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EXCESS PROFITS TAXATION - WARTIME PROVISIONS AND CURRENT PROPOSALS IN THE ENERGY CRISIS

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I. Introduction

The current energy crisis, with its scarcities and its rising prices of energy products, is reminiscent of similar conditions occurring during our Nation's past wars. Excess profits taxes were enacted during those war periods, applicable to business and industry generally, in order to eliminate undue profits arising because of the war emergency. In addition, it was hoped that the excess profits taxes would help to hold down the prices of consumer goods despite their scarcity.

Now, excess profits taxes are being proposed during the current energy crisis for purposes of eliminating undue profits of the energy industry. In addition, however, it is hoped that such taxes would have an appreciable effect on curtailing rising prices of energy products, and at the same time contributing to relieving the scarcity of those products. This latter result would be achieved, in part, through investment of the proceeds of the tax in energy research and development.

This paper attempts to summarize the excess profits tax legislation enacted or proposed during the war years. Analysis of this history is relevant to the current situation since reference is often made to the difficulties and challenges excess profits taxes have encountered in the past. This paper then goes on to summarize the current excess profits tax proposals or proposals of similar nature directed at alleviation of the energy crisis. We are reserving for later analysis, a discussion of the policy, administrative, legal, and economic issues involved in applying excess profits taxation or similar approaches to the current energy emergency.

II. An Historic Overview

An excess profits tax is a form of business tax distinguished from the ordinary business income tax in one fundamental way.

> Whereas the ordinary tax is levied on all of a firm's income, the excess profits tax is levied only upon a portion of the income. Under an excess profits tax the income is divided into two parts, one of which is exempt on the ground that it represents "normal" earnings while the other part is subject to the tax on the assumption that it is "different" or "excessive." 1/

The United States has levied three major excess profits taxes in the course of its history: in World War I, in World War II, and in the Korean conflict. A fourth excess profits tax was proposed during the Viet Nam conflict but was not enacted. Each of these four levies was somewhat different from the prior taxes, based on difficulties encountered and experience gained.

A. The World War I Excess Profits Taxes

The World War I excess profits taxes were actually a series of three tax acts: The Revenue Act of 1917, the War Profits Act of 1917 and the Revenue Act of 1918.

1. The Revenue Act of 1917

The Nation's first excess profits tax law was passed on March 3, 1917, as the Revenue Act of 1917. The act applied to corporate businesses

1/ Curran, Excess Profits Taxation, 1943, p. 1 (Hereafter Curran) and to partnerships, but did not apply to sole proprietorships.

This act set the base of the tax at the excess over "reasonable" profits, defined as eight percent of the capital invested in the business. This provision led to interpretative difficulties. The act specified that borrowed funds would not, but only equity would be, counted as invested capital. Difficulties of interpretation arose over whether intangible assets, such as good will, were to be considered invested capital for the purposes of the tax. The Congressional intent was apparently to exclude such intangible assets[2/], but this opinion was not unanimous and the doubt might have posed difficult problems had the Act not been quickly superseded.

The excess profits tax was imposed at an eight percent rate on the "excess profits" exceeding $5,000.

This act contained no specific provision for relief of businesses in exceptional situations, in determining a "reasonable" profit.

2. <u>The War Profits Act of 1917</u>

On October 3, 1917, the Revenue Act of 1917 was superseded by the War Profits Act of 1917. The new act applied not only to corporations and partnerships but to sole proprietorships as well.

The base of the new tax was different from the earlier act. It was defined as the excess over that level of profits which was legislatively "reasonable," based on the average profits during the pre-war years 1911-1913. Capitalization was inquired into only where the capital used in the business was different for the taxable year from

2/ Hearings on H.R. 20573, U.S. Senate, 64th Cong., 2d sess., pp. 139-140.

the average capital during the pre-war period or where the average net income of the business during the pre-war years was lower than "normal". Capitalization was used as the base where the corporation or business was not in existence during an entire year of the base period.

The new act also changed the rates from 8 percent to 20 to 60 percent. Corporations were allowed $3,000 and proprietorships and partnerships $6,000 of exempt excess income.

