAN, ASSISTANT SECRETARY
OF THE TREASURY, BEFORE THE COMMITTEE ON WAYS
AND MEANS OF THE HOUSE OF REPRESENTATIVES,
MONDAY, MAY 19, 1941

* * * * *

My purpose today is to discuss with you the problem of corporate taxation in the present emergency. What I shall have to say is supplementary to the statement made by Secretary Morgenthau when the current hearings were opened and to the suggestions laid before you subsequently on behalf of the Treasury Department.

The Treasury is called upon to meet expenditures greater than have ever been made in the nation's peacetime history, and probably greater than at any period in our history, in peace or war. At such a time we cannot expect to rely on normal sources of revenue or be content with revenue in normal amounts. We must adopt extraordinary measures to deal with our extraordinary situation.

Your Committee is now formulating changes in our tax system, both to provide the revenues needed to finance the defense expenditures that we are committed to make, and also to assist in maintaining the economic health of the nation. Our people know that

great sacrifices must be made and they are prepared to make them. They rely upon you so to plan our financial program that, however severe its burdens may have to be,. they will rest fairly and justly upon all individuals and all businesses.

The tax program which you will propose will necessarily consist of many elements. Any one tax, viewed by itself, may appear to be stringent. All must be viewed, however, as parts of a whole. This is an emergency. Taxes that would not be proposed in normal times are a necessity now.

I have been asked particularly to discuss the excess profits tax, first enacted in the fall of 1940. Our experience with it is still limited, for many of the returns of the largest corporations have not yet been filed. Enough have been filed, however, to convince Treasury officials in charge of tax administration that important changes in the law must be made in the interests of fairness. We are collecting large sums by means of this tax, but the profits of a good many business firms are not being touched by the tax,

although some of those profits are excess profits by any reasonable standard. Here is certainly a place to broaden the base. Surely the skill of this Committee and its experts is adequate to the task of bringing within the tax the known cases of corporate excess profits.

I want first to outline the principles which I believe should govern the taxation of excess profits; second, to indicate respects in which the present law fails to accord with those principles; and third, to suggest possible remedies which the Congress may wish to consider.

I - Principles

Under present conditions some kinds of profits may be appropriately subjected to heavier taxation than other kinds. This may be necessary in order to distribute the burden fairly and to avoid unfavorable economic effects that might result if the revenue were raised in other ways.

1. Defense profits

The first type of profits which, in a period of this kind, should be subjected to special taxation comprises the profits which may be reasonably

attributed to the defense program. Such profits are being made out of the sacrifices of the people as a whole and should be returned to the people in taxes, insofar as may be possible without destroying necessary incentives to produce defense goods.

In many cases it is not possible to identify with precision the additional profits due to the defense program. The effects of defense spending are diffused throughout the whole economic system. It is necessary, accordingly, to assume that in general, increases in profits during this period are due to defense. Inability to measure defense profits precisely should not discourage us from subjecting them to special taxation even at the risk of hitting some income not derived from the defense program.

2. Profits in excess of a necessary normal return on invested capital

The other kind of profit that can properly be subjected to special taxation comprises profits in excess of a necessary normal return on invested capital, even if

this return was being earned in the years prior to the defense program. The existence of such profits, while often due primarily to good management, is in numerous cases due to monopoly, imperfect competition, or fortunate circumstances, and not to any outstanding service to the public. When as a result of the imperfections of our economic machinery such excess profits have been made, it is equitable and desirable that they be subjected to special taxation. Furthermore, at a time when heavy taxes must be imposed they should be levied where they will assist best in maintaining a well-functioning economy. To take an additional share of the profits in excess of a normal return on invested capital will not cause any companies to go into bankruptcy or withdraw from business.

I am aware that the anticipation of extraordinarily large profits may in many cases have put security prices well above a figure that would represent invested capital. The imposition of these special taxes may seem harsh to individuals who have purchased those securities at such levels. We must remember that no legislation is ever passed and no progressive step is ever taken which does not disturb expectations of some people. We submit that established expectations of high profits are entitled to no more protection than

an individual's expectation of a continued large salary which is now to be subjected to a much heavier tax. This is an emergency, and changes must be expected.

I am also aware that the application of the principle of taxing profits in excess of a necessary normal return on capital involves difficulties of both principle and technique. These difficulties should not be underestimated, but I feel sure that we should not allow them to stand in the way of our seeking to attain the main objective.

II - Defects of the present law

In the light of the principles just stated, let us now examine the excess profits tax law passed last year, to see in what respects, if any, it fails to correspond to them.

1. Failure to reach large parts of defense profits

The Excess Profits Tax Act of 1940 was a clear expression of Congressional intent that profits growing out of the defense effort should be subject to excess profits tax.

The law, however, has not achieved that objective.

Many corporations that are the principal beneficiaries of the defense effort and that hold large government

contracts are paying little or no excess profits tax.

