TAXES IN THE TIME OF CORONAVIRUS: IS IT TIME TO REVIVE THE EXCESS PROFITS TAX?

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The U.S. Excess Profits Tax, 1940-1950

- The WW2 excess profits tax was first adopted in 1940, then amended in 1941, 1942, 1943, and 1945. It was repealed in 1950
  - This was not the first time Congress has introduced an excess profits tax
- Excess profits taxes are designed to tax the proportion of profits **that derives from some external event not of the taxpayer's making**
  - The U.S. excess profits tax was aimed to "syphon off war profits"
  - Was intended both to address direct profits as well as indirect profits resulting from the war

The U.S. Excess Profits Tax, 1940-1950

- The U.S. excess profits tax rate was set at 95% on the excess profits tax net income
  - The definition of excess profits became crucial, as those profits would be subject to the high tax rate of 95%, while "normal" profits should only be subject to the regular corporate tax rate
- The excess profits tax net income
  - The calculation of the excess profits tax base began with the net income as shown on the corporate tax returns
  - Adjustments included certain items like long-term capital gains and losses, income from discharge of indebtedness, and income from recovering bad debts incurred before the war

The U.S. Excess Profits Tax, 1940-1950

- The excess profits tax ***credit***
  - The calculation of the excess profits tax credit was designed to remove normal profits from the tax base
  - There were two methods available:
    - The average earnings method - amount of the credit was 95% of the "average base period net income" plus 8% of the corporation's net capital addition (or minus 6% of net capital reduction)
    - The invested capital method - amount of the credit was the fair return on invested capital (8% on the first $5 million, 6% on the next $5 million, and 5% on invested capital beyond $10 million)
- ***Adjusted*** excess profits tax net income
  - The sum of the excess profits tax credit, any carry-back or carry-forward of unused credits, and a de-minimis exemption was deducted from excess profits tax net income
  - The result was "adjusted excess profits tax net income" which was taxed at 95%

Reviving the Excess Profits Tax

- If Congress wanted to impose a modern excess profits tax, how should it go about it?
  - Given the diversity of the corporations that are likely to profit from the pandemic and the fact that most of them are not engaged in capital intensive activities, the tax should use the **average earnings method** based on 2016, 2017, 2018 and 2019
  - We would start with the net income for 2020, subtract a credit for average 2016-2019 earnings plus 8% of R&D (the main capital investment), and apply a 95% tax rate to the excess profits
  - The resulting tax can be reduced by credits for wages of additional employees hired in 2020 to encourage the winners to hire and pay well during the recession
  - Total combined tax liability (of regular corporate tax and excess profits tax) should be no more than 80% of net income

Example

- Assume corporation A has $10 billion average net income in 2016-2019. In 2020 it has $20 billion net income and spends $3 billion on R&D
- Step One: Calculate Excess Profits Tax Net Income: $20 billion
- Step Two: Calculate Excess Profits Tax Credit: 95% x $10 billion = $9.5 billion plus 8% x $3 billion= $240 million, total $9.74 billion
- Step Three: Deduct Excess Profits Tax Credit from Excess Profit Tax Net Income: $20 billion minus $9.74 billion = $10.26 billion
- Step Four: Calculate Excess Profit Tax Liability $10.26 x 95% = $9.747 billion
- Step Five: Calculate Corporate Tax Liability on “regular” earnings that are not subject to the excess profits tax $9.74 x 21% = $2.05 billion
- Step Six: Add the regular corporate tax and the excess profits tax and make sure the total is not more than 80% of net income
  - $9.747+$2.05 = $11.797 billion total tax
  - Effective average tax rate: 13.797/20 = 58.985%
- Total tax is reducible by credit for wages of employees hired in 2020