The new act also contained the first relief provisions of an American excess profits tax. These provisions redetermined the tax base where it was shown that the net returns of the business were lower than industry or trade standards for that size business or that the ratio between net and gross income was unlike that of other similarly situated businesses.

3. <u>The Revenue Act of 1918</u>

The Revenue Act of 1918, enacted on February 24, 1919, replaced the 1917 tax with a new war profits and excess profits tax on corporations only. The new tax did not apply to individuals or partnerships, but the income tax and surtax on individuals were raised instead.

The tax base of the new excess profits tax was retained as income in excess of the pre-war period average net income. If no net income existed during this period, then the tax base was income in excess of 10 percent of invested capital. In addition, there was an exemption from excess profits tax of $3,000 plus eight percent of the invested capital for the taxable year. The rates were also changed to meet the new wartime situation, ranging from 30 percent to 100 percent.

In addition, the act provided relief where the Commissioner was unable to determine the invested capital of the corporate taxpayer for purposes of computing the excess profits tax credit and where abnormal conditions would work an exceptional hardship on the taxpaying corporation.

The World War I excess profits tax was terminated in 1921. The difficulties in the administration of the World War I acts were described by former Assistant Secretary of the Treasury Ballantine in 1931, when he stated that:

> The high rates, uncertainty as to the application and meaning of the Act in many connections, and defects in the records and accounting systems of taxpayers resulted in great delay in many instances in final determinations and in a great number of additional assessments, and in numerous abatements and refunds. Broadly speaking, however, these acts were administered so as to furnish the Treasury with the needed and expected funds. They brought into the Treasury through 1921 about $6,900,000,000 ... . According to ... calculation[s] based on reported incomes and taxes the taxes during the war, principally, of course, war and excess profits taxes absorbed about 70 percent of the increase of the average profits of the war years over the average profits for the years immediately before the war. 3/

B. The World War II Excess Profits Tax

After the excess profits taxes of the World War I period, it was not surprising that such taxes were resurrected with the advent of World War II. President Roosevelt stated in 1939 that:

> No American has the moral right to profiteer at the expense either of his fellow-citizens or of the men, women, and children who are living and dying in the midst of war in Europe. 4/

3/ U.S. War Policies Commission Report, H. Doc. 163, 72d Cong., 1st sess., pp. 689-690.

4/ New York Times, September 4, 1939, p. 6.

Congress listened and began to discuss an excess profits tax once more. A major determination had to be made as to the tax base. The Nye Commission supported a tax based on the profits determined by the government to be "reasonable,"[5] while the War Policies Commission supported the use of a prewar profit base period.[6] The latter was adopted and the World War II excess profits tax was born in 1940. Like its predecessor, the World War II excess profits tax was really a succession of enactments. This time, however, it took six successive tax measures to comprise the World War II excess profits tax experience.

1. <u>The Excess Profits Tax Act of 1940</u>

On October 8, 1940, the first excess profits tax in nineteen years became law. The tax was levied only upon corporations. The rationale for the exclusion of individuals and partnerships was stated as follows:

> As individuals and partnership incomes are subject to heavy surtaxes upon all net income, whether left in the business or not, while corporations and their stockholders are relieved from surtaxes upon earnings which are not distributed...[and] as all of the assets of an individual or all of the individuals comprising a partnership, are liable in any venture, it is extremely difficult, if not impossible, to determine the capital attributable to any particular undertaking or business in which an individual or partnership is engaged. ... [7]

Consequently, the Ways and Means Committee recommended, and the Congress agreed, on an act limited to corporations. In addition to partnerships and proprietorships, tax-exempt charitable organizations, personal service businesses and certain defense facilities were also

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5/ S. Rept. 944, pt. 2, 74th Cong., 1st sess. (1940).
6/ H. Doc. 264, pt. 3, 74th Cong., 1st sess. (1940).
7/ <u>Report of the Subcommittee on Internal Revenue Taxation to the Committee on Ways and Means Relative to Excess Profits Tax and Special Amortization</u>, August 8, 1940, p. 3.

exempt from the tax.

