Book Reviews

BOOK REVIEW

EXCESS PROFITS TAXATION. By Tax Institute, Inc., New York: Tax Institute, Inc. 1953. Pp. 183. $5.00.

In 1950, foreseeing the possibility of a new excess profits tax law, the Tax Institute arranged a symposium on the general topic of excess profits taxation. The participants included tax accountants, tax lawyers, representatives of industry, and a senator. By the time the papers were prepared and presented at Philadelphia on December 8 and 9, 1950, the House had passed HR 9827, and the Excess Profits Tax of 1950 was well on its way to enactment. The law expired on January 1, 1954. This, then, is a review of a book largely concerning a law which has expired, based on papers written just as the law was being enacted.

This is not to imply that the volume of papers does not fulfill the purpose for which it was published. Herbert M. Kelton, president of the Tax Institute, says in the foreword that it "will constitute a valuable addition to existing literature on excess profits taxation." It might be added also, that many cases involving questions relating to the excess profits tax law are still before the courts for decision, and in that respect the book is timely.

The papers have been assembled under five general headings. Alfred G. Buehler, of the Wharton School of Finance and Commerce, University of Pennsylvania, and President of the Tax Institute, Incorporated, prepared and read the first paper which is set forth in Chapter I of the Book. He points out that although the primary purpose of the Act is to finance the increased military costs entailed in the prosecution of the Korean War, it is also intended, as in the First and Second World Wars, to strike at war profits, windfall gains, and corporate profits exceeding certain standards.

Under a sub-heading—The Excess Profits Tax as a Revenue—Mr. Buehler discusses this type of tax as against the normal corporate income tax. He shows that during the active war periods of the First and Second World Wars, the revenue raised under an excessive profits tax equalled an amount which could only be matched by raising the rate of the Corporate Income Tax to 57%.

The Excess Profits Tax as introduced in 1940 relied primarily upon a prewar earnings basis to measure excess profits, allowing as a credit 95% of the average earnings of corporations in the years 1936-1939.

Mr. Buehler also discusses the administrative problems involved in such act. He points out that merely calling a tax an excess profits tax makes it such, and shows that except for those actually doing the fighting, much of the population, in one way or another, share in the windfalls. He stresses that comparing war earnings with those before the war is a deceptive measure of excess profits and gives several concrete examples of its unfairness. His view is that the logical test of excessive profits would be the rate of return on the capital invested. The real question is, how much is made on the money put into the enterprise. He further shows the complications involved in determining what the investment is. For example, he shows the effect due to the relationship of the purchasing power of the dollar when the investment was made to that when the tax is applied. Definitely the dollar during the war had much less purchasing power.

He recommends that a board of some kind be created to pass judgment upon all cases, because as he states, each problem is an individual one.

Mr. Buehler further quotes Secretary of Treasury Vinson in illustrating the difficulty in defining the concept of excess profits tax. Secretary Vinson said:

"The difficulty is that calling profits excessive does not make them excessive. Calling profits normal does not make them normal. Normal profits and excessive profits look alike.

There is no chemical reagent to distinguish them. The excess profits tax, to be sure, has a formula—a very complicated formula in its entirety—for distinguishing normal and excessive profits. But that formula is seriously defective."

Under the heading—Equity of the Excess Profits Tax—Mr. Buehler stresses some of the bad consequences of such a tax. It penalizes young growing risk ventures and favors well established heavily capitalized concerns; it encourages over-capitalization.

Mr. Buehler also examined the law from the standpoint of its usefulness as a wartime control over inflation. He contends that it has not been demonstrated that an excess profits tax has directly worked in an appreciable manner to lessen inflation, aside from the fact that resort to taxation rather than borrowing acts to prevent or lessen inflation. He points out that one of the by-products of such a tax is the temptation of management to spend more on advertising, grant wage and salary increases and divert money from the Treasury into the purses of those who benefit from the process.

He recommends that the adoption of such a tax should only be made after deliberate and careful consideration.

Chapter II of the Book covers—Concepts of Excess Profits Taxation—and is by E. Gordon Keith, also of the Wharton School of the University of Pennsylvania.

