SECOND REVENUE ACT OF 1940

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

SEVENTY-SIXTH CONGRESS

THIRD SESSION

ON

H. R. 10413

A BILL TO PROVIDE REVENUE, AND FOR OTHER PURPOSES

SEPTEMBER 3, 4, and 5, 1940

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SECOND REVENUE ACT OF 1940

TUESDAY, SEPTEMBER 3, 1940

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met, pursuant to call, at 10 a. m., in room 312, Senate Office Building, Senator Pat Harrison (chairman) presiding.

The CHAIRMAN. The committee will come to order. May I say to the members of the committee and to the witnesses who will appear before us, that we will hear testimony on H. R. 10413, referred to as the excess-profits tax bill. We felt, because H. R. 10413 was somewhat different from the original Ways and Means Subcommittee recommendations, which were considered by the joint meeting of the Finance and Ways and Means Committees, that individuals should have a right to be heard so that the committee might ascertain the sentiment of the country as to the bill, its interpretation and effect.

The clerk of the committee has told you that each one who appears before the committee would be limited to 10 minutes at most. That is a very brief time for anyone to explain the ramifications of this bill and to elaborate on it, but we had to impose a time limitation because of the necessity of expedited action on this important and necessary legislation and, in addition, we are approaching adjournment of the Congress. We want to get the recommendations of the Finance Committee before the Senate as soon as possible, so we hope to complete these hearings in 3 days. Tomorrow's time will be taken up by representatives of the National Defense Council, the representatives of the Treasury, and representatives of the Joint Committee on Internal Revenue Taxation. If we can complete those, we will take up some other witnesses who might have applied for time and whose names are not on the calendar for tomorrow. So you will have to bear with the committee in the imposition of a time limitation. We do not ask you to take the 10 minutes if you can make it shorter. When you have finished your time and if you desire to file a brief with us, we will accept those briefs. Our experts as well as the members of the committee are going over the briefs. If you can point out to us, in a brief statement, the important points that you want us to look into, we will appreciate it.

The first witness on the calendar is J. R. Short, of Chicago. Is Mr. Short here?

Mr. SHORT. Yes, sir.

The CHAIRMAN. All right, Mr. Short. Mr. Short represents the J. R. Short Milling Co.

STATEMENT OF J. R. SHORT, J. R. SHORT MILLING CO., CHICAGO, ILL.

Mr. SHORT. Senator Harrison and members of the committee: I am the president of the J. R. Short Milling Co. of Chicago. We manufacture special cereal products which we sell to industries. We are a small- or medium-sized corporation. During these 4 base years under which we would qualify we have been growing——

The CHAIRMAN. One moment, please. Are the Treasury representatives here?

Mr. TARLEAU (of the Treasury Department). Yes, sir.

The CHAIRMAN. I hope you will make notes on the testimony given, because we will want to ask you about them. Is Mr. Stam also in the room?

Mr. STAM (of the Joint Committee on Internal Revenue Taxation). Yes, sir.

The CHAIRMAN. Proceed, Mr. Short.

Mr. SHORT. I might say this, that so far as we can see we will derive no benefit whatever from the defense spending program. As a matter of fact there will be certain disadvantages to our business springing from the situation in the next few years. Increases in certain costs are almost inevitable. We have lost small revenues derived from English business and are penalized on such business as we do in Canada by reason of the exchange situation. Domestically we will be faced with undoubtedly rising costs, and we think we will do very well to be able to maintain our present earnings.

During the 4 base years our progress has been steady. That is, each year has shown a progressive improvement over the one before. Prior to that, for 6 years we showed the pattern of a new business which was developing profitably; sometimes showing a gain and sometimes showing a slight loss from the preceding year, but making substantial progress as the result of research, new products, and the building up of goodwill and a sales organization which resulted, during those few years, in a national business. Our business is a national one and we have developed a sales organization and goodwill which has brought results in these years.

In applying the law, as we understand it—we had a very brief opportunity to study it with auditors—it would result in this situation, that the base years average would show one-half of what might be called our stable earnings of 1939 and 1940. We are estimating, for the purpose of my remarks, that 1940 will be approximately the same as 1939, based on a study of our 1940 business. On that basis the 1940 taxes under the new law would show an increase of 72 percent over our taxes for 1939. The excess-profits tax alone would show 62 percent of the total Federal taxes for 1939. The provision for an increase of 4.1 percent and the higher schedule compared with the invested capital basis would account for more than one-half of our calculation as to what those excess-profits taxes will be.

We feel, therefore, with our history of growth, that we are facing two situations: That is, we see no opportunity for any improvement in business by reason of the defense spending program, and, in the next place, by reason of what may be called an extended record of growth during these years we shall be paying substantial increases out of normal earnings. There will not be any excess-profits record in our business, it will simply be a case of making this a "normal" tax contribution.

Now so much for our record as a growing business. May I say also that we have contemplated the construction of a new plant. We have been doing a good deal of research work on agricultural products, and that research promises to be productive of results. We do not know yet, but we have been giving serious thought to the building of a new plant, and either the formation of a new corporation or the inclusion of that new business in our present business. As nearly as we can calculate the effect of the law under which we would be placed, I believe in the investment capital class, there would be a very substantial question as to whether the hazards involved in that new development would justify our taking the risk. As a new company we would be very reluctant to go into such a hazardous development, you see. I cannot speak with definiteness on that, because I have not had an opportunity, Mr. Chairman, to study that exactly, but I think I know what it would do to a new business, and I think that is the answer.

I pointed out that our situation is the situation of a growing company. I do not know what relief this committee could give us. I feel it is a situation which will confront a great many companies. I do feel that it would help if they were permitted to take 2 or 3 out of 4 years.

I see for us considerable hardship in the imposition of the normal tax of 4.1 percent and a higher schedule of taxes beyond that. As I mentioned, that would more than double the amount of the excess-profits tax in our case. We would pay all of our taxes out of normal earnings. We realize that taxes must be levied and increased, but in comparison with many corporations which had reached a position of stability and had shown consistent earnings, even if they are not to be benefited by defense expenditures, the new corporation which is growing is heavily penalized.

That, I think, Senator Harrison, is all I have to say.

Senator GEORGE. How old is your corporation, Mr. Short?

Mr. SHORT. Beg pardon?

Senator GEORGE. How old is your business?

Mr. SHORT. It was formed in 1909, sir. It had a long record of indifferent success and losses up until about 1929.

Senator GEORGE. I take it that your corporation would be almost compelled, if the option was fair at least, or equitable, to deduct the prior earnings.

Mr. SHORT. Yes, sir.

Senator GEORGE. And you would have to elect that credit.

Mr. SHORT. Yes.

Senator GEORGE. For 4 years.

Mr. SHORT. Yes; that is correct.

Senator VANDENBERG. Why is that? Is that because your invested capital is low?

Mr. SHORT. The invested capital is relatively low, and from a study of the bill, that is what our auditors told us, that that is to be the case.

Senator VANDENBERG. Your only suggestion is that you be allowed to choose 2 or 3 out of the 4 years as your comparative base?

Mr. SHORT. I said, Senator Vandenberg, that that would help us. Of course we have not had much chance to study this law. I can only suggest to the committee that you have here a situation with respect to growing corporations. I am not an expert and I do not pretend to offer what might be a final solution, but I am presenting the problem and it would help if we were permitted to choose 2 out of 4 years; yes. In addition to that I feel that the imposition of a normal tax increase of 4.1 is a very severe hardship, with the higher schedules which run 5 percent higher, as I understand it, than in the case of the other section of the bill providing for a computation on invested capital.

Senator VANDENBERG. I think your situation is typical of many corporations in the country, middle-class corporations that are just about going to be decimated by this bill.

Mr. SHORT. Yes. It is going to be a very severe hardship. So far as a new corporation is concerned I see great difficulty in the formation of new corporations, because they are compelled, as I understand it, to come under the invested-capital provisions. A man of great wealth I take it is not going to invest in that kind of project. That means smaller men have got to go in in projects which will offer better than the average opportunities for profit but which do, of course, result also sometimes in considerable losses. You see, we would hesitate very, very, decidedly in undertaking any additional enterprise.

The CHAIRMAN. Have you a brief or written statement that you want to file?

Mr. SHORT. No, sir; I was not informed of the meeting in time.

The CHAIRMAN. Thank you very much.

Mr. SHORT. I shall be glad to present one, if it is desired, Mr. Chairman.

The CHAIRMAN. Well, time is of the essence.

Mr. SHORT. Thank you.

The CHAIRMAN. Is Mr. Cohen here yet?

Mr. COHEN. Yes, sir.

The CHAIRMAN. All right, Mr. Cohen. Mr. Paul P. Cohen, Niagara Falls, N. Y.

STATEMENT OF PAUL P. COHEN, REPRESENTING THE SPIRELLA CO., THE CREO-DIPT CO., AND VARIOUS OTHER TEXTILE AND BUILDING MATERIALS COMPANIES, NIAGARA FALLS, N. Y.

The CHAIRMAN. Whom do you represent, Mr. Cohen?

Mr. COHEN. I represent the Spirella Co., the Creo-Dipt Co., and a number of other companies in the textile and building materials businesses in western New York.

The CHAIRMAN. Do you desire to file your brief?

Mr. COHEN. Yes. I have asked the messenger to pass around the memorandum, which I think is on your desk already.

The CHAIRMAN. Yes; we have it before us.

Mr. COHEN. I have pointed out in this memorandum, and I would like to call your attention just to the highlights of it here, three points which, on analysis, I think are true of the present proposed excess-profits-tax law.

The first is that small companies—and that includes a number in the group which I represent—will probably be driven into a partnership form of organization with a likely net loss of revenue to the Government rather than any gain. I was informed just a few days ago that the present corporate burden in the form of taxation on the smaller companies in the State of New York has resulted in the present statistics in the State of New York, that 10 corporations are being dissolved for every 1 that is being organized. Those are the informal figures I received from our own corporation bureau.

Senator VANDENBERG. Those are the smaller corporations?

Mr. COHEN. Those are the smaller companies, and in those I would include companies with incomes up to $25,000 or $35,000 a year. If one-fourth of the companies with incomes up to $25,000 a year were driven into partnerships the loss in your present corporation normal tax and your associated taxes of capital stock and present excess-profits tax would exceed the gain that you would get from that group of small companies from the excess-profits-tax law as the bill has been passed by the House. Your computation will show that in such companies you are now getting about $4,500 a year, from a company with an income of $25,000, and from the excess-profits-tax bill you would not get that amount from 3 companies in 4 of the small companies that might stay in corporate form, to equal the amount you would lose in the case of the one that elected to go into partnership. The result is, in the case of these small companies, they are going to pay this tax, which you might call a penal tax, only if their internal organization is such that they can not reorganize as a partnership and must, therefore, submit to the burden.

Now the next proposition which seems quite clear to me is that to limit new capital to 10 percent on the first $500,000 of capital and 8 percent on the remaining capital invested in a new enterprise, or new capital invested in an existing enterprise, is certainly not going to be a sufficient inducement to induce intelligent capital to invest in business. In my memorandum I have collected some of the most recent figures showing the life and mortality of the business corporations in this country, and they do prove that at least four out of five new ventures or new products that existing companies attempt to bring forth prove to be failures. Intelligent men know that and certainly will not invest in a new enterprise or a new product unless their engineers and advisers can advise them that at least 14 to 15 percent is the likely return on their investment if the thing goes over. A man who invests on a lesser basis of return just shows up at the end of a year, or series of years, at a total net loss. That, I believe, is the experience of you gentlemen. It has been the experience of the businessmen with whom I have been associated for a number of years.

Now I come particularly to the textile and construction or building-materials companies in the group up to $500,000 or $750,000 of invested capital. The companies that I am talking about are in that general range. The figures of the Treasury Department show that for the years 1936 and 1937, taking those 2 years, which are the only years for which income figures are yet available, show a net loss in the textile industry generally of 1.45 percent. For the textile industry generally, in the group of companies below $500,000 of invested capital, therefore, you have given them no reasonable possibility of any experience earnings basis. They are necessarily thrown into the second method of a minimum return on their invested capital, namely, 7 percent on the first $500,000 and 5 percent thereafter.

In the construction industry, in 1936 and 1937 the average rate of return on invested capital for such companies was only 0.27 of 1 percent. The figures in those two industries, which have been perhaps slower to recover from the depression than many of the other industries in the country, indicate that you have not given those industries time to catch their breath. They lost, according to the figures available from the Treasury Department and Department of Commerce, a substantially greater amount during the first 5 years from 1931 through 1935 than they have earned in the past 4 years, based upon all the figures that are now available. To say to those industries that "We are now going to impose on you an excess-profits tax based either on 5 to 7 percent of your invested capital or upon your earnings experience of the past 4 years," before they have recouped their losses of the first 5 years of the past decade, does not seem to me to be a reasonable or equitable procedure.

Senator VANDENBERG. What would you do about that?

Mr. COHEN. I would say, first, when you come to the question of a rate for invested capital in these industries which have had very low earnings in the past 4 years, that you have to adopt a rate both for new capital and, it seems to me, for existing industries as well, which we can say is a fair return to equity venture capital. I have used the figure of not less than 15 percent. I have stated to you gentleman that my experience has been that in the one venture that is going to be a success you have to get a return of many times that to equal your losses in the four out of five ventures that are not a success. An existing industry investing new capital it seems to me should get a base rate of not less than 15 percent.

I have put in the footnote a collection of figures from 1919 to 1928 made by the National Bureau of Economic Research, which shows an average earning during that period, which might be called the nearest to a norm that we are able to lay hands on, because there were periods of depression as well as periods of excessive activity, the norm then was about 12.6, as computed by Professor Epstein for the National Bureau of Economic Research during that entire decade. I do not believe in those companies he took into consideration the new companies which just rise and disappear and represent just so much lost capital, but rather limited his inquiry to those companies that have a fair history of experience. That is the nearest to a norm that I have been able to find in the neighborhood of 12½ percent, and you will recall that the norm which was taken in the excess-profits-tax bill, which was adopted and is now on the books, of 12½ percent is the normally expected return. To reduce that to 10 and 8 percent on new capital and 7 and 5 percent on the invested capital of those companies which existed throughout the 4-year period it seems to me is unfair and unwise and can only result in loss of revenue and in general harm to your social and economic structure.

Senator VANDENBERG. Would there be any way to cushion the presumed net earnings from 1936 through 1939 by making some sort of allowance for losses from 1931 to 1935?

Mr. COHEN. Yes; there would.

Senator VANDENBERG. How could you work that out?

Mr. COHEN. The losses of a company instead of being treated generally as a deduction from their base might, rather, be treated as an addition to their base, just exactly the reverse procedure. Namely, if the principle is recognized that a company should be allowed to recoup its losses before it is regarded as having acquired excessive profits, then to your average earnings, which in the two industries I speak for would be very low, for 1936 to 1939, if you added to that the losses which they should be allowed to recoup you would come nearer to what seems to me a fair treatment of the problem of excess profits.

Senator VANDENBERG. Well, I think the most significant thing in your whole brief is the statement that the Treasury Department statistics indicate that the actual net profits of all business corporations in groups of assets of less than $500,000 during the period from 1936 to 1939, the profits from 1936 to 1939 amount to less than the losses from 1931 to 1935. I think that is a challenge that cannot be overlooked.

Mr. COHEN. That is true. I have specifically worked out the figures for the two particular industries and I have the various percentages. There is no doubt that that is exactly true of all manufacturing industries with investments of below $500,000. These averages are raised only by reason of the very substantially greater earnings of the companies with very large invested capital. They, as you know, have survived the depression years much better than have the smaller companies.

Senator VANDENBERG. To what extent would you meet your problem, if your suggestion was followed, by raising the exemption from $5,000 to $25,000? Would that generally meet the relative gain and loss situation that you have been discussing?

Mr. COHEN. It would not. That would simply be a certain amount of relief to these small companies, companies which have been fighting for years against the unequal competition of the larger units, with reduced salaries to management, with no return to investors, and companies which are just about beginning to see daylight, especially in the construction and textile industries. To say to these smaller companies, "Your efforts of the past 4 or 5 years are now to be discounted in substantial part" is certainly a very discouraging and a very unfair proposition.

Senator TOWNSEND. The bill, in its present form, affects smaller companies to a much greater degree than larger companies, does it not?

Mr. COHEN. It does, because the larger companies have had comparatively large earnings in the past 4 years. The small companies, as the figures which I gave you indicate—and I might say in addition to those figures companies with average invested capital of $250,000 over the past 4 years, in all manufacturing industries for the years 1936 and 1937, according to the Treasury's statistics, earned an average of 2.1 percent, and in 1938 and 1939, when the figures come out, which are not yet available, they may show a higher percentage, slightly higher, but they certainly do not equal the losses of those smaller companies, which are set forth in the footnote on page 9. The figures were collected by the professor of statistics for Harvard School of Business Administration.

Senator VANDENBERG. You assented to Senator Townsend's statement that the bill affects smaller corporations rather than the larger ones. Would it not be a little more accurate to say that the big ones and the small ones are not affected but it is the middle ones that are the chief sufferers?

Mr. COHEN. No; I would say that the small ones are affected as seriously as any, comparatively, because they have the harder row to hoe. The middle companies are seriously affected; the larger companies, or the largest companies, are not so seriously affected, except by the 4.1 percent addition to their normal rate of income taxes, because they have had pretty substantial earnings over the past 4 years as compared with all the companies with invested capital up to a half million dollars.

Senator VANDENBERG. Yes; but according to your own statement the $5,000 exemption takes out 400,000 of the 478,000 corporations entirely.

Mr. COHEN. That is right.

Senator VANDENBERG. So it seems to me that the little one is out, the big one is out, but it is the in-between class that pays the freight.

Mr. COHEN. The 400,000 of the 478,000 that are out are to the extent of 70 percent, either companies that have sustained losses and are expected to continue in the losses, or that will earn not over $5,000.

The CHAIRMAN. Thank you, Mr. Cohen.

Senator CONNALLY. Just a minute, Mr. Chairman, I want to ask him one question. The fact that the small ones, you say, are more hard hit than the big ones is not because they are small but just simply because they did not make any profit to speak of in the last 4 or 5 years, is that not right?

Mr. COHEN. That is right. That is because their general problem in industry is more serious.

Senator CONNALLY. The reason I asked you that, everybody comes up here complaining about a tax comes up with a small-man viewpoint, that it is going to hurt the small man, and during this war we have got to take into consideration our national defenses. This law just happens to hit the small ones because they did not make any money.

Mr. COHEN. That is correct.

Senator CONNALLY. Of course the theory is because they did not make any money therefore they are the hardest hit.

Mr. COHEN. In a broad way the more difficult you make it for the small and medium-sized corporations, I might say, the easier you make it for the very large corporation.

Senator CONNALLY. If they made profits.

Mr. COHEN. That is right.

Senator CONNALLY. The big corporation that did not make any profit is not any better off than the little one, is it?

Mr. COHEN. That is true.

Senator CONNALLY. That is all.

Mr. COHEN. I should say the excess-profits tax is, on the whole, at this time quite unfair also to the large companies.

(The memorandum submitted by Mr. Cohen is as follows:)

MEMORANDUM SUBMITTED ON BEHALF OF VARIOUS TEXTILE AND BUILDING MATERIALS COMPANIES PROPOSING AMENDMENTS OF EXCESS PROFITS TAX BILL

With a view to preserving present tax revenues, encouraging investment in new enterprises and avoiding substantial injustice to corporations in such industries as textiles and construction, which during the past 4 years have had abnormally low earnings, the excess profits tax bill passed by the House—if the imposition of such a tax at this time is deemed advisable—should be modified at least in the following respects:

1. The exemption of $5,000 proposed in the bill should be increased to $25,000.

2. The base rate of return for new capital invested should be increased from 10 percent upon the first $500,000, and 8 percent upon new capital in excess of that sum, to not less than 15 percent upon all new capital invested during or subsequent to the base period.

3. The maxmum (10 percent) and minimum (7 percent to 5 percent) base rates of return allowed under the second method to corporations existing throughout the base period should be eliminated and a flat base rate of return of not less than 15 percent substituted.

1. *The flat exemption of $5,000 proposed in the House bill should be increased to $25,000*

The present bill provides a flat exemption of $5,000. As the chairman of the subcommittee which drafted the bill stated on the floor of the House, this exemption will remove from the burden of the tax approximately 400,000 of the estimated 478,000 corporations in this country. Those companies with incomes of from $5,000 to $10,000 together with those corporations having no net income make up approximately 80 percent of all of the corporations engaged in business in this country.[1]

The number of corporations whose annual net income in 1936 ranged from $5,000 to $25,000 was 20 percent of all corporations.[2] While some of these will pay no excess profits tax under the bill as passed by the House because of the base earnings rate allowed under the first method, the vast majority of these—approximately 100,000 corporations—will be subjected to the tax. These companies, in addition to the normal corporate income taxes of approximately 15 percent which they are now required to pay, will under the excess profits tax bill as passed by the House be required to pay an additional 20 percent on their profits up to $20,000, after taxes. The Federal and State income taxes (in such a State as New York)[3] which a corporation with an annual net income of $25,000 is required to pay, under existing law, amounts approximately to $5,250, in addition to whatever Federal capital stock and excess profits taxes may be due.

Any substantial additional tax burden for the privilege of transacting business in corporate form is bound to drive a substantial proportion of these smaller companies into general or limited partnerships. If the excess profits tax proposed in the House bill (added to the present Federal and State corporate taxes) drove one-fourth of these corporations into partnerships, the resultant loss to the Federal Government of the corporate taxes payable under the present law would more than exceed the excess profits tax realized from the remaining three-fourths of these small companies who elected to pay the increased price of continuing their businesses in corporate form. In operation the excess profits tax bill, as passed by the House, is, therefore, likely to yield no additional revenue in the case of existing companies with incomes of less than $25,000. On the contrary, it may very well result in a loss of revenue, while at the same time unfairly burdening those companies which by reason of their internal organization are unable conveniently to discard the corporate form.

2. *The base rate of return for new capital invested should be increased from 10 percent upon the first $500,000 and 8 percent upon new capital in excess of that sum, to not less than 15 percent upon all new capital invested during or subsequent to the base period*

The House bill allows a base rate of 10 percent on new capital invested up to $500,000 and 8 percent on new capital invested above that amount, whether after

[1] See schedule prepared by Treasury Department, Division of Research and Statistics, November 12, 1937, printed in Hearings Before the Committee on Ways and Means on Revenue Revision, 1938, p. 125.

[2] Ibid.

[3] The New York tax on corporations is 6 percent of the net income.

January 1, 1940, or prior to January 1, 1940 (if subsequent to January 1, 1936). Such a rate cannot by any test be deemed a fair return upon capital invested in new enterprises. This is especially true of the developement of new products. The statistics reveal that the equity capital invested in at least four out of five enterprises is lost and the businesses abandoned within a period of from 5 to 10 years after the ventures are begun. Dun & Bradstreet's Vital Statistics of Industry and Commerce, the most comprehensive study of the life of business enterprises in this country, shows that of all business enterprises commenced or in existence during the period from 1900 to 1939, an average of 20.3 percent, or one in five, were discontinued in each year of the period from 1900 to 1939.[4] "Based on the 1-year turn-over of 20 percent, the average life of business enterprises would appear to be about 5 years. Actually it is a little longer, nearer 7 years, for the reason that chances of survival improve with age."[5]

It is obvious, therefore, that intelligent capital will not flow into new enterprises without the inducement of a sufficient profit from the 1 venture in 5 which may prove to be a success to compensate for the "blanks" drawn by the investor in the other 4 ventures which experience shows will prove a failure. The fact that of the 478,000 companies in the United States 67.59 percent incurred a loss or had income of less than $5,000 in the year 1936,[6] shows that the vast majority of ventures undertaken by corporations, as well as by individuals, do not achieve success.

With the statistics of probable success and failure before him, no intelligent investor could be expected to supply risk capital for any new venture with a promise of a return of only 8 to 10 percent.[7] If a reasonably assured return of 5 percent plus reasonable safety of principal is deemed to be a fair average rate of return on savings devoted to productive use, an investor must be assured a return of at least 40 percent upon his investment in the one venture in four that proves a success, in order to give him an average rate of return of 5 percent upon the investment in the five or more ventures that experience proves he must invest in if he is to participate in one profitable enterprise. To fix a base rate of return of 8 to 10 percent, above which a substantial part of the profits are taken by the Government as excess earnings, can, therefore, have no other effect than to so discourage investors as substantially to diminish the flow of capital into new enterprises.[8]

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[4] Since new businesses begun each year amounted to approximately 26½ percent of all enterprises, the net addition to business enterprises in each year amounted to approximately 6.2 percent during the 40-year period.

[5] Treasury Department, Division of Research and Statistics, November 12, 1937: Hearings before Ways and Means Committee on Revenue Revision, 1938, p. 125.

[6] Letter of research and statistical division of Dun & Bradstreet, Inc., August 30, 1940.

[7] This point has nowhere been more succinctly or fairly stated than by Dr. Frank W. Taussig in the chapters on business profits, in his rinciples of Economics:

"The businessman stands at the helm of industry and guides its operations. Into his hands first flow the proceeds, and he distributes to others their share. He pays to the hired workmen their stipulated wages. Similarly, to those who lend him capital he pays stipulated interest. * * * After making these various payments he retains in his own hand what is left. His income may, therefore, be described as residual. This position as residual claimant explains one striking characteristic of business profits—the irregularity of the income. In 1 year the businessman may earn nothing, may even lose. Another year he may gain great sums. The variation from year to year of the same individual's profits arise from the businessman's assumption of industrial risks (ch. 49, par. 2).

"When there are blanks as well as prizes, it may well happen that the prizes do not suffice to offset the blanks, and then the earnings on the occupation (of business) as a whole contain no surplus and there is no element of risk. This, it is said, is peculiarly the case with business profits. Success in business is highly uncertain. * * *

"The investor who is looking for a return in the way of interest pure and simple does not take shares in new undertakings; he buys 'solid' bonds. Those who 'go in' for new ventures expect to secure more than interest on what they invest; otherwise they would not assume the risks.

"The large and conspicuous gains are in fact associated almost invariably with advances in the arts, with boldness and sagacity in exploiting new enterprises and new methods.

"The community, on the whole, gets an equivalent for the businessman's earnings; indeed, must allow some such earnings in order to secure the useful services rendered" (ch. 50, pars. 1, 4, 7, 9).

[8] The average rate of profit upon equity capital earned by corporations engaged in manufauturing during the 10-year period from 1919 to 1928 has been computed in a careful, detailed study made under the sponsorship of the National Bureau of Economic Research at 12.68 percent for smaller companies with an average equity capital of $171,000, and at 11.69 percent for the larger companies having an average equity capital of $13,500,000, or at an average of 12.09 percent (Ralph C. Epstein, Industrial Profits in the United States (1934), p. 242, 364–365).

The average rate of earnings upon tangible net worth of 9 automobile companies listed on the New York Stock Exchange for the year 1939 was 16.86 percent. Of the 9 companies, however, 5 sustained substantial losses during that year (Securities and Exchange Commission, Survey of American Listed Corporations, Supp. No. 4, August 1940).

The harmful results of such a discouragement of the flow of capital into new enterprises needs no comment. They are obviously of a serious and widespread character. To mention a few: A substantial barrier is placed in the way of reemployment of the millions of employables who still are unemployed; the increase in the general standard of living which the promotion of new products and new enterprises bring to a community is retarded; and, what is perhaps of equal importance to this committee, the revenue which would be derived as a result of the promotion of such new enterprises from the corporate income, capital stock, excess profits, and undistributed profit taxes now upon the statute books is lost to the Government.

It seems reasonably clear, therefore, that the base rate to be allowed to new capital must be substantially higher than the 8- to 10-percent rate provided in the House bill, if the flow of capital into new enterprises is not to be seriously diminished.

3. *The maximum (10 percent) and minimum (7 to 5 percent) base rates of return allowed under second method to corporations existing throughout the base period should be eliminated and a flat base rate of return of not less than 15 percent substituted*

The minimum base rate of return of 7 percent on invested capital up to $500,000 and 5 percent on invested capital in excess of $500,000 provided in the House bill for established corporations is grossly unfair to those industries which by reason of their nature have emerged slowly from the losses of the depression years, and accordingly are forced to accept that base because during the past 4 years they have experienced continued losses or very low rates of return on their invested capital. Two of such industries, which together contribute more than 35 percent of the gross dollar volume of all tangible goods produced in this country, are the textile and construction industries. The textile industries in the years included in the base period for which figures are available, 1936–37, show an average return on net worth (which may be taken as the rough equivalent of invested capital under the House bill) of only 4.94 percent.[9] For companies in the textile industries with net worth or invested capital of $250,000 or less, the average net *loss* for the years 1936–37 amounted to 1.45 percent.[10] The average rate of return in the textile industry for those years compares with an average of 12.6 percent per year upon equity capital invested in that industry during the 10-year period from 1919–28.[11]

Similarly in the construction industry, in which are included the manufacturers and suppliers of building materials of all kinds, the average rate of return on invested capital for the available years of the base period 1936–37 was 4.91 percent per year. During those years the average rate of return for companies in that group having invested capital of less than $250,000 amounted to only 0.27 percent per year. Adopting the volume of business done by that industry in the period from 1924–26 as a norm, the construction industry (exclusive of public works) has risen from a low in 1932 of approximately 15 percent to an average of approximately 46 percent of normal in the 4-year period 1936–39.[12] In ordinary course, and irrespective of any defense program, the normal cycle of activity in that industry over the next 5 years, may reasonably be expected to bring the volume of business in the industry to from 75 to 100 percent of the 1924–26 average.

Neither the textile industry nor, except in certain limited branches, the construction industry, will participate to any substantial extent in the profits which may be expected to be realized as a result of the defense program by industry generally. Yet, corporations in these two basic industries, with few exceptions, will be limited to a base return of 7 to 5 percent upon their invested capital under the House bill. Instead of thus penalizing these cor-

[9] W. L. Crum, Corporate Size and Earning Power, Harvard University Press, 1939; appendix, table B, compiled from U. S. Department of Commerce Statistical Abstract of United States and U. S. Treasury Department's Statistics of Income.

[10] Ibid.

[11] Epstein, Industrial Profits in the United States, p. 242.

[12] Statistics of Contracts Awarded, 37 Eastern States, compiled by F. W. Dodge Corporation. The average number of dwelling units erected in the years 1936–38 amounted to approximately 29 percent of the average number of dwelling units erected during the years 1924–26. (Statistics for 1936–38 from data compiled by Bureau of Labor Statistics, Department of Labor, statistics for 1924–26 from data compiled by National Bureau of Economic Research.)

porations because their industries have been among the last to emerge from the depression, they should, if anything, be given a higher base than that deemed to be a fair average return to equity investors. For in those industries, companies must, during the years ahead, make substantially greater profits than might be deemed a fair return on venture capital generally, if they are to recoup the very substantial losses sustained by them in the years from 1931–35.[13]

What is true of the textile and construction industries is also true of other industries whose return on invested capital has been below a fair rate of return during the proposed base period of 1936–39.[14] In justice to those industries, as well as with a view to simplifying the application of the excess-profits-tax law, if it is enacted, the maximum and minimum rate of return provided under the second method should be eliminated and a flat base rate of return made available for all corporations under the second method equal to the rate determined by this committee to be fair for newly invested capital.

CONCLUSION

The figures compiled by the United States Department of Commerce for the 9-year period from 1931 to 1939 published in the Department's annual Statistical Abstract of United States and the statistics of corporate income compiled by the Treasury Department for the years 1931–37 indicate that the actual net profits of all business corporations in the groups with assets of less than $500,000 during the period from 1936 through 1939 amounted to less than the losses sustained during the period from 1931 through 1935.[15]

These figures suggest the basic inquiry: Is it in the public interest—is it in the interest of national defense, of labor, of investors, of consumers, of industrial and social progress—that a substantial excess-profits tax be imposed upon the corporate business enterprises of this country before they have been given an opportunity at least to recoup the losses sustained by them during the depression years of 1931–35?

To enact any excess-profits tax measure at this time, before business corporations in many industries have recovered from their losses of the depression years, is neither fair to investors in corporate equities nor calculated to promote the general public interest. Without a substantially higher exemption than that provided in the House bill, small companies will be driven into partnership form with a probable net loss of revenue from corporations with incomes under $25,000 rather than any increased revenue by reason of the excess-profits tax. If such a tax is enacted the base earnings rate for both new and existing investment should be substantially increased. Certainly corporations in industries which have been slow to emerge from the depression years—and these are a large percentage of the whole—should not be unfairly penalized, as they are in the House bill, by being in fact limited to the minimum base rate of 7 percent to 5 percent of their invested capital because of low earnings in the far from normal years of 1936–39.

Respectfully submitted,

PAUL P. COHEN.

NIAGARA FALLS, N. Y.,
September 3, 1940.

[13] The average annual loss or profit in terms of percentage of invested capital of companies in the construction and textile industries and of companies in all divisions of industry during the 6-year period from 1931 to 1936 classified into groups according to volume of total assets were as follows (W. L. Crum, Corporate Size and Earning Power, appendix, table B):

Total assets (in thousands of dollars)	Construction	Textile	All divisions
0–50	−22.14	−23.86	−16.34
50–100	−8.74	−7.64	−4.73
100–250	−4.92	−3.73	−2.68
250–500	−1.79	−.73	−1.40
500–1,000	−1.17	.01	−.80
Over 1,000	3.25	.38	−.05

[14] Ibid.
[15] Footnote 9.

The CHAIRMAN. Mr. Benson.

Mr. BENSON. Yes, sir.

The CHAIRMAN. Mr. John Benson, New York City, president of the American Association of Advertising Agencies.

STATEMENT OF JOHN BENSON, NEW YORK CITY, PRESIDENT, AMERICAN ASSOCIATION OF ADVERTISING AGENCIES

The CHAIRMAN. Have you a brief?

Mr. BENSON. Yes, sir.

Mr. Chairman and members of the committee: As its president, I represent the American Association of Advertising Agencies, whose members do approximately two-thirds of the total national advertising of the country. I would like to point out to the committee the effect on our business of the excess-profits tax measure as passed by the House.

We do not expect, nor are we entitled to any lesser tax burden than is imposed on other business, but we would like to avoid discriminatory hardship as between our business and all other business, and as between one advertising agency and another of equal earning power.

Specifically, I wish to point out—

First, how inequitable it would be to base excess-profits taxes or any exemption thereof on net earnings in excess of a 4-year base-period average whenever that average falls below the normal earning power of our industry. The House bill takes care of this for general business by providing a minimum limit of 7 percent and a maximum of 10 percent of invested capital, but we cannot make use of that, because we make so minor a use of capital, and that mostly for nonoperating purposes.

Secondly, that under the definition of a personal-service corporation, as defined in the House bill, quite a few of our members can benefit substantially by qualifying, but there are many others I fear who could not.

Now, before developing this argument any further I would like to briefly describe to this committee the nature of the advertising-agency business and its use of capital, to what extent and for what purpose. Our business renders a strictly professional personal service in that its end product is not a manufactured commodity and is not a physical service, but is a mental product composed of ideas, plans, and counsel to clients.

Now, it follows that the advertising-agency business requires relatively little capital to conduct. In 1939 it averaged only 6.16 percent of the annual volume, and a mere fraction of that is needed for operating purposes, its major need being for insurance against serious credit and operating losses which are a real hazard because of the relatively few clients each agency serves and the relatively large commitments we make for them.

Now, in contrast to our capital-to-volume ratio of 6.16 percent in 1939, that of all business reported for 1937 in the Statistics of Income published by the Bureau of Internal Revenue was over 105 percent.

Capital in our business is not a material income-producing factor; it is merely incidental to our way of serving clients, and does not directly earn income except in very minor ways. For advertising space and radio time we purchase for account of a client we are paid by him before we pay the media. The amount of capital held by agencies of equivalent size varies widely, largely because it is not much needed for operating and is held as a liquid reserve required of agencies by publishers as a basis for credit.

Now, to give you an idea of how widely rate of earnings based on volume differs from their rate based on invested capital, I herewith submit a schedule of figures compiled from profit-and-loss statements furnished by a representative group of 52 members who have made them available to us. We have not taken any more because we have been unable to get them at the present time.

These indicate that a rate of net profit based on volume of only 2 percent would be the equivalent of 35.29 percent based on invested capital, which would, of course, be heavily taxable as excess profits under the provisions of the House bill. Now compare this wide differential with that prevailing in general business in 1937, according to statistics issued by the Internal Revenue Bureau, which show a net profit on all business of 8.50 percent of capital assets and 8.97 percent of volume transacted. Now if all deficit concerns are included, then these percentages would be 5.5 and 5.6 percent, respectively. Note how closely the two bases agree.

The justice of figuring excess-profits tax on volume in our business is thus well supported by the fact that basing it on invested capital in general business is practically equivalent to basing it on volume.

Why is it not ordinary equity to allow the personal-service corporation to use the volume basis for figuring the exempted rate of profit? It has no other basis. In the advertising agency business that rate can be definitely determined as a normal earning power from our official records and authoritative figures available to the Internal Revenue Bureau. They should be equally available in all other lines of personal service business, properly organized and compiled. It should not be incumbent upon the Internal Revenue authorities to dig out the facts; the industry should do so itself. If no data are made available, the industry does not deserve relief.

This method seems to us both feasible and fair. If it is denied to us and the invested-capital basis is required, then in all fairness the maximum exemption rate of 10 percent should be materially raised for the personal-service corporation to compensate for the very minor use it makes of capital. For instance, if a low average earning rate of 2 percent on volume is the equivalent of 35 percent on capital in our business, then 35 percent should be our upper limit, to put us on a par with all other business.

Now the alternative of qualifying as a personal-service corporation, as defined in the House bill, would give real relief to quite a number of our members; but many, I fear, could not qualify because of the distribution of their stock among active and inactive stockholders and also more importantly its nondistribution among key men in the organization who contribute materially to the earnings of the corporation. The inactive stockholder problem has been measurably taken care of in most cases, I believe, by the revised and liberalized provision of the House bill, but not so the question of income-producing factors which own no stock, and they are many.

Many of the agencies who could qualify as personal-service corporations might not be financially able to meet the requirement that all their net earnings be paid out to their stockholders when these earnings are much needed to build up reserves necessary to finance an expanding business; and when such dividends are not actually paid out to the stockholders but merely credited to them on the books of the corporation and to be returned by them as personal income, some might not be financially able to pay the surtax when not in receipt of the money; in fact, many of them may be hard put to it to pay up their subscriptions to the capital stock of the corporation. This is not uncommon.

Now this involves a discriminatory hardship when you consider that under the provisions of the House bill many other concerns earning a larger rate of income escape all excess-profits tax because of the 7 to 10 percent limit on invested capital, without having to pay out all earnings in lieu of it.

Many of our people are afraid of the personal-service-corporation status, due to their experience with it during the World War and after the World War. They became involved in expensive disputes with the internal-revenue authorities and went through widespread litigation over provisions of the law which were either ambiguous or difficult to comply with. The problem, for instance, of determining who in an advertising agency, stockholder or employee, actually produces the earnings, was not easy to decide. That was a cause of much debate.

The present definition of a personal-service corporation would be beneficial to more of our members if it were clarified and broadened a bit; but everyone of them could be protected on a par with all other business if the volume basis of figuring net rate of profit were accorded instead of the invested-capital basis, and thus escape a discriminatory hardship.

I submit herewith a suggested revised definition of a personal-service corporation, for your consideration:

For purposes of this subsection, the term "personal-service corporation" means:

1. One which renders a personal or professional service to clients.

2. One at least 80 percent of whose capital stock is held by shareholders who are regularly and actively engaged in the conduct of the business. (In this connection, a shareholder shall be considered as holding stock owned by his spouse or minor child.)

3. One whose capital is not a material income-producing factor: which means that it is relatively minor in amount and its use is mainly incidental to the serving of customers and clients, and that any direct earnings from its use are minor compared with the fees, commissions, and retainers earned by the firm for services rendered.

This definition shall not include any foreign corporation which is not a subsidiary of or owned by a domestic corporation of which it is a branch.

Senator CONNALLY. That includes insurance companies, incorporated agencies?

Mr. BENSON. The parent company.

Senator CONNALLY. If a firm of insurance agents—general, fire, life, or any kind—should incorporate, that would be a personal-service corporation, would it not?

Mr. BENSON. Well, I do not know whether it would.

Senator CONNALLY. You wrote the provision. I just want to understand what it covers. Did not you write the amendment that you suggested?

Mr. BENSON. Yes.

Senator CONNALLY. Tell us now whether it would cover a case like that or not.

Mr. BENSON. Of course I thought of the personal-service corporation from the standpoint of the initial definition that it rendered a professional service. For instance, a railroad or utility renders a service that is not a commodity, but it is not a personal service, it takes capital and plant to produce that service.

The CHAIRMAN. Thank you.

Mr. BENSON. Also, Mr. Chairman, I want to leave with you the figures on which I base my conclusions.

The CHAIRMAN. You may do so.

(The matter referred to is as follows:)

Net current assets and net tangible assets as percentages of average monthly billing

[NOTE.—Data taken from standard American Association of Advertising Agencies balance sheets of 88 members]

Agency billing classification	Number of agencies	Total average monthly billing	Total net tangible assets	Total net current assets	Total net tangible assets as percentage of total average monthly billing	Total net current assets as percentage of total average monthly billing	Total net tangible assets as percentage of volume
					Percent	*Percent*	*Percent*
Under $500,000	40	$744,810	$1,481,044	$1,177,033	198.8	158.0	16.57
$500,000 to $1,000,000	15	882,578	1,027,031	904,945	116.4	102.5	9.70
$1,000,000 to $2,000,000	11	1,389,000	1,109,843	998,317	79.9	71.9	6.66
$2,000,000 to $5,000,000	9	2,165,000	1,601,459	1,272,654	74.0	58.8	6.17
Over $5,000,000	13	13,960,000	8,923,160	6,428,817	63.9	46.1	5.33
All	88	19,141,388	14,142,537	10,781,766	73.9	56.3	6.16

Profit as percentage of total annual volume and total gross income; also of total net tangible assets (capital invested)

[NOTE.—Data taken from standard American Association of Advertising Agencies balance sheets of 52 members]

Agency billing classification	Number of agencies	Total annual volume	Total gross income	Net profit	Profit as percentage of—		Total net tangible assets	Profit as percent of total net tangible assets
					Total annual volume	Total gross income		
					Percent	*Percent*		*Percent*
Under $500,000	26	$5,886,960	$883,044	$55,760	0.95	6.31	$690,533	8.07
$500,000 to $1,000,000	12	8,268,600	1,140,290	96,207	1.16	7.76	677,900	14.19
$1,000,000 to $2,000,000	5	7,374,000	1,106,100	70,418	.95	6.37	455,722	15.45
$2,000,000 to $5,000,000	6	16,080,000	2,412,000	223,429	1.39	9.26	938,706	23.80
Over $5,000,000	3	48,540,000	7,281,000	1,309,971	2.70	17.99	2,212,882	59.20
All	52	86,149,560	12,922,434	1,755,780	2.04	13.59	4,975,743	35.29

American Association of Advertising Agencies

420 Lexington Avenue

New York

[Figures from Statistics of Income published by the Bureau of Internal Revenue for year 1937]

Total receipts or volume for all business		$107,028,613,000
Gross sales		85,005,675,000
Receipts from operations		15,700,181,000
Capital assets:		
Preferred stock		13,368,817,000
Common stock		56,562,090,000
Surplus		45,462,349,000
		115,393,256,000
Less deficit		2,490,954,000
		112,902,302,000
Net profit (for all nondeficit concerns)		9,601,841,000
Rate of net profit on volume	percent	8.97
On capital assets	do	8.50
If deficit concerns included these figures would be:		
Volume	do	5.6
Capital	do	5.5
Capital ratio to all volume in business	do	105.6
In agency business	do	6.16
Average earning power in agency business	do	2.04

Exhibit "A"

[Each horizontal line refers to a single agency]

BAD DEBT LOSSES

Year	Percent which bad debt losses were of gross income	Percent which bad debt losses were of average monthly billing	Estimated bad debt loss	Year	Percent which bad debt losses were of gross income	Percent which bad debt losses were of average monthly billing	Estimated bad debt loss
	Percent	*Percent*			*Percent*	*Percent*	
1929	17.20	31.0	$9,700	1933	17.43	31.5	$5,200
	8.70	15.7	4,900		13.00	23.4	3,900
	6.41	11.5	1,900		10.33	18.6	3,100
	6.07	10.9	1,800		9.79	17.6	5,500
	4.27	7.7	9,600		7.80	14.0	4,400
	4.08	7.3	25,000		6.51	11.7	3,700
1930	27.63	49.7	62,000		4.22	7.6	9,500
	8.50	15.3	4,800		4.13	7.4	2,300
	6.00	10.8	3,400		4.11	7.4	9,300
	4.67	8.4	10,500	1934	7.02	12.6	2,100
	4.08	7.3	25,000		6.98	12.4	3,900
	2.82	5.1	85,000		6.63	11.9	3,700
1931	10.97	19.7	10,300		5.44	9.8	12,200
1932	18.83	34.0	10,600		4.35	7.8	1,300
	11.95	21.5	11,200		3.87	7.0	43,500
	7.67	13.6	2,300	1935	10.21	18.4	3,100
	6.29	11.3	1,900		9.40	16.9	2,800
	6.09	11.0	1,800		4.00	7.2	1,200
	4.29	7.7	2,400		4.00	7.2	1,200
	4.18	7.5	9,400	1936	8.00	14.4	2,400
1932	2.74	4.9	82,000	1937	9.08	16.3	2,700

Exhibit "A"—Continued

OPERATING LOSSES

Year	Percent which net loss was of gross income	Percent which net loss was of average monthly billing	Estimated net loss	Year	Percent which net loss was of gross income	Percent which net loss was of average monthly billing	Estimated net loss
	Percent	*Percent*			*Percent*	*Percent*	
1929	27.03	48.6	$8,100	1933	43.06	77.5	$12,900
	13.20	23.8	7,400		41.75	75.2	12,500
	10.65	55.2	17,200		24.89	44.8	7,400
1930	30.70	55.3	17,200		22.93	41.3	51,500
	15.90	28.6	20,800		20.88	37.6	6,200
	8.41	15.1	95,000		19.89	35.8	5,900
1931	31.89	57.4	9,500		18.10	32.6	10,100
	31.38	56.5	17,600		16.39	29.5	15,300
	26.81	48.3	8,000		11.36	20.4	3,400
	23.47	42.2	30,800		10.83	19.5	3,200
	19.25	34.7	10,800		10.63	19.1	23,900
	16.71	30.1	9,400		10.51	18.9	9,800
	16.70	30.1	37,500	1934	82.27	148.1	24,600
	15.25	27.5	4,500		52.08	93.7	15,600
1931	14.01	25.2	4,200		35.79	64.4	10,700
	13.00	23.4	7,300		12.69	22.8	11,900
	12.46	22.4	7,000		12.13	21.8	6,800
	4.80	8.64	28,800		10.38	18.7	5,800
1932	68.61	123.3	64,200		10.16	18.3	5,700
	60.56	107.2	17,800	1935	94.85	169.8	28,300
	35.40	63.7	10,600		57.77	104.0	17,300
	32.78	59.0	18,400		30.19	54.3	9,000
	29.32	52.8	8,700		21.18	38.1	6,300
	25.26	45.5	7,500		10.35	18.6	5,800
	24.77	44.6	23,200	1936	39.83	71.7	11,900
	24.46	44.0	13,700		10.92	19.6	3,200
	22.77	41.0	6,800	1937	14.00	25.2	15,300
	21.52	38.7	12,100		13.03	23.5	3,900
	21.50	38.7	6,400	1938	46.60	83.9	26,200
	17.00	30.6	5,100		42.15	75.9	12,600
	16.97	30.5	15,900		35.73	64.3	10,700
	15.94	28.7	4,700		20.01	36.0	26,200
	15.90	28.6	8,900		15.45	27.8	57,900
	12.60	22.7	28,300		14.72	26.5	4,400
	11.34	20.4	25,500		12.05	21.7	6,700
	6.54	11.8	24,500		11.57	20.8	3,400
1933	44.32	79.8	13,300		6.40	11.5	38,400
	43.84	78.9	12,100		4.51	8.1	135,000

AMERICAN ASSOCIATION OF ADVERTISING AGENCIES,
OFFICE OF THE PRESIDENT,
420 Lexington Avenue, New York.