The excess profits tax base for the 1940 Excess Profits Tax was determined by an alternative choice of methods. The corporation could determine its "reasonable" profits by a 9 percent return on invested capital or 95 percent of its profits during the prewar years of 1936-1939. Corporations in existence during the prewar period had an election to choose whichever base best suited their tax needs, but new corporations could only select the invested capital base. The invested capital included 50 percent of borrowed capital as well as all of the equity capital. A string attached, however, was that where borrowed capital was utilized to determine reasonable profits 50 percent of the interest paid on such borrowed capital should be added to income in computing excess profits net income. The Act applied tax rates of 25 to 50 percent to "excess profits" net income, with an exemption of $5000.

The relief provisions, Section 722, were designed to:

> Afford relief in the case of certain situations not covered by other sections of the bill. The relief [was] confined to the adjustment of the abnormal base period net income of a taxpayer electing the average earnings credit, and applies only in the case of a taxpayer whose first excess-profits tax taxable year began in 1940.
>
> In order to obtain any benefit under this section, the taxpayer had to meet one of the following tests:
>
> (1) The character of its business as of January 1, 1940, must have been different from the character of the business engaged in during one or more of the taxable years in its base period.
>
> (2) Normal production, output, or operation in one or more of the taxable years in the base period must have been interrupted or diminished because of events abnormal in the case of the taxpayer. 8/

8/ S. Rept. 75, 77th Cong., 1st sess. (1941).

The subjective and vague nature of the grounds for relief led to thousands of appeals of determinations by the Internal Revenue Service holding that there was insufficient ground to consider the base period to have been abnormal. If any section of the 1940's Excess Profits Acts created an excess of problems, it was Section 722.

2. The Excess Profits Tax Amendments of 1941

The Revenue Act of 1940, which set up the first of the World War II excess profits taxes, also directed the Treasury and members of the staff of the Joint Committee on Internal Revenue Taxation to study relief problems and report their findings to appropriate Congressional bodies. These findings led to the Excess Profits Tax Amendments of 1941.

The Amendments were almost entirely directed to changing the relief provisions of the earlier Act. Specifically the new relief provisions incorporated were:

(1) Allowance of a 2-year carry-forward of unused excess-profits credits designed to alleviate the unusual effects of sharply fluctuating earnings as well as to benefit both new corporations and old corporations which were undergoing a period of expansion;

(2) An additional adjustment in section 711(b) for abnormal deductions of any class during the years in the base period;

(3) A growth formula to give effect to the ratio of increase in production capacity during the base-period years;

(4) Extension of section 712 to grant relief not only with respect to the six specified abnormalities in income in the taxable period as under the existing law but also with respect to any abnormal items of income during the excess profits tax period; and

(5) A new section 722 to afford relief in cases of abnormal base period net income where the taxpayer had elected the average earnings credit. 9/

The general grounds for relief in the 1940 act were retained as follows:

(a) That the character of the business engaged in by the taxpayer as of January 1, 1940, was different from the character of the business engaged in during one or more of the taxable years in its base period; or

(b) That in one or more of the taxable years in such period normal production, output, or operations were interrupted or diminished because of the occurrence of events abnormal in the case of the taxpayer. 10/

3. The Revenue Act of 1941

The Revenue Act of 1941 did not make sweeping changes in the structure of the Excess Profits Tax, in spite of recommendations by the Department of the Treasury that such changes were in order. 11/ However, it did make a change in the "return on invested capital method" of calculation, which allowed 8 percent as normal return, under the earlier acts. The capital investment credit was left at 8 percent for the first $5,000,000 of invested capital, but was lowered to 7 percent on invested capital over that figure. In addition, new capital was accorded a higher percentage by including it at 125 percent, under the rationale that this would encourage new investment and expansion, sought during this war period. The result was to permit a return of 10 or 8.75 percent for new capital.

9/ Federal Excess Profits Tax Report Prepared by the Joint Committee on Internal Revenue Taxation, November, 1950, p. 8. (Herafter Federal Excess Profits Tax Report)

10/ Ibid.

