THE EXCESS PROFITS TAX ACT OF 1950

By CARL R. SMITH, CPA*

The Excess Profits Tax Act of 1950, passed by Congress on January 1, 1951, and approved by the President on January 3, 1951, imposes a tax of 30% on excessive profits of corporations. While certain types of corporations are exempt from the tax, such exemptions are not reviewed in this article.

The tax is imposed on corporate profits for taxable years ended after June 30, 1950, but in the case of a taxable year beginning prior to such date and ending after such date, the tax is reduced to the portion which the number of days of the taxable year after June 30, 1950 bears to the total number of days in the taxable year.

The tax is not imposed on the full amount of corporate profits, nor is it imposed on all types of income.

In the computation of excess profits tax liability, the starting point is the determination of the income which is subject to excess profits tax. The "excess profits net income" is the normal tax net income, subject to a number of possible adjustments. Probably the most frequent of such adjustments is the elimination of divided income and capital gain income, which, in general, is not subject to excess profits tax. Most of the other possible adjustments are indicated on page 1 of the excess profits tax form, and, in general, are not discussed hereinafter.

From the excess profits net income is deducted the excess profits credit. The excess, if any, of the income over the credit, is called the adjusted excess profits net income, and it is upon this item that the 30% tax rate is applied.

The tax is subject to a limitation of the excess of 62% of the excess profits net income over an assumed amount of normal tax and surtax computed on the excess profits net income.

A minimum excess profits credit of $25,000 is allowed to every corporation in the event that its excess profits credit, computed in accordance with all of the various possible methods, is less than such amount.

The two principal methods of computing the excess profits credit are the "income method" and the "invested capital method."

The Income Method

Under this method, the excess profits credit consists of 85% of the average base period excess profits income, plus 12% of the base period capital addition (if the general average is used), plus or minus 12% of the capital addition or reduction, as the case may be, during the excess profits tax taxable year.

The base period consists of the 48 months ended December 31, 1949, except, if the last taxable year preceding the first excess profits tax year was a fiscal period ended January 31, February 28 or March 31, 1950, then the base period is the 48 months ended with such date.

The excess profits net income for each month of the base period is first determined. After eliminating 12 consecutive months or retaining 36 consecutive months, whichever produces the lesser adjustment, the aggregate of the base period excess profits net income retained is divided by 3 to arrive at the average base period net income.

The excess profits net income for any month in the base period is arrived at by first determining the excess profits net income for the taxable period within which such month falls and dividing the amount by the number of months in such period.

In computing the excess profits net income for any taxable period ending within or beginning in the base period, the starting point is the normal tax net income for such period. While the law provides for a number of possible adjustments, the most common are the elimination of dividend income, capital gains, and gains and losses on the sale or exchange of assets to which Section 117(j) applies. Net operating losses are also eliminated. Most of the other adjustments which may be required are indicated on page 2 of the excess profits tax form and, in general, are not discussed hereinafter. The excess profits net income for any base period month is not less than zero, so that if a minus amount is computed, zero is substituted for such amount.

In addition to the general average method

**Member of Chicago Bar Association, Illinois Society of CPA's Tax Department of Peat, Marwick, Mitchell & Co., Chicago, Illinois.*

of computing the average base period net income, a taxpayer may be eligibe to use one of the growth formulaes if a higher credit will result.

The growth formulaes fall into two groups. For eligibility to use the first group, (1) the taxpayer must have commenced business prior to the beginning of the base period; (2) the aggregate of its assets at the beginning of the base period must not exceed $20,000,000, and either (3) its aggregate gross receipts for the last half of the base period must have equalled 150% of such receipts for the first half, or (4) its aggregate payroll expense (payable in cash) for the last half of the base period must have equalled 130% of such payroll expense for the first half of the base period. If the taxpayer meets the above eligibility requirements, its average base period net income may be computed by using the average of its excess profits net income for the last half of the base period, or the excess profits net income for the last year of the base period, whichever is higher, or use the excess profits net income for the 12 months from July 1, 1949 through June 30, 1950. The excess profits net income for each of the 12 months is determined by dividing the excess profits net income for the period within which such month falls by the number of months in such period. The excess profits net income for the taxable period is first weighted as follows:

100% if the year ends before 7/1/50
90% if the year ends after 6/30/50 and before 10/1/50
80% if the year ends after 9/30/50 and before 4/1/51
70% if the year ends after 3/31/51

In addition to the three growth formulaes mentioned above, a taxpayer may, if (1) it commenced business prior to the base period, and (2) net sales of the first six months of 1950 when multiplied by 2 equals or exceeds 150% of the average sales for the calendar years 1946 and 1947, and (3) 40% or more of the sales for the calendar year 1950 are attributable to a product, or class of products not generally available to the public at any time prior to January 1, 1946, and (4) the 1946 sales of such product is 5% or less of sales of such similar products in 1949, use an additional alternative method if the net income for 1949 is not more than 25% of the net income for 1948. The average base period net income may be computed by substituting the income of the last six months of 1948 for the last six months of 1949.