Supplementary testimony of John Benson, President of American Association of Advertising Agencies, at Finance Committee hearing in the Senate, September 3, on excess-profits legislation.

Requiring personal service corporations to pay out all their net earnings during the taxable year in dividends to their shareholders, or, if it keeps them, compel their shareholders to pay personal income tax and surtax on dividends which are not received will be financially embarrassing to many.

This embarrassment is not imposed upon any other corporations which escape excess-profits tax under the 7 percent minimum rate of profit limit and the 10 percent maximum limit, and hence is a discriminatory hardship upon personal service corporations qualifying as such under the terms of the House bill.

Especially hard on young concerns which are building up their business and need more liquid reserves to finance expansion and also upon stockholders whose income tax is in the high brackets.

It would seem unfair, on the other hand, to let such corporations go excess-profits tax free; no classification of corporation should seek to avoid tax on an equivalent basis with all other corporations. This should be also avoided.

Why not modify the penalty for escaping excess-profits tax as a personal-service corporation by requiring the taxpayer to distribute in dividends that portion of its income which would be excess profits under plan No. 1 for exempting average earnings during the 4-year base period? There would be some equity in that.

Personal service corporations are especially in need of relief, because they cannot use the percentage on capital base-period exemption and might be forced to use the average volume of profit base with its 4.1 percent extra tax and higher excess-profits tax rates.

Respectfully submitted.

JOHN BENSON, *President,*
American Association of Advertising Agencies.

SEPTEMBER 4, 1940.

SUPPLEMENT TO TESTIMONY OF JOHN BENSON BEFORE THE FINANCE COMMITTEE ON SEPTEMBER 3, AT EXCESS-PROFITS TAX HEARING

These suggestions I believe would avoid discriminatory hardship as between taxpayers and still raise substantial revenue, by combining an increased normal tax imposed alike on all corporations and an excess-profits tax limited to supernormal earnings.

1. Instead of imposing an added normal tax of 4.1 percent exclusively on one group of taxpayers, namely, those who elect to base excess profits on average earnings during the previous base period, tax the normal income of all corporations 2.1 percent or 3.1 percent additional to the 20.9 percent. This would be nondiscriminatory and independent of any excess-profits tax.

2. Tax excess profits on a single sliding scale of 20 percent to 50 percent of their amount, the same for all, exempting $5,000 or more if feasible, to protect the small business.

All excess-profits tax might be limited to concerns taking on war preparation contracts, if not unduly discriminatory or discouraging to the national-defense effort. This should not be done without consent of the Advisory Commission to the Council of National Defense.

3. Determine excess profits by fixing maximum normal rate of profit, say at 10 percent of invested capital, except for the corporation rendering a personal service and having but relatively minor capital.

4. In the case of personal-service corporations regard as excess profits all earnings over and above a normal earning power in each major line of personal-service business, to be determined by the Bureau of Internal Revenue, based on official records and authoritative figures for the industry in question, and made available to the Bureau. (By "normal earning power" is meant the average rate of profit earned on volume by well-established and substantial units of the industry during the year 1937 or 1939 or both.)

Or, as an alternative basis, use 1937 average rate of net profit of all industry of 5.16 percent on total annual volume, above which net earnings during the taxable year to be considered excess profits and taxable as such (1937 average profits chosen because most nearly normal since 1929 and most recently published by the Bureau of Internal Revenue).

5. Permit, at its option, the personal-service corporation to qualify as such under the terms of the attached revised definition of it and be relieved of excess-profits tax. In doing so do not require distribution of all net earnings to the stockholders, but merely of excess profits. This would relieve many of the embarrassment of having to pay out funds needed in a growing business to finance expansion, and also relieve stockholders from having to pay surtax on dividends credited to them constructively and not received. Compelling the disbursement of all earnings, both normal and excess, does not seem fair when the corporation is not put entirely on a partnership basis of being relieved of all corporate taxes.

6. Authorize a nonpolitical body like the Board of Tax Appeals to deal with cases of individual hardship for which it is not feasible to provide legislative relief from inequity of discrimination.

The above suggestions are my personal views only and are respectfully submitted for what they may seem worth to the Finance Committee.

JOHN BENSON,
President, American Association of Advertising Agencies.

WASHINGTON, *September 5, 1940.*

REVISED DEFINITION OF "PERSONAL SERVICE CORPORATION"

For purposes of this subsection, the term "personal service corporation" means:

1. One which renders a personal or professional service to customers or clients.
2. One of whose capital stock at least 80 percent is held by shareholders who are regularly and actively engaged in the conduct of the business. (In this connection, a shareholder shall be considered as holding stock owned by his spouse or minor child or by any trustee representing them.)
3. One whose capital is not a material income-producing factor.

(This revision to be substituted for any previous definition submitted by John Benson, president, American Association of Advertising Agencies.)

NOTE.—If the above proposed definition of a personal service corporation is not adopted by the Finance Committee of the Senate, which we much prefer it would be, most of our members would be able to qualify under the definition in the bill passed by the House, H. R. 10413, if the following two changes were made:

First: In line 4, page 36, substitute 70 percent for 80 percent.

Second: In line 12, page 36, add at the end of the sentence the clause "or any trustee representing them."

The first change is suggested to enable advertising agencies to qualify which fall a little short of the 80 percent ownership of stock by those "engaged in the active conduct of the affairs of the corporation."

The second change would take care of cases where stock belonging to a spouse or minor child might be held by a trustee on their behalf.

Respectfully submitted.

JOHN BENSON,
President, American Association of Advertising Agencies.

SEPTEMBER 7, 1940.

The CHAIRMAN. Mr. Powell is the next witness. Mr. Henry M. Powell, New York City, chairman of the tax committee, Associated Industries of New York. All right, Mr. Powell.

STATEMENT OF HENRY M. POWELL, NEW YORK CITY, CHAIRMAN, TAX COMMITTEE, ASSOCIATED INDUSTRIES OF NEW YORK

Mr. POWELL. Mr. Chairman, and gentlemen of the Finance Committee, unlike the previous speakers, I am not here to represent any particular and special class of industry. I represent an association of manufacturers who manufacture or do business in the State of New York, and I should like to tell you something about that association so that you can tell how it affects our business in New York. To give you an idea of our association, I will state that while it was originally incorporated in 1914 with 39 manufacturers and corporations, it now represents 1,500 manufacturers and corporations organized or doing business in New York, and the members of the association now give employment to nearly 600,000 men and women out of an approximate aggregate of 1,300,000 wage earners of the State of New York, and the members of that association represent an invested capital of about $2,000,000,000.

The CHAIRMAN. Is that in your brief?

Mr. POWELL. Yes.

The CHAIRMAN. I would like to have you point out to us the important points which you desire to raise.

Mr. POWELL. I simply will apply myself to what I consider the high spots of the bill as it is presented to your committee.

The CHAIRMAN. That is what we want.

Mr. POWELL. I shall not burden you with any illustrations or schedules of figures. I shall apply myself to the general principles, and I think in that respect it applies to all industry.

The bill now before your committee has been drastically amended by the Ways and Means Committee of the House. The Ways and Means Committee had originally received a report from the Subcommittee on Internal Revenue Taxation which, in turn, had been advised by the representatives of the Treasury Department. After the face-lifting operation performed by the Ways and Means Committee I do not believe the original framers of the report could recognize or would even acknowledge its offspring.

The CHAIRMAN. Which one of the bills is more appealing to you or your association; the bill that finally was passed by the House or the one on which we held hearings?

Mr. POWELL. The one that is covered by the 105 pages?

The CHAIRMAN. Which is the most appealing?

Mr. POWELL. That is the bill that is now before your committee.

The CHAIRMAN. I asked you this question; Which is the more appealing? Which bill do you think is the better bill?

Mr. POWELL. Well, the bill that was originally presented by the subcommittee.

The CHAIRMAN. You like that better?

Mr. POWELL. Undoubtedly. It conforms to what is known by people generally as an excess-profits tax. While this bill is termed an excess-profits tax or war-tax measure, in its present form it is neither an excess-profits tax nor, as far as the great majority of domestic corporations are concerned, is it a war-profit tax, particularly for these corporations not engaged in manufacturing ammunitions and in kindred war business. It may, perhaps, be correctly termed a graduated corporation tax, depending upon income, with a punitive tax of 4.1 percent plus the normal tax imposed, and that is imposed upon successful corporations electing to be taxed on the basis of previous income.

The excess-profits tax, as that term is usually understood, is a war tax in which the tax is graded or increased depending on the percentage of profits of corporations when compared with the capital employed in business. That was the plan originally submitted by the Ways and Means subcommittee and recommended by the advisers, the advisory committee of the Treasury Department, as I understand it. That plan is now used in Canada and England, which countries are actually engaged in war, and that plan was used during former excess-profits taxes in 1918–19 by the United States when it had 2,000,000 men or more in arms and engaged in war. At that time the normal tax was 12 percent, afterwards reduced to 10 percent, and the excess-profits tax graded according to the percentage of profits compared to the capital employed in business, that was 20 percent and 40 percent and afterward increased as high as 80 percent. This was at a time when the country was comparatively prosperous, and the normal tax was only one-half of what it is today. The bill which is now presented to your committee for consideration, in its method of grading the tax, has thrown aside the percentage of profits when compared to capital employed, and that is really the crux of an excess-profits tax and the only equitable base on which it could be applied. In addition to that, and this is the most extraordinary and inequitable feature of the whole tax bill, it has imposed a special 4.1-percent excess-profits tax levied on all income of corporations electing to follow the average-earnings method of determining excess profits.

Now there is another and most discordant feature of this tax bill, in my opinion, and that is the attempt to pass an appropriate defense measure so that there may be speedy execution of necessary contracts with munitions manufacturers, shipbuilders, and similar industries. In that respect the Ways and Means Committee has linked up and tarred with the same tax brush thousands of corporations not engaged in any business remotely connected with war. Presumably their idea is that they indirectly will get some profits out of war. This bill, of over 100 pages, in its present form is a monumental specimen of statutory incomprehensibility. [Laughter.]

Senator DAVIS. Say that again. It is what?

Mr. POWELL. It is a monumental specimen of statutory incomprehensibility and should be separated into two distinct parts, each of which should be taxed and treated differently; one dealing with corporations engaged in the munitions and kindred businesses, the other dealing with other forms of corporate business.

Senator CONNALLY. Why should there be? Suppose a man is making arms and munitions, there is no reason why he should be taxed differently for other business by reason of the state of preparedness for war, if his profits have increased. Every time you increase the employment in a factory do not immediately the merchants around the edge of the settlement have their business improved and they sell more stuff, or the moving-picture shows get more people that come to them, and the cigarette people sell more cigarettes? Is Mr. Williams here?

Mr. POWELL. Indirectly, Senator, they do, but there are two reasons for it. The first reason is that the Government wants to have it contracts speedily executed in connection with the munitions business.

Senator CONNALLY. Just leave that out. That has got nothing to do with the profit business.

Mr. POWELL. That is true. That is the reason why it should be separated. I think there should be more time for this committee to consider that provision.

Senator CONNALLY. I wish we had more time for all of us. I would love to have 25 or 30 years.

Mr. POWELL. In my humble opinion there should be more time.

Senator CONNALLY. I am agreeable with you on that. You are not in the business of making munitions or war supplies?

Mr. POWELL. No. As I say, I am chairman of the tax committee of an association of many thousands of manufacturers in New York who represent all lines of business, whether it be shoes, hats, optical goods, or anything else.

Besides the departure from the original measure of the subcommittee in taxing income on the dollar volume instead of in the proportion that the profits bear to the capital investment, and in fixing a so-called additional excess-profits tax of 4.1 percent by way of penalty on all corporations exercising the option of using prior profits as a base, there are other features of the bill that should be changed that I briefly want to refer to.

Briefly, the failure to give corporations the option to file consolidated returns. This was permitted under the former excess-profits tax bill in effect in 1917 and subsequent years.

The failure to provide for a wider and more flexible base in which to establish normal net profits, say 3 years out of 5 or 2 years out of 4. Business moves in cycles—in waves of depression or in waves of good business.

The failure to give effect to certain intangibles, such as built up but unrecorded goodwill shown by continued earnings.

The failure to make adequate provision in the bill itself for cases of unusual hardship. This was done under the former excess-profits tax law. I believe there is a regulatory provision in this bill, but it is so vague in its purposes that I am afraid it will not have the result that the provisions under the former excess-profits tax bill had, namely, section 327.

It has been said that the reason for applying the 4.1 additional so-called excess-profits tax was because the committee did not at first realize the amount of loss of income taxes from individuals failing to receive the income from dividends cut off by the imposition of the excess-profits tax. What then would be the effect of the punitive tax of 4.1 percent on the individual shareholders, many of them widows and orphans? It has been estimated in a recent statistical study that there are at least 11,000,000 shareholders in this country, more than one-half of whom participate in enterprises the largest in the country. The American Telephone & Telegraph Co. alone is said to have nearly 700,000 stockholders. But the excess-profits tax does not apply only to the large capitalized corporation. A Treasury Department study of 2,195 corporations whose average invested capital was less than $70,000 paid an excess-profits tax averaging 67 percent under the old excess-profits tax law. Somehow the idea seems to prevail that this is going to tax the larger corporations. Many of those larger corporations are overcapitalized; they represent a lot of watered capital. It is going to hurt a lot of smaller corporations, and therefore I give you these figures, which are made by the Treasury Department, so you will have an idea how it is going to affect the smaller corporations. These shareholders are not localized in New York State or in the East. They are widely scattered in the 48 States of the Union and the average shareholder holds less than 100 shares, and if these taxes are pyramided as goods are passed from manufacturer to dealer and from dealer to consumer the effect will be cumulative.

May I say in conclusion that the limitations in the proposed tax bill of what should be considered normal profit on ordinary industry are too narrow. These limitations on industry will make it more profitable for persons with small as well as with large incomes to invest in nontaxable securities.

Industry asks for fair and equitable taxation, and I feel reasonably sure that your committee will remove some of the inequities that I have pointed out to you. Corporate business has aided the country in every crisis. Industry was a major force in the Civil War and in the Great War. It is no less potent today.

The CHAIRMAN. Thank you.

Mr. Carroad.

STATEMENT OF KENNETH CARROAD, NEW YORK CITY, CHAIRMAN, EXCESS PROFITS TAX COMMITTEE, FEDERAL TAX FORUM

The CHAIRMAN. This is Mr. Kenneth Carroad, New York City, chairman of the excess profits tax committee, Federal Tax Forum.

Mr. CARROAD. I should like to explain that our Federal Tax Forum is composed wholly of technical tax-minded men. In other words, we are all tax people, either as accountants or lawyers, and much as it sounds incredible, we represent no one in particular. However, our members, of whom there are about 75, cover clients who have billions of dollars in assets and millions of dollars in income. We spent a great deal of time on this problem, some of us have been working for a long time on it, and we are here to present to you some 30 pages of technical material which I will not bore you with currently.

The CHAIRMAN. It can be put in the record.

Mr. CARROAD. Thank you very much. I would like to talk on about five or six points which we feel would simplify the bill. We should like to stress the following items, apart from our written report.

1. We believe corporate taxpayers should have a *permanent option*, even after filing the tax return, to pay the lower tax of the alternative methods. The present bill is so complicated that it would be unfair to penalize a mistaken choice, especially in cases where the Bureau may make drastic changes in the taxable income of various years in the base period or tax period. Such a permanent option would be a useful safeguard to smaller corporations whose knowledge of taxes may be limited.

2. *Relief and Hardship Board.*—The 1936–39 returns for a great many corporations have not been finally audited. This creates a difficult problem. By prolonging audits or by obtaining waivers to keep the "base" years open, the Bureau is given great latitude in determining the "average annual earnings" in the base period. Except for the years when the undistributed profits tax was in effect, it made hardly any difference whether an item of expense or income was accrued in one year rather than another. But now, the accrual of expense or income in the year 1939 rather than 1940 will create a prolific field of dispute. This is obvious from the fact that the same year of income in 1939 carries a tax rate of about 19 percent whereas in 1940 it may be subject to 20.9 percent plus 50 percent or a total of about 70 percent. Much as the Treasury strives to be fair to taxpayers in actual practice the Bureau of Internal Revenue necessarily is technical minded and wholly nonequitable in action.

There are many types of expense which relate to more than one fiscal year. Among them are research, advertising costs, legal and accounting expense, experimental or development costs, amortization items, installment selling expense, etc.

There is nothing in the present bill or prior laws which could permit the Board of Tax Appeals or any court to take a long-range vision or an over-all viewpoint on such items. Only by the creation of a "relief and hardship" board could such matters be handled fairly to all parties.

Likewise, such a board could handle the cases of "growth" companies whose "average annual earnings" in the base period are not really representative. So also, the feast-and-famine cases, the textile cases, the leather and hide cases, and so forth. It could also cover cases of corporations whose profits accrue several years after an intensive and expensive advertising or promotional campaign has been made. It could cover the long-term contract cases where one job lasts over several years. The revenue law already recognizes special treatment for such cases in section (19.42–4 of Regulations 104) 42 of title I, but only for normal corporate tax purposes.

It could also handle difficult cases arising out of the fact that a partnership or proprietorship was converted into a *corporation* during the *base* period. We are recommending that such a "successor" corporation should have a limited right to use the base period income of the prior partnership or individual business. But if this cannot be done, at least a "relief" board could temper the *strict law* with a touch of equity.

There are also many "reorganization" cases where the "invested capital" basis will be radically increased or decreased. The decision now depends whether a taxable or nontaxable reorganization was effected. The difference is hard to analyze and the cases go off on technical issues.

Finally, there are hundreds of unusual cases in which simple injustice can be avoided only by the invocation of a broad equity power in a "relief" board.

Incidentally, such a board should be wholly independent of the Treasury Department and the Treasury should not be permitted to select the personnel.

The new bill is really complex. It is full of tax jargon which requires hard and painful mental effort to understand. Some of us may believe it is needlessly complicated. But one thing is certain, unless a relief board is included, this tax will be unfair and discriminatory. How much more simple it would be to include such a board than to fill the statute with special exceptions and provisos.

We believe the excess-profits tax should be administratively simple, but it should also be fair and equitable to everyone. And we mean everyone. The tax rates are geared so high that Congress should be especially alert to provide a "tax equality" for all. This can only be done through an independent and equitable board of relief.

3. *Consolidated returns.*—We are sorry to read that lack of time prevented the Treasury from inclusion of the right to file consolidated returns. We believe that the Treasury is needlessly worried about the complexities of the subject. Under the old excess-profits tax we had consolidated returns and it worked out reasonably. We had consolidated returns up to 1934, and it also worked out fairly well. The 1921 and 1932 regulations could be used as a basis today without much change. Business methods have not changed so drastically since 1934. In addition, today, the Treasury has the invaluable aid of the S. E. C. and other agencies who have compiled much corporation data on a consolidated basis.

Furthermore, the year 1940 is admittedly an experimental year. After March 1941 the Treasury will know from actual tax returns what the dangers really are, if any, in using consolidated returns. If the dangers are too great, the next Congress can readily and easily repeal the "consolidated-return" sections of the law.

On the contrary, by leaving out consolidated returns, a positive injustice is being worked on thousands of corporations. We cannot believe that Congress will permit such a situation when tax rates can reach 70 percent of the income of a corporation—and without this country actually being at war. Let us remain democratic and equally fair to our minority groups whether they are big corporations or small businessmen.

We also wish to point out that innumerable tax-avoidance plans will be scotched if *you do include* consolidated returns. Even a tax beginner can see that the provisions about "borrowed invested capital" can be distorted by "friendly loans" or "paper" transactions between subsidiary corporations or between parent and subsidiary. Such unfair inflation of the "invested-capital" exemption can even be worked out by friendly creditors, and others. The restrictions as to "interest deductions" are no real barrier in this regard.

So also, most of the trouble about taxable and nontaxable reorganizations will obviously disappear if you permit consolidated returns. I am also sure that everyone except possibly the learned writers of supplements A and B (pp. 40 and 47) will heave a healthy sigh of relief to see eliminated these complicated sections of the new bill. For if you include consolidated returns, you can safely eliminate almost all of supplements A and B.

The problems about unrecognized gain or loss also disappear, almost completely, by permitting consolidated returns. The 1921 act is a workable model of simplicity in this connection.

4. *Personal Service Corporation.*—The new bill so defines personal service corporations as to eliminate the very ones whom section 723 was intended to help. If such a corporation has as a stockholder a "silent partner" or "inactive backer," it is no longer exempt, especially so since the bill excludes a corporation having any such "silent partner" who owns more than 20 percent of the value of all the stock.

This section is also defective because it fails to define how material or large *capital as an income-producing* factor must be to make a corporation ineligible. It may also be defective on possible constitutional grounds in requiring a stockholder to include as his own income that portion of the income which has been earned on stock belonging to his wife or children. The clarity and fairness of the Forum's recommendation as to personal-service corporations is in striking contrast with the present bill. We offer it for consideration.

5. *Rates of tax.*—We request that a review be made of the proposed rates of tax. The rates in the new bill seem very unfair and unbalanced: To tax corporate income on dollar volume instead of by percentages or by some ratio to normal profits seems very unskilled and unsound.

There are several other weaknesses and abnormalities in the new bill. We shall welcome any conference with the Treasury Department or others to set forth more detailed and more technical comments on a sound and fair excess-profits tax law.

I might say most of us feel this bill is pretty complicated. There are some features of the bill which we think can be eliminated; there are other parts of the bill which we consider should be amended by additions, and I will turn to those promptly.

I think the first important point is that the bill gives a taxpayer a series of options of various kinds, but nowhere in the bill is there any statement that the taxpayer may change his mind about the option when he finds, for example, that the invested capital method makes him pay more tax than the average annual earnings method. Our first suggestion, therefore, is that the bill should include a specific provision that a taxpayer does not lose his option simply because he has chosen one method rather than the other on his return. In other words, the option should be made a permanent election of the taxpayer and should not be lost simply because one method has been used on the return rather than another. I imagine that is the most striking defect with the bill.

I should also like to return to the problem of a relief board.

Most of us who have gone over the problem for some time now have come to the conclusion there are so many hardship cases, so many problems relating to the feast-and-famine corporations, to the textile industry and the personal-service corporations—there are problems relating to these "growing-trend" corporations, like Pepsi-Cola, which I think is a striking illustration of that kind—that some measure of relief is needed.

It seems to us if you want a workable bill, instead of using the Treasury model, which is so complex, why not simplify it and then put in a relief and hardship board? We believe a relief and hardship board, given wide administrative powers, a really judicial board independent of the Treasury, will take care of the bulk of your problems in this bill.

There is not any question about the fact that it would be impossible to write all the possible exceptions, provisos, and limitations that so many people are going to come here to tell you about. It just cannot be done. There are too many variegated and complicated types of business in this country to work out a bill other than by a simple provision which will delegate to this board all the powers necessary to decide these cases.

The CHAIRMAN. Don't you think the Commissioner of Internal Revenue is the proper person to function there?

Mr. CARROAD. I did not get that.

The CHAIRMAN. The Commissioner of Internal Revenue, under the 1921 act, was the one who was designated to take care of relief cases.

Mr. CARROAD. Yes, Senator Harrison, that is correct. However, we feel that that type of discretion should not be vested in a commissioner. It is perfectly obvious that the commissioner acts more as an official carrying out a mandamus. He has very little power or discretion. Since this bill assumes that our tax problems call for equitable solutions rather than technical legal solutions, the power should be vested in an independent tribunal.

We have a few thoughts about how that tribunal should be constituted. It should be made up of nine men and there will be three panels. In other words, the country should be divided into three zones and in each zone you would have three men sitting collectively as a board. On each one of these three regional boards, should be one man representing the Treasury Department, one man representing business, and one man to give you the so-called chairman or final arbiter. Most of us thought the last man ought to be selected by the Defense Advisory Commission.

Now, we are not proposing that the Defense Advisory Commission members sit on the board; they have other work to do, but the fact that this third man is appointed by the Defense Advisory Commission, is some proof that he will be impartial. Such a man will give our taxpayers a great deal of confidence in that board.

I might try to distinguish that type of board from boards that we have today, like the Processing Tax Board of Review. Everybody has been criticizing it for the last year or so. That Board was appointed wholly by the Secretary of the Treasury. Every member of that Board came from the Treasury Department; every member of that Board was a former assistant General Counsel, and whether a taxpayer is right or wrong about it, a great deal of opinion exists that those members on that Board could not be fair if they wanted to be. My own opinion is to the contrary. I think the Board has done remarkably well, it has shown much restraint and good judgment in some of its decisions, but be that as it may, this subject is too important to take a chance along similar lines.

The board ought to be independent, and I might say that all these problems should be referred completely to the board. I presume someone, either here or elsewhere, is sure to ask the question: What kind of cases will the board take jurisdiction of; what will they listen to and what will they not listen to? It seems to me that the board should have the right to listen to any kind of case. At the same time, we also feel if the board did not want to hear the case, after it was submitted to them in writing, just as is submitted a petition in writing to any court, that the board could dismiss it.

In other words, you should give them exclusive power to determine what cases they want to hear and what cases they do not want to hear. If you try to limit the board's power by law in the sense that they should listen only to "growing trend" cases, to personal service corporation cases, or to cases of corporations that have to pay 50 percent tax or more on their net income, or that kind of thing, that board will not function equitably.

I also would like to point out that some of the many problems on unrecognized gain or loss on which the Treasury has filed two supplements (supplements A and B), that they are rather complicated. I think a good portion of them could be eliminated.

I think also that many of the problems relating to taxable and nontaxable reorganizations can be eliminated, because those problems would go to the board. All of the Senators know quite well that the distinction between a taxable and nontaxable organization is sometimes nothing but a hair line. We have all kinds of conflicting decisions from our various courts, from the Board of Tax Appeals and from the circuit court of appeals on the subject. It is a complicated maze. Even a tax man who is well trained has plenty of trouble weaving in and out of those decisions to find out what they mean.

Those problems will be taken out of the bill for you and be turned over to some board who will be able to handle the situation.

Senator VANDENBERG. Is there anything in this law now comparable to the special relief section that was in the 1921 law?

Mr. CARROAD. Senator Vandenberg, I would say no, with one minor exception. There is a provision which was carried forward that if the Commissioner could not determine what your invested capital is, that he would come in and try to determine the invested capital himself. But that is only limited to those corporations where you cannot determine what the invested capital is—I mean for lack of records or a great many other reasons—which is probably not one-tenth of 1 percent of the difficult problems. The real problem is not with corporations who do not know what is their invested capital. Most of them know what their invested capital is or can come to it with reasonable accuracy; most of the corporations know what their average annual earnings may be; that is not any problem, either; the question is: How much tax should you pay after you get those figures, what is the fair or normal income, the base income?

Senator VANDENBERG. I understand under the 1921 law there was authority in the Commissioner, for instance, to adjust competitive situations. Is there anything like that in this law?

Mr. CARROAD. No, sir. That section, I think, could be used to some advantage, although personally most of us in our own group felt that the problem was too large for such a solution.

May I point out what Senator Vandenberg has in mind about the 1920 law? You understand that it was before my own time, but many of our members had much experience with it in 1921 and the predecessor acts. A provision was made that the Commissioner could give you relief if he found that other corporations similarly circumstanced were making more profits. Consequently the amount of tax that you had to pay was adjusted to conform to what other corporations were paying. Another way of putting it is that the Commissioner would attempt to get the average gross profit of the steel trade or the cosmetics trade or any other trade. Suppose the average comes to 17 percent. Then he might determine that for that year 17 percent was a fair return for the given taxpayer, and everything in excess of that he would have to pay an excess-profits tax. But today, I am inclined to believe that such a provision could not work out well, because although we talk about the steel business, there are probably about 300 or 400 varieties of steel business. In other words, there are direct and indirect suppliers of all types of iron and steel articles; there are steel-window manufacturers, there are people who make rods, fittings, and gadgets of all kinds, like the United States Steel, the Inland, the Bethlehem. In other words, it would be almost impossible to try to put one large corporation in one bracket, because it had so many different things that it was doing within one corporation.

I do feel, Senator, that the solution is more toward a board. Of course, I am a little bit early on the program here, but I think you will find many justifiable complaints coming forward to you—all kinds of complaints from people who will suffer. Mr. Short, I think, put the situation well for his type of people; and Mr. Cohen in talking about the textile group, I think his point was well taken. I represent over 150 textile corporations, and my own experience with them and with their income for many years, from studies I have made, makes me feel that the law would be very inequitable as it is presently worded. On the other hand, frankly, I do not know how you could write the law much differently.

Senator VANDENBERG. Let me ask you this question: Here are two steel corporations in Detroit with approximately the same capital, each doing the same business, each making precisely the same profit, yet under this bill one could have an option of an excess-profits tax that would run down to $37,000, and the other could not possibly get below $145,000.

Mr. CARROAD. That is perfectly true.

Senator VANDENBERG. And the claim is made that that immediately creates an arbitrary competitive situation. Now, as I understand it, that could have been equalized under the 1921 law. Is that correct?

Mr. CARROAD. I think so; yes. I might say your point is well taken.

Senator VANDENBERG. And it could not be equalized under this law as written.

Mr. CARROAD. Absolutely not. There is no possibility of it.

The CHAIRMAN. Have you a memorandum you want to put in the record?

Mr. CARROAD. Senator, I have a few more points I would like to cover.

The CHAIRMAN. I might say your time is up. You have taken 12 minutes.

Mr. CARROAD. I think I have some useful suggestions that I would like to cover.

The CHAIRMAN. I understand there are plenty of useful suggestions, but you were told you would have 10 minutes.

Mr. CARROAD. Senator, may I talk about one special problem, a new excess-profits-tax plan of our own? It will only take 2 minutes.

The CHAIRMAN. Two minutes, all right.

Mr. CARROAD. I have reference to a so-called twilight-zone tax proposal. This twilight-zone tax of our own would be substituted for the 4.1 percent tax that the Treasury Department has offered.

This twilight-zone plan gets its name, at least from me, because the uncertain zone in all of these excess-profits tax problems is the difference between the average annual earnings and your invested capital. Stating it in another way, most of the debate centers about the point whether the difference between "average annual earnings" and a fair return on invested capital (say 10 percent) should be taxable.

I would like to illustrate it in this way: On the invested capital basis, a corporation is limited to a return of 10 percent. However, if you take for example Coca-Cola, its average annual earnings may be about 100 percent on its invested capital for the base period. Now it is perfectly obvious that if Coca-Cola has been making about 100 percent on its invested capital for the last 6, 7, 8, or 10 years or for some such normal period, it would be wholly unfair to tax Coca-Cola or a similar company on everything which it earns over 10 percent on its own invested capital. Yet, this 4.1 percent plan of the Treasury Department is nothing but an attempt to tax that kind of corporation. You might consider this problem as illustrating the high twilight-zone problem—whether the average annual earnings is higher than 10 percent return on invested capital.

Now, let us turn to the low twilight-zone problem. In this group we have corporations whose average annual earnings for the base period is lower than 6 percent on invested capital. For example, let us assume that United States Steel has an average annual income of only 2 percent on invested capital for the base period, or even for the last 6 or 7 years prior to 1940. Now this present bill gives them the right to increase their income 300 percent without paying any excess-profits tax at all. I think many of us, whether rightly or wrongly, believe that this type of corporation is definitely increasing its profits out of the war situation. This is true of other steel companies and similar companies who are profiting from an increased industrial activity. This bill lets those corporations go free. I am not saying that they should pay a full excess-profits tax, but I do say that they ought to pay some tax. The tax I am proposing is the twilight-zone tax. I suggest that those corporations ought to pay a small tax of about 4 percent on the difference between their average annual income and 6 percent on invested capital. On everything over 6 percent they ought to pay the full excess-profits tax. Take the United States Steel case; let them pay 4 percent on the difference between their average annual earnings and 6 percent on their invested capital. On the other hand, let us take the Coca-Cola case. I say that the Coca-Cola corporation and similar companies should pay a twilight-zone tax of 4 percent as well, but only on the difference between 10 percent on invested capital, which the bill says is the top reasonable return, and up to 100 percent. On everything from 10 to 100 percent, they would pay the small twilight-zone tax. On everything over 100 percent—assuming that they made in 1940 about 130 percent—on the 30 percent let them pay the full excess-profits tax proposed by the bill.

Now you will find that this will be a fairer proposal; it will give you more revenue than the present Treasury plan; it will get you to corporations who really should pay some tax; and it will help to solve the difficult problem about the kind of tax to be put on those corporations who have never made even 6 percent on invested capital. Let us say that they have previously been making 1 percent, and now they are making six times as much income; should not they pay samething? The Treasury has not been able to work this out in their present bill.

The CHAIRMAN. I am sure the committee will give your memorandum consideration on that point.

Senator VANDENBERG. At this point may we have printed in the record for easy reference, section 327 and section 328 of the law of 1921, which bears upon the point I was discussing with the witness?

The CHAIRMAN. Without objection, that will be done.

(Sections 327 and 328 of Public, No. 98, 67th Cong., are as follows:)

SEC. 327. That in the following cases the tax shall be determined as provided in section 328:

(a) Where the Commissioner is unable to determine the invested capital as provided in section 326;

(b) In the case of a foreign corporation or of a corporation entitled to the benefits of section 262;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

SEC. 328. (a) That in the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

(c) The Commissioner shall keep a record of all cases in which the tax is determined in the manner prescribed in subdivision (a), containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, and the amount of invested capital as determined under such subdivision. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257.

(The report referred to by Mr. Carroad is as follows:)

FEDERAL TAX FORUM,
New York, N. Y., August 25, 1940.

REPORT OF THE EXCESS PROFITS TAX COMMITTEE

FEDERAL TAX FORUM

PREFACE

The purpose of this report is to submit to the membership of the forum certain recommendations with respect to the provisions of the proposed excess-profits-tax measure which, if approved by a majority of the members, will be urged upon the Congress in its consideration of the bill which is expected to be introduced shortly.

Because of practical considerations, these recommendations are set forth herein in as brief a form as possible, those receiving the approval of the membership to be amplified and explained to the extent believed necessary if and when presented to the Congress.

Following a general statement of principles, the recommendations in this report are divided into three parts:

I. General recommendations.

II. Specific recommendations.

III. Suggestions for alternative or optional plans (in lieu of the excess-profits tax).

References herein to the "Treasury plan" relate to the Subcommittee on Internal Revenue Taxation, Committee on Ways and Means, House of Representatives, the report of which, dated August 8, constituted the only authoritative statement available with respect to the plan of the proposed excess-profits-tax bill, when this report was written.

INTRODUCTION

The taxes payable under an excess-profits tax are necessarily geared to high rates. Therefore, any Excess Profits Tax Act should be thoroughly considered in order that as few people as possible be unjustly penalized thereby. Such a tax must be—

(a) Workable.

(b) Equitable.

(c) Adequate to raise needed revenue.

It is also self-evident that such a tax, being limited to corporations, should treat them as economic units. Therefore, at least for excess-profits-tax purposes, tax returns should be filed on a "consolidated return" basis. It must also be recognized that the pattern of industrial life in the United States is so variegated and complex that no excess-profits-tax bill can be wholly fair to all taxpayers. Thus it is a prime requisite that the bill should include a provision for the creation of a "Relief and Hardship" Board. It is also plain that such a Board must not be dominated or controlled by the Treasury Department, since the proposed Board should function as an equitable tribunal.

GENERAL RECOMMENDATIONS

1. It is essential that taxpayers be given an opportunity to attend hearings on the bill as it is finally worded, and not merely on a plan for a bill. The committee is united on the point that the essential fairness or inequity of any tax law is found in its precise wording; and a general statement or outline, in tax work, is inadequate for a proper study of so complex a subject. This recommendation is vital and paramount to all other matters.

2. The committee was wholly agreed that the special amortization bill of 1940 should be passed at once, so drafted as to be equally fair to all suppliers, including subcontractors and indirect suppliers. It should be completely separated from any proposed excess-profits tax bill. Defense needs dictate such a separation. At the same time, the interests of all corporate taxpayers must be safeguarded by permitting full discussion on an excess-profits tax.

3. Your committee was wholly agreed that consideration of the Vinson-Trammell Act should also be completely separated from any excess-profits tax law for similar reasons.

4. Your committee has considered the following alternative proposals but is making no recommendations except that each of such proposals has some merit and is offered to the Forum for further comment:

(a) Colonel Dewey's proposal.

(b) The Knowles' plan.

(c) Stop-gap plan.

(d) The "twilight zone" excess-profits tax plan.

In order to avoid a diffuse report these four proposals are set forth in detail in a supplement. It will repay the reader to study these alternative plans.

SPECIFIC RECOMMENDATIONS

(This section of the report is confined to proposed changes in, or criticisms of the Treasury plan for a proposed excess profits tax bill. This part of the report has been deemed to be the most important work of the committee because of the probability of enactment into law of the main body of the Treasury plan.)

A. Consolidated returns

The inclusion of the right to file "consolidated returns" by corporate taxpayers is considered by your committee as the major omission from the Treasury plan. However, the mere right to file "consolidated returns" will prove to be an empty or illusory benefit unless the section of the law dealing with "consolidated returns" fairly covers the following points:

a. The principle of consolidation should include all domestic subsidiaries of a domestic or foreign parent but exclude all foreign corporations (whether foreign parent or foreign subsidiaries).

b. Exclusion of "personal holding companies" from a "consolidated return" basis is recommended by a majority of the committee.

c. The filing of a consolidated return should be made mandatory, in the opinion of your committee.

d. Your committee was not agreed on the amount of control which would permit or require affiliation. The leading views are set forth below:

(1) Consolidation to be allowed and required (in the committee's opinion) only where a parent owns more than 50 percent of the voting control.

(2) Consolidation to be required only where a parent owns 80 percent or more of the voting stock.

(3) Same as above, but if stock ownership is less than 80 percent but more than 50 percent, the taxpayer should have the option of including a subsidiary over which it exercises working control.

(*a*) Some of the committee believed that permissive affiliation should be limited only to those cases where control was equal to 50 percent or more of stock ownership.

(*b*) Another view among the committee was that any working control, even less than 50 percent would entitle a taxpayer to include such a controlled subsidiary in its consolidated return.

e. The entire committee was agreed that if a taxpayer included a subsidiary in its consolidated return, all of the income of such subsidiary would have to be reflected in such return, even though the parent owned less than 100 percent of the stock.

f. The Treasury plan contains a proposal allowing every corporation an exemption of $5,000. Your committee was of the opinion that the right to file a consolidated return was sufficiently a privilege, so that the entire consolidated group should have only a $5,000 exemption, exactly like any individual corporate taxpayer.

g. If a parent lost voting control or the requisite ownership which is needed for affiliaiton, then such subsidiary would be excluded in the taxable year. At the same time, the committee strongly recommends that the base period be appropriately adjusted. However, your committee recognizes that the extent of such adjustment may be difficult to determine; hence such disputes might be referred to the relief and hardship board.

h. In conclusion, your committee stresses the advantage that the right to file a consolidated return will eliminate many inequities, abuses, and tax avoidance plans. For example, borrowed invested capital, as described by the Treasury plan offers many loopholes for tax avoidance if separate returns are required. Obviously an increase or decrease in borrowed invested capital is not difficult to arrange among affiliated subsidiary or otherwise related corporations.

Likewise, many difficult problems as to taxable and nontaxable reorganizations, mergers or liquidations (in whole or part) will disappear if consolidated returns are permitted. So also, much of the work of a relief and hardship board would be obviated if consolidated returns were permitted.

The need for a fair and equitable tax law is more important than the loss in revenue which might result. Your committee recommends that the need for consolidated returns is so great that an increase in excess-profits-tax rates (to offset possible loss of revenue) would be preferable.

NOTE.—Because of the prevailing illusion that it is impossible to draft a workable consolidated return amendment to the law, it has been deemed advisable to include a short draft of such a provision. Combined with the Treasury regulations which governed consolidated returns prior to 1934, we believe the principal objections to consolidated returns are thus fully overcome.

B. *Definition of invested capital*

Second in importance is the necessity for a definition or determination of invested capital to be submitted by the Treasury Department. Your committee believes that discussion or criticism of the Treasury plan is almost pointless, unless a specific definition of invested capital is submitted. Since the nub of any excess-profits tax is invested capital, it seems plain that the Treasury should currently submit a detailed statement indicating exactly what is includible in its concept of "invested capital," how it defines "property paid in," and how it treats "Treasury stock" and gain or loss from transactions therein.

C. *Deficits as an offset to invested capital*

It is recommended that accumulated deficits in earnings and profits should be ignored in determining invested capital. In brief, your committee believes that an accumulated deficit should not be used to reduce invested capital. This concept of a minimum invested capital will be a useful safeguard to taxpayers, who will thus know that the invested capital which was originally put into a corporation (less withdrawals) will become the "floor" or minimum upon which figure it can safely rely in determining corporate policies.

D. *Profit deficiencies*

Your committee offers for discussion an interesting proposal that a taxpayer be permitted to carry forward (against excess-profits-tax income) in a future year that amount by which the net income was less than the normal or exempt earnings.

(ILLUSTRATION.—Assume that a corporation has normal or exempt earnings of $100,000, as determined by its base period figures. Assume that in 1941 its net income was only $85,000. Under this proposal, since the net income was less than the normal profit by $15,000, the $15,000 would be a carry-over to 1942. Hence, if the taxpayer earned $160,000 in 1942, its excess income of $60,000 would be offset by a profit deficiency credit of $15,000. Thus, it would pay an excess-profits tax on only $45,000.)

E. *Capital gains and losses*

Your committee concurs in the proposal that long-term gains and losses should be excluded in determining income for excess-profits-tax purposes (in the base period as well as the taxable year).