In the absence of complete excess profits tax returns an examination has been made of published financial data for certain corporations. One company whose profits in 1940 were more than 3,000 percent larger than in 1939 is subject to no excess profits tax whatever on 1940 earnings and this is a company which has thus far received over \$70 million of defense contracts. A large industrial company which has received over \$250 million of defense contracts and had earnings in 1940 of nearly 200 percent larger than in 1939 will pay no excess profits tax. It appears that only 5 out of 12 large integrated steel companies will be subject to excess profits tax on the income of 1940, although steel companies have in general received huge amounts of defense orders.

These companies pay little or no excess profits tax because they are allowed a minimum credit of 8 percent of invested capital.

2. Failure to tax profits in excess of a necessary normal return

Another serious shortcoming of the 1940 excess profits tax law is that profits in excess of a necessary normal return on invested capital are not subject to the tax unless such profits also represent an increase

over the profits of the base period. Companies which earned during the base period an average of 30 percent, 50 percent or even more on their present invested capital will be free from the excess profits tax on income in any year equal to approximately these percents and will be taxable only on increases in their incomes.

This failure of the law to reach a large portion of excess profits is due to the provision of a credit for every corporation equal to 95 percent of its base period earnings, regardless of the size of those earnings in relation to its invested capital.

III - Remedies

Revisions of the excess profits tax to be considered adequate, must reach the two kinds of profits which I have been discussing. The tax can reach a much larger proportion of defense profits if there is a reduction in the 8 percent credit on invested capital. Profits in excess of a necessary normal return can be reached by taxing all profits above a stated percentage of invested capital, regardless of average base period earnings.

These were the basic elements of the Treasury excess profits tax proposal of 1940, and it is this plan, with modifications dictated by experience, that we suggest. In that proposal corporations were to be allowed free of the excess profits tax an amount of earnings equal to their earnings during the base period, but not more than 10 percent of invested capital. However, they were granted a minimum credit of 4 percent of invested capital with 6 percent allowed on the first \$500,000. Thus, under that plan a concern which earned 7 percent during the base period would be allowed to continue to earn 7 percent free of tax. A concern which earned only 2 percent during the base period would be permitted to earn 4 percent free of tax. A concern which earned 15 percent during the base period would be allowed to earn 10 percent free of tax.

Under the 1940 Treasury proposal it was recognized that if business is to expand and investors are to put money into new corporations, an opportunity must be allowed to earn an adequate rate of return on new capital. The plan allowed an 8 percent return on new capital, with a 10 percent return up to \$500,000, regardless of the earnings experience during the base period on old capital.

If the plan submitted by the Treasury last year had been applied to the examples previously presented, the tax results would have been quite different.. For example, one corporation which had a 30 percent return on its invested capital in the base period would have paid excess profits tax on over half of its 1940 income instead of on one-twelfth as under the present law. Another with a slightly lower rate of return would also have paid on over half instead of on one-fifth of its income. The large industrial company which received over \$250 million of defense contracts would have paid excess profits tax on over one-third of its income and the other company with poor earnings in the base period would have paid on about one-fifth of its income instead of both companies being entirely exempt.

Even this plan, however, would have failed to reach substantial amounts of defense profits received by corporations which had especially poor earnings during the base period. To meet this defect we would suggest revising the 1940 proposal to provide that where the average earnings of the base period were less than the minimum of 4 percent, the excess profits tax should be applied at a low flat rate, possibly 10 percent, to that part of the current profits that is in excess of

7

the base period earnings but not in excess of 4 percent of invested capital. For example, if a corporation earned during the base period an average of \$100,000 a year, while 4 percent of its invested capital amounts to \$300,000, the first \$100,000 of profits in the current taxable year would be entirely exempt from excess profits tax, the next \$200,000, representing the difference between the \$100,000 average earnings and the \$300,000 credit on invested capital, would be taxed at 10 percent and any earnings over \$300,000 would be subject to the regular excess profits tax rates. This minimum rate of tax would subject all increases in profits during the defense period at least to some excess profits taxation without unduly burdening concerns whose increased earnings are not truly defense profits.

We would suggest also that the rate allowed on new capital be the same as that originally suggested, namely, 8 percent, with 10 percent for additions to capital that do not bring the total invested capital above \$500,000. Any maximum return on capital must be a somewhat arbitrary figure because businesses differ widely in the degree of risk they face. Accordingly,

it is desirable not to set too low a maximum rate of return.

Similarly, it would be desirable to keep the tax rate low on that part of profits which is immediately above the credit. To this end we suggest that tax rates be graduated in accordance with the rate of return on invested capital starting with a moderate initial rate.

Moreover, with this new broad excess profits base, it would be possible to adapt ourselves quickly and much more easily to a need for still larger revenues if the emergency should so require. The future is especially uncertain during an emergency period, and we might have to act quickly. It is better to have a broad excess profits tax base carefully worked out while we still have the time than to patch up the present law and take the risk of finding ourselves confronted with the necessity of improvising such a base on short notice at a later date.