11/ Hearings on Revenue Revision by the Committee on Ways and Means, 77th Cong., 1st sess., pp. 1335-1375 (1941).

The other major adjustment changed the treatment of income tax and surtax in computing excess profits tax. Formerly, income tax had been allowed as a deduction in the computation of excess profits tax. The new provision disallowed the deduction of income taxes both in the base period and in the taxable year in computing excess profits taxes. The change made the use of the average earnings credit relatively better than the invested capital credit. This followed because the disallowance of the income tax deduction increased both excess profits income and base period income in the former case but increased only excess profits income in the latter.

4. The Revenue Act of 1942

The average earnings credit was expanded in the Revenue Act of 1942. Where the taxpayer so desired he could raise the lowest of his 4 base period years to 75 percent of the average of the other three years. A further reduction was made in the rates of return permitted on invested capital. These were now graduated from 8 percent down to 5 percent.

In addition, the relief provisions were altered under the 1942 Act by permitting use of the average earnings credit by those corporations which came into existence after the base period. These new corporations could obtain relief under this new provision if there was also some inadequecy of the invested capital computation. They then had the burden of establishing a constructive average base period net income as a fair standard of normal earnings.

5. <u>The Revenue Act of 1943</u>

The 1943 amendments dealt largely with rates and the exemptions. The existing tax rate was increased to 95 percent with a ceiling on all taxes (corporate normal tax, surtax and excess profits tax) of 80 percent.

The rate of return allowed in computing the investment capital credit was again rescaled from 8 percent on the first $5,000,000 to 5 percent on capital over $10,000,000. The specific exemption from excess profits tax was also increased from $5000 to $10,000.

6. <u>The Tax Adjustment Act of 1945</u>

This final act of the World War II excess profits tax embodied five major provisions, summarized below. Its major purpose was to facilitate reconversion by improving the cash position of business enterprises and to relieve smaller businesses of some or all excess profits taxes. The major effects of the act were:

1. An increase in the specific exemption from excess profits tax from $10,000 to $25,000, effective in 1946.

2. A provision that the postwar credit of 10 percent of excess-profits tax be taken currently with respect to tax liabilities of 1944 and subsequent years.

3. A provision that outstanding postwar refund bonds be made payable, at the option of the owner, on or after January 1, 1946.

4. A provision for speed-up of refunds resulting from carrybacks of net operating losses and of unused excess-profits credits.

5. A provision for speed-up of refunds resulting from the recomputation of deductions for amortization of emergency facilities. 12/

12/ <u>Federal Excess Profits Tax Report</u>, at p. 8.

C. The Korean Crisis Excess Profits Tax

The World War II excess profits tax was no longer effective after 1945. Twice in 1948, however, there was a new period of rearmament and President Truman requested that Congress restore the expired excess profits tax. The suggestion was oftentimes repeated until, in 1950, the excess profits tax was restored.

Unlike its precedessors, the 1950 Excess Profits tax was fairly complete when first enacted. Such completeness was not without its complexities, however, and the act has been called the most technical taxing statute ever enacted.

The 1950 Excess Profits Tax Act applied to corporations only, again exempting individuals and partnerships.

The base of this excess profits act depended upon the "reasonable" profit margin of the corporation. This latter concept was determined by either the corporation's average rate of profit and earnings for the base years of 1946-1949, or the invested capital of the corporation taken at a flat rate of 12 percent for the first $5 million, 10 percent for the next $5 million and 8 percent for the balance. All profits in excess of the reasonable profit margin and an exemption of $25,000,were taxed at a flat rate of 30 percent. An exception to the flat rate was provided for a new corporation which would be charged from 5 to 14 percent for the first five years of operation.

The act contained relief provisions relating to numerous situations. A few examples of the relieved corporations would include those experiencing unusually rapid growth in the 1946 to 1949 base period, corporations whose average earnings in 1946-1949 were less than those generally earned by other corporations in the same type of business in those years, and television broadcasting corporations and other new and growing industries. These provisions were very complex and produced prolific administrative appeals and litigation.