F. *Short-term gains and losses*

However, your committee was in dispute whether short-term gains and losses should be similarly treated. The majority view is that the normal corporate tax rules should prevail.

However, certain alternative proposals were made as follows:

(1) That statutory net income be used in determining average annual earnings. This suggestion was made because of its simplicity.

(2) On the other hand, it was suggested that all abnormal additions or deductions be excluded in determining average annual earnings. Such abnormal items would include—

(*a*) Unexpected recoveries of bad debts.

(*b*) Large refunds of various excise taxes or duties.

(*c*) Cancelation of indebtedness, etc.

(*d*) Destruction or abandonment of property as well as capital gains and losses on depreciable assets.

In essence, this suggestion is an attempt to determine the true operating income of a taxpayer. Although desirable in theory, the inclusion or exclusion of such items would probably raise innumerable conflicts between the Treasury and taxpayers.

G. *Borrowed invested capital*

A suggestion was made that borrowed invested capital be wholly eliminated as a factor in determining invested capital. Some committee members thought that the interest restrictions almost wholly outweigh any advantage which a taxpayer could obtain from including borrowed invested capital. So also, the cost of borrowed money varies so widely especially in comparing big with little corporations that the Treasury plan was deemed inequitable.

The suggestion was made that the taxpayer be given an option to exclude borrowed invested capital.

A third suggestion was that borrowed invested capital be allowed in full as an addition to invested capital; but the taxpayer would be prohibited from deducting all interest in computing excess-profits-tax net income.

(At this point it is useful to note that the lack of a specific bill made it impossible for the committee to determine whether the Treasury plan requires a taxpayer to include borrowed invested capital or whether the Treasury plan makes this optional with the taxpayer. Obviously, in many cases, if borrowed invested capital is required, it will increase the excess-profits taxes payable, rather than decrease the amount of tax.)

H. *Average invested capital*

The Treasury plan failed to define the treatment of invested capital changes during a taxable year. There is set forth below a proposed statement as to average invested capital which is deemed to be fair to taxpayers and to the Treasury.

Changes in invested capital during year.—In the interest of simplicity, your committee recommends that the bill provide substantially as follows:

"Only the following changes occurring after the beginning of the year are to be taken into account in computing invested capital, prorated for the number of days in effect:

(1) Cash paid in for stock or as a contribution to capital.

(2) Property paid in for stock or as a contribution to capital, in an amount equal to its statutory basis in the hands of the taxpayer as of the date so received.

(3) Withdrawals of capital or accumulated surplus (but not dividends to the extent that they are paid out of total earnings and profits of the taxable year).

(4) Changes in the amount of inadmissable assets owned.

(5) Changes in the amount of indebtedness coming within the definition of borrowed invested capital, the average amount of which, for the entire year, then to be subject to the percentage limitations provided in the bill (if borrowed invested capital is retained in the final bill).

(6) Increases or decreases in capital surplus arising from transactions in Treasury stock or in the retirement of stock.

I. *Inadmissible assets*

The Treasury plan is again rather vague in defining "inadmissible assets," especially with respect to Government obligations. In any event, only those Government obligations, the interest on which is wholly tax exempt, should be treated as inadmissible assets. There are many types of Government obligations the interest on which is not deducted in arriving at net income, and it would be unfair to exclude such securities in determining invested capital.

J. *No-Tax-Benefit Theory*

The committee favored the view that the no-tax-benefit theory be recognized by the Treasury in adjusting invested capital. However, since this subject is somewhat intricate, the committee confined itself in this report to the following illustration of an important principle in taxation. For example, where a corporation has claimed an excessive amount of depreciation in a prior loss year, and has had no tax benefit from the excess amount over the allowable depreciation, such excess should be eliminated in arriving at the accumulated profits or earnings in the computation of invested capital.

K. *Invested capital as fixed by 1921 return*

It was suggested that taxpayers be given the option to use, as a starting point, the invested-capital basis, as determined by the final audit of their 1921 tax return by the Commissioner of Internal Revenue. This might help to narrow the field of dispute over equity-invested capital. (However, some committee members pointed out that many taxpayers might have agreed to revisions in their 1921 tax returns, only to compromise an old liability or end a protracted contest; therefore, it would be wholly unfair to make the invested-capital basis in the 1921 return a mandatory starting point.)

L. *Determination of the base period*

The committee gave much thought to all kinds of proposals for determining which years in the base period should be included. The problem revolves around the fact that many taxpayers suffered losses in one or more of the 4-year base period from 1936 through 1939.

The divergent views of the committee members make it impossible to offer a final recommendation, but certain points are worth mention.

1. The committee agreed that all the base years should be consecutive, on the ground that net income was closely identified with inventories, seasonal factors, etc.

2. It was suggested that 1 loss year be counted as zero in determining average annual earnings, but the total income for the base period should be divided by 4 to obtain an average. (This is supposed to be the latest subcommittee plan.)

3. It was also suggested that loss years be disregarded completely; hence if a taxpayer had 2 loss years and 2 profit years, his average annual earnings would be the sum of the 2 profit years, divisible by 2 instead of by 4.

4. It was suggested that a taxpayer be permitted to take any 4 consecutive years from 1930 through 1939, if the normal base period (from 1936 through 1939) included loss years.

5. It was suggested that a taxpayer be allowed to take the last 4 profit years, working back from 1939, but ending with 1930. (However, this election violates the consecutive-year rule.)

6. Your committee believes that each suggestion has some merit but also is accompanied by inequitable features. Therefore, the committee neither approves nor disapproves of any of the above suggestions.

M. *Financial corporations*

Your committee recommends that certain classes of financial corporations such as insurance companies, certain investment companies, and corporations whose principal activities consist in investing and reinvesting in securities should be separately treated for excess-profits-tax purposes. The form of such separate treatment is a subject in itself. One suggestion was that the normal corporate-tax rates on such corporations be increased and that they be otherwise exempt from excess-profits taxation. Another suggestion was their complete exemption from excess-profits taxes.

There are so many problems and features about these financial corporations which distinguish them from the usual industrial, commercial, merchandising, or business corporation that separate treatment seems not only advisable but would have an indirect advantage in helping to simplify the excess-profits-tax law itself (by eliminating the need for too many exceptions). It is suggested that corporations 50 percent or more of whose assets consist of cash, securities, or stock be treated as such a financial corporation.

N. *Treasury stock*

Your committee is of the opinion that the subject of Treasury stock in determining invested capital is a special and important subject. It suffices here to state that the Treasury Department should be requested to state in some detail its proposed treatment of Treasury stock in defining invested capital. (This is still another illustration of the important fact that a detailed discussion of the Treasury plan is made difficult in the absence of specific provisions. In view of the innumerable ambiguities in the Treasury plan, it is hard to offer precise criticism of defects in the plan.)

The two principal queries as to "Treasury" stock are:

1. Does the increase or decrease in assets from transactions in the purchase and sale of "Treasury" stock change the "capital surplus" or "surplus" accounts or
2. Should it be reflected as an "income" item?

O. *New corporations*

It was recommended that any corporation formed prior to the Munich incident, about September 1, 1938, be permitted to use "average annual earnings" as an alternative basis. The Treasury proposal requires all corporations which were not in business during all of the base period to determine their tax only on an "invested capital" basis. However, your committee thought that if a new corporation had at least 2 years in its base period, it should be given option to use "average annual earnings" for the portion of the base period during which it was in business. (Ordinarily, newly formed corporations do not enjoy large profits in the first few years; therefore, any possible loss in revenue would be very small and would be more than offset by the right of such new corporations to have an option like older corporations.)

P. *Corporations formed after September 1, 1938*

Your committee recommends that the Treasury proposal for treatment of such new corporations be amended. The Treasury plan requires such new corporations to use invested capital alone as a basis. The committee recognizes that "average annual earnings," as an alternative, is inapplicable in such cases.

However, it was suggested that all corporations formed after September 1, 1938 be given the option to be taxed as "personal service corporations." It will be recalled that the Treasury bill exempts such corporations from excess profits taxes if all of the net income is treated by all stockholders as taxable to the stockholders for normal and surtax purposes. (Your committee recommends this option even in cases where capital may be a material income-producing factor.)

Q. *Repeal of capital-stock tax*

Your committee hesitates to recommend the repeal of the capital-stock tax and its accompanying excess-profits tax, because it is recognized that the loss in revenue may be so large. But the committee stresses the point that the capital-stock tax and the excess-profits tax are illogical and inconsistent features in a tax system which includes an excess-profits tax of the kind proposed by the Treasury Department.

R. *Recognition of accounting standards*

The committee recommends the adoption of the following provision:

"Generally recognized principles of accounting are to be followed in determining what is gross and net income and the year of its realization, and what constitutes paid-in capital and earned surplus except to the extent, if any, that such determination be clearly contrary to specific provisions of statute, or established court precedents."

S. *Relief and hardship board*

Your committee considers that an excess-profits tax law which does not set up a "relief and hardship" board is fatally defective and becomes inequitable to many taxpayers for all of whose special problems it is impossible to provide in advance. The board should be independent of the Treasury Department. It is suggested that nominees of the Defense Advisory Commission be appointed to each section or panel of the board. It is recommended that at least three regional panels be named to cover the country. It is further recommended that one-man panels be prohibited.

T. *Extractive industries*

The committee recommends some special relief for the extractive or mining industries. The extraction of many minerals or metals which have been defined as "essential" for defense purposes may conceivably be inhibited if such operations are subjected to heavy taxation. The Canadian system was discussed by the committee, but without approval or disapproval. (In Canada, any increase in the annual quantity of units extracted, results in a corresponding increase in the amount of excess-profits-tax exemption.)

U. *Mitigation of statute of limitations*

Section 3801 of the Internal Revenue Code should be extended to cover those cases where the Treasury Department now disallows a loss on the ground that it should have been taken in an earlier year, where in such earlier year the Treasury had then ruled that the los shad not yet been realized. Section 3801 should be clearly defined, as well, so as to apply to excess-profits taxes.

V. *Rate differentials in favor of new corporations*

The higher yields allowed on invested capital to new corporations is approved (in order to encourage new capital ventures) provided that the new corporation does not in fact represent a factual continuation of a preexisting business.

W. *Invested capital—Valuation of assets*

The Treasury bill should provide that the amount to be included in invested capital on account of property paid in for stock or as a contribution to capital, is the adjusted basis of the property in the hands of the taxpayer as of the date so acquired by it.

X. *Deduction of corporate surtaxes*

In computing excess-profits-tax net income for the taxable year, a deduction should be allowed for all corporate surtaxes as well as for normal corporate-income taxes.

Y. *Unrecognized gain or loss under chapter 1 of the internal revenue code*

Attention is invited to page 14 of the House Ways and Means subcommittee report. It will be noted that the Treasury plan recommends a clarification of the normal corporate-tax law so that unrecognized gain or loss with respect to liquidated subsidiaries properly be reflected in the earnings or profits account of the parent corporation.

This is a very serious and complex matter. While your committee agrees in principle with the Treasury proposal, it is also clear that the specific wording of such a new section might be utterly unfair to all or many taxpayers. Here again, it is not possible to give a precise opinion because the Treasury proposal is so vague.

In defining invested capital it is urged that earnings or profits should include the amount of the earnings or profits of a predecessor company under a reorganization merger or liquidation, which was a tax-free transaction, effective for the year in which it occurred.

Likewise, where a parent company acquires the assets of a subsidiary in a tax-free liquidation under section 112 b (6), the parent should be privileged to include all the earnings or profits of the subsidiary as an integral part of its base period earnings. Section 112 b (6) provides that the assets acquired by a parent upon liquidation of a subsidiary results in no recognized gain or loss for tax purposes.

Your committee refers to a related problem, the solution for which would appear to be by vesting control or discretion to settle such cases in a relief and hardship board. For technical reasons the courts or the Bureau have held seemingly nontaxable liquidations or reorganizations to be taxable transactions. As a result, the transferee obtained a new or statutory basis thereby. It is probable that many taxpayers will be inequitably affected if required to use such statutory basis in determining their invested capital. It will be only through equitable adjustment by an independent board that such hardships can be corrected, if at all.

Collateral problems appear where a nontaxable liquidation or reorganization was effected in the years 1936 through 1939 by creating a new corporation to succeed to an old or a group of old corporations. The status of such new corporation is left in doubt, especially insofar as the average annual earnings method is concerned.

Z. *Effect of tax deduction on the computation of average annual earnings*

Your committee discussed, but without final decision, the advisability of disregarding all income and other taxes on corporate income in computing average annual earnings as the basis against which to measure net income in the taxable year. Theoretically and logically such corporate income and surtaxes should be disregarded in the base period and in the tax period. (Please note that your committee is not referring to the deduction for normal corporate taxes and surtaxes prior to computing the amount of income subject to excess profits tax. Reference is made only to a uniform yardstick to be used in the base period and the tax period in arriving at the extent of the exempt income.)

AA. *Credits for dividends received and dividends paid*

Special attention is directed to the fact that dividends received income, and a credit for dividends paid, have been the subject matter of diverse treatment in the revenue acts applicable to the years 1936, 1937, 1938, and 1939.

The Treasury plan exempts dividends received income in full only under the invested capital basis. Therefore, if a corporation elects the use of the average annual earnings basis, the law should be carefully worded so that such dividends received income is not taxed twice for excess-profits tax purposes. Assume that Corporation B owns some common stock of Corporation A; if Corporation B receives dividends on its "A" stock, it seems that Corporation B might have to pay excess-profits taxes on 15 percent of the dividend income obtained from Corporation A even though Corporation A may have paid a full excess-profits tax thereon, prior to declaring and paying a dividend.

BB. *Personal service corporations*

The Treasury requirements as to such corporations seem overly drastic. In a great many service corporations a good portion of the common stock (up to

50 percent) is owned by a silent partner. Therefore the requirements should be broadened as follows:

(*a*) That capital should not be the material income-producing factor.

(*b*) That inactive stockholders do not disqualify a service corporation if they number less than five and collectively own no more than 50 percent of the voting stock.

(*c*) That the principal source of income of the corporation be truly from personal services or certain occupational activities such as advertising, investment counseling, selling, or purchasing agencies, brokerage work, etc.

In conclusion, your committee has agreed that the present Treasury plan will produce insufficient revenue to meet any material part of the cost of defense. Your committee believes that the Treasury proposal should be wholly divorced from any political flavor. The tax should be a real revenue-producing bill and should be fair as it is humanly possible to make it. In so devising this tax, your committee believes that unjust leniency in favor of special classes of taxpayers is as undesirable as unduly harsh treatment of other groups of taxpayers.

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PROPOSED DRAFT OF SECTION OF LAW PERMITTING THE FILING OF CONSOLIDATED RETURNS

(*a*) An affiliated group of corporations shall, subject to the provisions of this section, have the option of making a consolidated return for each of the taxable years in which this excess-profits tax is in effect, in lieu of separate returns. The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to all the regulations under subsection (*b*); and the filing of a consolidated return shall be considered as such consent and as the exercise of such option. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group. A consolidated return shall be made only for the domestic corporations within the affiliated group.

(*b*) The Commissioner, with the approval of the Secretary of the Treasury, shall prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined, computed, assessed, collected, and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability.

(*c*) In any case in which a consolidated return is made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (*b*) (or in case such regulations are not prescribed prior to the making of the return, then tentatively in accordance with sound accounting principles until regulations have been prescribed).

(*d*) As used in this section, an "affiliated group" means one or more chains of corporations connected through voting stock ownership with a common parent corporation if—

(1) At least 50 percent of the voting stock of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations; and

(2) The common parent corporation owns directly at least 50 percent of the voting stock of at least one of the other corporations.

In any case in which a consolidated return is filed for excess-profits tax purposes for any taxable year, the determination of "average annual earnings" and "invested capital" for the base period years (1936, 1937, 1938, and 1939) shall be made as if the members of the affiliated group had been thus affiliated in the same relationship as existed for the taxable year. The Commissioner, with the approval of the Secretary of the Treasury, shall prescribe such reasonable regulations as he may deem necessary fairly to effectuate the purposes of this section.

NOTE.—The accumulated experience of the Commissioner's office in handling consolidated returns up to 1934 as to all corporations and subsequently as to railroads should be utilized in rephrasing the few parts of the regulations which might need revision.

SUPPLEMENT ON ALTERNATIVE PROPOSALS

First. Colonel Dewey's proposal which suggests that no excess-profits tax be levied upon any corporation which distributes to its stockholders as a dividend, all of its excess earnings together with two-thirds of its "normal" earnings. Through such a distribution, a corporation would "relieve" itself from liability for any excess-profits tax.

Second. The Knowles proposal which is similar to the Dewey plan, but required a corporation to distribute at least 60 percent of its annual profit to stockholders, or else be subject to excess-profits tax. It will be noted that both the Dewey plan and the Knowles plan assume the existence of an excess-profits tax or a penalty tax which would be an alternative tax if a corporation failed to distribute sufficient earnings to stockholders as dividends. It is worth while to note that under the Knowles and Dewey proposals, section 102 of the revenue act might become unnecessary. (Section 102 relates to the tax on unreasonable accumulation of surplus.) However, since section 102 is part of the permanent revenue laws, it was not deemed useful to discuss further the suspension of this section.

Third. The third proposal was discussed fully at the August 15, 1940, meeting of the forum. This plan is the so-called stopgap proposal. It suggested that no excess-profits tax bill be adopted by Congress until after the Presidential election of 1940, thus removing the excess-profits tax as a political issue. As a stopgap, it was suggested that the normal corporate tax rate be temporarily increased by 2 or 3 percent and that this temporary tax be automatically annulled upon the enactment of a complete excess-profits tax bill in the spring of 1941. This proposal also included the immediate enactment of the amortization bill; and further included a proviso that if the Vinson-Trammel Act were suspended or repealed, it should be made retroactive to cover all 1940 transactions.

THE TWILIGHT ZONE EXCESS-PROFITS TAX PROPOSAL

The fourth plan has been offered by Kenneth Carroad, in an effort to reconcile the leading theories in a compromise tax. The theories in question are:

(1) A tax based on invested capital only.

(2) A tax based on average annual earnings.

(3) A tax based on the ability to pay.

(*a*) Ability to pay being measured by ratio of earnings to capital; (*b*) or based on bigness (a graduated tax rate which would tax a corporation earning $1,000,000, but at a higher rate than a corporation earning $100,000, but at a lower rate than a corporation earning $10,000,000; (*c*) or based on heavy taxation on the excess over reasonable return.

All these theories have a common weakness—how to determine what is normal income; or what is a reasonable return; even the Treasury plan is fatally defective in this sense. It uses alternative yardsticks which are so far apart that few taxpayers will have any material tax to pay. In fact the estimated revenue is so small that the common opinion among tax men is the replacement of this tax by a stiffer tax after January 1941.

The flexibility of the twilight-zone plan is plain. If more revenue is needed for defense or war, it is fairer and simpler to obtain such extra money by raising the rates. But the Treasury plan is defective in this respect because a sharp increase in rates, on the present framework, will not increase the revenue materially. Therefore, to raise more money under the Treasury plan (as seems almost a certainty in the future) it will be necessary to take away the option from taxpayers or to limit the exempt income by arbitrary methods. This would require a structural change in the Treasury plan.

Under the twilight-zone proposal, most taxpayers pay somewhat more tax immediately; but the plan is permanent and reasonably fair; it will not be distorted in structure, if more taxes must be raised in the future.

THE PROPOSAL

(1) Every corporation must determine its invested capital in the base period, and also its average annual earnings in the base period.

(2) The amount of net income for the taxable year is determined.

(3) A reasonable return on invested capital will be fixed for normal corporations at between 6 and 10 percent. Naturally, three possible situations can result, and only three.

In terms of invested capital—

(a) The average annual earnings can be less than 6 percent on invested capital;

(b) The average annual earnings can be more than 10 percent on invested capital;

(c) The average annual earnings can be between 6 and 10 percent on invested capital.

(A) It is proposed to create a low twilight zone for the first group, where average annual earnings are less than 6 percent on invested capital. On the twilight-zone income the taxpayer would pay only 4 percent or so in excess tax. On the balance, it would pay the full tax. In other words, on the twilight-zone income, it will pay a reduced or very small tax, because it is doubtful if such income should be subject to tax. But on the income which exceeds average annual earnings there is a strong presumption that such profits are truly excess and should be subject to full excess-tax rates.

Illustration: Assume that corporation A has 1941 profits of $1,000,000.

(1) Its average annual earnings are $120,000 or 2 percent of—

(2) Its invested capital, which is $6,000,000.

(3) The minimum return of 6 percent on $6,000,000 is $360,000. The twilight zone is between 2 and 6 percent, or a zone of $240,000.

Computing the tax: First $120,000 is wholly exempt from tax (first 2 percent on invested capital); next $240,000 is taxable at the twilight-zone rate of 4 percent (the twilight zone is the difference between average annual earnings of 2 percent on invested capital and 6 percent minimum return on invested capital); the balance, or $640,000 is taxable at the full excess tax rate.

(B) The second group is the high twilight zone where the average annual earnings are greater than 10 percent of invested capital. Assuming that the average annual earnings are 42 percent, the taxpayer would pay a twilight-zone tax of 4 percent on the profit which fell between 10 and 42 percent. On the excess income over 42 percent, the full excess-profits tax would be payable.

Illustration: Assume that corporation B has 1941 profits of $700,000.

(1) Its average annual earnings base is $420,000.

(2) Its invested capital is $1,000,000.

(3) The maximum reasonable return is 10 percent and so the first $100,000 out of the $700,000 is wholly exempt from tax. The twilight zone income is from $100,000 to $420,000 or a zone of $320,000. The remaining income ($700,000 less $42,000) or $260,000 is subject to the full excess-profits tax.

Computation of tax: First $100,000 is wholly exempt from tax, next $320,000 (twilight zone) at 4 percent tax; balance $260,000 (full tax).

(C) The third and final group is the class of taxpayers whose average annual earnings is more than 6 percent but less than 10 percent. In this group, the taxpayer pays no twilight-zone tax, but is permitted to use the average annual earnings percentage. On all profit in excess thereof, it pays the full excess-profits tax rates.

Illustration: Corporation C has profit in 1941 of $500,000.

(1) Its average annual earnings is $300,000, or 7½ percent on—

(2) Its invested capital which is $4,000,000.

(3) Since its average annual earnings is more than 6 percent but less than 10 percent of invested capital, the base earnings exemption is $300,000.

Therefore the taxpayer pays a full excess-profits tax on everything in excess of $300,000 or on $100,000 of income.

It is also suggested that the excess-profits tax rates be changed as follows: Take the average annual earnings or 6 percent of invested capital, whichever is higher. Income in excess of this base is taxable as follows:

One-half of the base is taxable at 20-percent-tax rate, next one-half of the base is taxable at 40 percent tax rate. Everything which is in excess of double the base is taxed at 60 percent.

But in no event shall the entire excess-profits tax exceed 40 percent of all excess income for the year.

Illustration: Suppose corporation D has profit in 1941 of $3,000,000.

(1) Assume that its base is $700,000, which is its average annual earnings.

Tax computation:

Total income for year	$3,000,000
Deduct base	700,000
Excess profits taxable income	2,300,000
50 percent of base or $350,000 is taxable at 20 percent	70,000
Next 50 percent of base or $350,000 is taxable at 40 percent	140,000
Excess over double the base ($2,000,000 less $1,400,000 or $1,600,000) at 60 percent	960,000
Total excess-profits tax	1,170,000

Let us further assume that the same corporation had an invested capital of $6,000,000. Therefore it would be entitled to 10 percent thereof or $600,000 free from any tax. The difference between its average annual earnings of $700,000 and the exemption of $600,000 is $100,000. This amount of $100,000 is subject to the twilight-zone tax of 4 percent, or a tax of $4,000. Therefore the total tax would be $1,174,000. Since this tax is greater than 40 percent of $2,300,000 the final excess-profits tax is 40 percent of $2,300,000 or $920,000.

Illustration No. 2:

Assume corporation E has net profit (after deducting normal tax) of $1,200,000.

(1) Its invested capital is $5,000,000.

(2) Its average annual earnings is $750,000.

Tax computation:

Total income	$1,200,000
Less exemption of 10 percent on $5,000,000	500,000
Balance	700,000
Twilight-zone income (average annual earnings of $750,000 less maximum reasonable return or $500,000)	250,000
Twilight zone tax rate of 4 percent thereon or	10,000
Balance subject to full tax or	450,000
50 percent of base ($750,000) or $375,000 is taxable at 20 percent or	75,000
Balance ($450,000 less $375,000) or $75,000 is taxable at 40 percent or	30,000
Total tax	115,000

FINAL COMMENT

It is proposed that all the recommendations of the forum be embodied in this proposal insofar as they relate to—

(1) Consolidated returns, and the principles of affiliation.

(2) Determination of invested capital.

(3) Abandonment of borrowed invested capital concept.

(4) Selection of the base years to determine average annual earnings.

(5) Appointment of relief-and-hardship board.

(6) Average invested capital.

(7) Admissible assets.

(8) Accumulated deficits not to reduce invested capital below the original capital.

(9) Exclusion of capital gains or losses, etc.

In other words, the "twilight zone tax" proposal is suggested as the structure about which a good bill should be drawn. The detailed items in the forum report relate to the definition or delimitation of the taxable income, the base income, etc. The combination of the two, it is respectfully submitted, make up an equitable, fair, and workable excess-profits tax, which will raise much more revenue than the Treasury plan.

The CHAIRMAN. Is Mr. Walter A. Cooper here? Mr. Cooper of New York City, chairman of the Committee on Federal Taxation, American Institute of Accountants.

STATEMENT OF WALTER A. COOPER, NEW YORK CITY, CHAIRMAN, COMMITTEE ON FEDERAL TAXATION, AMERICAN INSTITUTE OF ACCOUNTANTS

The CHAIRMAN. You have a brief that you will file?

Mr. COOPER. I have, sir.

My name is Walter A. Cooper, of Scarsdale, N. Y., appearing for the American Institute of Accountants, not representing any taxpayer at all. As a matter of fact, the worse you make it the better it is for us. [Laughter.]

We are here to try to give you our views on this law.

Senator GEORGE. It is a pretty good bill, then, is it not?

Mr. COOPER. Yes, sir; from that point it is. We do have 18 specific recommendations, of which I would like to take up a half dozen at this time.

The first one is, we do not believe the excess profits tax law should be rushed through now and made retroactive. It is intended, as we understand it, to be directed at excess profits growing out of the war business program, yet it is perfectly obvious, the way the program is going, that profits to be taxed will not be realized until next year. You are rushing through a bill with many complications that no one yet understands fully.

Senator DAVIS. What page are you reading from?

Mr. COOPER. I am not reading at all, I am just discussing what is in here in more specific terms.

Just to illustrate the retroactive features, how this is going to affect some taxpayers, I am going to give you just one case. It is the case of a corporation engaged in the contracting business in Florida. In 1936 and 1937 it realized no profits because it had little work. In 1938 it got busy on a long-term contract that was completed in January of this year. It reports on a long-term contract basis, so it figured no profit until the contract was ended. That was 1940. So it has no income in 1938, or 1939, either, for tax purposes. Although actually this profit of $150,000-odd realized in 1940 is the result of work in 1938 and 1939, it has very little capital, because, as a matter of fact, it is insolvent and its creditors have been carrying it. It started with a small capital and built that up through earnings, had some bad contracts during the depression period, and lost its accumulated capital. So now on this profit of $150,000, it is going to be called on to pay an excess-profits tax of $33,000-odd, on top of an income tax of $25,000, and that is a total of $58,000; yet had it known that this tax was going to be put into effect, it could have taken steps to reduce that liability, which obviously is excessive. It could have had its creditors take notes and develop a borrowed capital; it could have requested permission to use the proportional income basis so as not to defer all that income into the excess-profits-tax year.

But you are making it retroactive, when the water is over the hill, as far as that is concerned, and it cannot do anything now. That is just one way in which the retroactive feature works a hardship in this case, and there will be many others.

I am going to jump now to something that has been discussed before, and that is the so-called special assessment provision. My committee submitted to the Joint Internal Revenue Committee last July a long memo, the result of our study, on this excess-profits-tax matter, before any bill was proposed, and we therein hoped that special assessment would not be necessary, but it is perfectly obvious, the way this bill now works out, that there are going to be so many cases of hardship that we must have some form of special relief. What is in there now is not a special relief at all; it is just hitting the case where they cannot determine the capital. It has no effect on those cases where it can be determined, and the law works a hardship.

I personally had a lot of experience with that law, and while it is not all that could be hoped for and the best thing in the world, it is much better than nothing at all.

Senator VANDENBERG. You are speaking about the 1921 law?

Mr. COOPER. I am speaking about the 1921 law. We therefore recommend something similar to sections 327 and 328, with a more specific statement of the abnormalities to be covered, and which will grant relief, and we also recommend a separate board outside of the Treasury Department. We do that because the Commissioner of Internal Revenue is charged with the duty of collecting the revenue, and he follows the law. We do not think he also should be the one to grant relief, to either determine whether it is proper or how much.

Senator VANDENBERG. Cannot the Board of Tax Appeals do it?

Mr. COOPER. It raises this question, that the Board hearings and records are open to the public, and it might lead to making available to the general public information about other taxpayers who are not before the Board. I think the Board would be an ideal body if it could be so provided that any information with respect to comparatives, as we used to call it, be kept confidential and not a matter of public record.

Senator VANDENBERG. Your judgment is that without something comparable to section 327 of the 1921 law, that this law would be seriously inequitable to many taxpayers?

Mr. COOPER. Exactly. The company that I mentioned is one that would have obtained relief under the old section of the law.

Senator DAVIS. Are you of the opinion that the National Defense Commission should have some representation on that board?

Mr. COOPER. I do not think that is material, if you have the right men. I think the Board of Tax Appeals is perfectly capable of doing it. I think that is enough. I do not think it needs the representatives of any industry. It should be a relief board composed of capable men who can determine whom to relieve and how it should be computed.

The CHAIRMAN. Can you write out a provision for us applying to the Commissioner of Internal Revenue?

Mr. COOPER. I can.

The CHAIRMAN. You will take care of it?

Mr. COOPER. Yes, sir.

Senator VANDENBERG. I wish you would also write one out involving the Board of Tax Appeals and the necessary protection to be put around that process.

Mr. COOPER. I will do that.

The CHAIRMAN. Please do so right away.

Mr. COOPER. The second point I want to bring out is the consolidated returns feature. Much has been said about that, and in the memorandum that we submitted, as I mentioned before, we outline our reasons for suggesting and feeling that consolidated returns should be permitted, not the least of which is the fact that the Securities and Exchange Commission requires consolidated statements for the purpose of properly determining income.

The CHAIRMAN. Mr. Cooper, our draftsmen tells us it would take them at least 6 weeks to write that out. Will you give us that as a part of your testimony?

Mr. COOPER. I will be glad to cooperate with your draftsmen. It seems to me they have taken long enough to work out a complicated bill now, and I think they might spend a little time on a consolidated returns feature instead of the complications they now have.

That, again, goes right back to the first point I made, that rushing through a bill leads to a bad bill, if you haven't time to do it.

Senator VANDENBURG. We cannot collect under this bill until March 15 of next year.

Mr. COOPER. That is right. If excess-profits taxes are to be made out of the defense program, they are not going to be made this year anyway.

The third point is, while you call this an excess-profits tax bill, I think it is really a tax on normal income. I understand it has been estimated that $900,000,000 will be raised, or thereabouts, after the first year, or after it gets into effect. If you assume an excess-profits tax rate of 35 percent—and that is probably a little high—that envisages approximately $2,600,000,000 of annual excess profits growing out of the defense program in which you are going to spend $2,800,000,000. That means either the contracting agencies are going to make contracts at exorbitant prices or else this bill is going to tax normal earnings.

We recommend that you allow a minimum rate of 8 percent in all cases. Another reason is that the normal base period is not normal for many industries, many companies. We originally recommended in that connection that the taxpayer be given the opportunity of taking in 3 of the years 1935 to 1939, consecutive years, or any 3 of the years 1924 to 1927. The year 1926 is being referred to often as a normal year. That 1924 to 1927 period will exclude the 1928 and 1929 booms.

Senator VANDENBERG. I do not understand what you will do with that period.

Mr. COOPER. Instead of the taxpayer being required to use as the base period for computing its base earnings the 1936–39 period, that it be given the option of taking 3 years out of that period, or 3 years out of the 1924–27 period. Those industries that were in the doldrums in the 1936–39 period but were on a more normal basis in the 1924–27 period, can thus have a normal base.

The CHAIRMAN. You do not think they went far enough in this bill?

Mr. COOPER. Not at all, because they still require the use of the 4 years and merely say, "Do not deduct the loss, if it happens to be a loss, in one of those four years." That does not help the company at all that did not have a loss but made no money either.

We would like to point out that the bill as written is very complicated. We think it can be simplified. I just listed in here eight different possible rates, depending on whether you are using the lowest invested capital or the preferential invested capital, or borrowed capital. I shall not read them, but we suggest that the whole thing can be simplified by providing for a recognition of paid-in capital plus accumulated earnings, if any, under all circumstances. If you adopt the idea of lowest invested capital, which may change each year, then a corporation may have two rates on its lowest invested capital and then on its excess, which ties the thing up in knots, makes it more difficult to follow. It can be simplified if you merely recognize 8 percent minimum, or whatever rate may be finally adopted. We recommend that apply on capital paid in plus accumulated surplus in all cases, whatever it may be, and eliminate the preferential rate, a lowest rate, and all those complications. We do not believe that all these different rates justify the complications that will develop.

We recommend an unused exemption in any year be carried forward. Business does not run annually and evenly, it runs in cycles, and if a corporation should lose money or make less than its allowable exemption in 1 year we suggest it be permitted to carry that unused exemption forward, so in the final analysis it will pay only on the excess profits exceeding accumulated exemptions.

There are many things we have to do in determining income, from an accounting point of view, that you cannot do for tax purposes. For instance, a corporation is working on munitions and an explosion occurs this year and it has a lot of damage claims, they are not settled until next year, and that loss this year cannot be deducted this year. We accountants would make them set up a reserve to cover it, but for tax purposes you cannot deduct the reserve. Similarly, we cannot defer expenses for tax purposes. For all these reasons we think it is equitable to provide for carrying forward any unused exemption.

Senator GEORGE. That would be true in the case of old corporations?

Mr. COOPER. That will be true of all corporations, but it will only apply to the excess-profits-tax years. A new corporation could not have any carry-forward until after the first year. They then may or may not have one.

We call attention to the fact that the method of computing the tax in the case of a period of less than 12 months can and will, in many cases, work out very inequitably. There has been a definite trend in recent years toward the use of the natural business year for accounting purposes. When a corporation changes to that kind of a fiscal year it is a short period. As a rule, that is the end of a business season, when it has made the most money. The law requires that they be put on an annual basis, and it will work out fairly only if the earnings for that short period are comparable with the monthly earnings for the entire year.

Take the illustration of a corporation operating a Florida hotel. Let us say it decides to close its accounts May 31, which is the end of the season. In that 5 months it makes all its profits, and it does not make anything the remaining 7 months, or may make some little profit or a loss. If that corporation's tax year were continued for the end of the year—I have used some figures in a table that I have submitted—suppose it makes $66,000 in that 5 months' period and if the rest of the year it breaks even, it should be taxed on the full $66,000, and that would be $4,250. I am taking the excess-profits tax. Under this law it would be required to pay taxes as though it were going to make in the whole year something like $157,000, so its excess-profits tax would be $13,000 instead of $4,250. We have a definite suggestion here for a means of computing the tax in a short fiscal-year period. I am not going into it in detail, unless you want it later. There is an illustration of just how it will work out in each case.

The CHAIRMAN. Mr. Cooper, we thank you very much.

Senator VANDENBERG. Let me ask Mr. Cooper one question.

I am interested in your theory of carrying over exemptions. I want to ask you whether that fully covers the particular thing that challenges me. The Department of Commerce reports that the profits, the annual net profits of all business corporations with assets of less than $500,000,000 from 1936 to 1939 is less than the losses sustained by those same corporations from 1931 to 1935.

Mr. COOPER. Yes.

Senator VANDENBERG. In other words, they lost more from 1931 to 1935 than they have gained from 1936 to 1939, which is the earnings base period for excess profits under this law. It seems to me obvious that that is not a fair profit base in view of the previous experience of losses.

Mr. COOPER. Yes.

Senator VANDENBERG. And I am wondering whether, in line with the exemption carry-over idea, there is any equitable fashion in which credit could be given for losses during a previous base period.

Mr. COOPER. Well, my provision with respect to carrying forward exemptions would have no bearing on that at all.

Senator VANDENBERG. I understand that. It is in line with the general relief idea.

Mr. COOPER. Yes.

Senator VANDENBERG. I am asking you whether there is any sense in it.

Mr. COOPER. There is. It is in line with the same idea that business does not run on an annual basis. You have a year of loss and a year of gain. There are certain types of businesses, I suppose the dairy business runs fairly even—there are many businesses that make good money one year and expect to lose the next year. It depends on seasons. Take the company engaged in making spring wear, and if this spring its business is bad, all that business is piled up the next year. You and I who did not buy a spring coat because there was no spring will buy that next year. In the meantime they have not only lost money but have not certainly earned any excess profits, unless in the 2 years the result is that it made excess profits.

Senator BYRD. On page 16 of your brief you state that the election of the taxpayer should not be binding.

Mr. COOPER. That is right.

Senator BYRD. It is my understanding in theory it was not binding; that he can change it from year to year. Do you think that is clear?

Mr. COOPER. We think it is clear that from year to year the taxpayer can change; we do not think it is clear that a taxpayer can change with respect to any one year. That is what we think ought to be done. In other words, if a taxpayer signifies in his return that he wants the income basis, let us say, for 1940, we think if there is any change made in those figures he ought to be able to switch over to the invested capital basis, if he wants to, for that same year.

Senator BYRD. As of what date? There ought to be some date somewhere.

Mr. COOPER. Whenever the income or exemption in 1940 is finally determined. There are hundreds of cases in which a taxpayer would have to make up his 1940 return without knowing what his income is in 1936, 1937, 1938, or 1939, or some of those years. I can think, in my own office, of at least 30 cases where we are tied up, we do not know what the income is going to be for 1937 to 1939, and we do not know for 1940 either. We have many cases in which invested capital will have to be determined.

Senator BYRD. The language in the bill does not cover it.

Mr. COOPER. It is very similar to the joint-return election which has been held to be binding for the particular year.

Senator BYRD. Would you mind submitting to the committee your recommendation for some change that should be made to cover it?

Mr. COOPER. Yes, sir; I shall.

Senator BYRD. I assume this is going in the record, this brief of Mr. Cooper's.

The CHAIRMAN. Yes.

Senator BYRD. I think it ought to be in the record. It is very good.

Senator RADCLIFFE. Is it not true that the figures for the latter period are a little bit misleading because the methods employed by different companies, in setting up a depreciation reserve or charging off in the previous period might differ very materially, and consequently the profits in the second year would be a little bit artificial, because they have taken that as one of the different methods of realizing on this reserve?

Mr. COOPER. There is no question about that. In our original recommendation submitted last July we suggested that income for the base periods and current period be both adjusted with respect to depreciation, so that they be put on a comparable basis. We have any number of cases in which the taxpayer's rate for depreciation ought to be figured on the same basis through a number of these years. Let us say they use 10 percent, the Treasury Department comes in in 1938 and 1939 and says that is excessive and cuts it for the year 1938–39. In the meantime income for 1936 and 1937 has been reduced by that high rate, so you have a low base income because of the high rate.

The CHAIRMAN. If you want to submit an additional memorandum on that point, Mr. Cooper, you may do so.

Mr. COOPER. I shall do that.

(The brief submitted by Mr. Cooper is as follows:)

STATEMENT OF WALTER A. COOPER AS CHAIRMAN OF THE COMMITTEE ON FEDERAL TAXATION OF THE AMERICAN INSTITUTE OF ACCOUNTANTS BEFORE THE SENATE FINANCE COMMITTEE

My name is Walter A. Cooper, of Scarsdale, N. Y., chairman of the committee on Federal taxation of the American Institute of Accountants. I do not appear as a representative of any corporation, group, or corporations, or industry. As a representative of the accounting profession of this country, the members of which have had long and broad experience with the application not only of recent income tax laws but of former war and excess-profits tax laws, I am here to express our views on the proposed legislation. These are expressed on the basis of as complete a study of a most complicated proposal as time has permitted, and in the light of an experience with and knowledge of corporations of all types engaged in all kinds of business.

Our recommendations, some of a technical nature, follow:

I. A RETROACTIVE EXCESS-PROFITS TAX LAW SHOULD NOT BE ENACTED NOW BUT TIME SHOULD BE TAKEN TO DEVELOP FAIR AND MORE EQUITABLE LEGISLATION WHICH SHOULD BE MADE EFFECTIVE JANUARY 1, 1941

Although the burden of determining excess-profits tax liabilities under such a complicated and involved law, the like of which has never been seen before, will fall, to a material extent, on the accounting profession, which, from a selfish point of, view, may be benefited thereby through the creation of a greater demand for its services we nevertheless feel that in the interests of the country as a whole and business in general, our tax legislation should be as simple as possible and should be fair to all.

No law imposing so severe a burden upon the taxpayers of this country should be enacted until they have had an opportunity, not only to study and understand its contents, but to apply them to their particular circumstances and ascertain their effects. That has not yet been possible. The indicated purpose is to prevent the development of so-called "war millionaires" who might prosper unduly under the defense program activities. Yet, such activities are barely getting under way; little, if any, production has been started; and certainly little, if any, income will be realized therefrom in 1940. Why, then, should there be such haste, particularly when haste undoubtedly will lead to an unsatisfactory law, and the proposed retroactivity will work undue hardship on many taxpayers. There is need for the amortization provisions because taxpayers must now contract for such additional facilities as may be required. The profits from their operation, however, will not be realized to any appreciable extent until next year, and the excess profits tax is aimed at those profits.

The circumstances of many taxpayers, who will be harshly treated under the pending bill, not only because of its general terms, but also because of its retroactivity, have been brought to your attention as many have been brought to the attention of my committee. A single further illustration is all I now submit in that respect.

It is the case of a corporation engaged in the contracting business in Florida. It earned no income during the 4-year base period, but during the last 2 years it was working on a contract which was completed in the early part of 1940. As it reports on a completed contract basis, the entire income for the past 2 years' work becomes taxable in 1940. The closing of the contracts will thus produce an income of $125,000 (after income tax). Not only does it have no base period earnings, although the income taxable in 1940 is wholly the result of business carried on during the base period, but it has only a nominal invested capital. That is because it started with little capital, built that up through earnings and then lost so much it became insolvent, its liabilities now exceeding its assets. Under the proposed bill, it will be required to pay an excess profits tax of approximately $33,255 on top of an income tax of $24,745, a total of $58,000 on an income of $150,000.

Had the company known at the beginning of the year what was to happen taxwise, steps might have been taken to alleviate the situation, such as having the creditors take notes for their claims, thus, creating a borrowed invested capital. The harshness of the general provisions of the law, and especially its retroactivity, is clear in this case, and many other similar situations exist.

Accordingly, we urge that the excess profits tax proposals be eliminated from the pending bill and that sufficient time be taken to develop a sound law that will be prospective, rather than retroactive in its application.

II. CONSOLIDATED RETURNS SHOULD BE REQUIRED FOR INCOME AND EXCESS-PROFITS TAXES

We submit that the only proper way in which the income, be in ordinary or excess, of any group of affiliated corporations can be determined is on the basis of consolidated accounting. It is necessary in many cases to have subsidiary corporations and for reasons that are fundamentally, economically and socially sound. As a matter of fact, the Government through the Reconstruction Finance Corporation is now insisting on the organization of what they refer to as dummy corporations, but which are really subsidiary corporations, in connection with loans for defense purposes. Private financing frequently requires the use of subsidiaries for similar reasons. State laws or regulations, the retention of trade names and goodwill, and many other reasons, make necessary the use of subsidiary corporations. Much progress has been made in eliminating those that are unnecessary, but many still remain and must remain.

Subsidiary corporations are nevertheless an integral part of a business unit and any determination of income on the basis of the separate companies results in an incorrect determination of the group income. Consolidated income statements are required by the Securities and Exchange Commission and thus our Government now says to taxpayer corporations that for the purpose of acquainting present and prospective investors with the true earning power of a group of corporations consolidated income statements must be filed, yet for tax purposes they cannot be filed.

Furthermore, if consolidated returns are not required the field will be open for much tax avoidance. In some cases this may be merely avoiding the unjust burden of separate return requirements; in others, it will lead to inequitable avoidance in that the aggregate taxes will be less than would be payable on the same business and income earned in a single corporation or computed on a consolidated basis.

It has been suggested that the taxation of affiliated groups on a consolidated basis would result in less revenue the first year. However, there should also be taken into account the probable greater revenue that would result over an extended period of time. Aside from that, the effect on revenue should not be the controlling motive. Equity in the assessment of the burden is more important and an unjust levy is never justified because it will produce more revenue.

