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# Legislation

Hugh E. Wall

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## LEGISLATION

LEGISLATION—TAXATION—CAPITAL STOCK AND EXCESS PROFITS TAXES.—Today everyone is aware of the tremendous problem which confronts the Federal Government in its effort to balance the budget. The ever increasing functions of the government have swelled the amount of expenditures to unprecedented proportions. To a great extent these have been emergency expenditures, necessitated by the breakdown of our economic system. They have been emergency measures because they had to answer the needs of the millions of private citizens who had not the means to supply their own necessities of life.

There are two methods of solving this problem of balancing the budget: (1) By taxation; and (2) By compelling the capitalist to return to his employees an equitable share of the profits of industry, thus reducing the necessity of increased government expenditures, because of the lessening of the needs of private individuals, and, consequently, permitting the lowering of taxes.

Faced with the problem, our tax legislation experts in Washington did their part by devising a new tax, which embodies the best features of former taxes and is regarded as the cleverest piece of revenue legislation yet enacted. It is a combination of a capital stock and an excess profits tax and is imposed upon corporations. The present article will be limited to a discussion of the provisions of this new law and of their effect upon corporations.

The proposition that a good tax should be simple in its nature and just in its effects admits of little argument. This new tax answers both qualifications. The capital stock tax is an excise tax imposed on all corporations for the period ending June 30, 1934, and is based on the value declared by the corporation for its capital stock as of the date of the close of the last income tax taxable year ending on or before June 30, 1934. Every corporation must pay a tax of \$1 for each \$1,000 of such declared value. An excess profits tax of five per cent is imposed on the income of a corporation in excess of twelve and one-half per cent of the "declared value" of its capital assets.

As to the filing of the return and the payment of the tax, the law<sup>1</sup> provides that each corporation must file a capital stock tax return for the year ended June 30, 1934, on or before August 31, 1934, and the tax must be paid on that date. Returns for the excess profits tax are to be made and the tax is to be paid at the same time as other income taxes.

Returning to the statement that this tax is simple in its nature, we find proof of this in the fact that it has none of the features of

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<sup>1</sup> REVENUE ACT OF 1934 § § 701, 702.

former taxes, which caused so much litigation in income tax matters. In past years nothing has given the Treasury Department so much trouble or has been the cause of so much dispute with the taxpayer as the ascertainment of the value of invested capital. This was true of the war-time excess profits tax and, more recently in an indirect sense, of the regular income tax. For example, since the tax on excess profits was based on the percentage of profits made upon the invested capital of the corporation taxed, a corporation could avoid the payment of this tax by overvaluing its capital assets. Government investigations always ended with the issue being what was a proper evaluation of these corporate assets.

In order to avoid all this, the new law provides that each corporate body is free to declare the initial value of its capital stock, upon which the tax will be subsequently based. There are no provisions as to any absolute method to be employed in this evaluation. The book value, the costs of reproduction, the market value, the capitalization of prior earnings, and so on, are of no binding concern. "Not only does the law state that the declaration of value cannot be amended, presumably by the corporation, but it seems to permit of no review or change by any authority. The scope of the administrative regulation seems to be limited to the determination of the adjustments of the initial declared value, which are required to reflect subsequent transactions, and to such problems as the adoption of a new declared value after a corporate reorganization."<sup>2</sup>

The initial declared value is final and cannot be amended—not even by the Bureau of Internal Revenue. Considering the all-important part which this original declared value of the capital assets plays in the final determination of the amount of excess profits tax to be paid, and keeping in mind the fact that it cannot be changed, the necessity on the part of the corporation officials of exercising good judgment is apparent. If a low "declared value" is fixed, it will avoid the payment of a high capital stock tax, but renders the corporation liable to an even greater tax on excess profits if its income for any year should very far exceed twelve and one-half per cent of that "declared value."

The following table, reproduced from the Prentice-Hall Cumulative Tax Service,<sup>3</sup> illustrates the importance of making the original declared value in the 1934 capital stock tax return high enough to take care of future contingencies. The illustration shows corporations *A* and *B*, both of which have the same net income and dividend distributions over a three year period. *A* uses a declared value of \$1,000,000 and *B* uses \$1,500,000 in its 1934 capital stock tax return.

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<sup>2</sup> TAX MAGAZINE (July, 1934).

<sup>3</sup> Regulations 64 relating to the Capital Stock Tax under Section 215 of the National Industrial Recovery Act, par. 27, 100 (1934, by Prentice-Hall, Inc.).

COMPARATIVE TABLE

	DECLARED VALUE		NET INCOME	DIVIDENDS PAID	CAPITAL STOCK TAX		EXCESS PROFITS TAX		TOTAL TAX		
	A	B			A	B	A	B	A	B	
1934	\$1,000,000	\$1,500,000	\$100,000	\$ 50,000	\$1,000	\$1,500	None	None	\$1,000	\$1,500	
1935	1,050,000	1,550,000	90,000	40,000	1,050	1,550	None	None	1,050	1,550	
1936	1,100,000	1,600,000	200,000	180,000	1,100	1,600	3,125	None	4,225	1,600	
Total capital stock and excess profits tax for 3-year period .....										\$6,275	\$4,650

"It will be noted from the above that although *A* pays \$500 less capital stock tax than *B* in each of the 3 years, this \$1,500 difference is more than offset in 1936 when *A* is liable for an excess profits tax of \$3,125, while *B* pays no excess profits tax for that year. The net result over the three-year period is that the total capital stock tax and excess profits tax of *A* is \$6,275, while that of *B* is \$4,650."<sup>4</sup> The difference in the declared value of each corporation during the years subsequent to 1934 is caused by the necessary adjustments as provided for in the law.<sup>5</sup>

In endeavoring to arrive at a favorable "declared value," and thereby subject the corporation to but a minimum amount of tax, the officers of the latter must take into consideration several things. The most vital information needed concerns the estimate of the profit in the years to come. And because of the unsettled and changing conditions of industry today, there is a great deal of uncertainty attached to any such estimate. The possible percentage of error in estimating future earnings, however, can be greatly reduced by a careful analysis of the problem.

Every corporation is wondering how long this present capital stock and excess profits tax will be in force. It is important to take this into consideration in estimating the average profits of future years. The statute provides that these taxes shall not operate after the end of the Federal deficit. Well-informed tax experts have conservatively placed the estimate of years that it will be in force at five, and they hint that it is probable that they will become permanent fixtures of our revenue system, because of their certainty and the small amount of administrative difficulties and expense. Then, too, the present rates will probably be increased.

Let us suppose that the officers of a certain corporation have carefully analyzed their own individual problem with regard to the estimation of future earnings. They believe that their average profit for the next five years or so will be \$10,000 a year. In order to avoid the payment of the excess profits tax, they should multiply this average yearly profit by eight. Their original "declared value" will then be \$80,000. This will subject the corporation to a capital stock tax of \$80. for each succeeding year (\$1 for each \$1,000 of capital valuation). Consequently, there will be no excess profits tax assessed, except in those years when the profits exceed \$10,000 or 12½% of \$80,000.

Although there seems to have been no ruling on the point, the possibility of escaping the payment of an excess profits tax any year can be done away with entirely. As pointed out before, the returns on the

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<sup>4</sup> *Op. cit. supra* note 3.

<sup>5</sup> REVENUE ACT OF 1934 § 701 (f).