D. Proposed Viet Nam Excess Profits Tax

The Korean excess profits tax ended on January 1, 1954, but in the next twenty years there were several calls for its resurrection. One of the most pressing came during the height of the Vietnam war, in 1969. In that year, Senator McGovern and others submitted bills to create another excess profits tax. As one of the most notable spokesmen for this proposition, Senator McGovern stated that he intended to procure more equitable financing of the war effort by increasing the tax on those making profits from the war economy and reducing the tax on the average taxpayer.

> It is my judgment that a tax on excessive corporate profits, induced by wartime military spending, is a more equitable means of financing our war effort than extension of the surtax levy on individual incomes.
>
> I think it is time for American industry, which has enjoyed an unprecedented 33 percent rise in net after-taxes profits since the combat escalation in 1965, to assume more of the tax burden generated by the war.
>
> And I think it is time to relieve the middle and low-income taxpayer of the war costs he must carry in the form of the surtax charge, the inflation which cuts so cruelly into the income of the poor and the elderly, and the high and increasing interest rates of all categories. 13/

13/ Congressional Record, S. 5759, May 27, 1969.

His bills, S. 2277, 91st Cong., 2d sess. (1969) would have imposed an excess profits tax on corporations only, refraining from taxing individuals and partnerships in apparent consistency with the aim of placing the tax burden on larger taxpayers.

Under the proposed tax, income equal to the average profits of the corporation during the base years 1961-1964 or $25,000 would be exempt from excess profits tax. Income above that figure would be taxed at 37 percent. The bill also provided for carryover and carryback of excess deductions and credits and the tax was only to apply to years beginning with 1969. No provisions were included for relief from the tax for abnormal situations, a feature which, while prompting some possible criticisms, nevertheless added simplicity to the proposed bill.

III. Excess Profits Tax Proposals Relative to the Energy Crisis

Recently there have been a number of major proposals to reintroduce the excess profits tax in one form or another to alleviate certain effects of the energy crisis. Five major proposals are now under consideration in the Congress. Each proposal combines ideas and concepts from past excess profits acts with some improvements made possible by the experiences of the past. Additionally, each proposal is adapted to fit or take advantage of the special single-industry principally involved in the energy crisis.

A. The Prohibition Against Windfall Profits in the National Energy Emergency Act of 1973: H.R. 11450 and S. 2589

The proposed Energy Emergency Act of 1973 began as H.R. 11450 introduced in the House of Representatives by Congressman Staggers (D., W,Va.) on November 13, 1973. As it was introduced, the bill did not contain any provision for the prevention of windfall profits. However, a proposal for a prohibition against windfall profits as a means of controlling prices was added by the House Committee on Interstate and Foreign Commerce and passed by the House on December 15, 1973. The Senate then passed the bill on December 20, 1973, but without the windfall profits proposal. The Conference Committee restored the windfall profits proposal to the bill but changed its effective date from January 1, 1974, to January 1, 1975. For the year 1974, the Conference Committee provision required the President to "set prices for crude oil, residual fuel oil and refined petroleum products which avoid windfall profits," (defined as profits excessive or unreasonable taking into consideration normal profit levels). The Ninety-Third Congress adjourned on December 23, 1973, without voting on the conference report. On January 29, 1973, the Senate recommitted the entire bill to the Conference Committee because of failure to agree on the windfall profits proposal and the President's expressed opposition to it.

The last version of the windfall profits proposal, as reported by the Conference Committee, provided for a right of action after January 1, 1975 in "any interested person" to petition the Renegotiation Board for a determination by rule of the existence of any unreasonable profits and for their recovery. The Conference bill states that:

> (2) Any interested person, who has reason to believe that any price...of petroleum products permits a seller thereof any windfall profits, may petition the Renegotiation Board...for a determination under subparagraph (A) or (B) or paragraph (3).