It is stated in the report of the Ways and Means Committee that consideration was given to the matter of consolidated returns, but satisfactory provisions covering the same could not be developed in the time available. That is just another illustration of the manner in which haste makes for poor legislation which prompted the suggestion previously made, to defer the enactment of the excess-profits tax provisions. We again urge that the right to file consolidated returns be recognized to the end that our income-tax income conform to accepted accounting principles, to business practices, and the requirements of the Securities and Exchange Commission, which in the interests of obtaining informative and proper statements of income requires that consolidated statements be filed by all registrants.

III. THE RATES OF EXEMPTION ON INVESTED CAPITAL SHOULD BE INCREASED

It has been said that the pending bill is intended to tax excess profits and to prevent the development of so-called war millionaires who might prosper unduly as a result of the defense program expenditures. It has also been estimated that the bill will produce some $300,000,000 of revenue annually in later years. If that be true the tax will be levied on not merely excess profits but normal income, or else Congress expects the contracting agencies of the Government to make contracts with producers at exorbitant prices. Assuming an average excess-profits tax rate of as high as 35 percent, the revenue estimate envisages annual excess profits of approximately $2,000,000,000. On the average that is almost as much as we propose to spend for defense activities ($14,000,000,000 in 5 years averages $2,800,000,000 per annum).

It is obvious, therefore, that the real effect of the law will be to tax normal earnings. This results, in part, from the fact that the rate of return proposed to be allowed on the majority of invested capital will be less than normal. The minimum 5 percent rate, which will be allowable in many cases because the average earnings during the base period were subnormal, is less than normal interest rates and less than average preferred stock dividend requirements in most cases. To levy such high rates of excess-profits taxes on income which does not exceed a normal return on capital is not only unjust but it will certainly tend to retard business activity. The inherent risks in general business operations will be greater because business which rests on defense program activities is likely to cease whenever the defense program activities cease. Obviously, business will not go ahead on that basis.

To make the legislation more truly an excess-profits tax law, we urge that the exemptions on capital be placed at a minimum of 8 percent, and that the maximum rate allowable be 12 percent if earned during the base period. We further recommend, in order to equalize the effect on and credits of companies engaged in industries that operated on a subnormal scale during the proposed base period, that taxpayers be permitted to use as the base period any 3 of the years 1924 to 1927, inclusive, or any 3 of the years 1936 to 1939, inclusive, instead of being required to use the 4 years 1936 to 1939, inclusive. A statement outlining more fully the reasons for that recommendation was submitted by our committee to the Joint Committee on Internal Revenue in July.

Should this recommendation be adopted, the excess-profits tax law will undoubtedly produce less revenue than the pending bill, but it will be more truly an excess-profits tax law and will prevent the unreasonable accumulation of wealth out of defense activities just as well as the legislation now proposed. More important, it will not create the hardships and difficulties that are bound to arise under the pending bill and will prove less deterring upon general business activity. We must always remember that though defense program work may provide increased business and activity in the production of the means of defense, that activity will, we hope, come to an end in due course. We should not meanwhile enact legislation that will tend to kill off general commercial activity not based on defense program contracts. Should that come to pass we will find our country worse off than ever when the defense program work ceases.

IV. THE PROVISIONS FOR MANY DIFFERENT EXEMPTION RATES AND INVESTED CAPITAL BASES ARE TOO COMPLICATED AND SHOULD BE SIMPLIFIED

The many different rates and invested capital bases provided for in the pending bill lead to an unusually complicated tax structure which we believe is not warranted by the benefits to be derived by either the taxpayers in the form of equitable taxation or the Government in the form of revenue or the prevention of tax avoidance.

It is proposed to have rates of:

1. Five percent and 7 percent minimums for old corporations having a lower base period earning rate.

2. Five percent to ten percent on invested capital of old corporations that earned in excess of the minimum rate during the base period.

3. Six percent and eight percent adjustments for decreases or increases in paid-in capital when the income method is used.

4. Eight percent and ten percent for new corporations.

5. No recognition of capital increases through accumulated earnings when the income basis is used.

6. Eight percent and ten percent for new capital in old corporations regardless of their base period earning rates, such new capital including accumulated earnings.

7. Eight percent and ten percent on net recoupment of original capital which may be lost after the tax goes into effect—the lowest capital basis regardless of the earnings rate in the base period.

8. When successor or transferee corporations are involved preferential rate amounts combining several of the foregoing may apply to the one corporation.

We strongly urge that the entire construction of the law as well as the invested capital and credit determinations which may be required be simplified by:

1. The general recognition of increases or decreases in capital invested whether they result from capital paid in or increases and decreases in accumulated earnings under both invested capital and income credit methods.

2. The adoption of a maximum and minimum range of 8 percent to 12 percent for the adjustment of the base credit for recognized increases or decreases in capital invested.

3. The application of the mean between such rates, or 10 percent to new corporations.

4. The simplification of the tax structure and the law by providing for a straight recognition of all capital increases regardless of whether they arise from capital paid in or accumulated earnings at the 8 percent to 12 percent rates (depending on the base period earnings rate) in the case of corporations existing (actually or constructively) during all or part of the base period and 12 percent in the case of taxpayers usings the base period income method (whose base rate must have exceeded 12 percent since otherwise the invested capital method would be used.)

The adoption of this proposal will make possible the elimination of those sections of the law requiring the determination of whether capital increases are due to earnings or paid-in capital, make unnecessary the determination of the source or preferential amounts in the case of mergers, exchanges, etc., make unnecessary the complicated provisions dealing with lowest invested capital under or over $500,000.00, etc., and, except as to the increased exemption rates proposed should not appreciably affect the revenues.

V. UNUSED EXEMPTIONS SHOULD BE CARRIED FORWARD

Any unused exemptions should be carried forward to become available in succeeding years so that there will be no excess profits, on a cumulative basis, until the aggregate income exceeds the aggregate exemptions.

Under the law income must be computed on an annual basis—though business cycles never conform to such a basis. Also, technicalities as to time for the deduction of expenses or losses, or taxation of income, frequently require a treatment that is not in accord with good accounting practice, which seeks to apply expenses against the income produced thereby.

In many businesses fluctuations are expected so that in 1 year a loss or little income results while in another year substantial income results. These are the "feast or famine" companies. The average may not be excessive—and the average income for 1936-39 is required to be used as the exemption base—not the highest yearly earnings only.

Deductions for reserves of many types are required for the purpose of determining true income but are not allowed for income tax purposes.

Disputed losses are deductible only when settled—not when really sustained and are thus not deducted from the income resulting from the operations which led to the loss.

In expanding operations preliminary expenses are sustained, to be recouped out of future income, which may come in the succeeding year.

When long-term contract business is involved and profits are determined when contracts are completed, the result of more than 1 year's business may be piled up in 1 year for tax purposes.

For any or all of the foregoing reasons the profits for one year alone may be excessive, though the average of several years will not be excessive. This inequity can be alleviated in part if unused credits or exemptions can be carried forward to apply against future profits.

VI. THE BASIS FOR COMPUTING TAX FOR PERIODS OF LESS THAN 12 MONTHS SHOULD BE MODIFIED

Subsection 711 (a) (3) will apply in cases where the taxable year is changed so that for the period of the change, a return for less than 12 months is required; or in the case of newly organized corporations adopting a fiscal year ending less than 12 months after organization. The requirement that the income be placed on an annual basis will produce an equitable and fair tax only if it be a fact that the income for the short period is ratably comparable with the earnings for a full year. Should such short-period earnings be in excess of the average rate per month, the tax will be excessive and unduly burdensome. Should the earnings be less, a way for avoidance of tax is open.

During recent years there has been a definite tendency and trend on the part of business in general to adopt fiscal years that coincide with the natural business year, instead of the calendar year. This change has been fostered, not only by the accounting profession, but by business organizations generally, and particularly, the Securities and Exchange Commission, which supports the use of a natural business year in the interest of providing security holders and prospective investors with the more informative statements and earnings reports that the use of the natural business year for accounting purposes makes possible. Treasury statistics indicate that during the 15 months from January 1939 to May 1940, inclusive, 4,808 taxpayers requested permission to change from a calendar to a fiscal year basis.

Many businesses are seasonal and when changes in fiscal years are made, the income for the short period is usually considerably in excess of a ratable portion of the year's earnings because the proper fiscal year should end with the active business season; thus including, as a general rule, the profitable period of operations. A typical illustration is that of a corporation operating a hotel, let us say, in some part of Florida. The season generally ends in midspring, say May 31, and all the income of such a corporation will be derived from operations during the first 5 months of the year. During the remainder of the calendar year, the corporation will be lucky to break even, particularly as during the last few months of the calendar year, it is likely to be incurring substantial expenses in the nature of getting ready for the seasonal operations, training and developing staff, etc., for the next year. To illustrate the effect of section 711 (a) (3) as proposed, take the case of a corporation engaged in the business indicated and earning, during the 5 months ended May 31, a net income for excess-profits tax purposes of $60,000. Assume further that it has an invested capital of $500,000 upon which it is entitled to an exemption rate of 8 percent. Such a corporation will probably earn little or nothing during the remaining 7 months of the year, and for this illustration I shall assume that the remaining 7 months produce neither net gain or loss. If it continued for the full calendar year, its tax, on the figures given would amount to $4,250, but under the provisions of section 711 (a) (3), if it should change to a natural business year, ending May 31, it would be required to pay a tax of $13,178. A law that produces such a result is most inequitable. Conversely, of course, if the income for the short period should be less than the annual average, too low a tax will be payable.

To remedy this, we suggest that the proposed bill be modified to provide that in the case of a period of less than 12 months, there be added to the income for the short period the income for the remainder of the full 12-month period, taking the months immediately following the end of the short period; that the tax be computed on the basis of that 12-month income and that the amount payable for the short period be such proportion of the tax on the 12-month income as the amount of the income for the short period is of the income for the 12-month period.

If the income for the short period be the same as for the year, the full tax thus determined should be payable and if the income for the short period be greater (because a net loss was sustained during the balance of the year) there should be payable an excess-profits tax, computed at the same average rate on the larger short period income as results from the full year computation. A tabulation of how this suggestion would work out is annexed.

Such a change would present no complications and would not reduce revenues, but, if anything, is likely to increase revenues. Obviously, a corporation that would be required to pay an excessive tax, under the proposed law, would simply not change its fiscal year; while one that might pay a lesser tax, under the law now proposed, would request permission to make such a change. On the other hand, the enactment of the present proposal will likely stop completely the very desirable trend of business corporations toward the use of a natural business year for accounting and other purposes.

VII. THE ELECTION TO USE FOR ANY YEAR EITHER THE INCOME OR INVESTED CAPITAL METHOD SHOULD NOT BE BINDING FOR THAT OR ANY OTHER YEAR

Section 712 (a) requires the taxpayer corporation to signify in its return for each year whether it desires its excess profits credit to be computed under section 713, the income basis, or section 714, the income and invested capital basis. The law does not indicate whether such election is intended to be binding with respect to such year, regardless of what changes may later be made in the income, invested capital, or base period rates upon the audit of the returns for the several years involved. Perhaps it is not intended to be binding, but experience with the administration of other elective provisions of the income-tax code, such as the joint return election, indicates that the language used may be held to involve the making of a binding election as to the particular year involved.

If it is not intended to be a binding election, the law should be clarified to make that intention clear. If it is intended to be a binding election, the law should be changed so as to provide that the tax, as finally determined, be computed under whichever method produces the lower tax.

This is important because there will be hundreds of cases in which it will be impossible at the time of the filing of any return to know the amount of excess-profits credit under either basis. There are many pending cases involving the base period years, both in the courts and in the Bureau of Internal Revenue; and until they are disposed of, the base period income or capital will not be known. In many cases, too, the adjustment being considered or discussed with respect to the base period years will affect the current year.

A typical illustration of that is the possible and probable adjustment of depreciation under the provisions of T. D. 4422. In many other cases the amount to be included in invested capital with respect to assets paid in, particularly intangible and nondepreciable assets, has never been determined; and with respect to such values, particularly as to intangible assets, there is much room for difference of opinon regarding values.

A taxpayer should not be required to make a binding election with respect to the basis of its excess-profits credits in the face of either a lack of knowledge as to its base period or current period income and/or capital, or uncertainty regarding same. We therefore recommend that the election with respect to any year be not binding and that the law so state.

VIII. DETERMINATION OF INCOME IN BOTH THE CURRENT AND BASE PERIODS SHOULD EXCLUDE LOSSES OR DEDUCTIONS ARISING OUT OF THE RETIREMENT OR DISCHARGE OF BONDS, ETC., AS WELL AS THE INCOME THEREFROM

Paragraph 711 (b) (2) (A) (iii) (and comparable subparagraphs of other sections make the same requirement with respect to taxable periods) provide that in the computation of excess income any income arising from the retirement or discharge of bonds, etc., shall be excluded. This is sound as it excludes income of a nonrecurring nature, although the effect of it generally will be to reduce the income and earnings rate of corporations which were operating on a low-profit basis (which made possible the discharge of indebtedness at a profit).

We urge that equity requires that losses or deductions growing out of similar circumstances which will involve primarily the deduction of unamortized discount or premiums on call should likewise be excluded. Such deductions are of a nonrecurring nature and have no relation to current business operations, income, or excess profits. The failure to exclude such deductions, which are really not applicable to the income of the period in which sustained and which usually serve to reduce future expenses through the flotation of new securities at a lower interest rate, will have the effect of reducing the base-period income and/or earnings rate on which the excess income of the current year is based, while the current-year income will be greater than it otherwise would be because of the lower interest rate on the replacement indebtedness. While accepted accounting practices do not treat these deductions as applicable to the income in the year in which the bonds are retired, income-tax procedure has made the deduction in that year mandatory, even though it may result in a net loss for the year.

We urge, therefore, that the subparagraph referred to and comparable subparagraphs in other sections of the law be modified to provide for the exclusion of any unamortized discount or premiums arising out of the retirement or discharge of bonds, debentures, notes or certificates, or other evidences of indebtedness which have been outstanding for more than 18 months, as well as the exclusion of income as now provided.

IX. LONG-TERM CAPITAL GAINS AND LOSSES ON DEPRECIABLE ASSETS SOLD FOR LESS THAN UNADJUSTED COST SHOULD NOT BE EXCLUDED

It is proposed that long-term capital gain and loss be excluded in determining either the current year and base period excess-profits income. It is further proposed that assets held for more than 18 months and subject to a depreciation deduction should be regarded as capital assets, the gain or loss on the sale or exchange of which is to be excluded from the income computations.

During recent years the matter of depreciation deductions has been the subject of much discussion and dispute between the Bureau of Internal Revenue and taxpayers, as the Bureau has sought, through administrative policy, to substantially reduce depreciation deductions. Normally, the question of the rate of depreciation really involves the year in which deductions are taken, as under-depreciation produces a write-off or loss when the asset is eliminated or sold, while over-depreciation, should the property be sold, will result in a taxable profit. At first, when the provisions of the income-tax law denied to corporations deductions for net losses on capital assets, including depreciable capital assets, there was much taxpayer resistance to proposals to reduce depreciation charges. A year or so ago, however, the law was amended to exclude depreciable capital assets from the definition so that the losses resulting from the disposition of such assets became deductible, thus providing the Treasury with the argument that if the rates proposed were too low, a loss deduction would be allowed later.

It is now proposed to deny the deduction for excess-profits-tax purposes. This is certain to lead either to considerable dispute and litigation regarding the amount of depreciation charges or to the enforced scrapping (as in the recent past) of assets which might otherwise be salable and useful to other producers, as losses from scrapping would not be disallowed as a loss on sale. This may be particularly serious if such equipment should be useful to others in consummating the defense program and becomes unavailable by reason of such demolition.

We suggest, therefore, that the proposed bill be modified so that the provisions of section 711 (a) (1) (B) and other comparable subsections be made nonapplicable to gain or loss resulting from the sale of a depreciable capital asset for an amount less than the cost or other unadjusted basis of such asset. Under such circumstances, then, the gain or loss on the sale or exchange of the asset, which in reality represents over- or under-depreciation, as the case may be, will be taken into account in determining excess-profits tax liabilities.

X. UNDER THE INCOME METHOD TAXABLE STOCK DIVIDENDS SHOULD BE TREATED AS ADDITIONAL CAPITAL PAID IN

The bill provides that in computing capital additions under the income method a distribution of stock or rights to acquire stock shall not be regarded as capital paid in. We recommend that this be modified to exclude from capital additions only such stock dividends or rights as are not regarded as taxable income in the hands of the shareholders and that there be included in capital additions such stock dividends or rights as constitute taxable dividends to the shareholders. Should a corporation distribute a cash dividend and the stockholders turn about and reinvest such dividend through the purchase of additional capital stock, the shareholders would be taxable on the dividends received, and the corporation would receive credit for an addition to capital. Should such a corporation issue a taxable stock dividend, the shareholders will be taxable just as though they had received a cash dividend, yet the corporation will receive no credit for additional capital.

There is no reason to force the use of the roundabout method, which is obviously what will be done where it is possible so to do, or to require the payment of a larger excess-profits tax in such cases where the distribution of a cash dividend and its reinvestment is not feasible by reason of the peculiar circumstances of a taxpayer corporation. More likely, of course, in such cases the dividends will not be distributed. It is desirable to encourage the distribution of taxable dividends, which will serve to increase the personal income taxes of the shareholders. The change here recommended is not at all likely to decrease revenue, but, on the contrary, if it has any effect, will increase revenues from personal income taxes.

XI. ON THE INCOME BASIS, CAPITAL REDUCTIONS SHOULD BE ADJUSTABLE FOR DECREASES IN THE INADMISSIBLE ASSETS

Section 713 requires that the capital additions for which credit is allowable, in computing the excess-profits credit based on income, shall be reduced for any increase in the investment in the inadmissible assets. This is sound, but it is noted that in the case of a reduction in capital through a distribution to shareholders that is not out of earnings or profits, no comparable adjustment is allowed for a decrease in the investment in inadmissible assets. Thus, for example, if a taxpayer corporation should distribute shares of stock of another corporation and the distribution be one that is not out of earnings or profits, it would be charged with a capital reduction, although its income would not be similarly reduced, inasmuch as 85 percent of the dividend from such stock is not taxable. The same result would obtain if the corporation should sell its stock in the other corporation and distribute the proceeds.

We recommend, therefore, that appropriate adjustments comparable to those contained in section 713 (c) 3 (A) and (B), be allowed for the distribution of an inadmissible asset as an offset against any capital reduction representing distributions not out of earnings and profits, now covered by section 713 (C) (4).

XII. DISTRIBUTIONS IN FIRST SIXTY DAYS OF TAXABLE YEAR SHOULD NOT BE AUTOMATICALLY DEDUCTED AS OF THE BEGINNING OF THE YEAR

We suggest the elimination of subparagraph 718 (c) (2) requiring the deduction from invested capital of distributions during the first 60 days. It appears to be a carry forward from the old 1921 excess-profits-tax law which, however, required invested capital to be reduced by any distributions during the year in excess of the earnings accumulated at the date of the distribution, such earnings to be computed on a pro rata basis. However, with respect to income taxes under the existing statute, any distribution made during the year is deemed to have been made out of current-year earnings regardless of distribution during the first 60 days or of the amount earned at the date of the distribution, and the proposed excess-profits-law tax applies the same theory and principle to distributions after the first 60 days of the taxable year. There is no reason for the distinction under these circumstances, particularly as subparagraph 718 (c) (2) is likely to be ineffective anyway since it will lead to a delay in the payment of dividends until after the first 60 days have passed (except as to early 1940 distributions before an excess-profits tax was contemplated.)

XIII. ON THE INCOME BASIS RECOGNITION SHOULD BE ACCORDED CAPITAL INCREASES OVER THE AVERAGE BASE PERIOD CAPITAL INSTEAD OF BEING LIMITED TO INCREASES AFTER THE FIRST EXCESS-PROFITS TAX YEAR

It is provided, in section 713 (c) (dealing with the income method credit) that the base-period income be increased by a percentage of the additions to capital subsequent to the beginning of the first taxable year coming under the excess-profits tax. Thus, a corporation that happened to increase its capital, December 31, 1939, will obtain no increased credit by reason thereof, while a corporation that increased its capital on January 2, 1940, will obtain an increased credit. This is clearly improper and inequitable as between taxpayers.

Capital added during the base period has been effective in producing income only since it was added. The additional income it produces is divided by 4 in the averaging, but no increase is recognized for the added capital.

To use the illustration previously given, capital added in December 1939 could have produced no income. It will produce income during the excess-profits tax years and assuming the other capital produces the same income as it averaged during the base period, all the income from the new capital would become excess profits. If the new capital were added during the base period, the inequity is proportionate. To remedy this, we suggest that section 713 be modified to provide that, in addition to an increased exemption based on the capital additions subsequent to the beginning of the first excess-profits tax year, an addition be recognized for the difference between the paid-in capital as of that date and the average paid-in capital during the base period. Thus, for example, a corporation having average capital during the base period of $500,000 and earnings of $100,000 would, if it increased its capital December 31, 1939, have the same credit as a corporation in otherwise similar circumstances increasing its capital on January 2, 1940. In the case of increases subsequent to January 1, 1936, and prior to January 1, 1940, proportionate recognition would be given.

A table is annexed to show how this suggestion would work out in comparison with the pending proposals.

XIV. EXEMPTIONS SIMILAR TO THAT GRANTED PERSONAL-SERVICE CORPORATIONS SHOULD BE AVAILABLE TO ALL CORPORATIONS HAVING A LIMITED NUMBER OF SHAREHOLDERS

Some of the serious hardships likely to grow out of the proposed law involve the smaller corporations, in the operation of which the principal stockholders are quite active, and which have relatively small capital in relation to their earnings. In many cases, by reason of general business conditions during the base-period years, which made it difficult for the smaller businesses to operate profitably, many such corporations had low income. A return to more normal operations and income yield will require such corporations having little or no base-period income and low invested capital, to pay an unduly burdensome and much higher excess-profits tax than would be payable if the shareholders conducted business as a partnership rather than a corporation. Unless they be personal-service corporations, there is no way out.

Accordingly, we recommend that all corporations having 30 stockholders or less be given the privilege of electing to be exempt from excess-profits taxes, provided their shareholders include their proportionate shares of the corporate income in their individual income-tax returns in the same manner as provided for personal-service corporations. This will not make possible substantial avoidance of excess-profits taxes that ought to be paid because, in the case of corporations having large incomes, the personal surtaxes on the shareholders will probably be increased at least as much as the excess-profits tax thereby eliminated. It will be helpful only in the case of the smaller corporations, but that will merely eliminate a hardship that should not be imposed rather than confer a benefit.

XV. INSURANCE COMPANIES SHOULD BE EXEMPT

There appears to be no provision in the law for the exemption of insurance companies whose normal net incomes are determined under special provisions of the Code. Furthermore, with respect to mutual insurance companies which have no capital paid in and whose incomes bear no relation to capital of any kind no provision is made in the pending bill for any invested capital.

Mutual insurance companies have no capital and though there may be a small amount designated as surplus their total holdings of assets are offset primarily by retained reserves; thus except for the effect of the base period income method all income might be subjected to excess-profits tax. The fund-in the possession of mutual insurance companies represent the deposits of thousands of policyholders to provide for the mutual protection of each other. The income derived from them can only be investment income and the nature of investments available to insurance companies are limited by State-regulating authorities. Should such deposits increase so that the total assets increase the income would also increase, yet the only credit available for excess-profits-tax purposes would be the base period income, if any, arising out of a smaller amount of premium deposits.

Stock companies, on the other hand, would have an invested capital, but the assets with which they operate represent not only their own capital but deposits or premium payments of the insureds which are paid in advance. The investment of such funds is limited by regulating authorities to the more stable and lower income-producing investments, yet the requirement for the reduction of invested capital on account of inadmissible assets might so reduce the invested capital allowable as to subject the companies to excess-profits tax, and it can hardly be said such companies realize excess profits when both their income and their premium rates are so subject to the control of the States as to prevent the realization of excess profits.

Provision has been made for the exemption of certain types of investment companies. The real income of insurance companies generally is the income derived from investments. In view of the substantial inequities that would result if insurance companies are subjected to tax on any portion of their incomes which may be determined to be excess profits under the proposed legislation and in view of the fact that they are comparable to controlled investment companies of the mutual type, which are to be exempted, we urge that all insurance companies be exempted from the proposed excess-profits tax.

XVI. A REAL EQUITABLE RELIEF PROVISION SHOULD BE ADDED TO THE LAW

About the middle of July, shortly after the Joint Committee on Internal Revenue Taxation started consideration of an excess-profits tax law, the committee on Federal taxation of the American Institute of Accountants, after a rather comprehensive study of the problem, submitted to the Joint Committee on Internal Revenue Taxation a complete memorandum on the subject. In that memorandum it was suggested that a relief provision, similar to the special assessment sections of the old excess-profits tax laws, was not desirable and that a law should be developed to make the inclusion of such a relief provision unnecessary.

It seems now obvious, however, that any excess-profits tax law along the lines of that now proposed, as to the basis, rate and method of determining exemptions or the rate of tax requires the inclusion of some equitable relief provision the present proposal merely covers cases in which capital cannot be determined) that will avoid the undue hardships certain to arise in many cases. A number of these have been brought to your attention. The proposed law can be well-nigh ruinous to a number of taxpayers, not the least extreme example of which is the illustration of the contracting company previously given.

We urge, therefore, that a relief provision similar to that of prior laws, be included with a more adequate statement of the abnormalities to be recognized and the hardships to be alleviated, and that the determination of whether or not relief should be granted and, if so, the amount or basis thereof, should be made by an independent board or group outside of the Bureau of Internal Revenue.

XVII. THE EXISTING EXCESS-PROFITS AND CAPITAL-STOCK TAX LAWS SHOULD BE REPEALED

It is now proposed that we have not one but two excess-profits tax laws. We realize that to make a capital stock tax law workable, if it is to be based on a free declaration of value, some form of excess-profits tax must be coupled with it. However, inasmuch as a capital basis must be determined by most corporations for the purposes of the new excess-profits tax, there now seems to be no need for a capital-stock tax based on a declaration of an arbitrary value having no relation to actual or invested capital values.

We, therefore, recommend that if the revenues presently being obtained from the capital-stock tax are required, the present law should be repealed and one of the following be substituted in lieu thereof:

(a) Increase the normal income-tax rate by 1 percent. Under the existing law taxpayers who guess correctly their future earnings and provide through their declarations of capital-stock values just enough exemption to equal the income, pay a capital-stock tax exactly equal to 1 percent on net income. Those who are bad guessers may pay more, but there is every reason to eliminate the guessing feature and substitute a 1 percent additional income tax so as to place all taxpayers on a comparable basis.

(b) If a capital-stock tax not related to income should be preferred (and we deem it preferable), the tax should be levied on the average invested capital for the year as determined for excess-profits tax purposes and in those cases where the base period income method is used, the basis for the capital-stock tax should be a capitalization of the base period income at the maximum rate plus or minus capital additions or reductions recognized in computing the excess-profits income credit.

This suggestion will simplify the tax structure materially, will not require any computations or determinations in addition to those required for excess-profits tax purposes, will put the tax on a logical rather than a speculative basis, the computation of the tax can be shown on the excess-profits and income-tax return, and the tax can be paid at the same time as the income tax. This will simplify the preparation of returns, eliminate the filing on the part of the taxpayer and the auditing and handling on the part of the Treasury Department of an additional return for each corporation and will reduce the work of collecting the tax, as it will merely require the payment of larger quarterly amounts instead of a separate additional amount.

XVIII. AMORTIZATION SHOULD NOT BE LIMITED TO COSTS INCURRED AFTER JULY 10, 1940

The amortization provisions seem to be very well outlined to protect the Government, on the one hand, and be fair to taxpayers, on the other hand, except in one respect the deduction is limited to costs incurred after July 10, 1940. In many cases taxpayers, anticipating the ultimate need of the United States to have available facilities for manufacturing the materials of war or defense, undertook plant expansions prior to the date stated. In many cases these steps were taken after discussions with and, in some cases, at the request of, representatives of the War or Navy Departments.

Corporations which undertook to make such expenditures in anticipation of our requirements and should be commended therefor are now being penalized in comparison with taxpayers who declined to incur expenditures for additional facilities until assured of an amortization deduction.

We, therefore, suggest that the provisions be expanded to apply to any facilities, the construction or installation of which was undertaken after the outbreak of hostilities in Europe. The provisions of the pending bill requiring the appropriate authority certify that such facilities are essential for the prosecution of the defense program should be here applied also. Thus no expenditures made for normal purposes would be certified and would not be subject to an amortization allowance.

EXHIBIT A

Illustration of the effect of the suggested change in section 711 (a) (3) relating to the computation of tax for periods of less than 12 months.

Assumed facts

(1) A corporation changes from a calendar-year basis to a May 31, fiscal year. Its invested capital for the year is $500,000 and it is entitled to an 8-percent credit.

(2) It earns $68,000 excess profits net income during its 5 months' season ending May 31.

(3) The three alternative possibilities are that during the succeeding 7 months it—

(a) earns or loses nothing—12 months' result would be $68,000.
(b) earns $11,000—the 12 months' result would be $77,000.
(c) loses $8,000—the 12 months' result would be $60,000.

(4) The tax results would be:

	Case (a)	Case (b)	Case (c)
Under pending bill	$13,178	$13,178	$13,178
Under suggested change	4,250	6,000	3,300

(5) Computed as follows:

(I) Under pending bill:

Excess-profits net income ($66,000÷153×366)	$157,882
Less credit (8% of $500,000=$40,000+$5,000)	45,000
Balance	112,882
Tax on $112,882	31,008
Tax payable ($31,008÷366×153)	13,178

(II) Under suggested change:

(a) 12 months' income	66,000
Less credit as above	45,000
Balance	11,000
Tax on $11,000	4,250
Tax payable	4,250
(b) 12 months' income	77,000
Less credit as above	45,000
Balance	32,000
Tax on $22,000	7,000
Tax payable (6/7ths of $7,000)	6,000
(c) 12 months' income	60,000
Less credit	45,000
Balance	15,000
Tax on $15,000	3,000
Average rate on income 3/60ths or	5%
Tax payable (5% on $66,000)	$3,300

EXHIBIT B

Tabulation illustrating effect of proposal to give recognition to increases in capital during the base period in determining credit by the average income method (under sec. 713), assume—

Amount of invested capital Jan. 1, 1936	$400,000
Amount of invested capital Jan. 1, 1940	500,000
Amount of increase in capital during base period	100,000

Computation of amount to be included in credit under section 713 on account of increase:

Date of increase	Average invested capital for base periods after giving effect to increase (period of 1 day ignored)	Amount of credit (equal difference between invested capital as of Jan 1, 1940, and average for base period)	Date of increase	Average invested capital for base periods after giving effect to increase (period of 1 day ignored)	Amount of credit (equal difference between invested capital as of Jan. 1, 1940, and average for base period)
Dec. 31, 1939	$400,000	$100,000	June 30, 1937	$462,500	$37,500
June 30, 1939	412,500	87,500	Dec. 31, 1936	475,000	25,000
Dec. 31, 1938	425,000	75,000	June 30, 1936	487,500	12,500
June 30, 1938	437,500	62,500	Jan. 1, 1936	500,000	0
Dec. 31, 1937	450,000	50,000			

Under the pending bill there would be no credit for the added capital.

SUPPLEMENTAL MEMORANDUM SUBMITTED BY WALTER A. COOPER

During my oral testimony some questions were asked regarding deduction of depreciation reserves when rates were changed by the Bureau of Internal Revenue and I was requested to submit a supplemental memorandum with respect thereto, as well as to suggest appropriate provisions of law to cover certain changes recommended. The supplemental memorandum with respect to depreciation deductions and one other point follows:

THE EFFECT OF CHANGES IN DEPRECIATION RATES AND A SUGGESTION TO REMEDY THE SAME

During recent years the Bureau of Internal Revenue has undertaken to revise and materially reduce the depreciation deductions of many taxpayers. These reductions have been made either because it is alleged the basis upon which depreciation has been computed is excessive or that the rates of depreciation applied to cost of depreciable assets were excessive usually the latter). In many cases these changes were first made subsequent to 1936 and in some of them the first changes will not be made until 1940 or later years. If the changes in depreciation deductions are made in excess-profits years only or during part of the base period only, the result is distorted and the taxpayer may be required to pay an excess-profits tax on income which is really not excessive. To illustrate the effect the tabulation below shows the net income during the base period and during the year 1940 as it would be computed under the taxpayer's method. In this illustration the net income before depreciation deduction during the base years and the first taxable year remains constant in order to eliminate from the illustration the effect of fluctuation in income or expense other than depreciation adjustments. Thus the amount of net income before the depreciation deduction is assumed. However, the depreciation deduction is taken from an actual case that is now pending. The figures follow:

	1936	1937	1938	1939	4-year average	1940
(a) Net income before depreciation deduction	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000
(b) Depreciation	95,000	98,000	95,000	100,000	9,7000	97,000
(c) Net income	405,000	402,000	405,000	400,000	403,000	403,000

From the foregoing illustration it is clear that the taxpayer's average income during the base period is the same as its average income in 1940 and there should be no income subject to excess-profits taxes. At the present time the Bureau of Internal Revenue is auditing the tax returns filed by the taxpayer for 1938 and 1939 and it proposes to reduce depreciation for those 2 years by reducing the rate of depreciation from 10 percent to 5 percent. This will cut depreciation practically in half so that as the result of these changes the figures given in the illustration above will be changed as follows:

	1936	1937	1938	1939	4-year average	1940
(a) Net income before depreciation deductions	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000
(b) Depreciation	95,000	98,000	47,000	50,000	72,500	48,500
(c) Net income	405,000	402,000	453 000	450,000	427,500	451,500

From the foregoing it will be observed that although the income of the taxpayer remains the same, the adjustment of the depreciation charge (a matter of mathematics only) for only 2 of the base years, coupled with the adjustment of the charge for the taxable year 1940 will result in the taxpayer showing profits of $24,000 in excess of the base period income, subject to excess-profits tax if the rate be 50 percent of 12,000, yet as a matter of fact it has realized no excess profits at all.

The pending bill provides for making certain adjustments to the base period income in order to put the computation thereof on a normal basis comparable with the computation of the taxable year net income. In order to relieve this situation so far as it involves a change in the base or rate of depreciation, it is suggested that in any case where the basis or rate of depreciation is changed by a determination of the Commissioner of Internal Revenue, the deduction for the same item during all of the base years should be recomputed and redetermined on the same basis and at the same rates. Under such a provision the computation in the illustrated case given would then show the following:

	1936	1937	1938	1939	4-year average	1940
(a) Net income before depreciation deduction	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000
(b) Depreciation	48,000	49,000	47,000	50,000	48,500	48,500
(c) Net income	452,000	451,000	453,000	450,000	451,500	451,500

From the above illustration, it will be observed that if the appropriate adjustment is made during all of the base period years the average base period income will be the same as the current year income and there will be no income subject to excess-profits tax which is the fact. Without provision for such a correction the base period comparatives would be distorted in such a way as to show excess income where none exists.

THE PROVISIONS RELATING TO FOREIGN CORPORATIONS SHOULD BE CHANGED SO AS NOT TO REQUIRE THE PAYMENT OF EXCESS-PROFITS TAXES WHEN NO EXCESS PROFITS ARE EARNED

Section 712 (b) provides that foreign corporations engaged in business in the United States during any part of each of the 4 base period years must compute their excess-profits credit under the provisions of section 713 and accordingly must be taxed under the provisions of section 710 (a) (1) (the income credit method). They are not given the right to elect either the income or invested capital method.

As a result of the above such foreign corporations will be required to pay the additional 4$\frac{1}{10}$-percent tax on normal-tax net income even if they earned no excess profits.

To illustrate: Assume a foreign corporation earned during the base period $100,000 on average invested capital of $2,000,000. It has thus earned only 5 percent and under the invested capital method it would pay no excess-profits taxes even if it had the same capital during the taxable year and earned $100,000.

However, because it is required to use the income method such a corporation will be required to pay 4$\frac{1}{10}$-percent additional income tax on that $100,000. As a matter of fact even if it earned only 2½ percent on its capital during the taxable year, or $50,000, which is one-half of its base period income, it would still have to pay the additional 4$\frac{1}{10}$-percent tax on that $50,000.

It is understood that this result was not intended; that in the first draft it was provided that resident foreign corporations should compute their excess-profits credits under the income method so that only earnings in excess of the base income would be taxed. Subsequently the requirement that 4$\frac{1}{10}$ percent of the normal-tax net income be levied on corporations using the income method was added, apparently without realization of the fact that it would require a foreign corporation to pay that additional or excess-profits tax though it actually earned no excess-profits income. This should be corrected.

In order to correct the two situations above described and to provide for equitable relief and an election for domestic corporations that is not binding, there follows below four suggestions for changes in the pending bill.

With respect to the equitable relief provisions, it is not now suggested that the Board of Tax Appeals be empowered to grant that relief because the methods under which the Board operates are such that it would be impracticable for the Board to undertake to determine the amount of the relief to be afforded in any particular case. To do that properly it would have to have available and before it a complete record of the data with respect to all corporations. Otherwise, it would not know the correct or proper comparatives to use or proper tax to levy in any particular case. It is, therefore, recommended that the granting of such relief as may be in order in any particular case be left to the administrative authorities, who will have available all the necessary data.

SUGGESTED CHANGES TO COVER DEPRECIATION ADJUSTMENTS

Add to sections 711 (b) (2) (A) (on p. 10) and 711 (b) (2) (B) (on p. 12) the following:

"(VI) ADJUSTMENTS OF BASIS FOR OR RATE OF DEPRECIATION.—If, as the result of a determination by the Commissioner of Internal Revenue, the deduction for depreciation allowable under section 23 (L) for any taxable year beginning after December 31, 1939, is computed on a basis or at a rate different from the basis for or rate applied to the same or similar depreciable assets for any of the taxable years in the base period the amount of the depreciation deduction under section 23 (L) for such base period year or years shall be recomputed on the same basis as and/or at the same rates applied in the taxable years and there shall be deducted for such base period year or years only the amount of depreciation as so recomputed."

SUGGESTED CHANGE TO PERMIT TAXPAYER TO ELECT AT ANY TIME TO USE EITHER INCOME OR INVESTED CAPITAL METHOD WHICHEVER PRODUCES THE LOWER TAX IN THE LIGHT OF FINAL DETERMINATIONS OF NET INCOME OR INVESTED CAPITAL FOR THE TAXABLE YEAR OR THE BASE PERIOD

Change section 712 (a) (on p. 13) to read as follows (omitted portion in brackets—new portions in italics):

"(a) DOMESTIC CORPORATIONS.—In the case of a domestic corporation, the first taxable year of which under this subchapter begins on any date in 1940, which was in existence during the entire forty-eight months prior to such date, the excess-profits credit for any taxable year shall, [at the election of the taxpayer made in its return for such taxable year,] be an amount computed under *either* section 713 or section 714, *whichever results in the lower tax under the application of sections 710 (a) (1) or (2)*. (For election in case of certain reorganizations of corporations not qualified under the preceding sentence, see section 741.) In the case of all other domestic corporations the excess-profits credit for any taxable year shall be an amount computed under section 714."

SUGGESTED CHANGE TO ELIMINATE THE DISCRIMINATION AGAINST SOME FOREIGN CORPORATIONS

Change section 712 (b) (on pp. 13 and 14) to read as follows (new matter added in italics):

"(b) FOREIGN CORPORATIONS.—In the case of a foreign corporation engaged in trade or business within the United States or having an office or place of business therein, the first taxable year of which under this subchapter begins on any date in 1940, which was in existence on the day forty-eight months prior to such date and which at any time during each of the taxable years in such forty-eight months was engaged in trade or business within the United States or had an office or place of business therein, the excess-profits credit for any taxable year shall be an amount computed under section 713, *but in such cases the tax equal to 4$\frac{1}{10}$ per centum of the normal-tax net income provided for in section 710 (a) (1) shall not be levied, collected, or paid*. In the case of all other such foreign corporations the excess-profits credit for any taxable year shall be an amount computed under section 714."

Also change the first part of section 710 (a) (1) (on p. 2) to read as follows (new matter in italics):

"(1) INCOME CREDIT.—If the taxpayer's excess-profits credit is computed under section 713, *and except as provided in section 712 (b)* a tax equal to 4$\frac{1}{10}$ per centum of the normal-tax net income, as defined in section 13 (a) (2), plus":

A possible alternative method which may be preferred by the committee and would eliminate the discrimination is:

"Permit foreign corporations to elect the same as domestic corporations can elect to use either the income or invested capital credit method and then pay the same taxes, including the 4$\frac{1}{10}$ percent of normal-tax net income if that provision is retained."

The above has not been suggested as the committee had some reason, not apparent to the writer, for requiring some resident foreign corporations to use the income method.

SUGGESTED SUBSTITUTE RELIEF PROVISIONS FOR SECTION 721 IN H. R. 10413

SEC. 721. EQUITABLE RELIEF IN SPECIAL CASES.

(a) The excess-profits tax shall be determined under the provisions of subsection (b), in lieu of section 710, in the following cases:

(1) Where the invested capital of any corporation at the beginning of any taxable year or during the base period or the excess-profits net income during the base period, or the invested capital or excess-profits-tax net income during the base period of any acquiring corporation, component corporation, transferor, transferee, predecessor, or successor cannot be determined in accordance with the provisions of subchapter E.

(2) Where the tax if determined without the benefit of this section would, owing to any abnormal conditions, nonrecurring income or nonrecurring deductions affecting the invested capital or excess-profits net income during the taxable year or the base period of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax of representative corporations specified in subsection (b).

(b) In the cases specified in subsection (a, the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $5,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $5,000) for such year.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital and excess-profits net income during the taxable year and the base period can be satisfactorily determined under subchapter E and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, and all other relevant facts and circumstances.

(c) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

NOTE.—In order to prevent the excessive tax burden from which the above section is intended to give relief, working hardship upon the corporation before the relief can be determined, it is suggested that any taxpayer making application for relief in its tax return be given the privilege of abating, with proper security to the collector, 50 percent of the tax otherwise determinable under the statutory method. The 50 percent of the tax abated should become payable to the extent assessable after the determination of the tax under this section, interest at the statutory rate to be paid on any balance then payable.

The CHAIRMAN. Mr. Kenneth Armstrong, Chicago, Ill., representing Marshall Field & Co. All right, Mr. Armstrong.

STATEMENT OF KENNETH ARMSTRONG, CHICAGO, ILL., REPRESENTING MARSHALL FIELD & CO.

The CHAIRMAN. You may proceed, Mr. Armstrong.

Mr. ARMSTRONG. Gentlemen of the committee——

The CHAIRMAN. Is it the same matter that you testified on before the joint hearings?

Mr. ARMSTRONG. After giving effect, Mr. Chairman, to the bill as it has been revised, it brings up a new point in our issue.

The CHAIRMAN. Have you got a brief memorandum?

Mr. ARMSTRONG. No, sir; I have just some notes here that I would like to follow.

The CHAIRMAN. All right.

Mr. ARMSTRONG. Gentlemen, I am here today as one of the many thousand employees of Marshall Field & Co., and for the purpose of representing the many stockholders of that company, much in the same capacity that you gentlemen represent and protect the interests of the people of these United States.

House bill 10413 states as its objective, "to provide revenue and for other purposes"; and my company has asked me to appear here today not to protest any increase in taxes which in the wisdom of Congress is necessary in view of the increased expenditures for national defense, nor does my company object to the principle of an excess-profits tax as a means of raising the additional revenue needed; but we are here to point out to you, gentlemen, that the proposed bill as it now stands taxes at an exorbitant rate, earnings of this and many other companies which are not excess earnings.

The CHAIRMAN. Do you think this is more objectionable than the other bill that you testified about?

Mr. ARMSTRONG. Yes, sir.

The CHAIRMAN. You think it is?

Mr. ARMSTRONG. Yes, sir. Due to the improvement in general business conditions in this country today, we anticipate a 25-percent increase in earnings before Federal taxes over the results for 1939; but when we apply the formula, as we are obliged to do under section 710 (a) 2 of the proposed bill, we calculate that our Federal taxes for this year will be 180 percent in excess of our Federal taxes for 1939. In dollars, gentlemen, this means that a 25-percent increase in income produces $1,414,000, and that the increase in taxes is $1,715,000, or $301,000 more than the total increase in earnings. We are sure that it is not the intention of this Congress to pass an excess-profits tax that not only takes all the increase in profits and then some.

Because of the conditions existing in our business we are not able to qualify under section 710 (a) 1 of the act and must content ourselves with figuring excess profits at the minimum rate of 5 percent.