Thus far I have outlined the principles of excess profits taxation which in our opinion should be followed in this emergency period and have indicated ways in which the existing law fails to carry them out. If you share our belief in these principles, I believe you will agree that a plan like the one I have outlined

is the logical method of putting the principles into practical operation. Variation in details is not a matter of concern, so long as the plan adopted taxes both defense profits and excess profits, which the present law does not do.

IV. Possible alternative

If these principles are not to be the guide for taxing corporations during the emergency period, it would be well to bear in mind the disadvantages of the tax in its present form, which involves the administrative difficulties inevitably accompanying excess profits taxation but fails to tax large amounts of profits that it properly should reach. A simpler, more easily administered plan would, of course, be to abandon the excess profits tax and to increase the corporation income tax by enough to produce the desired revenue. With such an increase in the corporation income tax there should, in my judgment, be coupled a provision for reducing the tax when the earnings of the corporation are immediately made subject to the individual income tax.

This kind of a plan would be in harmony with the idea of integrating the corporation and the individual taxes, placing chief reliance on the taxation of income of individuals. Profiting from our experience with previous plans of this general character, many difficulties previously met can very likely be avoided and

equitable taxation of profits to the individual stockholder provided.

I do not set forth this plan as one that carries into effect the principles which I previously discussed. It is based on principles of its own and is suggested as an alternative, not a substitute.

When I first appeared before the Committee in executive session and discussed this tax program with you generally, I told you that I thought there were certain types of durable commodities, such as electric refrigerators, automobiles, watches, clocks, and cameras, the reduced consumption of which would be helpful to national defense, not only because the plants are adaptable to defense work, but also because the materials used in these commodities are used in defense articles and the workmen who manufacture these things are possessed of the very skills that are needed in many of our defense plants. During that first discussion different members of the Committee expressed the view that taxes on some of these articles should be higher than were recommended and I assured them that we would not object to some increases on these particular articles. Since that time there has been so much discussion about various excise taxes that I think I should repeat to you what I said before -- that I do

believe these articles are the type that it is highly desirable to tax not only for revenue but also to reduce demands for goods which compete with the defense program.

We cannot expect to devise a painless tax bill. The situation calls for sacrifices. As Secretary Morgenthau has already told you, we have had unmistakable evidence that the people are willing to make sacrifices according to their ability. Outside the tax field greater sacrifices are being asked and cheerfully made. There is no basis for comparing the sacrifice of those who are asked to exchange the security of a job and a home for a soldier's pay and a soldier's hardships with the sacrifices of those who are asked to pay even drastically higher rates of tax.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

R&S 100-234
May 20, 1941

Board of Governors

Proposed revision of excess

L. M. Piser and Haskell Wald

profits tax law

John L. Sullivan, Assistant Secretary of the Treasury, yesterday presented to the House Committee on Ways and Means the Treasury Department's proposals for revising the present excess profits tax law.

Defects of present law

The proposed revisions are aimed at eliminating the following defects of the present law:

1. Because of the allowance of a minimum tax-free credit of 8 per cent of invested capital, many of the principal beneficiaries of the defense program pay little or no excess profits tax at present.

2. Because of the allowance of a tax-free credit equal to 95 per cent of earnings during the base period, regardless of the size of those earnings in relation to invested capital, a large amount of corporate profits is not subject to the excess profits tax, even though these profits are considerably in excess of what is generally regarded as a normal return on invested capital.

Proposed revisions

The proposals made by Mr. Sullivan may be summarized as follows:

1. The minimum tax-free credit of 8 per cent of invested capital allowed under the present law be reduced to 6 per cent on the first \$500,000 of invested capital, and 4 per cent on the remainder.

2. Profits in excess of earnings during the base period (1936-1939), but less than the minimum tax-free credit mentioned in (1.), be subject to a 10 per cent tax. (The present law does not apply to earnings which are less than 8 per cent of invested capital.) Earnings above the minimum credit would be subject to the regular excess profits tax rates.

3. Average base-period earnings be allowed as a credit in computing excess profits tax net income only to the extent that they do not exceed 10 per cent of invested capital. (At present a credit equal to 95 per cent of base-period earnings is allowed, regardless of the size of those earnings in relation to invested capital.)

4. New capital be allowed a return of 10 per cent on the first \$500,000 and 8 per cent on amounts above that. (An 8 per cent credit is allowed at present.)

5. The rate schedule be as follows:

<u>Excess profits as percentage of invested capital</u>	<u>Tax rate to be applied</u>
Up to 15 per cent.....	33 per cent
15 per cent up to 30 per cent.....	52 per cent
In excess of 30 per cent.....	65 per cent

(The present tax rates are graduated from 25 per cent to 50 per cent in accordance with the dollar amount of excess profits, the maximum rate applying to excess profits of more than \$500,000.)

Estimated tax yield

Mr. Sullivan estimated that the above revisions, together with the 6 per cent surtax on corporate income previously recommended, would yield net additional revenue of \$1,096 million if levied on this year's earnings. Under the previous Treasury proposals it was estimated that a net revenue increase of \$793 million could be obtained from these taxes.