> (3)(A) Upon petition of any interested person, the Board may by rule determine after opportunity for oral presentation of views, data, and arguments, whether the price...of petroleum products permits sellers thereof to receive windfall profits. Upon a final determination of the Board that such price permits windfall profits to be so received, it shall specify a price for such sales which will not permit such profits to be received by such sellers. After such a final determination, no higher price may be specified...except with the approval of the Board.
>
> (B) Upon petition of any interested person and notwithstanding any proceeding or determination under subparagraph (A), the Board may determine whether the price charged by a particular seller of any petroleum product permitted such seller to receive windfall profits. If, on the basis of such petition, the Board has reason to believe that such price has permitted such seller to receive windfall profits, it may order such seller to take such actions...as it may deem appropriate to assure that sufficient funds will be available for the refund of windfall profits in the event there is a final determination by the Board... 14/

The proposed act then goes on to establish guidelines for the Board's determination of excess or windfall profits. At subparagraph (6)(A) it is stated that windfall profits are anything in excess of the lesser of:

> (6)(A) A reasonable profit with respect to the particular seller as determined by the Board upon consideration of:
>
> (i) The reasonableness of its costs and profits with particular regard to volume of production.
>
> (ii) The net worth, with particular regard to the amount and source of the capital employed.
>
> (iii) The extent of risk assumed.
>
> (iv) The efficiency and productivity, particularly with regard to cost reduction techniques and economies of operation.
>
> (v) Other factors the consideration of which the public interest and fair and equitable dealing may require which may be established and published by the Board; or

14/ Conference Report on the Energy Emergency Act, Conference Report 93-663 93d Cong., 1st sess., (1973) pp. 1-2.

(B) The greater of:

(i) The average profit obtained by sellers for such product during the calendar years 1967 through 1971.

(ii) The average profit obtained by the particular seller for such products during such calendar years. 15/

The bill covers all parties dealing in petroleum whether partnerships, proprietorships or corporations. The right of action before the Renegotiation Board as to windfall profits is not to be effective until January 1, 1975, when "it shall apply to profits attributable to prices charged after December 31, 1973, for crude, residual oil and refined petroleum products." The conference committee stated that for this purpose windfall profits are taken to mean those profits which "are excessive or unreasonable, taking into consideration normal profit levels." 16/ During the interim period of 1974, the bill provides that the President will set prices for crude oil and other petroleum products to avoid windfall profits for the period until December 31, 1974. In other words, the price of petroleum is to be controlled by the President for one year, then the prices will be controlled through rights of action by petition to the Renegotiation Board. Either there is a basic underlying belief in the conference committee that during the year 1974 some other means of regulating petroleum profits will be found, and in that event the 1975 rights of action would not take effect; or, the year 1974 is regarded as a time for the Renegotiation Board to prepare itself for its new duties.

15/ *Ibid.*, 3-4.
16/ Ibid.

In evaluating the bill K. Martin Worthy, Washington, D. C. attorney and former Chief Counsel of the Internal Revenue Service testified before the Finance Committee of the United States that:

> Having worked under both the relief provisions of World War II and the Renegotiation Act, I can only say that the World War II relief provisions were a model of preciseness and objectivity, compared to the standards of the Renegotiation Act. While I do not intend for a minute to deprecate the efforts of the Renegotiation Board, which must, of course, administer the law as it finds it, the lack of any precise rules as to how the various factors enumerated--such as reasonableness of costs and profits, volume of production, net worth, risk and efficiency--are to be taken into account, make any objective determination of the excessiveness of profits virtually impossible to attain. 17/

In addition to critizing the vagueness of the guidelines set for the Renegotiation Board's determinations, several witnesses before the Senate Finance Committee noted that the conference bill might lead to every gas station owner in the Nation being taken before the Renegotiation Board for determination of the reasonableness of their prices, with consequent litigation which could long outlast the energy crisis itself.

B. The McGovern Excess Profits Tax Proposal: S. 2799

The McGovern proposal was introduced into the Senate on December 12, 1973, as S. 2799, 93rd Cong., 1st sess. (1973). The bill would impose a temporary excess profits tax on every "energy corporation" for the duration of the energy crisis. An energy corporation is defined to be any corporation producing, manufacturing, or selling any form of energy. The act thereby would limit itself to corporations, exempting both proprietorships and partnerships, and would cover all energy forms, not just petroleum.

17/ Testimony of K. Martin Worthy before the Committee on Finance of the U.S. Senate, January 23, 1974, pp. 7-8.