Marshall Field & Co. was established in Chicago in 1856, and operated a wholesale and a retail dry-goods business. For a number of years the wholesale was the more profitable end of the business, but a change occurred in the buying habits of the country and the wholesale started a downward trend; and in 1935, as a result of a most thorough investigation, it was decided to liquidate the wholesale business. This liquidation was completed by the end of 1938, but it means that during 3 of the 4 base years provided for in this bill the retail store of this company was obliged to absorb not only the recurring operating losses of the wholesale but also the additional liquidating losses as well. The retail business of this company has made money in every year of its entire history, except 1932. Now that the wholesale business is no longer in operation, the corporation today is a different business than it was previous to 1939.

For today it is primarily a retail organization, and the retail division during the base years of 1936 to 1939 had satisfactory profits. As a matter of fact, they were better than the average when compared with the figures released by the Bureau of Business Research, Harvard University, which show that those stores doing an annual volume of business in excess of $10,000,000 reported a return on their net worth of 11.5 percent in 1936, 8.9 percent in 1937, 4.6 percent in 1938, and 8.3 percent in 1939. Yet this company, whose retail profits were in excess of these percentages, is precluded under this tax bill from using such rates of return and is obliged to use the minimum of 5 percent.

Profits in excess of 5 percent for this company surely cannot be called excess profits until they reach a figure substantially in excess of that percentage.

The preferred stock of this company pays a 6-percent return to its holders, and surely the common stockholders with the greater risk should be entitled to a higher return—if not, how are we going to interest new capital in this business?

Old corporations should be allowed the same rate of return on their invested capital as that offered to new corporations. The stockholders in old corporations are continually changing; with the economic changes that have occurred in this country within the last 20 years it is just as difficult to forecast the earnings for an old corporation as it is for a new corporation, and it is just as much a speculation on the part of an investor to put his money into stock of an old corporation as it is to buy stock in a new corporation.

I wish to reiterate that it is not our purpose to object to paying taxes or higher taxes, but we do believe that taxes should not be inequitable as between taxpayers, at least taxpayers in the same type of industry.

In view of the reluctance of Congress to enact in the proposed bill special relief provisions which would permit consideration of competitive conditions, we believe and respectfully suggest: (1) That corporations be allowed an exemption of 8 percent on invested capital before the imposition of excess-profits taxes, and (2) that borrowed capital be included 100 percent as part of invested capital—for large corporations the same as small.

Senator VANDENBERG. Mr. Armstrong, would section 327 of the 1921 law substantially meet your necessity?

Mr. ARMSTRONG. Yes, sir.

Senator BYRD. Are there many companies similarly affected as yours?

Mr. ARMSTRONG. Yes, sir; Senator Byrd. I have heard previous witnesses speak of the textile business. We have a number of textile mills down in Virginia and North Carolina who are penalized by having to use the 5-percent rate. On the other hand, there are corporations who are not affected the same as we are, such as the retail end of our business, but because of having this wholesale liquidation, which was an unusual situation, and our retail is not going to be competitive with the other retail industries of the country, and we have to meet this competition. So I think there are any number of corporations that will be affected one way or the other. This bill will either create a benefit or an undue penalty and the bill will not be equitable between the vast majority of taxpayers in this country.

Senator BYRD. Did your company invest any new capital?

Mr. ARMSTRONG. Yes, I think so, definitely. This company spent, during the 4 base years of 1936 to 1939, the sum of $23,000,000 to increase its facilities, that is the purchase of land, buildings, and equipment, and under this bill, because of the fact that they are obliged to take the minimum of 5 percent they are not allowed, or rather they are forced to consider all the income that arises from this increased expenditure as excess profits, which, in effect, in our opinion, are only normal profits accruing to a business that has the foresight to step out and increase its facilities.

The CHAIRMAN. You would elect then the invested-capital method?

Mr. ARMSTRONG. Yes.

The CHAIRMAN. Your concern would?

Mr. ARMSTRONG. Yes.

The CHAIRMAN. It gets a break in that over the original House subcommittee recommendations on which the committee heard you, up to $500,000 from 6 to 7 percent credit; that is true, is it not?

Mr. ARMSTRONG. Yes.

The CHAIRMAN. And over $500,000 you get a break from 4 percent credit to 5 percent, is that right?

Mr. ARMSTRONG. Yes, sir.

The CHAIRMAN. And then you get a further credit, those who elect to take the base period, you save from that penalty, that we put a 4.1 penalty on them, is that right?

Mr. ARMSTRONG. Yes, sir, but contrary wise, Mr. Chairman, the excess-profits tax rate is increased from 40 to 45 percent, so that the advantages that we have in increasing the rate on the invested capital from 4 to 5 percent are offset by the increase in the tax rate of from 40 percent to 45 percent. So that, in answer to your original question to me, this bill does not benefit us any more than the original bill submitted by the House Ways and Means Subcommittee on Taxation.

The CHAIRMAN. Then there is also a difference on the excess profits of about 5 percent, if you take the method that you say your company would take rather than the average earnings period.

Mr. ARMSTRONG. There is that advantage, but it is offset by this other disadvantage, in my opinion.

The CHAIRMAN. All right, Mr. Armstrong. Thank you.

Senator CONNALLY. You are a professional tax man, are you not?

Mr. ARMSTRONG. No, sir; I am comptroller of Marshall Field & Co. As I said in one of my opening remarks, I am one of 16,000 employees working for that company.

Senator CONNALLY. That does not identify you. What kind of employee are you?

Mr. ARMSTRONG. I am comptroller of that corporation.

The CHAIRMAN. Anything else, Mr. Armstrong?

Mr. ARMSTRONG. That is all. Thank you.

The CHAIRMAN. Mr. E. D. Evans of Chicago who represents Arthur Andersen & Co., is the next witness.

STATEMENT OF EDWIN D. EVANS, REPRESENTING ARTHUR ANDERSEN & CO., CHICAGO, ILL.

The CHAIRMAN. All right, Mr. Evans. Have you got a brief that you want to put into the record?

Mr. EVANS. Yes, sir; I have.

The CHAIRMAN. Just point out the important points to us.

Mr. EVANS. I have only one point, Mr. Chairman, and it will only take me a minute.

The CHAIRMAN. All right.

Mr. EVANS. My name is Edwin D. Evans. I am partner in the accounting firm of Arthur Andersen & Co., of Chicago, Ill., one of the national accounting firms, and I have charge of the tax work in all the offices of that firm.

I am a certified public accountant in a number of States and am a member of the American Institute of Accountants and of the Illinois Society of Certified Public Accountants.

I am here as a representative of Arthur Andersen & Co.

This tax bill is designed to levy an excess-profits tax on that part of corporate income for current or subsequent years that is in excess of a stipulated return on invested capital or of average earnings for certain prior years. The Ways and Means Committee made a very definite attempt to exclude unusual items in determining income subject to the tax and income of the base years where such items would result in the distortion of the income. These adjustments are set forth in section 711 of the bill.

One of these adjustments eliminates income derived from retirement or discharge of indebtedness. However, no provision is made for the elimination of losses or expenses incident to similar transactions. An example will clarify the point.

Corporation A sold its bonds in a prior year at par but in 1938 was able to repurchase them at 80. The 20-point profit was taxable in the year of purchase and the House, quite properly, has eliminated this unusual and nonrecurring item from base-period income. However, the reverse of this situation has not been accorded similar treatment. Suppose Corporation B sold $5,000,000 of its 10-year bonds in 1934 at a discount of 5 percent or $250,000. Each year it was permitted to deduct one-tenth of this discount or $25,000. In 1939, due to the existence of a favorable money market, it refinanced and thereby reduced future years' interest charges. The bonds of 1934 having been retired, the remaining unamortized discount, of $125,000, together with any retirement premium which may have been paid, was charged against 1939 income in accordance with the Treasury Department's rulings, as approved by the courts. These items of expenses are of the same unusual and nonrecurring nature, as is the income mentioned in the first part of this example, and often result in serious distortion or even elimination of income.

I suggest, therefore, that section 711 be amended in the four places[1] where income from bond retirements is dealt with by inserting the phrase—

> and deductions for retirement premiums paid and unamortized discount and expense allowed in connection with

so that the revised paragraphs will read as follows:

> Retirement or discharge of bonds, and so forth: There shall be excluded, in the case of any corporation, income derived from and deductions for retirement premiums paid and unamortized discount and expense allowed in connection with the retirement or discharge of any of its bonds, debentures, notes, or certificates or other evidences of indebtedness, which have been outstanding for more than 18 months.

That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Mr. I. R. Glass, New York City, representing the Tanners Council of America.

[1] Sec. 711 (a) (1) (C), (a) (2) (E), (b) (2) (A) (iii), and (b) (2) (B) (iii).

STATEMENT OF I. R. GLASS, NEW YORK CITY, REPRESENTING THE TANNERS COUNCIL OF AMERICA

Mr. GLASS. Senator Harrison and members of the committee: As economist for the Tanners Council I am not here to go over some of the technical features or deliver any speech on the technical features of the measure as enacted by the House. The tanners whom the Tanners Council represents are not concerned with excess profits; they do not question the validity or purpose of such a bill. As the operations of the tanning industry have been rather notoriously unprofitable, the tanners are very seriously concerned, as members of an unprofitable industry, with the aspect that the high rate of the tax contemplated in the House measure would be paid from returns which, over a period of 2 or 3 years, would actually be low or show a loss. The earnings of tanning companies over 2 or 3 years might well show a net loss, yet because of the character of the industry the high rates of tax might impinge upon a single year and might, in that single year, become 50 or 55 percent of the total income—that is, the total after the taxes, including the excess-profits taxes that the rate contemplated would take.

I think the two options offered in the House bill, that is to say, either the average income or average earnings ratio or invested capital option are predicated upon two assumptions, or rather three: First, that earnings in a base period are representative of the normal or reasonable or fair returns to which a corporation is entitled; second, that those earnings are actually available in such form as they can be utilized through the payment of taxes; and, third, that the earnings of corporations are regular and stable, not only in the base period but in other times as well, and particularly in those years which will be affected by the excess-profits-tax measure.

Now those assumptions or premises may be true of some industries, but they are not the case, emphatically not the case, in the tanning industry. The income of a tanning corporation is extremely erratic. From year to year fluctuations may be as great as 100 or 200 percent. Profits in one year may be followed by equivalent losses in the next.

I should like to cite, if I may, several figures. For example, in the period from 1929 on, based on a report by the Federal Trade Commission on income taxes and processing taxes on agricultural commodities and the tanning industry, at least the representative tanners showed losses between 1929 and 1935—showed losses in all but 2 years. The net loss over that period was something like $17,000,000 for 11 companies. In the period between 1936 and 1939 average earnings for the 4-year period were extremely low. In 1939 the report showed $600,000 earned on invested capital of approximately $7,100.000. The preceding year, however, that company had a loss of $603,000. In other words, the profit earned in 1939 was completely offset by the loss taken in the preceding year.

The point I should like to emphasize has been brought up here before. It relates to the erratic and fluctuating character of income in certain industries. I can speak best for our own, the tanning industry. We have such an erratic and fluctuating character of income, that it is almost impossible to assess fair excess-profits taxes in terms of annual income. The income for a single year can never be representative of earnings in the tanning industry. The reasons for that are fairly obvious and do not have to be repeated in great detail.

The industry has a very slow turn-over. It has an unusually high proportion of inventory to total asets. The coincidence of a sudden price rise and large volume may easily produce a large income for a given year, a fairly heavy return on invested capital, but a year of that character is unusual. It is axiomatic, as a matter of fact, in the tanning industry that 1 year out of 4 or 1 year out of 5 is the year that carries the tanners. Nevertheless the taxes which would be imposed on a tanning corporation for that good year—taxes upon income which would certainly be offset inevitably as the price cycle reached the bottom—would absorb a very heavy proportion of income for the single year.

Most tanning corporations would have to elect the invested capital basis of determining their excess-profits credit. Upon that basis they would have the minimum option, that is to say 7 percent on the first $500,000 and 5 percent on all capital thereafter. That minimum would become to many companies the maximum tax credit which they would be allowed.

It is probably quite true that the income of tanning corporations over a period of years would not be seriously affected by those minimum rates, in sofar as tanners do not have any excess profits, insofar as they have been able to operate and will probably continue to operate for a few years, and that without reference to the new situation which may be created by the national-defense program. Nevertheless, the House bill, as written, will make it necessary for tanners to face a very inequitable and, potentially, a very dangerous situation for any single year.

There is a third point in connection with that analysis, and that is the availability of income in a single year for the payment of taxes. I think most tanners would concede, if income were available and were actually realized and on hand, the dangerous or inequitable and potential discrimination involved in the tax rate would not be very serious, but the whole difficulty of our tanners is that they do not have the income available for the payment of taxes at the rate called for under the House measure.

Senator BAILEY. They recoup in prosperous years the losses that they sustained in prior years, where they have such losses?

Mr. GLASS. Yes.

Senator BAILEY. That being so, there would be no inducement to carry on an enlarged business or to invest new capital in it, is that right?

Mr. GLASS. If I may I would like to read just a sentence or two from a letter of a comparatively small tanner in which he expresses his reaction to the House measure:

> As you will readily realize from these figures, our only hope of continuing in business is to ultimately eliminate our deficit position and to get some net worth behind our stock.

The point he is making is that the company has been making a deficit for a number of years, it had losses for the past 12 years. It continued in business by virtue of loans and by virtue of credit extended to it by creditors.

Senator BAILEY. We ought to levy a tax bill that ought to be an inducement to the investment of new capital, if we want the country to grow.

Mr. GLASS. I agree with that, sir.

Senator BAILEY. If we want business to grow, and if business does not grow we will lose the last hope, whether the balancing of the Budget will pay the national debt. That is the last hope.

Mr. GLASS. I concede heartily in that statement, Senator.

Senator BAILEY. If we do not get that we will have socialism. Is not that the alternative of the proposition? We must fix it so the people will be willing to invest capital or take the whole thing over and run it. Is not that what we have got to do?

Mr. GLASS. That would be the practical effect of the measure as applied to the tanning industry, because it would certainly tend to dissuade the investment of capital in any tanning industry where the condition would be faced that in the profitable years they would be taxed at extremely high, unreasonable rates, without any offset, without any compensation for the inevitable and necessary loss years.

Senator VANDENBERG. What would you do to meet that situation?

Mr. GLASS. It seems to me, sir, that there are two possibilities. If no specific cognizance would be taken of the situation in individual industries and if the tax is to be applied on an annual basis, then the exemption, that is to say the credit, ought to be high enough to comprehend situations of this sort, a credit of 10 percent on invested capital, so in no single year could a company be seriously and adversely affected by having to pay out most of its income for Federal taxes without any offset in subsequent years of loss. On the other hand, if it is possible to write a measure which will take practical recognition of this problem, it would seem to me that the point of view expressed by several witnesses today is extremely germane; that is to give recognition of the fact that corporate income is not an annual proposition, that corporate income cannot be measured in a period of 12 months; that the only fair way of measuring corporate income would, in effect, be on a cumulatory basis. In other words, to permit the excess-profits measure to carry forward deficiency of credit for a given year. Even that does not meet the problem, obviously, because in the first or in any year in which the excess-profits tax might apply there may be a very substantial levy on income without any previous deficiency to carry forward. So that the tax would fall upon an average or cumulative income, and that the excess be measured in terms of your average or cumulative income rather than the result for a single year. It seems to me in that way can most of the difficulties which would flow from erratic and fluctuating annual income be eliminated.

Senator GUFFEY. Is not the trouble today with the tanning business caused by two reasons: One, the time that elapses from when they buy the raw material until it is a finished product? How long does that take on the average? Fifteen to eighteen months?

Mr. GLASS. Do you mean in the case of tanners who import their raw material?

Senator GUFFEY. Yes.

Mr. GLASS. It takes as long as 15 months.

Senator GUFFEY. And the second reason is the decrease of consumption of leather, especially in ladies' shoes.

Mr. GLASS. Not particularly.

Senator GUFFEY. What is the decrease in consumption? I am asking for information. What is the decrease in the amount of leather consumed in ladies' shoes?

Mr. GLASS. In the past 10 years we have increased it approximately 8 or 9 percent.

Senator GUFFEY. It has increased instead of decreased?

Mr. GLASS. Yes.

Senator GUFFEY. I mean the amount of leather that has gone into a shoe.

Mr. GLASS. Into the shoe business?

Senator GUFFEY. Yes.

Mr. GLASS. The fact of the matter is that they made 361 million pairs in 1929 and 403 million pairs in 1939.

Senator GUFFEY. I mean the amount of leather that has gone into the shoe itself. They have cut the toes out of most of them.

Mr. GLASS. That has been offset by the increased growth in number of shoes produced annually.

Senator BAILEY. You are using more leather now than you used 20 years ago?

Mr. GLASS. Yes; except in 1920, when the volume was extremely high.

The CHAIRMAN. Have you something more?

Mr. GLASS. I should like permission to file an amplified statement in the record.

The CHAIRMAN. All right, we will be glad for you to do it, but do it right away.

The CHAIRMAN. Mr. Clinton Davidson, Jersey City, N. J., representing Fiduciary Counsel, Inc. All right, Mr. Davidson.

STATEMENT OF CLINTON DAVIDSON, JERSEY CITY, N. J., REPRESENTING FIDUCIARY COUNSEL, INC.

Mr. DAVIDSON. Senators, I have been wondering why this bill treats the allegedly wicked personal holding corporations more fairly than it does the great majority of personal service corporations. Now, we believe that this treatment was not intentional, but was rather due to an unintentional technicality.

Also, I cannot believe that this committee will intend that the definition of "personal service corporations" in the bill shall exclude about 90 percent of the real personal service corporations from the personal service corporations section of the bill, but I believe that the present bill does just exactly that, due to a technicality in the definition.

I shall, therefore, this morning suggest to you only one thing, and that is that the definition of personal service corporations be expanded so as to include the average rather than the exceptional, and when that is done we believe that the total revenue to be collected will be practically not less than it is under the present definition, and we believe that that definition can be changed by adding only 35 words in a very simple manner.

Ever since the World War I believe there has been in the minds of the revenue department, and I believe there is still in the minds of men connected with the revenue department, who were there during the World War, the picture of a personal service corporation being merely an incorporated partnership, and therefore it has always been the intention to tax personal service corporations as far as excess-profits tax is concerned just as if they were partnerships that had merely been incorporated because of the advantage of the limited liability. Unfortunately the wording of the definition in this bill eliminated the great majority of the real personal service corporations, merely because it states that to be a personal service corporation 80 percent of the stockholders must be actively engaged in the conduct of the business, and in most personal service corporations 80 percent of the stockholders are not actively engaged in the work of the business.

To explain that, I might ask this committee how personal service corporations are formed, and I believe that every member of the committee knows. It is something like this: Dick Jones or Bill Brown have a special experience or ability, we will say, in the general insurance business, and they have the opportunity of taking over a local general insurance agency, and so they go to some other people in the town and say, "We will need some capital. We believe this agency will be quite profitable, but we need a certain amount of capital to pay salaries to start with, to take over the business, to furnish the office, that is merely to get started."

They have to give the people who furnish that capital up to 50 percent or more of the stock, and if those stockholders who put up the capital own more than 20 percent of the stock, then, according to this definition, they are not personal service corporations, although substantially in every other way they are personal service corporations and they are really simply incorporated partnerships.

Senator BAILEY. What is your definition of a personal service corporation?

Mr. DAVIDSON. I have it on the last page here, sir, of my brief. Now, I might ask anyone what is, as the gentleman asked, what is a personal service corporation. I believe it is this——

Senator BAILEY. A personal service corporation, if I may anticipate you, is a corporation that does business upon the good will and upon the experience of the persons rather than upon capital invested.

Mr. DAVIDSON. That is right, sir; but they have to have some capital to furnish the office.

Senator BAILEY. The assets of a personal service corporation are the personal capacities, the good will and the experience of the persons connected with it.

Mr. DAVIDSON. That is correct, sir.

Senator BAILEY. Am I right about it?

Mr. DAVIDSON. That is right in most cases, but in some cases somebody has to buy into it.

Senator GEORGE. No one buys into it unless he has capacity and personal experience, is that not so?

Mr. DAVIDSON. In a great many cases they do, sir. As an example of how frequently it is done, the expression, "the silent partner" has become a byword. The silent partner is the one who put in the money but does not do the work. This is done so frequently that we are all familiar with the expression of "silent partner." I think the following are all of the characteristics of a personal-service corporation and an incorporated partnership: One, it renders personal service; two, capital is not a material income producing factor; three, there are usually a small number of partners.

I cannot think of, I never heard of, a partnership that had 200 or 300 or 400 partners. The very nature of a partnership limits it to a small number of partners, and because personal service corporations are usually merely incorporated partnerships they usually have a small number of stockholders.

Now, another factor, capital is not the material income producing factor, but yet, in many partnerships as well as in personal-service corporations there are partners who contribute capital rather than doing the work.

Now, if this definition in the act would include all of those characteristics, would give some attention to, for instance, the small number of stockholders, the comparatively small amount of capital instead of basing it so much on the fact that the stockholders who contribute capital must be engaged in the work, I think you would come to a more normal definition of a personal service corporation. It seems to me that the present definition in effect says to all of those personal-service corporations who have the silent partners in them, it says in effect to them:

You may be merely an incorporated partnership, but if those who furnish the capital instead of work own over 20 percent of the stock, you are not a personal-service corporation.

It says, in effect:

We give personal holding corporations, the allegedly wicked personal holding corporations, we give them the privilege that you are asking for, that is to be taxed as a partnership. That is the stockholders will pay the surtax and normal tax on the income. Now, we give that to personal holding corporations whether their 80 percent of the stockholders are engaged in the work or not, no qualification at all. We also give them the privilege of partnerships. We give them to the small percentage of personal-service corporations. We give them to mutual investment trusts. We give them to a great many other investment trusts, but if you happen to be one of the incorparated partnerships where the people who put up the capital instead of the work own more than 20 percent, you are just out, you are treated far worse than the personal holding corporations.

Now, I do not believe that it is the intention of this committee, nor do I believe it has been the intention of any one to treat the great majority of personal-service corporations that way. I think it is a purely unintentional technicality that has done it.

Here are three reasons why it is unfair to treat them that way: Section 713 of the bill does not apply to the personal service corporation unless it has been in existence from 1936 to 1939, unless it has been in existence all of that time they cannot take advantage of section 713. If it has been in existence all of that time and still is a young corporation, section 713 would not help it much, because it has not gained its stride.

Second, the investment capital basis is naturally unfair to a personal-service corporation because, as we said, one of the characteristics is that capital is not a material income producing factor, and if that is true, then the invested capital basis is manifestly unfair.

Third, the personal-service corporations who have to raise some capital—and they have to raise it from the people who do not do the work but merely people who have the money—if they cannot be treated as personal-service corporations then it is going to be extremely difficult for the average young man who has the ability and experience in some line of personal service, it is going to be extremely difficult in the future for him to get the capital that is necessary to get that business started.

Now, in conclusion, gentlemen, it is so easy to correct this difficulty. There is no drafting difficulty, it is merely a question of adding to the present provision 35 words. There is no drafting difficulty, and we believe that it will not decrease the total tax collected, or if it does decrease it the amount will be so very small that it will not be comparable at all to the great injustice that is being done to the great number of these personal-service corporations under the present act.

Now, if I may read this proposed amendment I shall be through.

(a) *Definition.*—As used in this subchapter, the term "personal service corporation" means a corporation in which capital is not a material income-producing factor and either—

(1) whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the owners at all times during the taxable year of at least 80 per centum in value of all the stock of the corporation, or

(2) all of whose stock is owned at all times during the taxable year by or for not more than 20 individuals and whose invested capital for the taxable year is not in excess of $500,000;

another usual characteristic.

If we merely add that one phrase into the definition we then believe that the definition of personal-service corporations will include the average incorporated partnership and will include the average real personal-service corporation.

Senator GEORGE. All right. Thank you, sir.

(The brief of Mr. Davidson is as follows:)

BRIEF OF CLINTON DAVIDSON ON BEHALF OF FIDUCIARY COUNSEL, INC., TRUST COMPANY OF NEW JERSEY BUILDING, JERSEY CITY, N. J., RE PERSONAL SERVICE CORPORATIONS

My name is Clinton Davidson.

I represent Fiduciary Counsel, Inc., of Jersey City, N. J., an investment advisory organization.

I wish to direct the attention of the committee to section 723 of the pending revenue bill which relates to personal-service corporations, that is, corporations in which ability and experience, rather than capital, are the material income-producing factors.

Since the inception of the excess-profits tax idea during the first World War, it has been universally recognized that personal-service corporations should be given the election of being taxed substantially as partnerships. Under this method, the corporation's income is subjected to the normal corporate tax, and the remaining balance, after deduction of such corporate tax, is picked up in the individual returns of the stockholders and subjected to individual normal and surtaxes. Section 723 of the bill is obviously intended to continue this policy.

As the section is now worded, however, an overwhelming majority of the personal-service corporations of the country are excluded therefrom. This is because the section is limited in its application solely to those personal-service corporations in which at least 80 percent of the stockholders are regularly and actively engaged in the conduct of the affairs of the corporation. The exclusion of most of the personal-service corporations of the country by reason of this limitation is because it constitutes a characteristic of only a small percentage of such corporations.

WHAT ARE PERSONAL-SERVICE CORPORATIONS?

This committee knows how the average personal-service company is formed. Bill Jones and Dick Brown have special ability and experience in the general insurance business and they desire to take over a well-known agency in their city. They need a certain amount of capital, however, with which to set up their own business—money to pay rent, buy furniture and equipment, pay salaries, and other expenses. The corporation is formed and the men who invest the capital customarily receive up to 50 percent or more of the stock in order to induce them to invest. Such inducement is necessary because Jones and Brown have no initial credit with which to borrow capital and the investment is uncertain and unsecure. Usually the men who invest the capital under these circumstances know nothing of the personal services to be rendered and consequently do not participate in the active conduct of the business.

Other types of personal-service corporations include investment-advisory services, publication and news services, and hundreds of other businesses in which ability and experience, rather than capital, are the income-producing factors.

These personal-service corporations are in the nature of incorporated partnerships. In some instances, as in the case of partnerships, all or substantially all of the members are actively engaged in the business affairs of the corporation. However, in many partnerships the interest of one or more of the partners is represented by his capital contribution and the interest of the remaining partners is represented by services rendered to the firm. This is more apt to be the typical relationship in the case of the incorporated firm by reason of the fact that incorporation is usually for the purpose of affording limited liability to the member furnishing the capital. As in the case of partnerships, the capital of the personal-service corporations is relatively small compared to that invested in industrial enterprises and the membership is almost invariably limited in number.

PRESENT PROVISIONS OF BILL

The proposed bill recognizes the unfairness of subjecting personal-service corporations to the excess-profits tax, and limiting its credit to the average earnings basis under section 713 or the invested-capital basis under section 714. Some of these unfairnesses are as follows:

1. Section 713 is available only to those corporations which have been in existence for the entire base period from 1936 to 1939 and consequently would not be available to personal-service corporations organized since 1936. New personal-service corporations a.. constantly being organized by men who are acquiring ability and experience in various fields. Even if the corporation had been in existence during the entire base period, it is very apt to be a relatively new corporation, the earnings of which during such period would not represent its normal earnings.

2. The percentage of invested-capital credit described by section 714 is obviously unfair in the case of personal-service corporations because their earnings are not based upon capital, but rather upon the experience and ability of those performing the services.

3. This treatment will make it more difficult in the future for such corporations to secure the capital needed to get their businesses under way.

The only fair treatment for personal-service corporations is to recognize their partnership characteristics and give them the right to be taxed accordingly. The bill does this for a limited group of such corporations. By reason of the artificial limitation referred to above, however, most of them are, in fact, denied this treatment.

SUGGESTED ALTERNATIVE LIMITATIONS

In order that those personal-service corporations whose investing members are not actively engaged in the business affairs of the corporation may be brought within the scope of the bill, it is urged that alternative limitations be added which will result in including them without expanding the section to take in corporations not entitled to the personal-service corporation treatment. The limitations suggested are based upon the typical characteristics of a personal-service corporation, namely, a relatively small amount of capital and a limited number of stockholders. It is submitted that if the capital limitation is placed at $500,000 and if the number of stockholders is limited to 20, with the over-all limitation that capital shall not be a material income-producing factor, the desired result will be obtained. An amendment to section 723 incorporating these alternative limitations will eliminate discrimination between personal-service corporations and will still keep the section within practical limitations.

Such an amendment, we believe, will involve no drafting difficulties. It would merely require the addition of the alternative limitations to the present provision. Nor would it have any substantial effect upon the revenues. The corporation itself will be subjected to the normal tax and, in addition, the stockholders of the corporation will be required to pick up the remaining balance of the income in their personal returns where it will be again subjected to tax at the individual normal and surtax rates. This latter tax alone is considered adequate in the case of partnerships to exclude them from the excess-profits tax. Similar tax treatment is even considered adequate to remove personal holding companies, both domestic and foreign, from the bill.

To effectuate the foregoing proposal, the following draft of an amendment is submitted.

PROPOSED AMENDMENT TO EXCESS-PROFITS-TAX BILL

Amend section 723 to read as follows:

"SEC. 723. PERSONAL SERVICE CORPORATIONS.

"(a) *Definition.*—As used in this subchapter, the term 'personal service corporation' means a corporation in which capital is not a material income-producing factor and either—

"(1) whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the owners at all times during the taxable year of at least 80 per centum in value of all the stock of the corporation, or

"(2) all of whose stock is owned at all times during the taxable year by or for not more than 20 individuals and whose invested capital for the taxable year is not in excess of $500,000—

"but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists of gains, profits, or income derived from trading as a principal. For the purposes of this subsection, an individual shall be considered as owning, at any time, the stock owned at such time by his spouse or minor child."

Senator GEORGE. Mr. Andrew Trudgian.

STATEMENT OF ANDREW B. TRUDGIAN, REPRESENTING THE NATIONAL ASSOCIATION OF CREDIT MEN

Mr. TRUDGIAN. I have prepared a statement that, with the leave of the committee, I would like to hand in and supplement with just a few remarks.

Senator GEORGE. You may put it into the record.

Mr. TRUDGIAN. I represent the National Association of Credit Men, and its interest in this law is the maintenance of a sound national credit. I myself happen to be the tax consultant of S. D. Liederdorf & Co., certified public accountants, and I have been in the tax business about 20 years. I worked under the old excess-profits tax law. I want to say that I had grave difficulty in computing the tax of three companies after I came into possession of a copy of the proposed bill, despite the 20 years' experience. It is extremely complicated, so complicated that the average businessman, who does like to understand what the tax that he pays is about, will never understand it; he cannot possibly do it.

The second thing I want to mention is that the law is based on a comparison of the result of two periods, 1936–39 as against 1940. Well, 1936 to 1939 was not necessarily a normal period. As a matter of fact, no base period is necessarily normal, but where you have a period, as in 1936 to 1939, where excise taxes were higher in some cases than they are now, where you had an agricultural adjustment tax law going off, where maybe you had some labor difficulties, or you spent a lot of money from which you would get the benefits in 1940, there is no fair comparison possible. If there is to be a comparison, certainly there should be an election on the part of the taxpayer to compare 1 year with 1 year in that base period.

One of the particular corporations whose income and tax liability I checked up on under this bill had one bad year under the income basis.

As the result of that, the corporation's excess-profits tax would be, $289,000. Its income tax will be something over $300,000. That is on an income a little in excess of $2,000,000.

I checked up on another company on the invested capital basis, on the same day that the court upheld their good-will claim: Their excess-profits tax would be $250,000. But if that good will does not hold up I do not know what will happen.

I checked up on another company that had been through a reorganization and their excess-profits tax will be $225,000 as against an income tax of $227,000.

Now, if you give an election to companies to pick out the best year then there is no reason why a company that was in existence just a part of the period cannot use that comparative basis. It should be able to use it because it is a normal period for comparison, and we have to at least give the corporation the benefit of selecting the best year for the comparison.

Another thing about the law where there should be some benefit is the fact that only borrowed capital covered by paper can be included in invested capital; open accounts cannot. Now, a lot of corporations have to finance with open accounts, and it does seem to me that all borrowed capital should be considered. They throw out the interest deduction on the amount of borrowed capital which the bill allows, so therefore if you pay interest on this open account indebtedness either the taxpayer should be able to deduct the interest or the indebtedness should be included in invested capital.

The bill itself, in my opinion, will today not be susceptible of any accurate enforcement. The law properly allows intangibles to be paid in for stock or shares to the fellow who was lucky enough to pay them off and have it recorded on the books for 20 years back to prove what the value was when he put them in. The formulas for figuring out these intangibles are very complicated. The bill has all kinds of formulas. It uses Hoskill's formula for leaseholds, and arbitrary formulas for good will. You have to have the figures required by the formulae, and if you are not lucky, or have not kept complete books from 1850 you will not get good will while some others will. Section 327 of the old law might help that situation, but it is not in this law.

Section 327 covered a company that was sustaining a hardship. The taxpayers' attorney would go out and survey all the favorable companies he could find, and the Government would get the favorable companies it would find, and, they would arrive at what was considered a representative percentage of invested capital for the purpose of working out this company's tax. All of those things are of course provocative of litigation, unknown liabilities for credit purposes, tremendous expense for accountants, and the businessman does not know what it is all about. A law of this kind today, especially with consolidated returns not in the picture, cannot help but produce the greatest inequity and unfairness, and until some better law can be worked out, I feel that this measure should not go through.

The provisions with regard to reorganizations and exchanges are unsatisfactory. To be required to trace down the values, to find them, and then if you cannot find them to be penalized, is a tremendous hardship.

I have only one more thing to mention. Most of what I have to say is covered in the statement, but I want to say this: Some corporations have to own subsidiary companies. Maybe they are selling their products, maybe they are manufacturing them. They do not have to own all the stock, but they own part of it. In a situation like that, the stock of a subsidiary company is an inadmissible asset under this bill. The company may get no dividends out of the other company, but the stock should be in invested capital and the corporation should have an election to include that stock in its invested capital.

Senator BAILEY. You had the experience of working under the old law?

Mr. TRUDGIAN. I did; yes, sir.

Senator BAILEY. Did you make a comparison between that act and this proposed legislation?

Mr. TRUDGIAN. Well, under the old law the base period picked out was possibly normal; it was 1911, 1912, and 1913. The base period picked out here is 1936, 1937, 1938, and 1939. We had an undistributed profits surtax in 1936. The top bracket was 27 percent. Corporations that could not pay out their money borrowed capital. That borrowed capital bore interest the next year. 1911, 1912, and 1913, the years picked out, were normal in many relationships between business and its employees. In those days there were not the ramifications of corporations that there ane now, no consolidations to the great extent that we now have. In 1911, 1912, and 1913, there were fewer varieties of business than there are now. So I say that while that law was objectionable and was abolished in 1921 for that reason, I myself—and I speak only for myself on this—I feel that it is a better reasoned-out law than this one.

Senator BAILEY. Suppose we should take the 1918 act and modify it with respect to the rates, apply increases in those rates; how about decreasing the exemptions?

Mr. TRUDGIAN. If you please, Senator, that depends on whether this is supposed to be a revenue bill or a recapture bill.

Senator BAILEY. My point is we did survive the old 1918 act, and I assumed in the question that we would survive this one. Now, you are a credit man. Under this bill, if I loan money to a corporation have I a reasonable prospect of ever collecting it?

Mr. TRUDGIAN. Now, of course, I would not know, but I would say this: Because of the complications of this bill and the impossibility, without court litigation, in some cases, of knowing the amount of the tax liability, such indefinite liability will have to be carried in the statements of many companies. Those conditions would have to be considered for credit purposes.

Senator BAILEY. Do not you think, under these present circumstances, that the primary need in this country is a system that will induce people to take their money out of banks and put it into business?

Mr. TRUDGIAN. I would say this: In 1922 we did not have any more excess-profit-tax laws. We lowered the capital-gains tax, and from 1922 to 1923 there was a decided business upswing. The trouble with this type of taxation is that the taxpayer has a tremendous expense under it. He has to hire outside talent at high prices. He is going to have a court fight in many cases, and that means lawyers.

In addition to that, he is going to have all along this feeling that he does not know where he is. Now, that was true also of the 1921 act, the 1918 act, and the 1917 act. A businessman, it seems to me, if he has to pay out his money, should be able to see where it is going and why it is going out. When he gets a law like this, and he knows that his competitor may be paying very little while he is paying a lot, he runs into the uncertainties and difficulties which always develop under a law based on excess profits.

Senator BAILEY. You say you read the Congressional Record. If you read the Record back there you would see where the Democrats criticized the Republicans about not paying off the public debt through revenue.

Mr. TRUDGIAN. I think Republicans are always criticizing Democrats and Democrats are always criticizing Republicans.

Senator BAILEY. I should like them to pay off the debt.

Mr. TRUDGIAN. That is all I have to say.

Senator GERRY. How much do you take into account the fact that in 1917 the country had been going along pretty prosperously, under pretty prosperous times for a couple of years and industry was on a little different level?

Mr. TRUDGIAN. In 1917 we had a war and there was an attempt in the law to recapture. In addition to that, it was a revenue measure. I forget the exact details of how it worked now, but England had put on an excess-profits tax or war-profits tax and in this country they felt that that was the thing to do. The income-tax rate was so low that it is possible that Congress felt it should not raise the income tax up to 20 or 30 percent from the low rate they had, but that it would be better to put on a new type of taxation modeled after the English system, or more or less modeled after the English system. They tried it; it was an experiment.

Senator GERRY. I guess that there was another factor involved, that is because the war had been going since 1914 and many industries had been established to meet the demands of the warring nations, that gave the basis on which to go.

Mr. TRUDGIAN. That is right.

Senator GEORGE. Thank you.

(The brief of the National Association of Credit Men is as follows:)

STATEMENT OF NATIONAL ASSOCIATION OF CREDIT MEN WITH REFERENCE TO H. R. 10413—EXCESS-PROFITS TAX ACT OF 1940

The National Association of Credit Men, with a membership of approximately 20,000 representatives of manufacturers, wholesalers, and insurance companies throughout the United States, is devoted to the maintenance of sound credit. Having this in mind it offers, through its committee on taxation, the following statement with reference to H. R. 10413—Excess-Profits Tax Act of 1940:

Inappropriateness to meet objective.—As appears from the report of the Subcommittee on Internal Revenue Taxation of the Committee on Ways and Means, the purpose of the proposed act is to recapture undue profits which companies may earn as a result of participation in the national defense program. It is understood that out of the 500,000 active corporations in the United States only 70,000 will be taxed under its provisions, and the revenue so raised may amount to around $700,000,000 annually.

It is submitted that if recapture of excess profits is the purpose of the tax, and if the revenue resulting thereunder is only a secondary consideration, then because of its grave faults and inequities, the measure is an unsuitable instrument for accomplishing what is desired. Some more selective form of taxation should be designed which will result in the desired recapture of excess profits but will not produce far reaching difficulties, hardships, and inequities.

If, however, the purpose of the law is no longer the recapture of profits but the raising of revenue, then the burden of such additional moneys should not be placed on only the 70,000 corporations under the guise of their having undue profits, but its heavy load should be generally shared. Moreover, as hereinafter pointed out many of these companies, because of their peculiar situation and not because it should properly be borne by them, will be forced to carry more of this burden than others. Further, the load to be carried will not be solely one of taxation, but of the difficulties and large expense they must incur in endeavoring to establish their correct tax liability. Through some form of taxation capable of simple determination and enforcement more revenue can be equitably raised, than through the cumbersome and inequitable tax law under consideration.

General method of proposed tax inequitable.—The general method of operation of the tax is to tax at high graduated rates the so-called excess income of corporations for years beginning after December 31, 1939, ascertained in one of two ways: (1) By subtracting from earnings of the taxable year the average earnings for the prior 4 base years, increased by 8 percent of additions to capital, and decreased by 6 percent of the reduction in capital occurring during the current year; or (2) by subtracting from earnings for the current year the same percentage of current invested capital as the earnings during the prior 4 years bore to the invested capital for those years. In any event such percentage may not exceed 10 percent or be less than 5 percent, except that for the first $500,000 of invested capital for the current year the minimum percentage is 7 percent instead of 5 percent. Moreover, corporations are allowed a 10 percent tax free return on new capital to the extent that it does not cause the invested capital to exceed $500,000, and 8 percent on new capital in excess of that figure.

It is submitted that this method of taxation is inequitable. Despite the elaborate and intricate provisions to obtain equality of comparison, it is impossible to obtain equality of comparison for all—or even many—taxpayers. Some types of business may have been fortunate enough to have had good years during the base period; others my not. Many conditions prevailed during the base period which make the comparison employed in the bill inequitable. Some businesses felt the result of the disappearance of the Agricultural Adjustment Act taxes, in resulting market disturbances. Others felt the press of the 10 percent manufacturers' excise taxes, since lightened. Still others had not yet recovered, during the base period, from the depression, or had their labor problems solved, or been able to effect necessary refinancing. There may also have been changes in management, and products marketed.

Equity in taxation, while it is recognized as not susceptible of absolute achievement, yet can be approached, and this is highly desirable. However, this cannot be accomplished by arbitrarily selecting a base period that may be suitable for one industry but not another. A comparison of the results of time periods cannot reveal excess profits due to an emergency.

Nor can it properly be urged that arbitrary 5 percent, 7 percent, 8 percent, or 10 percent returns on arbitrary invested capital are equitable allowances. Most frequently the important factors in successful operations are such elements as good management, well-organized employees, satisfied customers, and the results of advertising in prior years. Under the present bill these items are not reflected or capitalized in determining the basis for arriving at excess profits.

Inequitable limitation on operation of the election provided in the bill.—The terms of the bill do not extend the alternative income credit computation to all corporations. With certain limited exceptions, only those corporations may employ the income method which have been in existence during the entire 48 months prior to the beginning of the taxable year in 1940. All other corporations are confined to the invested capital method. Thus, a corporation which was in existence all but 1 month of the requisite 48 months would have no election to employ the income method. Certainly this is unfair, and such a corporation should have the election.

Moreover, it is inequitable that the average of 4 years must be compared with the condition and results of 1. The average of the 4 years may be lowered by the conditions connected with 1 or 2 which are not normal. The result may be that what is a normal year will show excess profits as compared with the average of 4 years 1 or more of which were not normal. In justice, if there is to be a comparison of the results of two periods, one of which is arbitrarily considered as normal the taxpayer should be permitted to select the income of the best year in the so-called normal period for comparison with the year supposed to reflect excess profits. If such a choice were allowed, then the election privilege under the law should readily be extended to all corporations in existence during any portion of the base period.

Time of election.—Another less fundamental defect in the bill is that it affords another example of the traps which have been allowed to enter the field of Federal taxation. The bill provides that the election between the alternative methods must be made at the time the return is filed. Similar time requirements have resulted repeatedly in injustice with respect to husbands and wives filing joint or several returns, capital-stock declarations, bad debt charge-offs, and consent dividend allowances. By the requirement that elections must be made as of a certain date, inequities have resulted because at the time set facts have not yet been obtained or fixed that would make a true election possible; also, when electing, mistakes have been made that should not be binding. The intricacies of the proposed law, as well as the heavy burden of ascertaining necessary facts, concerning which there may be reasonable differences of opinion, will make an election at the time the excess-profits tax return is filed extremely hazardous as well as onerous. The result of an error in fact or in law may deprive the taxpayer of the more favorable alternative. No reason appears for a time limit on the right of election.

Impossibility of accuracy in determining invested capital.—Section 718 of the bill provides that property of all kinds paid in for stock, or as paid-in surplus, or as contributions to capital, shall be included in invested capital at its basis, unadjusted, for determining loss upon sale or exchange. Thus, a company organized, say, in 1860, will have to go back and try to dig up the bases of the properties that have found their way into its possession. Moreover, the unadjusted basis of property varies over the years. Before January 1, 1921, it will be generally the fair market value thereof when paid into the company. After January 1, 1921, it may be the cost to the person who contributed the property; and what his cost is no one may be able to ascertain. But if it is not ascertained, great hardship will result.

Goodwill, patents, leaseholds, etc.—In the computation of invested capital appears another unfairness. Goodwill paid in can be included and should be included as an asset. Those fortunate enough to have had goodwill paid in before January 1, 1921, will get it included, usually at its fair market value when paid in. However, after January 1, 1921, it will be included at the cost to those who paid it in.

What is the fair market value of goodwill or leaseholds? There are conflicting formulas and there will be other conflicting formulas for their valuation with resulting endless disputes as to the applicability of such methods of valuing in the specific instances involved. Further, there will be endless disputes as to the correctness of figurs dug up out of incomplete records 20 or 30 years old for use under these formulas. It is submitted that the resultant litigation, and the expense that will result under the law as presently written should be avoided by some special provision.

Those fortunate enough to have figures available may achieve wonders if they have been likewise fortunate in paying in the goodwill. Those without figures will be at a disadvantage. Taxpayers who have achieved goodwill by honest effort may have none available to reduce their tax. The whole scheme as it now stands will delight the tax experts to the worry, expense, and distress of the taxpaying corporation and the Government agents. Goodwill and intangibles are most valuable assets to many businesses, and should be included in invested capital. But their inclusion should be open to all taxpayers who possess them, and if the law is to stand, there should be a reasonable basis provided for their determination and inclusion.