Base Period Capital Addition

Taxpayers using the general average method are allowed, in addition, 12% of the base period capital addition, computed as follows:

1. Compute the base period capital at the beginning of
   (1) the first excess profits tax year;
   (2) the immediately preceding year;
   (3) the second preceding year.
2. Determine the excess of the capital for the beginning of the first excess profits tax year over the higher of the amounts for the two preceding years.
3. Determine the excess of the lower of the first excess profits tax year or the year preceding, over the second preceding year.
4. The base period capital addition is the amount determined in step 2 plus ½ of the amount determined in step 3.

Space does not permit a full explanation of the computation of the base period capital. In essence, it consists of the equity capital at the beginning of the year plus 75% of the amount of borrowed capital, less the aggregate of the investment in inadmissible assets, and less an adjustment for interest on borrowed capital.

The equity capital consists of the aggregate of the income tax basis for determining gain of all assets (without regard to March 1, 1913 valuation of certain intangible assets) less the aggregate of all liabilities.

Borrowed capital consists of indebtedness, incurred in good faith, evidenced by a bond, note, certificate, bill of exchange, mortgage, or similar instrument in writing, or a conditional sales contract.

An inadmissible asset is an investment, the income from which is partially or wholly exempt from tax.

Capital Changes Subsequent to the Base Period

The income credit, as indicated above, is subject to increase or decrease of 12% of the net capital addition or reduction as the case may be, occurring after the close of the base period.

Excess Profits Credit Computed on Invested Capital

A taxpayer is entitled to use the income credit or the invested capital credit, whichever results in the lesser amount of excess profits tax liability. The use of either method in the return does not constitute a binding election; if the other method is subsequently found to result in lesser tax, it may be claimed.

The invested capital may be computed under either of two methods, and an election to use either method is binding as to the particular year. The two methods are generally known as the "asset method" and the "historical capital method." The historical capital method may not be used unless an election is indicated in the return.

Asset Method

Under this method, the credit consists of the net amount of three separately computed items, as follows:

1. The sum of—
   (a) 12% of the adjusted invested capital up to $5,000,000;
   (b) 10% of the excess of $5,000,000, but not over $10,000,000;
   (c) 8% of the excess of $10,000,000.
2. Minus—the ratio of inadmissible assets to the total assets (applied to 1 above).
3. Plus—12% of the amount of new capital.

The adjusted invested capital consists of the equity capital at the beginning of the year, plus the capital addition for the year, plus 75% of the average borrowed capital for the year, plus the recent loss adjustment. From the aggregate of the foregoing is deducted the capital reduction for the year.

Equity capital and borrowed capital are computed in the same manner as indicated above for base period capital under the income method.

Historical Capital Method

The credit computation is substantially the same as under the asset method, after the amount of invested capital has been determined. However, it is at this point that the two methods differ. Under the historical capital method, the primary concern is the determination of the amount of cash or property previously paid in to the corporation for stock, or as capital surplus. The aggregate thus computed is not reduced by any deficit in earned surplus, but is increased by any accumulation in earned surplus. This method of computing invested capital will generally be of benefit to a corporation which has a net deficit from losses in years prior to 1940. If a corporation has never sustained any losses in its operations, and does not have any assets subject to the depletion allowance computed on income, its invested capital computed under the historical capital and the asset methods should be substantially the same.

Special Considerations

The excess profits tax law contains many special provisions designed to prevent hardship situations.

Abnormal expense items appearing in any of the base period years may, under certain circumstances, be added back to the net income. If any large expense deductions appear in any of the base period returns, these should be made the subject of special study to determine if any adjustment may be made in computing the average base period net income.

If the taxpayer's operations were depressed during the base period, or its normal operations were interrupted or diminished because of unusual events, or if the taxpayer changed its products or services, or increased its capacity for production, or if it commenced business after the beginning of the base period, it may qualify for a credit computation higher than permitted under the income methods or the invested capital methods.

If the taxpayer has abnormal income in the excess profits tax year, which under certain conditions, might have been realized in a prior or subsequent year, or if it has income from the mining of certain minerals, or from long term contracts, or from installment sales, it may qualify for special methods of computing its excess profits tax liability.

If the taxpayer has received property in a reorganization, merger, consolidation, or through the liquidation of a subsidiary, or a tax free exchange during or subsequent to the base period, special study should be made of the various provisions for the computation of its excess profits credit.

It should be borne in mind that the excess profits credit for any year may be affected by a number of possible transactions occurring during the year, and wise tax planning takes into consideration the possible effect of proposed transactions on the current year's excess profits tax liability as well as that of subsequent years. It is requisite, therefore, that before giving any advise as to the effect of any proposed changes in the business or corporate finances of a taxpayer subject to the excess profits tax law, a thorough study should be made to ascertain all of the pertinent facts and the applicable sections of the law.