The bill utilizes the average earnings method of calculating excess profits and would set as the base period, theyears 1969-1972. It also would determine reasonable profits by the average of a month by month calculation during the base period. An alternative computation of normal earnings would be based on a six percent return on capital invested. The excess profits above either of these credits would be taxed at a flat 85 percent rate. There is also a "plow-back" provision, giving a deduction from income in calculating excess profits tax for those earnings which are reinvested in production or development, or "plowed-back" into the energy production and conservation fields.

The act also contains a limited relief provision. Adjustments are provided for corporations which were either not in existence during all or part of the base period or where tax free corporate reorganizations under the Internal Revenue Code occurred during or after the 1969-1972 base period.

The bill is a traditional excess profits tax and is intended to be "treated as imposed by Section 11" of the Internal Revenue Code, which provides for the imposition of the regular corporate income tax.

C. The Gravel Excess Profits Tax Proposal: S. 2806

Senator Mike Gravel's proposal for an excess profits tax, S. 2806, 93d Cong., 1st sess. (1973), is part of a comprehensive bill for dealing with the energy situation in both the short and long run. Its primary objective is the full development of adequate domestic sources of energy and the bill contains various taxing and non-taxing provisions to attain this goal. Among the provisions is Title VI, which is entitled "An Excise Tax on Uninvested Profits from Energy Sources," but which is closely akin to an excess profits tax.

This tax would apply to "every person" other than a public utility. And would, thereby, apply to corporations, proprietorships and partnerships.

The tax rate is 40 percent of the tax base <u>which is not reinvested in qualified energy projects</u>. The bill defines a "qualified energy project" as:

> An energy project [which] further[s] the expansion or improvement of existing energy sources, or must further the exploration for, research on, or development of new energy sources, which:
>
> (a) Are located within the United States or its possessions.
> (b) Have been determined by the Administrator of the Federal Energy Administration materially to assist in the development of the domestic energy resources of the United States. 18/

The provision of the bill amounts to a "plow back" relief from taxes whereby taxpaying persons are relieved of tax liability to the extent that they reinvest their profits in the further growth of American energy self sufficiency.

The tax base constitutes profits from energy sources in excess of the greater of 20 percent of the average net investment or $100,000. Energy sources are defined in the bill as "the production, transportation, transmission, importation and sale of consumable energy, or of fuel for conversion into consumable energy." The bill defines profits from these sources as the sum of:

> (1) The taxable income derived by the taxpayer from energy property...computed with the modifications specified..., plus
> (2) Gain realized from the sale or exchange of energy property... 19/

18/ S. 2589, 93d Cong., 1st sess. (1973).
19/ *Ibid*.

The modifications to taxable income used to reach energy profits include: elimination of capital losses or deductions treated also as qualified investments for excess profits purposes, disallowance of the 50% capital gains deduction on the sale or exchange of energy properties, the limitation of capital losses on such sales to the amount of capital gains in the case of noncorporate taxpayers, limitation of depreciation and amortization of energy properties to "straight-line", and deduction of regular income taxes attributable to profits from energy sources.

There is no specific relief provision to provide against unusual changes in invested capital or other factors contributing to the computation of the tax.

D. The Department of the Treasury's Windfall Profits Tax Proposal

On December 19, 1973, the Department of the Treasury released a notice declaring that they were proposing a Windfall Profits Tax on the petroleum industry and giving their reasons as follows:

> A scarcity of crude oil, abruptly worsened by the embargo of the Arab oil producing nations, has driven up dramatically the price of crude petroleum in free world markets.
>
> Crude oil prices in the near future will exceed what is required to bring forth the production which will eventually satisfy demand. The proposed Emergency Windfall Profits Tax would apply to that excess.
>
> In the long run, if the demand for oil is going to be larger and we must therefore turn to higher cost sources, prices must rise some reasonable amount above present levels. If the United States is to become self-sufficient, we must learn to live within our own resources. Nothing we can do will increase the amount of oil in the ground in the United States, but there is much that we can do to expand United States production. 20/

20/ Department of the Treasury News, December 19, 1973, at 1-2.