Relief provision unsatisfactory.—The effort in section 721 to circumvent the difficulties inherent in section 718 is not very helpful, or just. Even in section 721 it is necessary to go back into the past to obtain the adjusted basis of assets on hand. Nor should the taxpayer be compelled to rely on the relief to be afforded by regulations of the Commissioner as provided for in section 721. After all the Commissioner is an administrative tax officer, charged with the duty to collect the taxes. He is not an independent judge, and any rules he may lay down will, of necessity, be affected by his role as advocate of the revenue-collecting branch of the Government. This is illustrated by the difficulties experienced by taxpayers when seeking refunds after the Agricultural Adjustment Act was held unconstitutional. The law should provide that where concerns are lacking in the necessary facts or figures, for the determination of their tax, or where because of their peculiar circumstances hardship would result to them by a strict application of the provisions of the law, their tax shall be determined on the basis of the percentage of tax to taxable income existing with respect to representative concerns in their industry not so affected.

Graduated tax rates.—As the bill now stands, the rates are graduated according to fixed amounts expressed in dollars. These amounts apply to all corporations, regardless of their size or the amount of their invested capital. It is submitted that in fairness the falling into high brackets should have some reference to the capital invested. Under the existing excess-profits tax law recognition has been given to this fact.

Effect of the repealed undistributed-profits and other efforts to make companies distribute their earnings.—Beginning with 1936 and 1937, many taxpayers were compelled by the surtax on undistributed profits to distribute earnings to stockholders and finance with borrowed money rather than accumulated earnings. Under the present law they must now suffer because only a percentage of borrowed capital covered by paper, except within certain limits, can be included in invested capital, and borrowed capital on open account cannot be included at all. In various instances and for the reasons stated, capital in 1940 has been supplanted by borrowings which cannot represent invested capital under the law as proposed. It is submitted that in fairness taxpayers should have the option to treat borrowed capital as invested capital in its entirety. After all, if analyzed, borrowed capital is capital, except that it belongs to the lender as against capital which belongs to the stockholder.

Distinction between long- and short-term capital gains and losses—No reason appears for the difference in treatment of long- and short-term capital gains and losses. Short-term capital gains may occur during the current year as a result of which comparison with the years in the base period in which such gains did not occur is clearly inequitable. In the case of long-term capital gains or losses, the inequity is so obvious that the bill omits them from consideration. It should likewise omit short-term capital gains and losses.

Income from retirement or discharge of bonds.—The law specifically provides for the omission of income derived from the retirement or discharge of any bonds, debentures, notes, or certificates or other evidences of indebtedness which have been outstanding for more than 18 months. It makes no provision with respect to income so ensuing from those outstanding for a shorter period. However, it is possible that taxpayers will realize more income in the taxable year from the discharge or retirement of those outstanding for the shorter period than they realized from such source in the base years. Therefore, since equality in the factors involved in the comparative periods is being sought, taxpayers should be given the right to include or exclude such shorter term income as they might elect.

Interest and borrowed capital.—In computing excess-profits income under the invested-capital method, that portion of the interest is excluded which borrowed invested capital bears to the total borrowed capital. This will prove unfair where a taxpayer pays interest on a loan not evidenced by any paper and, which, therefore, is not includible in invested capital, and at the same time pays no interest on a loan evidenced by paper which can be invested capital. It is only interest on an invested capital loan that should be disallowed as a deduction. It should be added, moreover, that there appears no reason for the exclusion from borrowed capital of obligations not evidenced by paper. There appears to be no reason why financing in one way should be treated differently from financing in another.

Inequities in the instance of invested capital.—The provisions of section 714 providing different percentages with respect to lowest and average invested capital seem unsound and inequitable. It would appear that two corporations with the same invested capital for the year should be on a parity. They both have the same amount at the risk of the business. There would appear no sound reason for differentiation and there might result the bad effect of improper capitalizing or manipulating of business capital with tax objects rather than business objects in view if a distinction is drawn between taxpayers because of capital conditions at different periods.

Inequity of exclusion of stock in corporations from invested capital.—Under the proposed law stock owned in other companies is an inadmissible asset for invested capital purposes. This provision can result in hardships in that many companies may have a large stock investment in others from which they receive no dividends. Such investment may be essential to the operation of the owning company. It is suggested that an election be given to corporations to either include or exclude corporate stock investments conditional upon there being recognized the dividends from such stock.

Inequities with respect to electing.—Section 741 provides for an election in the case of a taxpayer "in existence" for 48 months prior to the beginning of its 1940 taxable year. Yet this taxpayer, which was in existence may have changed its accounting period, and, apparently under the law as worded in section 713, the 4 taxable years for comparison would include only the short period following the change and 3 succeeding periods; in other words a total for all periods of less than 48 months. By its action it may have eliminated a bad period in 1936 from the comparative figures. As a result its comparative period because of its fortunate action in 1936 will be more favorable than that of another taxpayer who must use 48 months. For a practicable working of the law it probably should so operate, but the point illustrates another instance of the inherent unfairness of the tax.

Inequality of the 4 1/10-percent tax.—The law provides with respect to taxpayers electing the net income basis of comparison that they in addition to an excess-profits tax are subject to a 4 1/10-percent tax on income. It is submitted that this brings out the general inequity of the proposed excess-profits tax law. It, as stated, is propounded as a means of recapturing excess profits. Yet a corporation which may, on the basis of comparative earnings, establish that it has enjoyed no excess earnings will still be charged with a heavy tax burden on its ordinary income for proving itself innocent in this respect. It would seem, therefore, that more consideration should be given to the subject matter of excess-profits tax legislation, and that some measure be drafted that would work more fitting results.

Reorganizations and exchanges.—Sections 740 to 760 of the bill are devoted to providing for the application of its general principles to reorganizations and exchanges. Dependent upon the viewpoint there is some probable unfairness in the election of the excess-profits credit bases as between so-called reorganizations. It may be stated, however, that these sections when applicable will require a very large quantity of mathematical calculations, and will, because of their complexity, result in much work for tax experts and tax accountants. They will probably never be traced through and understood by a businessman or the ordinary accountant in a corporate organization. Expense for outside help must be incurred to give effect to their provisions in instances where facts occur covered by these sections of the law.

Consolidated returns—The failure of the present law to consider or give effect to the filing of consolidated returns reveals that the measure is premature and consequently that legislation in this connection should be delayed until a proper scheme of taxation may be formulated. Under the economic organization of present-day business with its related and affiliated companies, no equitable excess-profits tax can be enacted which does not give proper effect to intercompany transactions and relationships.

SUMMARY

Summarizing what has been stated, it is submitted that the excess-profits tax law as proposed is unfair in that the taxable bases thereunder are derived from arbitrary comparatives that do not admit of comparison. In addition its administration will result in great hardship and expense in the instance of taxpayers, and great difficulties on the part of the auditors of the Treasury Department. Moreover, if its objective is to recapture excess profits it may well fail in this respect because of the fortunate situation of the particular taxpayers it should reach, and if there is a capture it may well occur in the instance of those who in reality have had no excess profits. If, on the other hand, its objective is the collecting of revenue, it is so unfair and awkward a medium for this purpose that any income collected under its provisions could not possibly compensate for the hardships it will work. It may be added that to most businessmen it will, because of the complexity of its provisions, forever remain an incomprehensible mystery, and the only people who will benefit from its provisions will be the tax expert and tax accountant, to whom it will prove a gold mine and delight.

CONCLUSION

In conclusion the committee also desires to comment concerning the association of the proposed amortization legislation with the excess-profits-tax proposal. It is generally understood that enactment of an excess-profits tax is regarded as an essential prerequisite to the adoption of a policy concerning amortization of expenditures for defense purposes which will be acceptable to the Government and to business. Whether separate legislation dealing with the question of amortization is necessary is perhaps outside the scope of this statement. More important, however, is the question of whether the development of a suitable policy regarding amortization should be made dependent upon the enactment of a tax which will impose numerous burdens on the general business structure. The committee believes that it would have been preferable to deal first with the question of amortization for the purpose of expediting the defense program and to proceed more deliberately with the important question of a tax on excess profits. That approach would have made possible a more deliberate study of the problems of taxing excess profits equitably and, we believe, would have been even more effective in protecting the public interest in connection with any special treatment which might be accorded to companies participating in the defense program in connection with the question of amortization.

The undersigned committee and the National Association of Credit Men are interested in only one aspect of the tax situation, namely, the probable effects of this situation upon the credit standing of companies which may suffer from the imposition of an inequitable and cumbersome excess-profits tax. The impairment of the credit condition of these companies would serve no useful purpose to anyone but might well create serious financial difficulties for the companies or result in their failure.

The committee desires to reiterate its clear recognition of the necessity of preventing profiteering in connection with the operation of the Government's defense program. It is forced to the conclusion, however, that the effect of the proposed tax in that direction may prove to be secondary to the unfortunate results which may follow the operation of the tax. Avoidance of those difficulties would necessitate a more deliberate approach to the problem of taxing excess profits.

The committee believes that it voices the sentiment of the entire membership of the National Association of Credit Men in recognizing that all elements of our country will gladly and willingly make sacrifices to promote the success of our defense efforts. It recognizes that those sacrifices will have to be made by business as well as by individuals. It believes, however, that the necessity for these sacrifices should not obscure the danger of enacting legislation which will be needlessly detrimental to many companies without producing any corresponding benefits. Nothing could be more harmful to the country at the present time than any action on the part of the Government which would disturb or impair sound credit conditions. Sound credit is essential to sound industrial and commercial activity, and consequently essential to the ultimate success of the efforts which are being made to mobilize industry and business in the common cause of national defense.

Respectfully submitted,

NATIONAL ASSOCIATION OF CREDIT MEN,
[s] ANDREW B. TRUDGIAN
Of Tax Committee.

Senator GEORGE. I think we will adjourn now and meet again at 2 o'clock.

Senator VANDENBERG. Mr. Chairman, a number of witnesses have dealt with the special relief section, and I have had a little to say about it. I would like permission to file in the record at this session a memorandum brief compiled by John E. McClure, counsel of the McLouth Steel Corporation, dealing with the experience under sections 327 and 328 of the law of 1921. I ask permission to have this printed in the record.

Senator GEORGE. Without objection, it may be printed in the record.

(The memorandum brief referred to is as follows:)

MEMORANDUM BRIEF

H. R. 10413 IS NOT SUFFICIENTLY BROAD WITH RESPECT TO SPECIAL RELIEF PROVISIONS

The bill affords no relief—

1. To a corporation which is placed in a position of substantial inequality because of the time or manner of organization.

2. To a corporation where tangible and intangible assets of recognized value and substantial in amount built up or developed by the taxpayer, are excluded from invested capital.

In administering the special relief provisions of the Revenue Acts of 1917, 1918, and 1921, the Bureau of Internal Revenue recognized certain definite situations as constituting "abnormal conditions affecting the capital or income of the corporation," as specified in the revenue act. During 1922, the then Solicitor of Internal Revenue (office title now Chief Counsel, Bureau of Internal Revenue), after giving the matter considerable thought and study, officially ruled as follows:

"Due to the difficulty which has been experienced in interpreting and applying Law Opinion 1090, it appears advisable to reconsider that opinion. Furthermore, it is necessary to give further consideration to the question of what constitutes proper comparatives for the M Company, the case which was under consideration in Law Opinion 1090.

* * * * * * *

"It is my opinion that the following represent the typical and common cases in which there is present an abnormal condition affecting capital or income of a corporation:

"(1) Where a corporation is placed in a position of substantial organization;

"(2) Where the capital employed, although a material income-producing factor, is very small or is in a large part borrowed;

"(3) Where there are excluded from invested capital computed under section 326 intangible assets, of recognized value and substantial amount, built up or developed by the taxpayer;

"(4) Where the net income for the year is abnormally high, due to the realization in one year of (a) income earned during a period of years, or (b) extraordinary profit derived from the sale of property the principal value of which has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, or (c) gain derived in one year from the sale of property the increase in value of which had accrued over a period of years; and (5) where proper recognition or allowance cannot be made for amortization, obsolescence, or exceptional depletion due to the World War."

From the foregoing it can be observed that one of the abnormal conditions is where a corporation is placed in a position of substantial inequality because of the time and manner of organization; also, where there are excluded from invested capital intangible assets of recognized value and substantial in amount built up or developed by the taxpayer. The present tax bill, H. R. 10413, however, does not recognize nor give any relief to either of the foregoing situations. The present bill has recognized the other abnormal conditions referred to in Law Opinion 1109, but entirely ignores the other two pertaining to the time or manner of organization and the building up of goodwill or other intangible assets by the taxpayer which cannot be included in invested capital proper.

M'LOUTH STEEL CORPORATION ADVERSELY AFFECTED BY BOTH OF THE FOREGOING OMISSIONS

The McLouth Steel Corporation was organized in 1934, and for the first 5 years of its existence the corporation spent substantially all of its gross income in developing and building up business. Its average annual earnings for 1936, 1937, and 1938 were approximately $34,000, but in 1939 and 1940 and as the result of spending large sums of money during the prior years, the corporation's annual earnings would be approximately $400,000 a year (actual earnings for 1939 of $296,000 and estimated earnings for 1940 of $500,000). These increased earnings for 1939 and 1940 are not the result of fortuitous circumstances, but result largely from efforts and money spent in prior years in developing the business.

Because of spending a large portion of the gross receipts during 1936, 1937, and 1938 in developing the business, the corporation's earnings during the base period are extremely disproportionately low as compared to previously established concerns engaged in the same line of industry. Clearly the time and manner of organizing the McLouth Steel Corporation would be recognized as an abnormal condition under Law Opinion 1109, supra, were the special relief provisions of the prior excess-profits-tax law made a part of H. R. 10413.

RECOMMENDATIONS

It is suggested that the present bill be amended so as to include the special relief provisions which were contained in the prior revenue acts during the excess-profits-tax years of 1918 to 1921, inclusive. Otherwise many corporations are going to have "exceptional hardship" which Congress heretofore recognized.

Respectfully submitted.

McLouth Steel Corporation,
By [signed] John E. McClure, *Counsel*.

Senator George. Are there any other witnesses here that were not here this morning when we called?

(No response.)

Senator George. The committee will take a recess until 2 o'clock.

(Whereupon, at 12:45, a recess was taken until 2 p. m. of the same day.)

AFTERNOON SESSION

(The hearing was resumed at 2 p. m.)

The Chairman. The committee will come to order.

Mr. Kuehnle.

STATEMENT OF C. F. KUEHNLE, CENTRAL NATIONAL BANK IN CHICAGO, CHICAGO, ILL.

The Chairman. Mr. C. F. Kuehnle, Chicago, Ill., representing the Central National Bank in Chicago.

You may proceed, Mr. Kuehnle.

Mr. Kuehnle. Senator Harrison and members of the committee, in appearing before your committee I want you to know that we recognize the national necessity for an emergency bill of this character and would not want our remarks construed as opposing the measure in any way. My purpose in appearing here is to endeavor to point out in a helpful way a number of phases of this bill which could prove to be inequitable to newly organized institutions and most particularly to commercial banking institutions.

I am not appearing as an expert in tax legislation. My work consists of directing the affairs of the Central National Bank in Chicago, of which I am the head. This is my first experience in matters of this nature, and I must present my material in a practical rather than technical manner.

The inequities in the proposed law as they affect virtually all younger commercial banking institutions, and very probably numerous other enterprises, are detailed briefly below:

(1) No alternative has been given to a corporation organized subsequent to January 1, 1936, other than they use a percentage of invested capital as the credit base for excess profits.

(2) Special consideration has not been given to banking corporations whose disposal of earnings is not their own private affair, but is subject to regulation and supervision by the Treasury Department and other regulatory bodies of the Federal Government.

(3) Banks have not been specifically exempted from section 720, which deals with inadmissible assets.

Theory and intent of banking legislation since bank holiday:

1. First, as a general proposition applying to all newly organized banks, there has been a revolution in the commercial banking business,

owing to legislation and regulatory control since the bank holiday, which makes the 4-year period 1936 to 1939 anything but a fair normal basis upon which to determine the relationship of income to capital, or of capital to potential business.

2. Reasons: A banking institution, to be consistent with conservative management and regulation, must build slowly. This retards the time when any new bank reaches its normal business within its particular field.

3. The whole theory of banking legislation since the bank holiday has been with the thought of securing sound banking on the long-pull basis.

4. No new bank operating consistently with and in the spirit of that theory could possibly have reached its normal position, either as to earnings or capital and reserves, in the short period of the past 4 years.

Federal Deposit Insurance Corporation theory of protection to the public: The objective of the Federal Deposit Insurance Corporation legislation and regulation is to place all banks on a sound basis with a ratio of deposits to capital of 10 to 1. There are just two ways for a new bank to attain that objective:

First, from net profits retained as reserves.

Second, from sale of stock.

(1) Any substantial added expense which reduces the net earnings retained as reserves will delay the day when new banks can hope to attain the objective of the Federal Deposit Insurance Corporation.

(2) This tax bill does exactly that. Hence, this legislation is in direct conflict with the whole theory and intent of bank legislation since the bank holiday.

(3) As to the other alternative—the sale of stock—this legislation closes that door to new banks.

Restricted limited earnings will make the sale of additional stock to present stockholders or the public most difficult.

We are here representing, not merely our institution but, unofficially, a score of newer banks in the city of Chicago whose situation is identical with hundreds of newly organized corporations throughout the country.

It is our opinion the bill in its present form distinctly discriminates against newly organized banking institutions which cannot use the average earnings credit either because they are precluded by the law because they were organized subsequent to January 1, 1936, or, as will generally be the case, no earnings to speak of were shown during the period on which the average is based.

Using the Central National Bank as an example for all young banks: We began business the fall of 1936, and, consistent with the conditions generally surrounding any new bank during its formative years, no earnings of any consequence were realized until the latter part of 1939. During the period from October 1936 to date, the operating expenses of the bank were kept at a very minimum and the officers and employees were paid very nominal salaries for their efforts in building the bank to its present status. According to income-tax returns as filed, the earnings during the base period—1936 to 1939, inclusive—were as follows as compared with estimated 1940 profit:

1936: Loss	$2,965
1937: Loss	11,520
1938: Profit	15,083
1939: Profit	39,137
1940: Profit, estimated	120,000

It is obvious that the resulting average would be so low it could not be used even though its consideration were permitted under the act.

It also appears that the percentages applicable to invested capital for exemption under the second alternative which must therefore be used are entirely too low for the banking industry as a whole and most particularly so for newly organized banks.

The reasons supporting our conclusions are:

For the purpose of presenting a comparison of the effect of this legislation, we shall use two existing banking corporations in the city of Chicago: First, the Central National Bank (our own institution), age 4 years; the second, a "Typical National Bank of Chicago," age 8 years, or exactly twice the age.

Considering these cases, Central, because it was organized after January 1, 1936, cannot use a base of 4-year earnings, and if it could, this base would be of no advantage, because the first 3 years of bank operation are loss years.

Typical Bank had passed the loss stage and was earning normal profits of $120,000 per year as of January 1, 1936. Hence they have a 4-year earnings base to use, whereas Central has not.

Now, both banks will earn $120,000 profit for 1940. Typical Bank, by use of 4-year average income base, has a tax to pay of $4,920.

Central must compute its tax by use of invested capital. Central would pay an excess-profit tax of approximately $15,000, whereas Typical Bank would pay $4,920 or nothing; for, Typical, having had 4 years' normal earnings of $500,000 which are retained, may, by use of its high invested-capital base, completely escape the excess-profits tax.

While this example is cited for the year 1940 only, your attention is called to the probability of this same situation and being further out of proportion in the years following 1940.

This is obviously an inequity; in fact, it seems contrary to public policy that the 8-year-old bank will, by reason of age only, receive a greater exemption basis under either alternative, when the 4-year-old bank is more in need of such relief. This condition is analogous to all newly organized corporations.

In mentioning the above parallel illustration, I speak with first-hand knowledge, since I myself was connected officially in the leadership of both institutions.

In regard to the second point, a 7-percent allowance for earnings on invested capital has never been regarded as a normal return for newer banking institutions until their reserves had been established. During the first 5 years of a bank's operations, a minimum of 50 percent, and not infrequently 80 percent to 100 percent of net earnings should be retained for the purpose of creating reserves, stability, and a satisfactory ratio between capital and deposit liability. This principle is a constant point of emphasis by the National Banking Department, the Federal Reserve authorities, and the Federal Deposit Insurance Corporation representatives. The principle has become recognized by virtually all authoritative bodies as fundamental, for it constitutes the basic safeguards thrown up for the protection of the public and hence is a matter of public policy.

In regards to point 3: The inadmissible-asset provision should not apply to banks, as it is not their capital funds which are invested in these assets, but customers' deposits.

We do not consider that the invested capital of any bank is invested in the so-called inadmissible assets, but do consider the capital as invested in those assets which are necessary to the normal operations of a bank. These would include our investment in furniture and fixtures, leasehold improvements, stock in the Federal Reserve bank, and stock in a safe deposit company.

As a businessman I submit my views of practical recommendations for your consideration:

(1) An increase in the specific exemption from $5,000 to $50,000, or, as an alternative, an allowance as a specific exemption of an amount which banks are urged to add each year out of their earnings to their capital surplus and reserve accounts by the National Banking Department and the Federal Deposit Insurance Corporation. Some specific exemption should be considered for all newly organized corporations, because any organization not in existence for 2 full years prior to January 1, 1936, is practically precluded from using an average normal earning base; or

(2) The privilege to use, as an exemption, the earnings for the first 6 months of the year 1940, converted to an annual base. It is our opinion that these earnings are not even remotely related to expenditures for national defense; or

(3) Section 205 of the act of 1917 approved October 3, 1917, granted relief to certain taxpayers who had no pre-war net income from trade or business, or whose percentage of net income based on invested capital was lower as compared to other representative comparable taxpayers. We suggest that a similar section be added to this proposed law—that banks and other corporations not having a 4-year base period be allowed to use an average of base period income credits of comparable representative corporations.

(4) Banks should be totally exempt from section 720 ("Inadmissible assets") for the reasons already specified.

I wish to thank the committee for their courtesy in permitting me to appear.

The CHAIRMAN. Thank you, Mr. Kuehnle.

Is Mr. Carroll, of New York City, here?

(No response.)

The CHAIRMAN. Mr. Carroll doesn't answer.

Mr. E. R. Mellen, Newark, N. J.

STATEMENT OF E. R. MELLEN, NEWARK, N. J., VICE PRESIDENT AND TREASURER, WESTON ELECTRICAL INSTRUMENT CORPORATION

Mr. MELLEN. Mr. Chairman, there hasn't been sufficient time in which to prepare a brief, but we would like to reserve the privilege to revise and supplement for the record anything that we may say at this time.

The CHAIRMAN. I hope you will do it quickly.

Mr. MELLEN. Yes, sir; we will.

My name is E. R. Mellen, vice president and treasurer of the Weston Electrical Instrument Corporation of Newark, N. J.

We manufacture electrical measuring instruments, a rather highly technical product, not particularly well known to the average layman, and yet having a very wide scope of application and use in many industries, including all branches of the electrical industries and aircraft, and so forth.

As we have studied this bill, we have come to the conclusion that for our particular industry there are certain discriminatory features which will bear very heavily upon us due to the business and the method of capitalization of our business.

Senator TOWNSEND. What is your capital?

Mr. MELLEN. We have 164,000 shares of common stock at the present time.

Senator TOWNSEND. At what par?

Mr. MELLEN. $12.50.

The bill as passed by the House of Representatives, and introduced in the Senate, contains many provisions which, to us, seem to be highly discriminatory against certain taxpayers, to the benefit of others.

The invested capital basis of computing excess profits credit is highly inequitable in that it discriminates against the companies who are either under-capitalized or who are operating on a minimum of paid-in capital.

It also discriminates against those companies with highly efficient managements, and tends to remove the incentive for economy and efficiency in management.

The differentiation in rates between the average earning basis and invested capital basis, will practically compel taxpayers to use the capital basis and thus force them into a situation to be discriminated against.

This would be particularly dangerous, in our opinion, from a competitive standpoint.

Following is a list of the modifications which seem to us necessary:

1. Equalization of rates of tax. Make excess-profits net income resulting from the average of base yearly earnings subject to the same rates as are to be used in the invested capital basis.

2. Give to taxpayers the election to use any 3 of the 4 years in the base years.

3. Relief to taxpayers for reduction in capital made by them during the base period.

4. Relief to taxpayers for losses incurred by them during the base period on account of venturesome risks entered into for profit.

I will elaborate on these four points.

The first probably requires very little supplemental information, because it is a self-explanatory statement.

The second—that the taxpayer may have the right to elect any 3 of the 4 years in the base period—is particularly pertinent as it applies to the earnings basis since, in our case, we were unfortunate enough to have 2 years in which our earnings were very low, and obviously we would be penalized in using that basis because of our inability to earn a normal profit in those 2 years.

Third, the relief to taxpayers for reduction in capital made by them during the base period is particularly important in our particular case.

During the year 1939, our directors at that time considered it desirable from a conservative and business point of view, to proceed to retire a preferred stock issue which we had outstanding at that time. To retire that issue required slightly over a million dollars in cash, and that stock issue had certain features which, in a sense, might cause it to be considered as practically a prior lien on the business itself.

Therefore, during the year 1939, we proceeded to retire that stock issue without issuing any additional stock, using our cash resources and also proceeding to borrow from the bank for that purpose.

Under these circumstances you can readily understand that, having reduced our invested capital during the year 1939, we will be unjustly discriminated against as we proceed to use the invested capital as a basis for the determining of the excess-profits tax to apply.

The final recommendation applies also in our particular case, because we had ventured into a new product approximately 4 years ago, and in doing so incurred losses amounting to approximately $250,000, as a result of which no profits have been made on that particular venture to date.

The product, I am glad to say, is now on a basis where it is showing a return, but obviously our capital investment has been reduced by the losses, and we will pay an increased excess-profits tax at the present time because of that particular venture.

In summary, we feel sure that it is not the intent of the Members of Congress to enact any discriminatory legislation which will unjustly react to the disadvantage of any particular company, and it seemed only proper that we should present our particular viewpoint.

I might also say, in conclusion, that from our preliminary analysis, we are quite confident that to pay the tax next year, because of our reduced capital investment at the present time, will probably necessitate us going to the bank and borrowing funds. I don't know that this perhaps would be unusual, but there was one other period in our history, namely, during 1918 or 1919, when the excess-profits tax applied during the war period, when our predecessor company, for the first time in its history, was obliged to borrow in order to pay its tax; and after the war was over, we found that we had substantial inventory, receivables, and so forth, in which, of course, most of our profit was tied up at the time.

Senator DAVIS. When you say that you borrowed funds, what do you pay for them?

Mr. MELLEN. At the present time 1½ percent.

I might also say, in conclusion, that we feel that probably we may be an exceptional case, because I haven't been able to find another company, although there must be some, which has, during this particular period, reduced its capital investment, and as a result may be subjected to this particular penalty to which I refer.

The CHAIRMAN. You speak of borrowing some money?

Mr. MELLEN. Yes.

The CHAIRMAN. And then increase your capital investment?

Mr. MELLEN. To a small extent. We borrowed $400,000, and the actual amount required to retire the stock was $1,020,000.

The CHAIRMAN. Thank you very much.

(The statement referred to is as follows:)

STATEMENT BY EARL R. MEILLEN, VICE PRESIDENT AND TREASURER OF WESTON ELECTRICAL INSTRUMENT CORPORATION, NEWARK, N. J., BEFORE COMMITTEE ON FINANCE, UNITED STATES SENATE, ON SEPTEMBER 3, 1940, WITH RESPECT TO H. R. 10413, SECOND REVENUE ACT OF 1940

The company which I represent, the Weston Electrical Instrument Corporation, manufactures electrical indicating instruments, a technical product not generally familiar to the average layman, but having wide application throughout the electrical industries, including public utilities, electrical manufacturers, aircraft, etc.

The business was founded in 1888. The basic patents originally taken out by Dr. Edward Weston 40 to 50 years ago have all expired, so that competition is keen. Among our competitors are included the two leading electrical manufacturers in the country, plus a host of smaller manufacturers who compete with certain types of our instruments.

Our ability to maintain a position of leadership is based on the quality of our product, and our price is generally higher than that of our competitors. Our product is supplied to the Army and Navy in various forms, and is also used extensively on all types of aircraft. During the last World War, practically 100 percent of our facilities were devoted to Government service.

We have 1,650 employees at the present time. Our capitalization consists of 250,000 authorized shares, $12.50 par value, of which there are outstanding 160,583 shares. This stock is listed on the New York Stock Exchange. We have approximately 1,500 stockholders, with no one individual stockholder owning as much as 5 percent of the outstanding shares.

In appearing before this committee, I represent no organization or group of organizations who may or may not be actively engaged in any activities in connection with this bill. However, as an officer and director of the Weston Electrical Instrument Corporation, I feel that a definite responsibility exists to present to the committee the viewpoint of my company on this proposed excess-profits tax bill, in the interests of our stockholders and employees who will be vitally affected by the provisions of this bill.

The bill as passed by the House has many technical features which in the short time available it has not been possible to analyze carefully. However, it is apparent that there are many provisions which to us seem to be highly discriminatory against certain taxpayers.

The invested-capital basis of computing excess-profits credit is most inequitable, in that it discriminates against the companies who are either undercapitalized or who are operating on a minimum of paid-in capital. It also discriminates against those companies who have efficient management, and tends to remove the incentive for economy and efficiency in management.

The differentiation in rates between the average earnings basis and the invested capital basis will practically compel taxpayers to use the capital basis, and thus force them into a situation where they will be discriminated against. This would be particularly dangerous from a competitive standpoint for a company such as the one I represent.

Without attempting to review or make any specific recommendations on many technical details of the bill, I am listing four specific modifications which to us seem necessary.

1. Equalization of rates of tax.
   Make excess-profits net income resulting from the average of the base year earnings subject to the same rates as are to be used in the invested capital basis.
2. Give to taxpayers election to use any 3 of the 4 years in the base year when using the average earnings basis.
3. Relief to taxpayers for reduction in capital made by them during the base period.
4. Relief to taxpayers for losses incurred by them during the base year on on account of venturesome risk entered into for profit.

1. *Equalization of rates of tax.*—We suggest the elimination of the provision of section 710 (a) (1) of the bill, which imposes an additional tax equal to 4.1 percent of normal-tax net income as the price for the privilege of using the average earnings basis.

We further suggest that all of the tax rates specified in section 710 (a) (1) to be applied to adjusted excess-profits net income resulting after deduction of the excess-profits credit computed in pursuance of section 713, be revised to coincide with rates as specified in section 710 (a) (2) of the bill.

We submit that the differentials in the tax rates in section 710 (a) (1) and section 710 (a) (2) of the bill will serve to minimize and, in fact, destroy the elective features of the bill as between the use of the average earnings method and the invested capital method of computing the amount of profits to be taxed as being in excess of normal earnings. As hereinbefore stated, it is our opinion that the differences in tax rates in the present bill will compel taxpayers to abandon the average earnings method in favor of the invested capital method, and thus force themselves into a position to be discriminated against.

2. *Election to use any 3 or 4 years.*—Our suggestion that taxpayers using the average income basis be permitted to use any 3 of the 4 years in the base period is due entirely to our own experience. We were unfortunate in that during 2 of the 4 years from 1936 to 1939, inclusive, our earnings were sharply reduced to a subnormal level; and, as a result, we shall now be penalized by having to pay a higher tax, because we failed to have adequate earnings in those 2 years.

3. *Relief for reduction in capital.*—At the beginning of 1939, the capital of the Weston Electrical Instrument Corporation included 27,376 shares of class A stock—a preferred stock both as to dividends, which were cumulative, also participating with the common stock after $1 had been declared payable to the common shareholders; and, furthermore, preferred as to liquidation and voting rights under certain conditions; in particular, if dividends on this stock were omitted in any one year, at such time full voting rights and control of the company passed to class A stockholders, to the detriment of the rights of the common stockholders. In a sense this particular stock issue was the equivalent of a prior lien on the business.

In the judgment of our directors, and in anticipation of continued satisfactory earnings, the decision was made, as a sound and conservative financing procedure, to retire this preferred stock. To accomplish this, the sum of $1,026,600 was required. This was provided partially out of earnings, the balance by a bank loan of $400,000. It was anticipated that such borrowings when incurred would be repaid out of 1940 earnings.

Under the provisions of the proposed bill, it is now apparent that our company will be penalized for following this sound and conservative procedure as approved by our directors this past year. In other words, we shall be obliged to pay a substantially increased tax, due to the reduction of our invested capital by the retirement of this preferred stock issue.

4. *Relief for losses resulting from venturesome risk.*—In order to expand the fields of sale of our products, thereby tending to stabilize our operations and provide more stabilized employment for our employees, 4 years ago we acquired the United States rights under certain foreign patents for the manufacture of a thermometer operating on a new principle. During the base period of 1936–39, inclusive, we expended considerable sums in engineering and development work on this product, plus marketing surveys, sales and advertising, etc. As a result, a total net loss in excess of $300,000 was incurred.

Now we are glad to say that this product is on a profitable basis, but it will be a matter of years before we shall recover the amounts expended during the development stages.

However, under this tax bill as now proposed, we shall be penalized and, we believe, unduly discriminated against because of our efforts in this direction, since our invested capital has been reduced by an amount to correspond with these losses.

Conclusion.—In conclusion, our preliminary analysis of this proposed excess-profits tax bill reveals that this tax will bear heavily and, we believe, unjustly upon us in comparison to many large industries who are in a much more favorable position, by having adequate capital or even being overcapitalized at this particular time. Our business has grown over the period of the last half century by the plowing back of earnings into the business. Dividend distributions to stockholders in the last 10 years have been very modest.

Furthermore, it must be realized that the proposed tax will be almost confiscatory in its nature, in that to provide the cash with which to pay the tax next year, it will probably be necessary for us to borrow from banking connections. Obviously with this condition in prospect, such dividends as we may pay this year and following years while this tax is operative must be very limited indeed in order to conserve our cash.

Unfortunately, when business trends are upward, profits do not all show up in cash. Most substantial amounts are reinvested in increased facilities, inventory, receivables, and so forth. During the last war, when a similar tax was enacted, we were also obliged to borrow in order to pay the tax. In fact, this was the first borrowing in the history of the company. In other words, it was not only necessary to borrow in order to pay the tax, but when the war was over such profits as were left were tied up in inventory, receivable, and machinery, and equipment.

We are only one of many small companies in the country who have, by careful and conservative management, been able to maintain a competitive position, provide employment, and a limited return to the stockholders who have invested their funds in the business.

While we can appreciate the necessity for raising funds with which to finance the proposed national-defense program (although we are not yet at war), nevertheless we are sure that it is not the intent of Congress to enact a tax law that would seriously discriminate against taxpayers.

It is our conclusion that such discrimination exists in the present bill, and, in particular, if we must have an excess-profits tax at this time, that some relief would be obtained by the modifications which have been suggested.

WESTON ELECTRICAL INSTRUMENT CORPORATION,
E. R. MELLEN, *Vice President and Treasurer.*

The CHAIRMAN. Mr. Flannery?

STATEMENT OF WILLIAM FLANNERY, CORNING GLASS WORKS, ELMIRA, N. Y.

The CHAIRMAN. Mr. William Flannery, Elmira, N. Y., of the Corning Glass Works.

Mr. FLANNERY. Mr. Chairman and gentlemen, I represent the Corning Glass Works and also the——

Senator DAVIS. Is Corning Glass part of Macbeth?

Mr. FLANNERY. Macbeth is part of Corning. The old Corning Glass and Macbeth were consolidated in 1936, and now constitute one company, operating plants in Pennsylvania, Rhode Island, New York, and with subsidiary companies in other jurisdictions.

From an examination of this proposed measure, we found two ways to determine whether we had an excess-profits tax: One, by the amount of invested capital over the base period, and the other, the average earnings.

For a company of our size—and we think for most companies of moderate size—dependent upon skill and economical operation, the base period of an average earnings is the one which we would be forced to choose, or to go to, in determining the amount of our excess profits.

Now, under this method the measure proposes a tax of 4.1 percent upon the normal income of a corporation as soon as any excess profits are determined.

The graduated tax is then applied to the excess profits after the 4.1-percent tax is imposed on the normal income.

Now, the normal income, of course, has no deduction for Federal taxes, for the ordinary income taxes. The result is that the 4.1 tax increases the income tax to 25 percent.

In consequence, a single dollar of excess profits results in an increase of the ordinary income tax, so to speak, regardless of whether that increase exceeds the so-called excess profits. As a result, unless the excess profits exceed the amount of the increase in the normal tax, so to speak, plus the graduated tax, you have a tax which may be in excess of the amount of profits involved.

For example, assume a corporation with a 4-year average net income of $134,000, upon which the income tax is approximately $24,000. The basis for the excess-profits tax is $110,000.

Assume in 1940 that, by reason of 12 percent better than average income, it has an income of $150,000, which parenthetically may not be due to defense orders at all but, say, to a more aggressive sales policy. The result is that you have a tax, normal income tax, deductible, of $31,350, a specific exemption of $5,000, and a base of $110,000. This leaves you an excess profits of $3,650 subject to the tax. The tax which follows, however, is $7,062.50.

A similar result occurs if you take a corporation with an average income of $1,340,000 over the base period, with an income-tax deduction of $240,000, leaving a basis of $1,100,000.

If the 1940 net income is $1,500,000, the normal tax is $313,500 to be deducted therefrom, with a specific exemption of $5,000. The remainder is $1,181,500, against which is applied a base of $1,100,000. The excess profits are $81,500, the tax is $86,525.

On the other hand, should these corporations make $300,000 and $3,000,000, respectively, the excess profits in one case would be $122,300, and $1,268,000 in the other. The tax upon one is $52,720, or 47.8 percent of the profits involved; and on the other is $711,000, or 56 percent.

In other words, with a small amount of excess profits you have a tax in excess of 100 percent thereon, while, when you have a large amount of excess profits, you have a tax approaching 50 percent, above or below it, depending upon the amount involved.

Now, it has been suggested that the failure to provide a credit for the increase in what we might call the normal income tax of 4.1 percent has been due to a desire to increase revenues. However, no increase in revenues can justify the fantastic results coming from the measure as now drafted, so it seems to us.

It is also in conflict with the policy of Congress, and inconsistent with the whole history of revenue taxation.

If Congress feels that additional revenue should be obtained by an increase in the ordinary income tax upon corporations whose earnings run above the average, and I should stop here to say that the net result, of course, of this average is to average down the good years to make up for the poor years; in fact, in our experience in the two corporations I represent, we have 1 poor year, 1 good year, and 2 years just fluctuating around the average. So that the tax would apply to all good years, and therefore reduce our average earnings.

If it is the desire of Congress to tax corporations when they have such years, by an increase in the income tax, then credit for that additional tax should be given, should be allowed, and the tax should probably not exceed the amount of excess profits involved; and in any event it should be deducted before the graduated tax is applied.

Now, this can be accomplished by a relatively simple amendment to section 710 (a) (1) of the bill, providing that the 4.1 percent tax shall be applied first against the excess profits to the extent thereof, and in no event more than the amount of the excess profits; and the scale tax, the graduated scale tax, applied to the balance.

I would like permission, Mr. Chairman and Senators, to file my memorandum that I have prepared.

The CHAIRMAN. There is no objection to your filing it.

Mr. FLANNERY. Thank you.

(The memorandum referred to is as follows:)

MEMORANDUM CONCERNING 710 (a) (1), IMPOSITION OF TAX AND RESULTS

The proposed measure provides the taxpayer a choice between two methods for determining excess profits. One is dependent upon invested capital and is particularly applicable to low-income-producing properties. It is the probable choice of public utilities, railroads, and banks.

The other method is dependent upon average earnings over the last 4 years with adjustments for income taxes and other items. It is the method which is most likely to be chosen by small or medium-sized corporations, especially manufacturing companies, whose success depends more upon skill and economical operation than upon bulk investment, and whose earnings fluctuate substantially with business conditions and their own developments.

Under the average earnings method the bill imposes a tax which in some instances exceeds the earnings or profits bringing about its application. When this method is chosen a tax of 4.1 percent is first imposed upon the entire net income of the corporation and then the graduatd tax is applied to the excess profits. No allowance is made for what is in effect an increase of the income tax by 4.1 percent, although the normal income tax is deducted from the earnings in arriving at the amount of excess profits. In consequence, a single dollar of excess profits over the exemptions imposes an additional income tax. As a result the excess profits must exceed such additional tax as well as the graduated tax or the taxpayer is assessed more than the amount of profits involved.

For example: Assume a corporation with a 4-year average net income of $134,000, the normal tax upon which is approximately $24,000. In the absence of adjustments for other deductions, its excess-profits basis is $110,000. Also assume that 1940 is better by 12 percent than the average year so that its net income is $150,000, parenthetically due, however, to better conditions or more aggressive sales efforts rather than defense orders. To determine its excess profits there would be deducted from the net incom a normal income tax of $31,350, a specific exemption of $5,000, and the exemption base of $110,000. The result is $3,650 in excess profits subject to tax. The tax which follows is 4.1 percent of the net income ($150,000×.041) $6,150 plus one-fourth of the adjusted excess profits ($3,650 ÷ 4) $912.50, a total of $7,062.50 upon excess profits of $3,650.

A similar result occurs if we take a corporation with an average net income without dividends of $1,340,000 over the base period. The income tax deduction is $240,000 and the excess-profits tax base $1,100,000. If the 1940 net income is $1,500,000 with a normal income tax of $313,500 to be deducted therefrom, together with $5,000 specific exemption, the remainder is $1,181,500 to be applied against the base of $1,100,000. Thus the excess profits are $81,500. The taxes following upon this would be $86,525, made up of 4.1 percent of the net income plus the graduated tax.

On the other hand, should these corporations make $300,000 and $3,000,000, respectively, in the current year, the excess profits in one case would be $122,300, and $1,268,000 in the other. The smaller tax would be $52,720, or 47.8 percent of the profits taxes; and $711,000 upon the larger, or 56 percent of the earnings taxed.

It has been suggested that the failure to provide a credit for the 4.1 percent tax was due to a desire to increase the revenues. However, no increase in revenues that can be obtained in such a manner under this bill justifies the capricious results or the imposition of a tax which within limits is greater upon smaller rather than larger profits. It is also in conflict with the policy of Congress and inconsistent with the whole history of revenue taxation.

If Congress feels that additional revenue should be obtained by an increase in the ordinary income tax upon corporations whose earnings are in excess of a base period when they have chosen that period for the measurement of profits, the tax should be applied evenly by percentage or graduated upward upon the amount of earnings.

Such a result can be obtained by an amendment to section 710 (a) (1) of the bill providing that the additional tax upon normal income shall be deducted from the excess profits and in no event be greater than the amount of such profits, and that the graduated tax following shall be levied only upon the balance of such profits after the deduction of the 4.1 percent tax.

The CHAIRMAN. Mr. Benjamin F. Castle.

STATEMENT OF BENJAMIN F. CASTLE, WASHINGTON, D. C., REPRESENTING MILK INDUSTRY FOUNDATION; INTERNATIONAL ASSOCIATION OF MILK DEALERS

The CHAIRMAN. Mr. Castle, of Washington, representing the Milk Industry Foundation and the International Association of Milk Dealers.

All right, Mr. Castle.

Mr. CASTLE. Mr. Chairman and gentlemen, I appear for the sole purpose of presenting the viewpoint of one businessman. I think that I understand the first page of this bill——

The CHAIRMAN. What did you say?

Mr. CASTLE. I said that I thought I understood the first page of this bill.

The CHAIRMAN. Well, you have made progress.

Mr. CASTLE. Therefore, I realize I have temerity in appearing here. I have sought some intelligent counsel, however, and I would like to suggest for the scrutiny of the committee—I think it has been mentioned by previous speakers—that there appears to be in the drafting of the bill a desire on the part of the drafter to drive corporations from the use of the average earnings arrangement to the percent on capital basis, because there appears to be a penalty of 4.1 percent operating against those who take the average earnings basis. It doesn't seem to me that if Congress desires to have an alternative method which is fair to the Government and fair to the taxpayers, there should be anything in the nature of discrimination between the two.

In other words, free selection on the part of the taxpayer should be there.

In attempting to see into some of the clauses of the bill, I believe I perceive that there is a definite loading in the ascending scale, placed upon the number of dollars of excess profits of any given corporation; and it strikes the casual and uninformed observer that a corporation could earn a very substantial number of dollars, that is, a very large number of dollars, and part of this earning could be called excess profits; and yet, on the basis of the total business done by that corporation and on the basis of the total number of owners, I mean stockholders, who are the owners of a corporation, on the basis of the percentage on capital, the earnings could be small as compared to a corporation with little invested capital earning a very much smaller number of dollars.

I cannot see the equity under our system of free enterprise and under our conception of democratic government, in making such a tax arrangement.