Mr. Keith in the course of his paper defines war profits as a windfall gain resulting from a sharp increase in aggregate money income, or from a war-stimulated increase in the demand for the services or products of particular firms.

He discusses alternatives to an earning standard as a basis for a war profits tax, particularly the profit-to-sales ratios and renegotiation of war contracts with the government. He points out by illustration that these alternatives do not prove practicable.

Mr. Keith discusses high or abnormal profits. He holds that not all high profits should be taxed as war profits and points out that profit ratios may vary as between firms on account of differences in risk, and cites as an example that the "normal" profits of a zinc mine or a powder plant are presumably greater than those of a bakery or shoe factory.

He also takes up necessary and unnecessary profits of corporations enjoying monopolies free of regulation. He states that there is no satisfactory method of separating monopoly or unnecessary profits from necessary ones, thus compelling so-called presumptive tests. Under these presumptive tests a percentage return on invested capital is suggested. Again as Mr. Buehler pointed out, you come back to the question of how to measure invested capital.

He recognizes the desirability of an excess profits tax in time of war from the standpoint of politics as well as for economic reasons. The problem still remains, how to make it a fair and effective money raiser.

Chapter III covers a paper read by Louis Shere, Professor of Economics of Indiana University, and deals with alternative corporate taxes. Mr. Shere stresses the need for some form of immediate taxation to forestall the threat of inflation. He is not in favor of an excess profits tax except as a last resort. He argues along the same lines as Mr. Buehler, that the excess profits tax fails to meet equity tests and is incompatible with integration. His recommendation is to adopt the plan suggested by the Committee of the National Tax Association under the chairmanship of Professor Groves. This plan differentiates the corporate tax rate in favor of distributed profits, as against undistributed profits on the basis of 40% for distributed profits and 60% for undistributed profits. In answer to the charge which might be lodged against such plan that it would promote the very thing he is trying to avoid, namely, inflation, he maintains that such distribution of profits flow up the income hill and are clipped by high progressive rates, so that the remaining balance can have no effect on the consumption markets. He does not favor an all out graduated corporation tax or a broadened corporation income tax base. However, it is to be noted that Mr. Shere says nothing with respect to the effect the plan he recommends would have on the growth of investment.

In chapter IV, Beardsley Ruml of New York discusses Excess Profits Taxation versus Increase in Corporate Income Tax.

Mr. Ruml at the outset of his paper, admits also that we need some emergency taxation because of our national situation. He states that the taxation should take the form of a direct tax on corporate earnings rather than any excess profits tax, notwithstanding the clamor of those who, because of psychological and political reasons, claim an excess profits tax should be enacted.

He then proceeds by sound cogent reasoning, based upon proven and established experience, to show that it is not possible to write a fair excess profits tax. Among the reasons he cites against any legislation for an excess profits tax law are the following:

1. Excess Profits Tax is a Subsidy to the strong:
   (a) creates cheap dollars and makes imprudent a business which without such tax would be prudent;
   (b) promotes carelessness, waste and extravagance;
   (c) results in making the big corporations bigger and forces the small and weak to merge or die.
2. Imposes Limitations on Growth of Investment. The tax will serve as a block to getting new investment particularly from the source provided by the reinvestment of undistributed profits.
3. Legislative Inequities. He says the tax should be rejected on principle on this ground alone—that a tax that is conspicuously inequitable will destroy the moral compulsions that are needed to make any tax system acceptable and efficient.

Having stated his reasons against, he does not stop here, but submits arguments for increase in the corporate tax law. He recommends an across-the-board rate increase for the following reasons: 1. it will be equitable; 2. it will not involve discriminatory exceptions and exemptions; 3. it will not produce a double standard of dollars, thereby corrupting managerial judgment.

He then disposes of the arguments for excess profits tax by showing that the law is inflationary; that the law is more selective; that it does not recover but a small amount of the unusual profits due to the war effort.

Ralph E. Flanders of the United States Senate, in chapter V, sets forth his views on whether we should have an excess profits tax. At the outset he stated he was for the bill of 1950 because he felt profits from waging a war should be returned to the federal treasury, and that such a tax would raise more money more easily and would hurt only a few. The latter reason surely would suit him more as a politician.