The Department of the Treasury, in drafting their proposal to provide a tax on profits from the petroeleum industry, stated that they were seeking three major goals.

> (1) To design the tax not only to capture future windfalls, but also to make up in some degree for windfalls which have occurred in the past.
>
> (2) To avoid a heavy tax on that part of the return to producers which is necessary to obtain increased production. It would be self-defeating to take away the profit which is needed to increase production and thus elimirate shortages.
>
> (3) To phase out the windfall tax as the windfall disappears and to place a definite time limit on the duration of the tax. Windfalls are by their nature temporary for the reasons cited. A normal free market will eliminate windfalls, given time. Unless the tax is permitted to phase out as the windfall disappears, it would continue to tax those profits which are necessary to induce greater supplies. The tax would then not reduce the return to producers; it would serve only to keep prices to consumers higher than otherwise would prevail. 21/

The tax proposed by the Treasury would apparently be imposed on all sellers of crude petroleum, with no regard for the form of legal entity; partnership, sole proprietorship or corporation.

The proposal establishes a base price above which the excess would be taxable. The base price is based upon the ceiling price for domestic crude petroleum, of the grade and location concerned, as of December 1, 1973. This is the price set under regulations of the Cost of Living Council. New fields or production without a ceiling price on December 1, 1973, would obtain a base price by reference to comparable production. The tax is at a graduated rate of from 10 to 85 percent, of the price per barrel of crude in excess of the base price. The Secretary of the Treasury would have the power to establish by regulation the top level

21/ *Ibid.*, pp. 3-4.

of the lowest bracket (initially 0-50¢ at which the rate is zero). The objective is that, after 36 months, the 10 percent rate would be applicable to amounts in excess of the expected long-run supply price of about $7 per barrel. Brackets taxed at higher rates would be adjusted accordingly. Where there is no sale of crude, as in the case of an integrated producer, the tax would be applied to the excess of the value at the field (the value used by the producer to calculate percentage depletion) over the base price. The collection process is anticipated as being a monthly withholding of the tax from the sale price and a remittal by the 15th day of the month following the tax month. The windfall profits tax will reduce the gross income of the seller for percentage depletion purposes and for income tax purposes generally.

In addition, the tax provides for the establishment of an Energy Development Trust Fund to lend money for conservation, production and development of new energy sources. The proposal also states that if the tax is enacted:

> Congress may wish to consider the desirability of refunding or otherwise forgiving all or part of the tax if the taxpayer "plows back" his profit into some energy producing investment. 22/

This plow-back provision is also present in the Gravel and McGovern bills described previously. The Treasury recognizes the plow-back provision as a means of encouraging energy production but points out some questions to be answered in this regard. Should the plow-back be by a credit, a refund of taxes paid, or a deduction from the windfall or excess profits tax? Should a carry back or carry over of excess expenditures over taxes be permitted? Should qualifying expenditures

22/ *Ibid.*, at Appendix B, p. 1.

include secondary and tertiary drilling?

There would be no express relief provisions for abnormal circumstances of particular producers.

It should be noted that while this tax proposal is termed a "windfall profits tax" it is not exactly that. The tax does not regulate the profits of a corporation directly, but rather indirectly through regulation of the price at which its product is sold. Rather than a windfall profits tax, it is more like a form of price control. While the result of the tax will be indirectly to control profits, the effect of the tax could be offset by the seller's increasing its efficiency or lowering its operating costs, thus increasing its profits despite the tax.

E. Possible Plan of the Ways and Means Committee

The Chairman announced, on January 20, 1974, that the Committee plans to begin drafting an excess profits tax of about 50 percent on oil companies to force them to invest more heavily in research and exploration. He indicated that such use of the profits would be preferable to passing them on to shareholders. He also indicated that the Committee on Ways and Means would study the possibility of partial Federal financing of the industry's exploratory work on shale oil and coal gasification.

Additionally, the Chairman indicated that the Committee might consider a plow-back provision in the bill it reports. Such a provision would aim to provide relief from the excess profits tax where the profits are plowed-back into research, development, production or conservation of energy sources.