I believe it is true—my figures are purely from memory—but I believe that there is one large corporation in the country that has 385,000 stockholders. It has about 200,000 employees. It is conceivable that that corporation would earn many millions of dollars—but when you divide it by the number of owners, it certainly doesn't look very big.

Therefore, I commend to your attention an arrangement by which the net profits will be based upon a percentage, a fair percentage on capital, or in excess of what you might call normal percentage earnings, rather than upon mere dollar size.

Amortization is not of especial interest to the business group that I happen to represent, but I have a feeling that all business is interested in anything which affects any other business group, anything which stops the activity of business or tends to slow it; and I am told by those who are definitely interested in the creation of manufacturing facilities which have a direct relation to the defense program, that the amortization feature of this bill is important to them not only in essence but in time. And one of my friends has suggested that the reason for rushing this bill through is in order to get the amortization provision approved and made a matter of law so that those who have to consider the construction of additional facilities can get busy.

I don't understand anything of parliamentary procedure or the legal procedure of drafting bills, but I can't see why that amortization bill cannot go in on its own merits, and your committee or any other committee concerned, could then have time to devote to this very complicated tax bill the time that it merits. I think a lot better men than I am have thought of that, sir, but it impressed me as a very practical thing.

The amortization is important to these people, and if time is of the essence, I don't see why it has to be incorporated in this bill, if it is true that a great deal of time is needed to draft a basic revenue measure such as this.

Thank you very much.

Senator GUFFEY. What is the Milk Industry Foundation?

Mr. CASTLE. The Milk Industry Foundation is the economic statistical organization that studies the economics of fluid-milk distribution in the United States.

Senator GUFFEY. How is it financed, and how is it maintained?

Mr. CASTLE. It is financed by the International Association of Milk Dealers, or rather by the members of that association.

Senator GUFFEY. Who are they; how many international milk concerns are there in this country

Mr. CASTLE. There are several thousand milk distributors.

Senator GUFFEY. By "international," do you mean trading with Canada and this country, or Cuba and this country?

Mr. CASTLE. I don't know any milk dealers you would call international, but there are some members in Canada, in England, and in the Argentine.

Senator GUFFEY. But they are not international milk dealers?

Mr. CASTLE. I said international association.

Senator GUFFEY. How is the revenue raised, on the basis of the volume of business by the people who belong to this Milk Industry Foundation?

Mr. CASTLE. You mean the revenue for the foundation?

Senator GUFFEY. Yes.

Mr. CASTLE. It is on the basis of the number of milk routes that each one operates.

Senator GUFFEY. How much do they raise a year?

Mr. CASTLE. About $40,000 or $50,000.

Senator GUFFEY. All the large concerns in this country are in it?

Mr. CASTLE. Yes.

Senator GUFFEY. And you are at the head of the lobby here, are you?

Mr. CASTLE. No, sir.

Senator GUFFEY. Who heads the lobby here?

Mr. CASTLE. I don't know, sir.

Senator GUFFEY. I am glad for this information. Thank you very much.

The CHAIRMAN. Mr. Richardson.

STATEMENT OF HENRY J. RICHARDSON, NATIONAL SLUG REJECTOR, INC., ST. LOUIS, MO.

The CHAIRMAN. Mr. Henry J. Richardson, representing the National Slug Rejector, Inc.

Mr. RICHARDSON. Mr. Chairman, I represent the National Slug Rejector, Inc., of St. Louis. This is a small corporation that was incorporated before 1936. It has a paid-in capital of something like $30,000, or less. It has lately perfected a device under patents, which throws slugs out of all of these automatic machines that take small coins to operate them.

All of its stock is owned by the patentees or members of their families.

During the year 1940 it is expected that the flush sales of this recently perfected device will bring the company's income up to something between $300,000 and $400,000. It represents the fruits of probably 10 or 12 years of industrious effort on the part of its inventors, who transferred it to this corporation.

Under this bill as it stands at present that company will pay approximately, or approaching, the full maximum limit of 45 percent on all of its profits.

Capital is not really necessary in the operation of its business. There are only a few machines needed to operate this device.

They, therefore, will distribute all of their earnings which are not used to pay taxes, and the stockholders who receive it will go into the surtax brackets at the very top. I figure that approximately 85 percent of all the income that will flow from this proposition will be paid to the Government in taxes under the present bill.

Under the prior war and excess profits taxes, such situations as this were relieved by the power given to the Commissioner to fix a rate of tax, based upon the average of concerns with a normal income and invested capital. No such provision is in this act at the present time, and we naturally recommend it.

There is also the possibility, it seems to me, in a case such as this, that the definition of a personal-service corporation might be sufficiently broadened to permit a corporation like this to fall under that, and then all the earnings would be taxable in the hands of the individual stockholder, whether distributed or not.

I have just heard of this situation this morning by long-distance telephone; I haven't prepared any drafts or sections, or anything of that kind. In fact, I can't find where it would fit into this bill unless it is under the definition of a personal-service corporation.

Thank you, gentlemen.

The CHAIRMAN. All right, Mr. Richardson.

Mr. Connolly.

STATEMENT OF JOHN L. CONNOLLY, SECRETARY, MINNESOTA MINING & MANUFACTURING CO., ST. PAUL, MINN.

The CHAIRMAN. John L. Connolly, secretary of the Minnesota Mining & Manufacturing Co.

Mr. CONNOLLY. Mr. Chairman and members of the Senate Finance Committee:

My name is John L. Connolly. I am secretary and general counsel of the Minnesota Mining & Manufacturing Co. of St. Paul, Minn., which has been, for the past 30 years, engaged exclusively in manufacturing.

We manufacture coated abrasives, that is, sandpaper; Scotch adhesive tape; rubber cement; roofing granules; and other related products. We have our main factory in St. Paul, Minn. We have a factory in Wausau, Wis., where we manufacture roofing granules, and a similar factory in Copley, Ohio; and our rubber cement is all manufactured in Detroit, Mich.

I have read the House subcommittee report, and the House bill 10413, which proposes to tax certain corporations for excess profits.

Our corporation would come under the average-earnings basis; that is, our earnings for the years 1936 to 1939, both years inclusive, would be more than 10 percent. Therefore, we would elect to use that credit.

The House bill increases our excess-profits tax 38 percent over the House subcommittee proposal. That is, taking the same excess-profits income, the tax is raised in the House bill 38 percent. Taking the normal net income for 1940, as estimated, the House bill increases the total amount 7.5 percent, that is, over the committee proposal.

Our company has consistently followed the policy of financing its growth out of earnings; that is, retaining a sufficient amount of earnings each year to finance its growth.

Neither the subcommittee report, nor the House bill, provides any credit for the second year, that is, 1941, for any earnings that have been retained to finance growth.

It does recognize, even where you use this credit, capital brought in from the outside, either by way of additional stock sold, or paid-in surplus, or other contributions to capital; but it fails to recognize earnings for the second year that is left in the business, and when I say earnings, I am talking about a reasonable amount of earnings retained in the business.

We believe that the House bill with respect to the credit based on average base period income should be amended to provide as follows:

> The credit is to consist of the average net income for the base period, increased by 8 or 10 percent of money or property (taken at its basis for tax purposes) paid into the corporation for stock or as paid-in surplus or as a contribution to capital, after the beginning of the taxpayer's first taxable year under the excess-profits tax and each excess-profits-tax year's undistributed earnings.

It is also believed that the House bill providing for a base period consisting of 4 taxable years could well be amended to provide that the right be accorded taxpayers to discard at least 1 of the 4 base-period-earnings years, or if 5 base-period-earnings years are adopted, the right should be accorded to taxpayers to discard 1 or 2 of those years. We recognize the fact that you may discard a loss year, or if you have 2 loss years, you may take the highest; but for the corporations that had had income, or no losses, this gives them no relief.

We further recommend that the excess-profits-tax law include a provision permitting or requiring affiliated corporations to file consolidated returns for each excess-profits-tax years, and their average earnings and average invested capital be based upon consolidated earnings and consolidated invested capital for the base period. This would be a fair provision from the viewpoint of the taxpayer and of the Government.

Mr. Chairman and gentlemen, I recognize that the members of your drafting staff say that this cannot be done in the short time allotted.

Our company has operated profitably for a number of years, and we know that one of the principal reasons for its success has been the constant development of new products, and the investment of capital in plant and equipment to produce and market such products.

The activities of the company and its progress may best be illustrated by the increase it has made in employment and research. In 1928, the company had 517 employees; in 1933, 956 employees; and in 1940, 2,380 employees.

It now employs in excess of 100 chemists, whose entire time is devoted to research and the development of new products. Such products in no instance replaced previously developed and marketed products—they are all new.

In other words, the research work and development of new products has been financed entirely out of undistributed earnings. At all times the company has been paying a reasonable dividend to its shareholders, and it has just paid its ninety-third consecutive quarterly dividend.

At the present time, the company is engaged in a large building program, which, consistent with its policy, is being financed out of undistributed earnings.

In 1930, its total property and plant account amounted to $2,140,-000. In 1940, that account had increased to approximately $6,700,000. Construction in 1940, now in progress, will result in an expenditure in excess of $1,000,000.

We also feel that the 4.1 percent increase in normal tax is very unfair. As I pointed out, it increases our total tax over the House subcommittee proposal 7.5 percent, and our total excess-profits tax, with the increase and change in the schedule, to 38 percent of our entire excess-profits income.

We feel if that is to be retained, as the previous speaker has stated, it should be allowed as a deduction from normal income before computing excess-profits income.

If the House bill is enacted into law without a provision for an added credit of a percentage of retained earnings, such a law would definitely, in our opinion, curtail the future expansion of our company, and similarly situated companies.

Senator GEORGE. Mr. Connolly, wouldn't it be fairer to give the taxpayer the election to use his prior earnings or his invested capital, and in the event he uses his prior earnings, impose the 4.1 percent, or a 25-percent tax, provided his normal tax, plus his excess tax, excess-profits tax, did not equal 25 percent, or whichever was the greater?

Mr. CONNOLLY. As I understand you, the amount of excess profits it would pay, or total tax, would be a minimum of 25 percent of its entire income?

Senator GEORGE. A minimum of 25 percent.

Mr. CONNOLLY. Well, I would think so.

Senator GEORGE. Now let me ask you, on the question of consolidated returns, is there anything difficult in drawing a simple amendment to this bill to permit affiliated companies to file consolidated returns under such rules and regulations as the Treasury might promulgate?

Mr. CONNOLLY. Well, that was in the prior excess-profits-tax law, and it permitted or required—the Commissioner had the authority, as I recollect now, to permit or require—and that is what I have recommended. I don't think it would be a hard proposition.

Senator GEORGE. It could certainly be made permissible under such rules as the Treasury might issue, so that any taxpayer who wished to file consolidated returns for the purchase of his excess-profits tax, might apply to the Treasury and obtain the rules and regulations under which he could be permitted to make that type of return. I don't see the difficulty myself in that simple regulation, or simple provision in the law which would authorize the Treasury to issue those regulations.

Mr. CONNOLLY. To tell you the truth, Senator, I don't either, but I haven't checked it back.

Senator GEORGE. If it were made compulsory to file, I can see then that we would have to set out in the law the terms under which the consolidated returns should be made, but where it is merely permissive, and the taxpayer desiring to use it can get the rules and regulations of the Treasury Department, I fail to see wholly why there is any difficulty about framing it, or allowing it. In the long run I believe that the consolidated returns would be favorable to the Treasury, not necessarily immediately, but for excess-profits-tax purposes it would seem to me to be, in the long run, favorable to the Treasury.

Mr. CONNOLLY. I would think the Treasury would have a vast experience on that, from the prior laws.

The CHAIRMAN. Thank you very much.

Are there any other witnesses here who have come to Washington to testify, who are here and who desire now to be heard briefly?

(No response.)

The CHAIRMAN. I take it that there are not.

I would like to say that tomorrow a representative of the Treasury will be heard, and Mr. Knudsen, of the Council on National Defense will be heard, as well as Mr. Stam, of the staff of Joint Committee on Internal Revenue Taxation. If, following those, there are any witnesses here who want to be heard, please give your name to the clerk of the committee, and we will try to hear you on tomorrow.

For the information of the committee, I wish to have incorporated in the record certain letters, briefs, and so forth, submitted by various individuals and organizations, relative to excess-profits taxation and special amortization.

(The letters, etc., referred to by the chairman are as follows:)

BRIEF OF THE MANUFACTURERS ASSOCIATION OF CONNECTICUT, INC., ON THE MATTER OF PROPOSED EXCESS-PROFITS TAXATION, SPECIAL AMORTIZATION, AND THE VINSON-TRAMMELL ACT

The Manufacturers Association of Connecticut, Inc., has a membership comprised of substantially all of the manufacturers, both large and small, in

Connecticut. Its members employ well over a quarter million people and approximately 95 percent of the total manufacturing employment in Connecticut. Among its members are manufacturers of products absolutely essential to the national defense, and manufacturers who are applying their machinery and facilities to the manufacture of essential defense products. The manufacturers whom the association represents, therefore, have a very real interest and concern in any measures adopted to aid the national-defense program by way of tax changes and any law designed to limit excess profits which might be derived as a result of the defense program, directly or indirectly.

I. THE VINSON-TRAMMELL ACT

We recommend the repeal of the Vinson-Trammell Act, as amended, with respect to contracts or subcontracts entered into or completed after December 31, 1939. The proposal of the subcommittee of the House Committee on Ways and Means is that the Vinson-Trammell Act be suspended during taxable years to which the excess-profits tax will be applicable. In the proposed excess-profits tax, there is no limitation as to the duration of the tax. It may last only 2 years, or it may be necessary to continue it long after the present emergency is over. In any event, it would be wise legislative policy not to allow the automatic revival of the Vinson-Trammell Act, since an entirely different form of tax might be desirable. Consideration of the desirability of a change would be forced if the Vinson-Trammell Act were repealed at this time, rather than suspended.

II. SPECIAL AMORTIZATION

It is recommended that in connection with the amortization of emergency facilities, such amortization be allowed for income and excess-profits tax purposes of facilities acquired or to be acquired in connection with the emergency declared by the President on September 8, 1939, to exist. The date we have suggested appears to us to be a more natural one in view of the fact that expansion coming under our proposal is properly within the present emergency. There seems to be no reason why a manufacturer who was more farseeing than others should be penalized by not being allowed the special amortization privileges. At any rate, the date of July 10, 1940, adopted by the committee, seems to have no reasonable connection whatsoever with plant expansion for defense purposes.

III. EXCESS-PROFITS TAXATION

The excess-profits tax as proposed by the committee contains an alternative credit against profits before the tax is imposed. The first alternative credit is average earnings over the years 1936 to 1939, inclusive. If a corporation chose to elect under this provision, its profits would be frozen at the 1936–39 average level—a depression level for most businesses. It would seem that war profits could be subjected to taxation without such a drastic limitation of the freedom of a corporation. We want good business and good times to return; we do not want to remain any longer in this period of low return to savings. We want to be induced to save; we can be so induced when there is a prospect of a good return on savings. If average earnings are to be taken as the base for a credit against profits, then it would seem fairer to allow a corporation to select any 3 of the 4 base years upon which to determine average earnings. It is well known that most corporations had a bad 1938 fiscal year. The treatment of loss years as zero years would help only a very little, and only those corporations who suffered losses. A majority of corporations suffered a deficiency in earnings.

Serious consideration should also be given to the proposal permitting a weighted average in accordance with the direction which earnings progress, for example, if earnings of 1936 to 1938 progressed upward, then 1936 should be weighted one, 1937, two, 1938, three, and vice versa if earnings decreased.

The second alternative credit allowed in the proposed excess-profits tax bill is an amount equal to the percentage of invested capital for the taxable years which a corporation's earnings during the base period bears to its invested capital for the base period, but not to exceed 10 percent or less than 4 percent. No one should deny that 10-percent earnings on a corporation's investment is excessive. Four-percent earnings as a minimum allowed by the tax law is low. The proposal would allow a minimum of 6 percent on the first $500,000 of invested capital, and there seems no logical reason why a 6-percent minimum should not be allowed for the entire invested capital.

In order to allow corporations who have had earnings of less than 6 percent over the base perod years to place their company back on a sound financial basis, a further credit should be allowed on the deficiency in earnings. The suggestion has been made that this provision allowing a carry-over of deficiency in earnings be extended to all corporations to allow them to earn an average of 10 percent on their invested capital. This is not an unreasonable proposition.

Borrowed capital should include borrowed physical assets as well as borrowed money. This is especially important at the present time, because plant facilities and equipment are being required by defense production industries. It is also very likely that the United States Government may purchase plants and equipment and loan them to manufacturers to operate in the production of goods for the defense program. These manufacturers should be allowed to treat this transaction as borrowed capital so far as the excess-profits tax is concerned, or some equitable treatment should be provided for.

The percentages of 66⅔ percent and 33⅓ percent for the allowance of borrowed capital as invested capital is an arbitrary selection. The greater burden is always enforced against the larger corporation who is the larger borrower. Such large borrowers would be entitled to include only one-third of the amount above $1,000,000 of borrowed capital as invested capital. In view of the limitation in the proposed tax bill of 4 percent minimum earnings, the further treatment of allowing only one-third of borrowed capital to be included in invested capital must be interpreted as discouraging large corporations and large borrowings. Congress should consider carefully whether any such policy is within its intention.

It is not entirely clear from the subcommittee's report as to just how payments on borrowed capital would be treated in the computation of the excess-profits tax. For example. a corporation with capital in excess of $1,000 000 borrows $10,000,000 for a new plant and new equipment not entitled to the special amortization as part of the defense program. If, during the tax year, $1,000,000 is paid off, how is that item to be treated? Will it be an addition to capital in its entirety entitling the corporation to a credit of 8 percent of the amount?

In the case of a credit on the average earnings basis, the question has arisen as to whether or not borrowed capital would be treated as additions to capital entitling the taxpayer to 8 percent of the percentage of borrowed capital which is permitted to be added to invested capital.

The method of computing equity-invested capital by the general rule will not be at all easy for corporations of long standing, and it would seem rightfully to be the taxpayer's option to use the cash on hand plus the aggregate adjusted bases of the assets of the taxpayer then held minus the indebtedness outstanding at such time, instead of allowing the Commissioner of Internal Revenue to determine when a taxpayer might use this method.

Several corporations will be confronted with a situation where a wholly owned subsidiary corporation was dissolved during the base period. Some provision should be made to allow them to consider the earnings of those subsidiary corporations in computing average earnings for the base period. Likewise, a similar provision should be made in connection with the computation of the credit on the alternative invested capital basis.

REPEAL OF PRESENT EXCESS-PROFITS AND CAPITAL-STOCK TAXES

It is recommended that the present excess-profits tax, based on the fictitious declared value of capital stock, be repealed. It has been a guessing game with corporations, the more fortunate ones having guessed a declared value high enough to absolve them from excess-profits taxes, the less fortunate, however, having guessed conservatively, suffer a tax of thousands of dollars. The capital-stock tax has little or no meaning divorced from the present excess-profits tax and it should also be repealed. The amount of revenue derived from these two taxes is insignificant compared to the value of ridding the tax structure of this "gambling game" and relieve corporations of the utter confusion in which they find themselves concerning this tax. The present excess-profits tax will become all the more absurd if the proposed excess-profits tax based on "invested capital" is enacted.

We submit these matters for your serious consideration.

Respectfully,

PAUL W. ADAMS.

AMERICAN NEWSPAPER GUILD AUXILIARY,
Silver Spring, Md., August 21, 1940.

Senator PAT HARRISON,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR: At its convention held in Memphis, Tenn., in July, the American Newspaper Guild Auxiliary adopted a strong resolution opposing all forms of war profiteering.

In keeping with this resolution I should like to request that your committee adopt a more effective excess-profits tax than the measure now under consideration—an excess-profits tax that will really prevent large corporations from making huge earnings at the public expense during this current emergency.

We feel that the tax proposed thus far by the House Ways and Means Committee contains so many loopholes and exemptions that they are scarcely more than gestures to offset repeal of the Vinson-Trammell Act limitations on profits.

Enclosed is a copy of our resolution. If your committee decides to hold hearings, we would appreciate having this communication and the resolution placed in the record.

Yours very truly,

ELFRIEDE RYHLICK,
Vice President, American Newspaper Guild Auxiliary.

RESOLUTION—ANTIPROFITEERING

Whereas one of the effective methods of keeping America out of all wars is to take the profits out of war, and

Whereas it is common knowledge that profiteers took advantage of the World War to raise to exorbitant heights the prices of food, clothing, rent, and other necessities of life, and

Whereas such profiteering and such increases in the cost of living inevitably result in a reduction of the real wages of workers and seriously depress their already inadequate standard of living, thus constituting in effect wage cuts: Therefore be it

Resolved, That the American Newspaper Guild Auxiliary in convention assembled at Memphis, Tenn., on July 11, 1940, go on record as opposed to all forms of war profiteering and pledge to combat them wherever they may occur; and be it further

Resolved, That we urge the Government of the United States to act by legislative and administrative means against war profiteering; and be it further

Resolved, That national and local antiwar profiteering boards bet set up with adequate trade-union consumer representation.

THE OKONITE CO.,
Passaic, N. J., August 20, 1940.

Hon. W. WARREN BARBOUR,
United States Senate, Washington, D. C.

DEAR SENATOR BARBOUR: I would very much appreciate word from you to the Senate Finance Committee urging the following provisions in the proposed excess-profits tax bill: (1) That the base period for calculating excess-profits credit be extended to the 5 years 1935 to 1939, inclusive, and, further, that the taxpayer be allowed to select the average of any 3 of these 5 years; (2) that those companies who have had a total deficit for the last 5 years be permitted a credit of 10 percent of their invested capital in force at the beginning of the suggested period (January 1, 1935)—this capital, of course, to be adjusted by any redemptions or additions taking place between January 1, 1935, and December 31, 1939.

We thoroughly appreciate that no excess-profits tax law can be written which will be satisfactory to everyone and we expect to pay our share. However, we are quite positive that it is extremely more important right now that capital-goods industries, which have existed under extreme hardships during the past 8 years, be permitted to regain their lost capital than it is to put them out of business for the sake of small additional tax revenue.

Our justification for this request is that this company suffered considerable losses for the whole of 1938 and for the first 6 months of 1939 and the tax laws of the last few years have not permitted replacement of capital depleted during the last 10 years. We think these circumstances embrace many companies and our request for 3 of the last 5 years is justified.

Furthermore, we have a half interest in a company which manufactures one type of product sold only to light and power utilities. Because of the general lack of confidence in this industry, the type of expansion by utilities requiring this product was so severely reduced as to cause losses for 10 years, accumulating an extremely high deficit. It is now quite probable this company will commence to make profits which can reach extremely high figures because of a general buying surge. Such profits will be entirely due to business which should have been placed during the last 7 or 8 years and which is now forced, not only by the present armament plans, but by general business improvement. Except for the fact that the two corporations owning the stock of this company have been able to invest further funds, the company would now be in bankruptcy. It is in consideration of this situation that we believe such a company should be entitled to a credit of 10 percent of the invested capital existing at January 1, 1935.

As the membership of the Senate Finance Committee is inclined to give these two matters serious and favorable consideration, we are quite sure that word from you will be of assistance to them.

Respectfully yours,

THE OKONITE CO.,
A. F. METZ, *Treasurer*.

THE ROCHESTER CHAMBER OF COMMERCE,
August 31, 1940.

Hon. PAT HARRISON,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR HARRISON: On August 8 Mr. Roland B. Woodward sent you a copy of the enclosed statement representing action of our board of trustees on the excess-profits tax.

I am asking that our statement be included in the record of Senate hearings on this subject.

The following additional comment based upon analysis of H. R. 10413 has been approved by our officers to supplement the recommendations appearing on pages 2 and 4 of our statement of August 7, 1940:

1. The rates of taxation should be the same regardless of whether credits are based upon invested capital or past earnings. To accomplish this, it is recommended that when credits are based on past earnings (a) the 4.1 percent additional normal tax be removed, and (b) the excess-profits tax rates be made the same as those for credits based on invested capital.

2. Provision should be made to repeal upon passage of a new excess-profits tax the present excess-profits tax, and the present capital-stock tax.

3. Consolidated returns should be permitted both for any excess-profits tax as well as for present corporation income taxes. With reference to this point it is noted that the report of the House Ways and Means Committee states that consolidated returns were considered in connection with the excess-profits tax, but "It was not possible to prepare a consolidated return provision without delaying the bill for a conosiderable length of time."

This last consideration points to the desirability of enacting separate legislation for amortization rather than allowing the need for amortization provisions to bring about hasty enactment of makeshift tax legislation.

Very truly yours,

WARREN S. PARKS,
President.

AUGUST 7, 1940.

STATEMENT OF THE ROCHESTER CHAMBER OF COMMERCE ON DEFENSE EXCESS-PROFITS TAX

The Rochester Chamber of Commerce recognizes the great need for improved national defense, and strongly urges that no obstruction be permitted to impede its attainment. We recognize also that heavy expenditures will be required for defense. It is our view that funds for these expnditures should be obtained as far as possible by the following means: (1) By funds that would be saved through economy in other governmental expenditures; (2) by bringing about an increased level of general business activity through modification of present Federal taxes which deter business expansion, and through correction which handicaps business.

While it is our view that an excess-profits tax would have dangers of diminishing industrial production, would be inequitable, and would be posseesed of great administrative difficulties, we would not oppose a defense excess-profits tax if it is found that it is inescapable in order to secure funds essential for defense purposes. We insist, however, that any defense excess-profits tax legislation be so drafted that it does not produce serious obstructions to national defense by preventing industry from obtaining funds for increasing productive output. In this connection it must be recognized:

(1) That only from private industry can the Federal Government secure the materials and supplies essential for defense. A basic defense problem, therefore, is to bring about the needed increased output in production. This, in turn, requires the investment of capital to create increased plant and equipment. Such investments can only be obtained by permitting the use of earnings for this purpose, or by allowing sufficient earnings so that the investment of funds will be attracted from outside of the business. Unfortunately any defense excess-profits tax would tend to decrease rather than increase the amounts of funds that would be available for expansion. At best, then the defense excess-profits tax can only be so designed as to minimize the adverse effects that would accompany it;

(2) That a defense excess-profits tax would produce further inequalities in the Federal tax structure. With respect to the present tax structure, the Rochester Chamber of Commerce has previously recommended that "the Federal Government undertake a nonpartisan study of taxation to secure a more equitable system of taxation, and to make more of the tax base visible by broadening the base of the income tax." It is inescapable that a defense excess-profits tax will make the present bad situation worse because of the diverse nature of financial structures, profit records, and degrees of development of various industries. These conditions require that a defense excess-profits tax should provide alternative plans as a means for minimizing injustices in widely different cases.

DEFENSE EXCESS-PROFITS TAX PROVISIONS

The only apparent ways for computing excess profits seem to be on the basis of (1) the taxpayer's invested capital, (2) the taxpayer's earnings record for previous years, (3) a combination of both, or (4) some special arrangement made between the taxpayer and the Government.

The first method was used in the excess-profits tax measures of 1917 to 1921. It also constitutes the basis of the La Follette bill which was considered in connection with the Revenue Act of 1940. During World War experience, many administrative difficulties were encountered. From the taxpayer's point of view one difficulty of the plan when it forms the sole basis of the tax is that large taxes unduly penalize corporations with capital investments which are relatively small with respect to earnings.

RECOMMENDATIONS FOR EXCESS-PROFITS TAX LEGISLATION

Primarily from consideration of the business structure of the United States, but not omitting our own experience in the World War and the more recent experience of Britain and Canada, the Rochester Chamber of Commerce recommends that if defense excess-profits tax legislation is inescapable, it should embody the following principles:

(1) Any defense excess-profits tax legislation should be limited to the period of the defense program.

(2) The plan should be flexible enough to provide for differences in financial structures and types of various corporations. To this end, a choice should be given the use of invested capital or past profits as the base for computing the tax. Provision should also be made for special determinations where necessary.

(3) Provision should be made for tax adjustments on account of new capital brought into a business at any time after the standard profit period.

(4) The amount of the normal income tax should be deductible in determining profits subject to the excess-profits tax.

(5) Credit for foreign taxes should be allowed against the total tax including excess-profits tax.

(6) In using the standard profits method, incomes of companies later merged or otherwise absorbed should be included in standard earnings.

(7) In using the invested capital method, the net worth of companies merged or otherwise absorbed should be included in the invested capital.

(8) A corporation should be given the option of being allowed an invested capital equal to the amount of its last adjusted declared value for capital stock tax purposes (excluding any increase in declared value as allowed the taxpayer for the year 1940).

AMORTIZATION OF COST OF DEFENSE FACILITIES

After a conference of the President, administrative officials, and congressional leaders on July 10 it was officially announced that "the excess-profits tax bill soon to be introduced will incorporate a provision for amortization over a 5-year period of additional facilities, including both plant and equipment, certified as immediately necessary for national-defense purposes by the Army and Navy and the Advisory Commission of the National Defense Council." The idea of including amortization provisions with the excess-profits tax has been retained in Washington, and is included in the measure reported to have been approved last night by the House tax subcommittee.

It seems unwise to have amortization provisions linked with the excess-profits tax. There is a possibility that it will take considerable time to handle the complexities of an excess-profits tax. But it is imperative that facilities for production for national defense be increased immediately. This, in turn, requires large investments of private capital without delay. Because a great part of the new facilities will have little or no useful life when the defense program is ended, investors in order to be induced to supply funds must be assured that such funds will be recoverable and will not be considered profit or taxable income.

It appears that the need for immediate provision for the amortization of the cost of defense facilities could be met independently of provision for an excess-profits tax. In this connection, it is noteworthy that under the Vinson Act and Executive order of 1940 provisions are made for certification by the Secretary of War or the Secretary of the Navy, to the Commissioner of Internal Revenue as to the necessity and the cost of special additional equipment to be charged against contracts. This certification has nothing to do with income tax.

Recommendation.—The Rochester Chamber of Commerce recommends that separate legislation be enacted at the earliest possible date to provide for amortization over a 5-year period of additional facilities certified as immediately necessary for national-defense purposes.

Respectfully submitted.

ROCHESTER CHAMBER OF COMMERCE,
WARREN S. PARKS, *President.*
ROLAND B. WOODWARD, *Executive Vice President.*

MEMORANDUM ON THE EXCESS-PROFITS TAX SUBMITTED BY MR. ELISHA M. FRIEDMAN

15 BROAD STREET, NEW YORK, N. Y.

Hon. PAT HARRISON:

I. THE BRITISH EXPERIENCE IN WORLD WAR

(a) Taxpayer received a choice of the best 2 of the 3 pre-war years.

(b) The principle of gradualness. The tax rate on war profits was set at 50 percent in the fiscal year 1914–15 and rose to 80 percent in 1917–18.

(c) The tax was truly a tax on war profits or the excess over pre-war profits. The tax ignored net capital or invested capital except in cases of new enterprises which had no pre-war base. In this event the law allowed an exemption of 7 percent on the capital invested for individuals and 6 percent for corporations.

II. FRANCE

France was late in adopting suitable tax measures. The excess-profits tax was enacted on July 1, 1916. It followed the British precedent of a base of the three pre-war years, and of a rate of tax which began at 50 percent and rose as the war progressed.

III. GERMANY

Germany had no tax on war profits because the Federal Government could levy only property taxes and taxes on income were reserved to the several member states. In June 1916 the Federal Government levied a tax on the increase in the value of property over the preceding year. In 1918 another tax was levied on the increase from 1914–18—a sort of war-wealth levy.

IV. ITALY

Italy's excess-profits tax was based on invested capital. The chairman of the Ways and Means Committee, then Representative Claude Kitchin favored this form so greatly that it was enacted in the United States. The tax in Italy enacted in November 1916 was imposed on all profits above 8 percent on invested capital. The rates begin at 20 percent and rose to 60 percent on profits, in excess of 20 percent on invested capital. On January 1, 1920, Italy imposed a tax on increase in war wealth, namely, the difference between a corporation's net capital in 1914 and 1918.

V. RUSSIA

Russia, like Italy, also adopted a tax on profits in excess of a certain percentage on authorized capital. Profit up to 8 percent on this capital was exempt and the rates of tax rose from 20 to 40 percent on the taxable amount above 8 percent.

VI. APPRAISAL

The British, who have the soundest fiscal policy in Europe and have the longest experience with taxes on income dating back to 1842, were fiscally in the best condition at the end of the war. The English pound suffered the least devaluation of any belligerent's currency. The other countries mentioned above suffered great devaluation up to 100 percent. The British procedure, therefore, is then and now worth studying. Our own excess-profits tax during the World War, based on invested capital, was severely criticized by a special committee of the American Economic Association (copy attached). It was difficult to find what constitutes invested capital and not to discriminate against efficient versus inefficient companies. Furthermore, many cases of unsettled taxes were pending for 10 years or more since the World War. The British type had practically no cases pending.

VII. RECOMMENDATION

Undoubtedly, the feature of net invested capital will again cause difficulty. To obviate it, would it not be possible to have a straight tax on increase of profits above some basic average period. However, because of the low level of corporate earnings in recent years, the increase in profits would be abnormally large. Perhaps the taxpayer should be afforded, as in the 1915 British law, a choice of years which would give a fair average or a normal year, as for example (*a*) choice of best 2 of the past 3 years; (*b*) choice of any 3 years, 1937–39 or 1936–38 or 1935–37. For newly established businesses, apply the experience of similar-sized companies in the same industry. In other words, tax the same percentage of the profits of 1940 or 1941 in a newly established business as applied to comparable profits in the same industry. For expansion of plants, the same principle could apply. To the additional plant built recently, allow a tax-exempt return or a pre-war base comparable to that which applies to the rest of the plant. For such purpose it would be necessary to have in the United States a device which has proven very successful in Great Britain. There the treasury has an advisory committee for each industry to handle tax appeals and technical matters concerning the industry. For instance, in the chemical industry there would be representatives on the chemical section of such a board of tax appeals, including manufacturers, independent accountants, not employed by the chemical industry, such as university professors of accounting, and others who would set rules for the industry and decide on appeals.

VIII. LATER ADJUSTMENTS

Since speed of defense is a prime prerequisite, it is important that the tax situation be clarified soon so that industry can proceed to the important work of production. Errors can be adjusted later by refinements and subsequent legislalation. Europe after the World War provides a wealth of experience on how war-gotten wealth was taxed by the government in a more leisurely and deliberate way after the crisis was over.

REPORT, PRINTED AS SUPPLEMENT NO. 2 OF THE AMERICAN ECONOMIC REVIEW, MARCH 1919, PAGE 15

The success of the tax was due not so much to the manner in which the law was drawn, as to the skill and good judgment of the Internal Revenue Department in administering the act and to the loyalty of the taxpayers in complying as best they could with the crude, obscure and, in many ways, harsh and unequal revenue measure.

The law undertook to levy the tax at rates varying with the percentage which the taxable income bears to the invested capital. Statistics show, as might have been expected, that the tax collected bore no necessary relation to war profits, and imposed much heavier rates upon small, than upon large, concerns. * * * Great difficulties have been encountered in administering the present law in defining invested capital; in the case of borrowed capital; in cases where corporations had issued stock for the purchase of tangible property; in connection with value of good will, and in the provision made for patents and copyrights. In the definition of income also, several difficulties have risen, especially in connection with the limitation of deductions on account of salaries actually paid in the case of profits which fluctuate from year to year; in the case of industry carried on with different degrees of risk and different degrees of stability, and in the case of net income in excess of the specific exemptions. Other great difficulties appeared in connection with the determination of nominal capital. In fact, had it not been for the administrative discretion exercised by the Internal Revenue Department which went to the extreme limit, and perhaps even transcended the limit, in interpreting the law, the results would have been far more unsatisfactory than was actually the case.

AIRCRAFT PARTS MANUFACTURERS ASSOCIATION,
Los Angeles, August 11, 1940.

SENATE FINANCE COMMITTEE *and* THE HOUSE WAYS AND MEANS COMMITTEE,
United States Capitol, Washington, D. C.

GENTLEMEN: The Aircraft Parts Manufacturers Association wishes to express its appreciation to this committee for the opportunity to present its views on proposed profit taxation. Unfortunately the information we have been able to obtain on the proposed legislation has been nebulous, and press reports indicate little time will be given for its study. Had more time been available a personal presentation would have given the committee a clearer picture.

Here on the west coast, the tremendous increase in aircraft production has drained the capacity of every associated trade, and the creation of the aircraft parts processing industry brought into being an integral and necessary element in the building of aircraft. In all, well over a hundred small companies, employing approximately 10,000 persons in this area alone, are engaged either entirely or partially in national defense collaterally to large aircraft manufacturers. This includes machine shops, heat-treating and plating companies, accessory manufacturers, tool makers, and precision shops of all kinds. From this group was formed the Aircraft Parts Manufacturers Association for the purpose of obtaining and disseminating information of interest to its members, and to cooperate with the military services and aircraft manufacturers in carrying out necessary regulations in keeping with present conditions.

Only indirectly engaged in military work, usually small in capital and lacking Washington representation, the aircraft-parts processor is not consulted and is uninformed when new legislation is drafted. In such a position these small businessmen often are unaware of the legislations and regulations that affect them. Had this not been the case, there is no doubt but that thousands of protests would have been presented to this committee to consider in connection with this legislation. Practically all of the firms engaged in the aircraft-processing industry are affected by this proposed legislation in varying degrees, but many of them are resigned to the fact that its enactment would put them out of business.

We feel sure that the intent of the proposed law is to provide revenue for national defense without placing an unfair hardship upon any size or class of industry. We submit, however, that the proposed legislation (insofar as we have been able to determine) not only is discriminatory against any small growing business but spells financial ruin for the aircraft-parts manufacturers and places a barrier in the path of creative development and ingenuity.

The aviation industry is in the unusual predicament of having little experience or precedent from which to gage its future policies. While this situation gradually is being overcome in the larger corporations, it is particularly distressing to the young growing concerns. Established practices so valuable to an older company simply are nonexistent. Parts are being machined and manufactured daily that are new in design and present new problems. They are subject to rigid inspection resulting in a sizeable percentage of rejections. Plant machinery formerly operated 8 hours a day often is in use 12, 18, or even 24 hours a day. Methods of depreciation and obsolescence become pure conjecture, and costs may be only roughly estimated. In the face of these difficulties, even the small subcontractor bids competitively for his business, and under legislation already in effect excess profits must be refunded but losses must be absorbed when unforeseen contingencies occur. Moreover, the entry of a company into the aircraft industry subjects it to so many laws and regulations that a larger overhead and consequent production cost results.

Some members of our association are not exclusively employed in the aviation field, but all are engaged in the business of manufacturing or processing parts, accessories, or products used in the aircraft industry. At a time when their existence and even their ability to prosper and expand is vital to American national defense, it seems incredible that legislation should be proposed which discourages sound management and initiative and encourages overcapitalization and inefficiency. It would place some of these processors in the difficult position of choosing between expending their efforts along the lines of stable and well-established industries where years of experience assure them of a moderate profit, or devoting their efforts to a growing industry which faces all the hazards and uncertainties of inexperience, changing conditions and obsolescence, with no guaranteed profit, and the probability of failure and loss that is an inherent risk in every new enterprise.

The companies engaged in this business range from those who have started on practically no capital to those who represent million-dollar investments, but almost all have been in business only a short while.

Let us take a few examples of how this proposed legislation may affect companies in this category.

A Company has just been incorporated with $200,000 authorized capital, of which $60,000 has been paid in. While reports concerning the proposed profits tax indicate that special treatment will be given to new companies, there is no indication as to the form such treatment will take. Under present proposals, new capital will be allowed a maximum normal return free of tax of 10 percent, which permits this corporation a tax-free profit of $11,000, including the $5,000 specifically exempted. At the present time the company employs 30 men but plans on engaging approximately 100 when new capital and new equipment is received. With only $11,000 tax-free profit, the purchase of one turret lathe ($6,000) and installation of any minor equipment would use up the company's entire annual profit without taking into consideration other taxes and any return on investment. The privilege of amortizing over a period of 5 years or less is, of course, better than over 10 or 15 years, but with the price of machinery at its peak and the probabilities of working these machines 24 hours a day, such amortization will leave no residue value. This particular company was established primarily for meeting the production requirements of the aircraft companies and may already be considered an important link in the chain of rearmament requirements. But the enactment of the proposed legislation will discourage, if not prohibit, the completion of its plans for expanding by sale of the remaining authorized stock or by reinvestment of earnings.

B Company was founded approximately 3 years ago and entered the field of automatic screw-machine and turret-lathe products. Its capital investment was $8,000 and it was doing approximately $8,000 worth of business per month on a 10-percent profit basis. For the most part, it supplied commercial accounts, such as refrigeration, heating, electrical specialties, and oil-well-tool manufacturers. A year ago the company entered the aircraft field. The volume was increased and overhead increased accordingly, but its entire plan of production changed. Instead of producing a certain amount of parts on a steady volume, its production became unstable. It was required at certain times to give overnight service and to plan a large expansion program which is in the process of being completed. The number of employees has jumped from 30 to 60. The officials of the organization have drawn only reasonable salaries and the capital investment has approximately doubled. The effect of the proposed legislation would be to force this company back into the more stable commercial line which could be followed with the same measure of profit and less hazard. Such a policy would halt the expansion program, cut down overhead, and release half of the employees.

C Company has an investment of $250,000 and has been in business for 4 years, more or less concentrating on the development of a few specialized products. It has suffered the pains of experimentation resulting in negligible earnings. The corporation feels that it now has "worked the bugs" out of its business and is in a position to earn a more equitable return on investment during the next few years. On varied anticipated earnings, however, the effect of the proposed legislation would be as follows:

On earnings of	$25,000	$60,000	$100,000
6 percent credit plus $5,000 exemption	20,000	20,000	20,000
Amount subject to tax	5,000	40,000	80,000
Subject to 25 percent tax	5,000	17,500	17,500
Subject to 40 percent tax	-----	20,000	20,000
Subject to 50 percent tax	-----	2,500	42,500
Excess-profits tax	1,250	13,625	33,625
Normal income tax (Federal)	4,750	11,400	19,000
Total of two taxes on earnings	6,000	25,025	52,625
Profits remaining	19,000	34,975	47,375
Percentage to capital	7.6	13.99	18.95

In other words, a 10 percent profit would be reduced to a net of 7.6 percent, a 24 percent profit to 13.99 percent, and a 40 percent profit to 18.95 percent—without taking into consideration State and local taxes. While the likelihood is remote, if this company is able to earn 24 percent for the next 4 years (reduced through taxation to 13.99 percent) with their negligible earnings for the past 4 years, the net experience in aviation development over an 8-year period would be less than 6 percent, out of which must come all the extra expenses of a normal business endeavoring to grow.

D Company entered the business in 1936 with a very limited capital, employing only a few men. It specialized on precision parts and some development and experimental work in the aviation field. Through personal management and supervision of the owners it has been successful in growing so that it represents an investment of approximately $100,000, entirely built up from earnings. This would indicate that approximately $30,000 has been turned back into the business each year for the purchase of machinery, etc., necessary for increased aircraft production. Under the suggested tax plan, with exempted profit of only $15,000, the continuation of such a policy of expansion is remote.

By comparison let us analyze the case of an overcapitalized corporation, say with $5,000,000 capital and expensive executive personnel and overhead which has contributed little toward the development of aviation. Irrespective of how poorly the company had been managed in the past, it would enjoy the possibility of a $305,000 tax-free profit while engaged in any long-established industry. This comparison is discouraging to the small businessman who has given willingly of his time and effort to have a small part in the creation of an industry that almost overnight has been represented as America's greatest potential element of national defense.

In many of his messages our President has encouraged the expansion of our particular industry, has expressed his concern for the small business, and has stated his desire to decrease unemployment. In most cases when one of the firms engaged in the aircraft-parts business accrues a $5,000 profit, it is returned to the business in the form of a machine or plant extension, thereby increasing national-defense production, stabilizing small business, and specifically placing four men in gainful employment in that shop without taking into consideration the men that will be employed in its manufacture, maintenance, and productive ability.

A fair and equitable return is one of the prime requisites of the investor. Necessary and immediate expansion is of major importance to our national defense. But with its uncertainties, aviation has to offer the investor some particular financial inducement over less-speculative forms of business.

If the vital defenses of the country are of any importance, and we believe they are, this business should not be handicapped by taxation which stultifies all who would risk their capital in it.

The legislation proposed may be considered fair merely because it applies to all industries. But obviously a tax of this type cannot be made equitable to all companies, and what investor is likely to risk his money in aviation under strict profit limitations when he can be assured of the same profit limitations in an established business with a moderate earnings record based on a generation of experience? We believe we are safe in stating that had such legislation been in effect during the pioneering stages of the automobile or aviation industries, no such industries would be in existence today. And the small growing aircraft parts processor needs support from the investing public. The alternative of borrowing money from the Government or elsewhere for expansion, is contrary to sound financial policy when little opportunity is afforded for its repayment. The aircraft-parts processor objects to having to pay all of his profits out in taxes and then be compelled to borrow from the Government to meet demanded expansion thereby relinquishing the advantages of individual enterprise and private management.