However, in the course of his paper he does point out the difficulties in separating wartime profits from peacetime profits, and then goes on with arguments against the law which follow the pattern of those advanced by Mr. Ruml. He did point up one new situation, and that is the very adverse effect such a law would have on industries such as shipbuilding, machine tool building and airplane building. Their growth in time of war preparation is intense and they are blown up all out of proportion to normal peacetime demands. (At least a partial answer to this argument can be had in the fact the government now allows accelerated depreciation). He then goes on to recommend other alternatives to bridge the gap in the tax return by raising rates in existing tax laws.

Chapter VI covers a paper prepared by Kenneth S. Reames, of Messrs. Touche, Niven, Barley and Smart, under the following heading—The Place of Carry-back and Carry-over of Credit in Excess Profits Taxation.

The author of this paper points out the operation of the carry-back and carry-over of credit in certain given situations, and demonstrates for example, because of the rigidity of the law, how inequitable results take place sometimes threatening the life of the corporation. The so-called 1950 law differed from the World War II law in the respect that the carry-back runs for one year only and the carry-over was for five years.

Alger B. Chapman, of Messrs. Chapman, Bryson, Walsh and O'Connell, is the author of chapter VII and his subject is—Rectification of Current Years Income.

This is a technical discussion of the changes wrought in the law of 1950 as compared with the old law, and the net effect upon corporations because of such changes. There is no need to discuss this technical and rather complicated paper, since the law has been repealed and the value of the points made are purely academic.

John McFarland, Manager, Tax Department, Sun Oil Company, is the author of the brief paper contained in chapter VIII. He urges that income taxes be deducted before determining excess profits taxes. He maintains that the true source of excess profits is profits remaining after you pay income taxes. It is logical.

The Role of Invested Capital in Excess Profits Taxation was the subject of a paper presented by Dan Throop Smith, of the Harvard Graduate School of Business Administration and constitutes chapter IX.

At the very outset Mr. Smith favors the invested capital base for excess profits taxes over the average earnings base. He maintains that this method is desirable because it is more economical and equitable. His paper is worth the careful reading by one not only interested in the excess profits tax, but also by a student of economics. This is so because the writer not only sets forth with plain and complete detail the operation of various economic laws, but also their effect upon our economic system when the stage is set for their release. He shows because of such economic laws the effect of such a tax upon economic efficiency, and economic growth. From his standpoint, at its best, it is an unworkable tax.

Chapter X covers a paper prepared by Clarence Heer of the University of North Carolina. Said paper deals with the role of Average Earnings in Excess Profits Taxes. A careful reading of this paper shows that the author using substantially the same arguments as appear in the other papers, shows that it is not possible to pass an excess profits tax which would raise the most money by making those pay who are best able to.

Chapter XI was prepared by Jacquin D. Bierman of J. K. Lasser & Company, and the subject of the discussion is—Why Do We Need Relief?

This paper brings out quite distinctly that because of the nature of the excess profits taxes, relief must be provided for the several kinds of industries he enumerates, such as the extractive industries, personal service corporations and corporations classified as growth corporations. This paper is another illustration of how difficult it is to enact a fair and workable law.

Chapters XII to XIX inclusive, consist of separate papers dealing with the impact of the excess profits tax upon various specific industries, all demonstrating that the tax is not only harsh but unworkable from the standpoint of what is best for the American economy and the American system.

Chapter XX is the final chapter of the book, and was prepared by Leon Henderson, of the Research Institute of America. Like the other economists he stresses the arbitrary character of the law and also fears that such a law can stifle growth in an economy which must be in these uncertain times, the strongest.

As I have stated elsewhere, this book has positive value and should be kept handy for future reference. It is axiomatic that economic laws are natural laws and operate inexorably. The writers of the articles in this book constitute a group which measures high in the field of economics and tax law knowledge. They have demonstrated well what will happen when such natural laws are thwarted by the arbitrary decisions of would-be statesmen. In recent times most of our run-of-the-mill Congressmen have been politicians rather than statesmen. They resort to the cupidity of the individual for vote seeking purposes. So that even though this law has been repealed, it can be expected that if we again have occasion to increase the tempo of our war preparation economy, such a law will be brought forward. Then this book should be taken from the shelves and recommended to the Congress for serious reading and assimilation.

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