To summarize, we present the following objections to this proposed legislation:

1. Congress should pass no bill that will place an undue hardship on small business.

2. The basis of taxation should be personal income and the rates adjusted to produce the revenue necessary to run the Government instead of penalizing productive enterprise.

3. Companies engaged in national-defense work already are swamped under an avalanche of laws and regulations requiring overhead out of proportion to their production. This proposed change in methods of taxation will greatly increase this condition because it introduces a new factor involving additional ramifications in its interpretation and administration.

No doubt many alternatives will be suggested, and may we respectfully offer the following:

(a) If the intent is to preclude the possibility of profiteering on military contracts, discard this plan of taxation bases on invested capital and revise the Vinson-Trammell Act to a 12-percent profit limitation on sales volume thereby giving a reasonable though limited incentive to the small businessman who is endeavoring to serve his country in national-defense production, and at the same time leave him a possibility of doing justice to his stockholders.

(b) If the resultant revenue is a necessary factor, increase the exemption from \$5,000 to \$50,000 profit, giving small business an opportunity to grow conservatively and at the same time remove only a negligible amount of possible revenue from the Treasury.

(c) Exempt those firms under \$1,000,000 capitalization which are engaged in national-defense work, or exempt the amount of their profits so reinvested. Certain instrument and specialized trades were exempted from the provisions of the Vinson-Trammell Act, recognizing the highly speculative and experimental phases of their business. The same condition certainly exists in the aircraft parts processing industry today.

(e) Finally, whatever form of tax legislation originates in this Committee, we hope it will be clear and concise in its terms and not such as may be subject to the variable interpretations and rapidly changing rulings of administrative officials.

May we point out that since childhood we have been told that there shall be 7 fat years and 7 lean years, and while the turning of reasonable profits back into an expanding business to take care of rearmament demands, hardly should be construed as "fattening," there is no doubt in the mind of any economic counsellor that extremely lean years may be anticipated in aviation production when the present defense objectives have been reached.

One of the greatest assets of American business is its ability to produce under a system providing incentive to ingenuity, initiative, and creative development.

We appeal to the members of this committee to protect this heritage.
Respectfully submitted.

AIRCRAFT PARTS MANUFACTURERS ASSOCIATION,
By JACK FROST,
Secretary.

The CHAIRMAN. The committee will now recess until 10 o'clock tomorrow.

(Whereupon, at 3 p. m., a recess was taken until 10 a. m., Wednesday, September 4, 1940.)

SECOND REVENUE ACT OF 1940

WEDNESDAY, SEPTEMBER 4, 1940

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met, pursuant to adjournment, at 10 a. m. in room 312, Senate Office Building, Senator Pat Harrison (chairman) presiding.

The CHAIRMAN. The committee will be in order.

Mr. Sullivan, we will hear you first this morning if you are feeling well enough to start this proceeding.

Mr. SULLIVAN. I feel very much better than I did yesterday, sir.

The CHAIRMAN. And may I say to the newspapermen that he will be followed by Mr. Stam, and at 2 o'clock Mr. Knudsen of the Defense Council will be here, and then, following Mr. Knudsen, we hope that there may be time to hear some of those who are on the calendar to be heard.

STATEMENT OF HON. JOHN L. SULLIVAN, ASSISTANT SECRETARY OF THE TREASURY

Mr. SULLIVAN. Mr. Chairman, and members of the committee: The bill, H. R. 10413, passed by the House on August 29, which is now before you for consideration, imposes an excess-profits tax, repeals the profit-limiting provisions of the Vinson-Trammell Act, and makes special provision for the special amortization of the cost of defense facilities.

These three aspects of the bill are interrelated. They have an important bearing on the rapid expansion of production under the national-defense program and on the equitable distribution of the cost of that program.

On June 8, 1940, during its consideration of the first Revenue Act of 1940 the Ways and Means Committee adopted a resolution containing the following sentence:

> It is the desire of this committee, which is favorably reporting a bill which will enable a larger proportion of our citizens to participate in the responsibility of providing an adequate national defense than has ever been the case before, that there shall not be an opportunity for the creation of new war millionaires or the further substantial enrichment of already wealthy persons because of the rearmament program.

The committee then instructed its technical assistants and the Treasury Department to accelerate their work on excess-profits taxation and also on special amortization for national-defense industries.,

The conference committee on the same bill on June 21, 1940. resolved that an excess-profits tax should be enacted as soon as possible. Its resolution called upon the Treasury Department to submit an excess-profits tax plan to your committee and the Ways and Means Committee of the House, not later than October 1, 1940,

At approximately the same time, the agencies of the Government charged with the duty of letting contracts for national-defense orders brought to the attention of the Treasury Department two aspects of existing tax legislation, which they believed retarded work on Government contracts. I refer to the provisions for depreciation or amortization and the profit-limiting features of the Vinson-Trammell Act.

In his message of July 1, 1940, the President recommended to the Congress the enactment of an excess-profits tax. He said in part:

> We are engaged in a great national effort to build up our national defense to meet any and every potential attack.
>
> We are asking even our humblest citizens to contribute their mite.
>
> It is our duty to see that the burden is equitably distributed according to ability to pay so that a few do not gain from the sacrifices of the many.

Accordingly, the Treasury Department speeded to a conclusion its study of these problems. Shortly thereafter it presented a plan for the taxation of excess profits with accompanying proposals for special amortization and suspension of the Vinson-Trammel Act to the Subcommittee on Internal Revenue Taxation, which had been instructed by the Ways and Means Committee to prepare an excess-profits tax bill.

During this time the staff of the Joint Committee on Internal Revenue Taxation also formulated a plan of excess-profits taxation which differed from the Treasury plan in certain important respects. In its recommendations to the Ways and Means Committee, the subcommittee combined some aspects of both plans.

The report of the subcommittee was presented to the full committee on August 8. Thereafter your committee and the Committee on Ways and Means held joint public hearings on the subcommittee's recommendations. The bill now before you embodies their recommendations, modified by the Ways and Means Committee as to rates and further modified to relieve certain types of hard cases disclosed in the public hearings.

It is highly desirable that taxpayers know as early as possible what the terms of this Revenue Act are going to be, since it applies to 1940 income. We all recognize the importance of this and it has been empahsized by the governmental agencies in direct charge of strengthening the national defenses. With this in mind, the Treasury Department, having made its recommendations to the subcommittee, has been guided by the purpose of encouraging the prompt formulation of a bill which would meet with the approval of the Congress. Accordingly, it has in the deliberations of both the subcommittee and the full Ways and Means Committee accepted those proposals made by members of the committee and the staff of the Joint Committee on Internal Revenue Taxation which appeared likely to speed action toward the desired end.

I turn now to a discussion of the three sections of the House bill.

First, the excess-profits tax.

The bill provides for an excess-profits tax on 1940 and subsequent incomes. The tax applies to corporations, but not to individuals or partnerships.

There are two important reasons why individuals and partnerships are excluded. Their incomes are already subject to graduated surtaxes which exceed 75 percent in the top brackets. The other reason is the difficulty of determining their invested capital. An individual doing business either as a sole proprietor or as a member of a partnership does not have the benefit of limited liability. He risks all of his assets, whether they are actually employed in the business or not. That makes it extremely difficult, if not impossible, to determine the invested capital of his business.

The bill also exempts from tax the first $5,000 of excess profits, and corporations with excess profits no greater than that amount are not required to file tax returns. There are at present approximately 500,000 active corporations in the United States. In 1937 less than 70,000 of these had normal tax net incomes of $5,000 or more. As a result of this exemption a substantial portion of all corporations and most small corporations will be relieved from the excess-profits tax.

Several other categories of corporations are also exempt. These include (*a*) the nonprofit corporations exempt from the general income tax (sec. 101, corporations); (*b*) domestic and foreign personal holding companies; (*c*) mutual investment companies; (*d*) foreign corporations not engaged in trade or business in the United States and not having an office or place of business therein; (*e*) domestic corporations which regularly derive substantially all of their gross income from sources outside the United States, if at least half of their gross income is derived from the active conduct of a trade or business; and, finally, (*f*) corporations receiving compensation from the United States for the transportation of mail by aircraft, if their income exclusive of such compensation is insufficient to establish excess-profits tax liability.

An excess-profits tax should apply only to those portions of a corporation's profits which are deemed to be excessive. The bill provides two alternative standards for the determination of excessive profits. In general, a corporation may elect to compute its excess profits either (1) on the basis of the absolute amount of its average earnings in the base period, or (2) on the basis of the average rate of return on its invested capital in the base period. The standard in either case relates to a base period consisting of the four years, 1936 to 1939, inclusive.

The choice of either method is available to all domestic corporations except those not in existence at the beginning of the 1936 taxable year—the start of the base period. It is available also to those domestic corporations which, while themselves not in existence in 1936, stem through certain tax-free exchanges or reorganizations from other corporations which were in existence at that time. Foreign corporations which did business in the United States during the entire base period are required to use the average earnings method. For other corporations the invested capital method is mandatory.

Corporations using the average earnings method measure their excess profits by a comparison of the earnings for the taxable year with the average earnings for the base period. If the earnings for the taxable year exceed average base period earnings, such excess over and above a $5,000 specific exemption is subject to the excess-profits tax. A corporation, for instance, with average earnings of $60,000 in the base period and taxable year earnings of $80,000 gets an excess-profits credit of $60,000 and a specific exemption of $5,000. It has $15,000 of taxable excess profits.

The amount of the credit, that is, the amount of income allowed free of excess-profits tax, is affected also by changes after the base period in the amount of invested capital employed in the business. The credit is increased by 8 percent of new capital or decreased by 6 percent of the reduction in capital.

In determining the average earnings for the base period, a corporation which had a deficit in one or more years of the base period may assume its income in one such year to have been zero. In this manner, the largest of the deficits is prevented from reducing the corporation's aggregate earnings for the other base period years, and thereby reducing the size of the credit. For example, a corporation with earnings of $1,000,000 in each of three base-period years and a deficit of $1,000,000 in the forth year, is permitted to enter its deficit year income as zero. Its excess-profits credit is one-fourth of $3,000,000 or $750,000. If the deficit year had been included, its credit would have been reduced to one-fourth of $2,000,000 or $500,000, rather than the $750,000 under the present provision.

Senator VANDENBERG. Why shouldn't it?

Mr. SULLIVAN. We think it should, sir.

Corporations electing to measure excess profits on the basis of average earnings in the base period are taxed at graduated rates ranging from 25 percent on the first $20,000 of excess profits to 50 percent on that portion of excess profits in excess of $500,000. In addition, they are required to pay a 4.1 percent tax on their normal tax net income.

The net income used in the determination of earnings for both the base period and the taxable year is the net income computed for income-tax purposes, with certain adjustments. Long-term capital gains or losses (on depreciable or nondepreciable property held for more than 18 months) are disregarded. Normal corporation income taxes are deducted. Income arising from the retirement or discharge of the taxpayer's own indebtedness is excluded.

Two special provisions in the bill prevent an unjustifiable reduction of the base-period income and the amount of the income free of tax. One of these pertains to corporations which suffered losses during the base period because of fire, storm, shipwreck, or theft not compensated for by insurance or otherwise. Such losses were deducted for income-tax purposes. The bill, however, permits them to be disregarded in determining base-period income. The other relates to processing taxes under the Agricultural Adjustment Act of 1933. When, early in 1936, that act was declared unconstitutional, some corporations reimbursed their customers for processing taxes previously collected from them in the selling prices of processed commodities. For convenience some of these reimbursements were allowed as deductions in computing income tax net income for 1936 and subsequent years, although the taxes collected from customers had been included as gross income in an earlier year. This method was simpler than recomputing the tax for 1934 and 1935. The process, however, resulted in a distortion of the income for the base period. In order that these corporations may not be penalized, the bill provides that such refunds should not reduce the amount of base-period income for purposes of the excess-profits credit.

Under the alternative method, the presence or absence of excess profits is determined by a comparison between the ratio of earnings to invested capital in the taxable year with such ratio computed for the base period. If, for instance, a corporation earned 8 percent on its invested capital in the base period, it is permitted to earn 8 percent on its invested capital for the taxable year, in addition to the $5,000 specific exemption, before the application of the excess-profits tax. As under the average earnings method, corporations having deficits during the base period are permitted to disregard the year of highest deficit in computing their average rate of return for the four base period years.

Corporations with deficits or very low earnings in the base period are relieved by being allowed to earn free of excess-profits tax a minimum of 7 percent on the first $500,000 of invested capital and 5 percent on the remainder of invested capital. In the case of corporations with exceptionally high rates of earnings in the based period, a maximum of 10 percent of the invested capital for the taxable year is permitted to be earned free of excess-profits tax. In all cases, a specific exemption of $5,000 of income is provided.

Additional capital is permitted a tax-free return of 10 percent in the case of new capital which does not cause the total invested capital to exceed $500,000 and 8 percent in the case of any additional new capital. All capital in excess of the amount of capital at the beginning of the taxpayer's first taxable year under the bill is considered to be new capital. If, however, invested capital subsequently reaches a lower figure, increases beyond that figure are counted as new capital. New corporations are allowed the same rate of return free of tax as new capital.

If the corporation was in existence during only a part of the base period, its credit is determined on the assumption that for the period it was not in existence it had an invested capital equal to its invested capital at the beginning of its 1940 taxable year; and that it earned 10 percent on the first $500,000 of such capital and 8 percent on the balance.

For corporations using the invested capital method, net incomes for the base period and for the taxable year are adjusted in the same manner as in the case of corporations using the average earnings method. Two additional adjustments are also made. Dividends received on the stock of all corporations (except foreign personal holding companies), included in income for income tax purposes, are eliminated. Net income is increased by the amount of interest paid on that portion of its indebtedness included in invested capital.

For corporations using the invested capital method the rates of the excess-profits tax are 5 percent lower all along the line than those imposed on corporations using the average earnings methods. They begin with 20 percent on the first $20,000 of excess profits and increase to 45 percent on that portion of excess profits in excess of $500,000. In addition, corporations using this method are not required to pay the 4.1 percent tax on normal tax net income imposed on corporations for the privilege of using the average earnings method.

Because of the variation in the manner in which the excess-profits credit—the amount of income permitted free of tax—is computed under the two methods, corporations with relatively high rates of earnings in the base period will generally have smaller taxable excess profits under the average earnings method than under the alternative invested capital method. The provision for lower tax rates under the invested capital method than under the average earnings method is intended to diminish the disparity of tax liability under the two methods.

The bill defines invested capital as the sum of equity capital and a part or all of borrowed capital.

The portion of borrowed capital included in invested capital decreases as the size of the corporation increases. This is a recognition of the fact that, in general, the smaller the corporation the less its ability to secure equity capital in the money markets. The amount of borrowed capital included in invested capital is 100 percent of an amount of borrowed capital, which when added to equity capital does not exceed $100,000; two-thirds of borrowed capital which, when added to equity capital, exceeds $100,000 but does not exceed $1,000,000; and one-third of borrowed capital which when added to equity capital, exceeds $1,000,000.

Senator VANDENBERG. I was just asking Senator Townsend whether he understood that.

Mr. SULLIVAN. I will be very glad to elaborate.

A corporation has $50,000 in equity capital, and it decides it wants to borrow $100,000. The first $50,000 of that $100,000 it borrows does not bring the total investment above $100,000. So that first $50,000 is admitted to invested capital 100 percent just as though it were new equity money. The other $50,000 above the total investment of $100,000, is admitted at two-thirds and is counted at 66⅔ percent in the computation of the investment.

When you get over $1,000,000 it is admitted at one-third; and from our examination it appears that that will correspond about with the rates those companies pay for money.

In other words, when a large company is floating new bonds upon which it is paying 2½ or 3 percent, we feel that we should not allow that to be admitted to the base in its entirety, and they be allowed to earn 8 percent of that free of taxation, because that certainly would encourage an over-expansion that might not be entirely desirable.

Income from Government bonds and the stocks of other corporations is not taxable. Therefore, these investments themselves should be and are excluded from invested capital.

Special relief is provided in cases where the Commissioner is unable to determine the taxpayer's equity invested capital. In such cases equity invested capital is taken to be an amount equal to the cash on hand plus the aggregate of the adjusted bases of the taxpayer's assets less his outstanding indebtedness.

Domestic corporations using either method of excess-profits taxation are allowed a foreign tax credit. In line with the practice under the general income tax, the bill allows a credit against the excess-profits tax for income and profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States to the extent that such taxes are not offset by credits against the income tax. The credit is subject to the limitations which apply to the credit allowed for the purposes of the corporate normal income tax. In other words, the foreign tax credit cannot reduce the income and excess-profits taxes otherwise due on the portion of income that is derived within the United States.

Personal-service corporations are accorded special treatment. A personal-service corporation is defined as one whose income is attributed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital is not a material income-producing factor. Such a corporation may signify in its returns for any taxable year its desire not to be subject to the excess-profits tax. In such case it will be exempt from tax. However, in order to obtain such treatment, the shareholders of the corporation are required to include their pro rata shares of the undistributed income of such corporations in their respective personal incomes subject to tax under the normal and surtax rates of the individual income tax.

Title II of the House bill relates to the amortization of emergency facilities. Under existing law, the taxpayer is permitted to spread the cost of his depreciable assets over their expected useful life. The rate of depreciation allowed is arrived at as the result of engineering studies, based upon what our best and most current information leads us to believe is the useful life of the building or equipment. With changing industrial conditions, these depreciation rates are being constantly revised. This arrangement is fair to the taxpayer and fair to the Government, since the cost is allowed to be deducted from income during the years when the asset is contributing to the taxpayer's income.

In the case of the expansion of plant and the construction of equipment for the defense program, however, the length of time during which orders for weapons and other materials of war will continue is uncertain. In those cases in which the plant and equipment will have little or no other use after the completion of the defense program, the rate of depreciation must be increased if the manufacturer is to have the opportunity of charging the cost against income during the period of the emergency. Such accelerated depreciation, or amortization, cannot be allowed under existing law.

Senator VANDENBERG. Will you just illuminate that subject at this point?

Mr. SULLIVAN. Well, we are allowed, under the present law, to give a reasonable allowance for depreciation. Depreciation, as distinguished from obsolescence, means the physical wear and tear.

We have, as I just said, a constant study going on as to the life of various types of equipment, machinery, and buildings, and we have those figures compiled for each type of machinery and all types of building construction.

Now, that is based on the most current engineering investigation, and that is the basis upon which we proceed.

In addition to that, we have the problem of obsolescence. If a company is manufacturing an article for which public demand suddenly ceases, then that plant becomes obsolete; it is still a perfectly good plant from the point of view of physical ability to stand up, but economically it becomes useless, and that is obsolescence.

Under the present law, when that becomes obsolete, the remaining undepreciated cost of that plant may be taken in the year when it becomes obsolete.

Now, for us to go ahead and allow special amortization rates would mean that we would arbitrarily be guessing two things; in the first place, we would have to guess that at the expiration of the emergency, or the particular contract, the plant would be economically useless. That is a very difficult assumption to make.

Then, you have to make a second guess, which is that it will become useless in a particular year. And those are two things that are very very difficult to do.

We do not believe that the present law gives us the power to do that. We further believe that it would be unwise for us to be given this power. We think that there is no problem more important to the taxpayers in the law than the problem of depreciation.

I think we all agree that they should all be treated the same, on exactly the same basis, except when a special emergency arises and Congress decides that certain exceptions should be made. We believe that the power to make that exception vests in the Congress alone, and not in the Treasury Department or the Bureau of Internal Revenue.

Senator VANDENBERG. Your statement says, on page 12 [reading]:

> Under existing law, the taxpayer is permitted to spread the cost of his depreciable assets over their expected useful life.

Mr. SULLIVAN. That is right.

Senator VANDENBERG. If their expected useful life is the existence of the emergency, why wouldn't you be entitled to make a contract of that sort with them?

Mr. SULLIVAN. We don't know that that is the expected useful life. There are certain facilities that are being constructed for purely national-defense projects, which may be just as useful after the war is over, or the present emergency is over, or the particular contract they are built to perform is over, as they are during the time that contract is being performed.

Senator VANDENBERG. I fully understand that, Mr. Sullivan. The only point I don't see is how you obviate any of these imponderables by new statute to any greater extent than you could face them under your existing power. Why do you need new law?

Mr. SULLIVAN. Because that law gives us the particular power in a restricted series of cases to confer special amortization.

Now, under the proposal, the bill as it comes before you, in order for a manufacturer to secure this special amortization, the National Defense Council, plus either the Secretary of War or the Secretary of the Navy, must jointly certify that this new facility is necessary to national defense.

Senator VANDENBERG. Well, then, this new statute is a limitation upon the power you already have?

Mr. SULLIVAN. I think not, sir.

Senator GEORGE. Just a minute, Mr. Sullivan. You say it is necessary for them to certify that it is necessary to national defense. Do they stop there?

Mr. SULLIVAN. I beg your pardon.

Senator GEORGE. Is the certificate that is issued on the recommendation of the National Council and the Secretary of War or Navy, as the case may be, limited to mere certification that the particular facility is necessary for defense, or do they go further and specify what the depreciation and obsolescence amounts to?

Mr. SULLIVAN. No; they do not.

Senator GEORGE. They turn that back to the Treasury?

Mr. SULLIVAN. No, sir; under the bill automatically the amortization to which they are entitled is 20 percent a year, for 5 years.

Senator GEORGE. Oh, yes; so you are relieved of any responsibility. But now, Mr. Sullivan, section 23-L of the Revenue Act, allows you to allow reasonable depreciation?

Mr. SULLIVAN. That is right, sir.

Senator GEORGE. And the same principle is inherent in the depletion allowance?

Mr. SULLIVAN. Including a reasonable allowance for obsolescence.

Senator GEORGE. Reasonable.

Mr. SULLIVAN. That is right.

Senator GEORGE. Very well. Now, why haven't you the power under existing law to allow reasonable depreciation and obsolescence? You say that it is a guess. Certainly it is a guess. But wouldn't it be very simple to say that this allowance is subject to readjustment when this emergency passes?

Mr. SULLIVAN. I don't think that would be very satisfactory to the taxpayer, and I don't think it would be strictly honest on our part, sir. If we are not sure enough about it so that we have got to go back and correct it later on——

Senator GEORGE (interposing). You want Congress, then, to say that it is going to be all obsolete and all pass out in 5 years, but you are not willing to take that responsibility?

Mr. SULLIVAN. I don't want Congress to say that at all.

Senator GEORGE. That is what you are doing.

Mr. SULLIVAN. I beg your pardon, sir. This bill says that in view of the present emergency and our necessity of speeding up these orders, and to encourage them, they must confer this special privilege which cannot be granted under the present law.

Senator GEORGE. I take issue with you on it, but that is probably a moot question if you are going to put it in the law that they should be allowed 20 percent. But if it is reasonable to allow depreciation of 20 percent per year on a facility constructed to meet this national emergency, and if it is reasonable to make an allowance for obsolescence, the Treasury has the authority to do it.

Mr. SULLIVAN. That is correct, but I think we are using "reasonable" in two different ways, Senator George.

Senator GEORGE. I don't think so.

Mr. SULLIVAN. Under this law, it may be prudent, it may be the wise thing to do; but I couldn't say to this committee that it is reasonable to expect that an ultra-modern factory that is to be constructed in the latter part of 1940 or the first part of 1941, built with all of the latest skill and engineering experience, is going to be absolutely useless in 1946. I don't think that is "reasonable," and yet I believe it is desirable and prudent to grant this amortization to those companies that are putting up new facilities for this picture.

Senator GEORGE. It may not be reasonable under the amortization section in this bill to reach that conclusion. It may be that that facility will have a use after the passing of the emergency. That is true. But we are saying here in the law that nevertheless it should be written off.

What I am saying is that under the statutes which permit you to allow "reasonable" depreciation and "reasonable" obsolescence, you could do the same thing; if you guessed that within 5 years it would become obsolete or obsolescent, you could do the same thing, couldn't you?

Mr. SULLIVAN. No; I think we would have to have something more than that to go on.

Senator GEORGE. What?

Mr. SULLIVAN. Well, for instance, when prohibition came into effect its date was anticipated, and we knew at that time that a brewery was going to become obsolete on a definite date. The Supreme Court in the *Niagara Falls Brewing Company case* held that as between the time of the passage and the time it became known that prohibition was coming into effect, and the date on which it came into effect, they could charge off as obsolescence whatever remained in the brewery.

Senator GEORGE. I understand that, but after all you have the authority to allow "reasonable" depreciation, and you have the authority to allow "reasonable" obsolescence. A plant becomes useless commercially when its machinery wears out, or when the product that it makes ceases to have a market, and we are framing this tax law on the theory that it is going to run for 5 years, that is the June tax act was framed on that theory.

Mr. SULLIVAN. But, Senator George——

Senator GEORGE (interposing). I understand. Now, you may not want to assume that power, but I am asking you if you haven't got the power?

Mr. SULLIVAN. I am saying that we have not, and the reason I am perhaps more emphatic than I should be about it, Senator George—because I recognize that this is a matter upon which people may very well entertain differences of opinion—is that the Supreme Court has very recently determined that mere extra facilities beyond capacity to use facilities does not make those facilities obsolete.

Senator GEORGE. Why? Because you decided that they were not obsolete and the Supreme Court merely said you have the power to say that?

Mr. SULLIVAN. I think the Supreme Court in that decision was pretty emphatic——

Senator GEORGE (interposing). I know; but your decision was that you wouldn't allow that obsolescence.

Mr. SULLIVAN. I think the Supreme Court makes up its own mind, they don't follow us willy-nilly.

Senator GEORGE. Suppose you had allowed it in that very case?

Mr. SULLIVAN. Then it never would have gone to the Court.

Senator GEORGE. And that would have been the end of it.

Mr. SULLIVAN. That is correct.

Senator GEORGE. Therefore, you have the power?

Mr. SULLIVAN. Oh, well, now just a minute. I will say this——

Senator GEORGE (interposing). I know you don't want to assume that power.

Mr. SULLIVAN. I will say this, that we had the opportunity of assuming a power which we did not believe we possessed, and we did not assume that power.

Senator GEORGE. You had the power, you simply denied the taxpayer what he claimed was the proper obsolescence or depreciation.

Mr. SULLIVAN. And the Supreme Court said that it was not proper.

Senator GEORGE. I think it is an academic thing. If we don't put something in the statute that covers it, of course there is no need of discussing it.

Now, you are statisfied that the statute is all right and Congress is going to rely on your judgment about it?

Mr. SULLIVAN. Yes, sir; we are satisfied that the statute is right.

Senator GEORGE. We take it to be your judgment on that question that these added facilities are going to become either what we now call for lack of better term, in "obsolescence" or that the depreciation is going to absorb all the value within the statutory period that follows the issuance of this certificate.

Mr. SULLIVAN. Excuse me, Senator George, that is not our judgment. We don't know that they are. We are saying that regardless of whether or not they do, it is prudent and wise to confer this special privilege of assuming that they are going to——

Senator GEORGE (interposing). But we are writing it in the law?

Mr. SULLIVAN. That is right.

Senator GEORGE. After all, we are basing our decision on your judgment, plus the judgment of the National Defense Council and that of the Secretary of War.

Mr. SULLIVAN. Yes, sir.

Senator GEORGE. Well, that is all right; and, as I say, in the sense that we are going to cover it by an express statute, of course it is an academic question as to what power you now presently have.

Mr. SULLIVAN. All right. I would like the opportunity of discussing it with you further at some later date.

Senator CONNALLY. Isn't the real issue between your views and those of Senator George, that your construction is that under the present law you have got to confine it to actual depreciation?

Mr. SULLIVAN. That is correct.

Senator CONNALLY. This is a sort of constructive depreciation. Whether it is depreciated or not, we are going to say it is.

Mr. SULLIVAN. That is right.

Senator GEORGE. You have to do that always when you say "depreciation" because a plant may last 25 years which you say won't last but 10, and they frequently do, and you may say it is obsolescent when actually it has got some commercial value?

Mr. SULLIVAN. That is right, Senator George, and when we are basing our opinions on the finest engineering experience, we go wrong. That is why we don't like to guess beyond that sphere.

Senator VANDENBERG. In opening up the subject, Mr. Sullivan, I want to assure you that I didn't mean to criticize any department of the Government for underestimating its legal powers these days. [Laughter.]

The CHAIRMAN. You gave this advice to the Council on National Defense, didn't you?

Mr. SULLIVAN. Oh, we consulted together frequently, Senator.

The CHAIRMAN. And you gave that opinion to them that it would be better to have an enactment of this into law?

Mr. SULLIVAN. Yes, sir.

Senator GEORGE. You do think that the 5-year period is, all things considered, a just provision in the act?

Mr. SULLIVAN. Yes, sir.

Senator GEORGE. You do approve that?

Mr. SULLIVAN. We do, sir.

Senator VANDENBERG. Suppose the emergency ends in 2 years?

Mr. SULLIVAN. Under the statute they then reopen their returns for those 2 years and, instead of taking 20 percent amortization, they take 50 percent for those 2 years.

Senator VANDENBERG. In other words, it all falls back on the period of utility?

Mr. SULLIVAN. That is correct.

Senator VANDENBERG. Which I supposed was what was in the law at present.

Mr. SULLIVAN. No; it is the period of the emergency, Senator.

Senator CONNALLY. I didn't understand that. If you mean that the period of the so-called emergency only lasts 2 years——

Mr. SULLIVAN (interposing). They are allowed to open their returns under the bill as now drawn.

Senator CONNALLY. Who determines whether they will take 20 or 50 percent, the Bureau?

Mr. SULLIVAN. Well, the amortization statute enables them to go ahead at regular depreciation rates.

For instance, if they complete their building in the latter part of the year, and they want to run 2 or 3 months on the regular depreciation rates, they are allowed to do that. They don't have to take this special amortization. But once they elect to go on amortization they then have one further election of going back to regular depreciation rates, and the reason why that provision is in there is that we anticipate that many of these plants may decide, after they have taken the 20 percent a year for 1 or 2 years, that they are taking it too fast, and they will want to then go back to regular depreciation, and they are allowed to do that.

But when they are working during the emergency on a particular contract, if they aren't to continue, or if the emergency ends, and they are not going to operate that plant any more, they are allowed to reopen their returns and take that amortization over the period in which they were working on the contract.

Senator GEORGE. The whole theory being that they are entitled to get back their cost for a facility constructed primarily and exclusively for national-defense purposes?

Mr. SULLIVAN. That is correct, Senator George.

I have already referred to the fact that the Advisory Commission to the Council on National Defense, and the War and Navy Departments have informed the Treasury Department that the inability of manufacturers to secure special amortization allowances is impeding the letting of defense contracts. In the light of this information, the Treasury recommends that provision be made by law for special amortization of the cost of new plant and equipment necessary to the defense program over a period of 5 years, with a provision for shortening this period if the emergency should last for a shorter period. Such provision is contained in the present bill.

This bill provides further that an emergency facility may not be destroyed, demolished, impaired, or substantially altered without the written consent of the Secretaries of War or Navy. If such consent is not given within 90 days the Secretary of War or the Secretary of the Navy is directed to purchase such facility at a price not to exceed its adjusted basis nor less than $1. The special deduction for the amortization of emergency facilities is conditional upon the taxpayer's acceptance of this restriction.

Title III of the House bill relates to the profit-limiting provisions of the Vinson-Trammell Act. That act limits profits on Government contracts for the construction of naval vessels and Army and Navy aircraft. The Treasury Department has been informed by the Advisory Commission to the Council on National Defense and by the War and Navy Departments that these restrictions have dissuaded many manufacturers from making contracts or subcontracts. The extensive special bookkeeping requirements necessary to determine the actual profit on the contracts are reported to have discouraged manufacturers from proceeding with national defense work.

The Vinson-Trammell Act deals only with a limited kind of contract—that for the construction of naval vessels and of airplanes. With the extension of the defense program to include large scheduled purchases of all types of equipment useful and necessary for the national defense, it is evident that broader profit-limiting provisions are necessary. The excess-profits tax, which is of general application. should accomplish that purpose. It is neither necessary nor desirable to have outstanding at the same time what are in effect two profit-limiting provisions.

In view of the situation, the Treasury Department recommends the suspension of the Vinson-Trammell Act for the period in which an excess-profits tax is in effect.

Senator BYRD. Mr. Sullivan, has either the Navy or the War Department made any contract with escape clauses, whereby if the Vinson-Trammell Act is repealed, that that can be opened up and the profits increased to the manufacturer?

Mr. SULLIVAN. I do not know, Senator Byrd, whether they have or not. I think I should say this in relation to your question. It is provided that inasmuch as excess profits go into effect as of last January 1, that the suspension of the Vinson-Trammell Act should also revert to that date.

Senator BYRD. It is a fact then that there is such a clause?

Mr. SULLIVAN. So far as the contracts are concerned, I do not know.

Senator BYRD. Who would know that?

Mr. SULLIVAN. The Navy Department——

Senator BYRD (interposing). And the War Department?

Mr. SULLIVAN. Yes.

Senator BYRD. They don't function through the Treasury; copies of those contracts are not filed with the Treasury?

Mr. SULLIVAN. Only in those rare instances where they ask for closing agreements.

Finally, I would like to refer to the similar limitations imposed, under the Merchant Marine Act of 1936, on the profits of ship construction contracts let by the Maritime Commission. The Treasury Department is informed by the Commission that these profit-limiting provisions of the Merchant Marine Act should not be suspended because of special considerations which do not apply in the case of the Vinson-Trammell Act, but that the companies involved should not be subject to both profit limitation and excess-profits taxation.

To meet his situation, the bill permits the taxpayer one of two procedures. It authorizes the inclusion in gross income of the entire amount of the gross proceeds of these contracts, and allows the payments recaptured by the Maritime Commission to be credited against excess-profits taxes due. Under an alternative procedure the taxpayer is required to include in his gross income only the 10 percent profit permitted under the Merchant Marine Act and to compute the excess-profits tax on that basis.

The CHAIRMAN. In that connection, I am in receipt of a letter from Chairman Land of the United States Maritime Commission which I want to put into the record at this point, and I would ask you to consider this matter so that when we get into executive session we can ask some questions with reference to their objections:

(Letter referred to it as follows:)

UNITED STATES MARITIME COMMISSION,
Washington, September 3, 1940.

Hon. PAT HARRISON,
Chairman, Committee on Finance, United States Senate.

MY DEAR MR. CHAIRMAN: The bill H. R. 10413, which has passed the House of Representatives and which has been referred to the Committee on Finance of the Senate materially affects the United States Maritime Commission in its ship-construction activities. As you know, a principal objective of these activities is the procurement of the modern merchant vessels required under the national defense program as essential auxiliaries to the Navy in war or national emergency.

The Merchant Marine Act, 1936, as amended, contains provisions relating to the recapture by the Maritime Commission of profits in excess of 10 percent of the total contract price of contracts and subcontracts for ship construction under that act. These provisions are similar to those contained in the Vinson-Trammell Act which applies to naval and aircraft construction. These profit recapture provisions of the Vinson-Trammell Act are suspended by the terms of the pending bill for such period as the excess-profits tax is in effect. It is understood that this Vinson-Trammell Act suspension resulted from representations to the effect that its operation tended to discourage competition among manufacturers and suppliers who preferred to accept commercial orders not subject to the complications of special accounting, etc., in preference to orders for naval and aircraft work to which that act applies, this being especially the case with respect to subcontracts. It is not believed desirable to suspend the recapture of profit provisions of the Merchant Marine Act insofar as they relate to prime contracts for the construction of vessels for the Commission since there are commercial considerations involved which do not apply in the case of the Vinson-Trammell Act. Provision accordingly was made in the bill by the Committee on Ways and Means of the House of Representatives, which provision was adopted by the House (H. R. 10413, sec. 724) to protect shipbuilders engaged on Maritime Commission contracts from being subject to two profit limitation provisions at the same time, the limitation provisions of the Merchant Marine Act and the excess profits tax of the bill.

The reasons which make it undesirable to suspend the profit recapture provisions of the Merchant Marine Act as related to prime contracts for ship construction apply with very much less force to subcontracts. It is expected that some of the various shipyards throughout the country will shortly be engaged exclusively upon naval ship construction whereas others will confine their activities almost entirely to commercial construction, largely on contracts with the Maritime Commission. In the case of subcontractors, however, the same concerns to a very large extent will be called upon to supply machinery, materials, and other items to both groups of shipyards, namely, those engaged on naval work and those engaged on work for the Maritime Commission. If these subcontractors are relieved entirely from the profit recapture provisions of the Vinson-Trammell Act, but are required to conform to the profit recapture provisions of the Merchant Marine Act it may become difficult for shipbuilders having Maritime Commission contracts to place orders with such subcontractors upon a satisfactory basis. It appears desirable, therefore, to accord to subcontractors under Maritime Commission contracts the same treatment as is provided by the pending bill with respect to subcontractors who would otherwise be subject to the provisions of the Vinson-Trammell Act. It is accordingly proposed that the profit recapture provisions of the Merchant Marine Act be suspended with respect to subcontracts, such suspension to be similar to that provided for in title III of the pending bill with respect to the Vinson-Trammell Act.

By suspending the profit recapture provisions of the Merchant Marine Act so far as they relate to subcontracts, the subcontractor for naval work and the subcontractor for Maritime Commission work will be put upon the same footing so far as relates to the limitation of profits, the Government relying for protection upon the pending Excess Profits Act instead of upon the recapture provisions of the Merchant Marine Act and the Vinson-Trammell Act. There is no reason to suppose that the Government's interest will be adversely affected since the excess-profits tax will thus replace the recapture of profits by the Maritime Commission. Since the building of merchant vessels suited to serve as naval auxiliaries is essential to the national defense, it is highly desirable to remove any possible cause for hesitancy in accepting Maritime Commission work on the part of suppliers of machinery, parts, materials, etc., who are offered business from both naval program shipyards and merchant-program shipyards.

It is suggested that the proposed suspension of the Merchant Marine Act recapture provision should not apply to subcontracts where the principal contractor and the subcontractor are owned or controlled by the same interests; this exception is obviously desirable to avoid otherwise possible improper use of the corporate veil.

In view of the foregoing, the Commission respectfully suggests that the bill H. R. 10413 be amended to add to section 721 thereof a provision to the effect that unless the principal contractor and the subcontractor are owned or controlled directly or indirectly by the same interests within the meaning of section 45 of the Internal Revenue Code, the provisions of section 505 (b) of the Merchant Marine Act, 1936, as amended, shall not apply during the period of suspension of the profit-limiting provisions of the Vinson Act as provided by title III of H. R. 10413, to subcontracts which are entered into or completed in any taxable year to which the excess-profits tax provided in title I of the bill is applicable or would be applicable if the subcontractor were a corporation subject to said tax, and during such period any provision in any agreement requiring any subcontractor to agree to pay to the United States Maritime Commission profit in excess of 10 percent of the contract price of any such subcontract shall be without effect.

Title II of the bill, with respect to amortization deduction in general permits a 5-year amortization write-off for emergency facilities based upon certification as to necessity in the interest of national defense by the Advisory Commission to the Council of National Defense, and either the Secretary of War or the Secretary of the Navy.

The title also includes provisions for payments of unamortized special-facility costs in cases of termination or cancelation of a Government contract, etc., and provisions limiting or governing the demolition of special facilities for which special amortization deductions have been taken, all of these provisions requiring action of one kind or another by the Secretary of War or Secretary of the Navy.

In view of the relation which the building of vessels under the Maritime Commission bears to the national-defense program, it is believed that the same amortization provisions should apply to such shipbuilding. It is respectfully requested that the bill be amended by inserting the words "or the United States Maritime Commission" after the word "Navy" at appropriate places so as to include the Commission with the Secretary of War and the Secretary of the Navy as having the authority necessary under this title.

If these suggestions are adopted, I believe that the national-defense program will be facilitated substantially without jeopardizing the interest of the Government.

I shall appreciate an opportunity to have these suggestions gone into more fully with you or your staff, in whatever manner you may find most convenient.

Sincerely yours,

(Signed) E. S. LAND,
Chairman.

Senator VANDENBERG. Is the Treasury Department satisfied with the bill as it passed the House? Has it any recommendations to make with respect to changes?

Mr. SULLIVAN. As I said in the statement, we feel that it is important that a bill should be passed. We feel that it is necessary for the manufacturers to know what they are to get in the way of special amortization, and also to know what they are going to have levied in the way of special taxes, and we think until they do know that, we are going to face delays.

We originally recommended a plan. It was known as the Treasury plan. I heard several witnesses testifying here yesterday refer to the present bill as the Treasury plan. It is not the Treasury plan.

But in the course of the work in the House, two plans were joined together and certain refinements and relief were added to them, and that is the bill that passed the House. I couldn't say that it is the bill that we would prefer above all others, Senator Vandenberg, and I think it is terribly difficult to ever get a bill satisfactory to everybody.

Senator VANDENBERG. I thought I read into some portions of your statement, a dissent to some of the provisions in the bill as it now comes before the committee.

For instance, in the example case you gave of the corporation which earns $1,000,000 a year from 3 years, and then loses $1,000,000 the fourth year, and is not permitted to deduct the $1,000,000 loss, I understood you to say that you thought they ought to be permitted to deduct that?

Mr. SULLIVAN. There was no dissent in that paragraph, Senator.

Senator VANDENBERG. But as I understand it, at the present time they are only permitted to consider that loss year at zero.

Mr. SULLIVAN. That is right, and that is what we approve.

Senator VANDENBERG. You approve of the zero?

Mr. SULLIVAN. That is right, rather than it appearing in the computation as a minus million.

Senator VANDENBERG. What is your feeling about section 327, the relief section, in the law of 1921?

Mr. SULLIVAN. Well, under our original proposal we were very definitely for a general relief provision, sir, but we have given relief in so many cases that we don't feel that there is left sufficient requirement to justify all of the administrative expense and inevitable legislation that would grow out of it.

Senator VANDENBERG. Well, repeated instances appear before the committee of taxpayers who apparently are going to be seriously and inequitably embarrassed by the terms of this law. It is not going to be an excess-profits tax as far as they are concerned, it is going to be a tax that reaches into their regular earnings, and in many instances it creates a competitive situation which is rather serious for them.

Should there be no forum in which they can appeal for equity, as was provided in the law of 1921, and as you recommended in connection with this law in the first instance.

Mr. SULLIVAN. We provided for special relief in some cases where records are lost, and for that reason they cannot determine their invested capital, and where it has to be reconstructed, or where the records are inadequate. We had many examples come up in the hearings before the House Ways and Means Committee, and as each example arose, we tried to cure it.

We had—and I refer to it this morning—a case where there was a hurricane or a flood, or something that destroys property, and there is no insurance. We are allowing that to be restored to the invested capital base. We provided to take care of those people who are seriously prejudiced by the refunding of processing taxes, and as they have come up, we have tried to take care of all of them.

Senator VANDENBERG. But the fact remains that it is obvious you haven't taken care of all of them, and what is the objection to at least a paraphrase of section 327 of the 1921 law so that there is some forum into which the taxpayer who obviously is aggrieved by a law, can go go for relief?

Mr. SULLIVAN. When these hearings are concluded, if we find that there are cases which we cannot cure in the statute itself, we would seriously consider what you are speaking of. But we want to have an attempt, since we have gone so far in relieving hardship cases in the statute itself, we want to have an opportunity to cure whatever is left without resorting to a method which in the past has proved administratively cumbersome and terribly expensive.

Senator VANDENBERG. Well, I agree that it would be preferable to textually correct the situation, but assuming that we were to take the law as it passed the House, it seems to me that something like section 327 is indispensable in the name of even decent fair play.

Mr. SULLIVAN. We are keeping track of all the criticisms that were made, and if, when you go into executive session, we cannot present you with a solution of those problems, we will seriously consider 327.

Senator VANDENBERG. And in the meantime you are expecting to make suggestions dealing with these specific cases that have been submitted to the committee?

Mr. SULLIVAN. Yes; there was one made here yesterday morning—and I don't remember the name of the gentleman who made it—where he expressed the belief that a corporation should have the power to change its election as to the particular method it was to use, because, since last year's and the previous year's tax liabilities hadn't definitely been determined, they weren't in a position to know. We don't object to that, we think that was a good suggestion.

I am not trying to defend any bill in its present form, I am merely trying to explain it.

The CHAIRMAN. Doesn't this bill give a right to change from one year to another?

Mr. SULLIVAN. It does, sir, but he was correct in his criticism that it did not give him the right to change after he had elected for a particular year, when the determination of tax liability of previous years might indicate that he should have elected the other method than the one he did choose. And we think he should have that privilege.

Senator BYRD. What date do you think he should have the right to elect, what is the latest date in the calendar year?

Mr. SULLIVAN. We haven't decided that, sir.

Senator CONNALLY. On that point, you would want him to elect before he paid the tax, you wouldn't want him to pay it and then come back and reopen it?

Mr. SULLIVAN. We are giving a little thought to that too. We just don't know.

Senator TOWNSEND. Mr. Sullivan, under section 718 of the bill, page 26, equity invested capital is defined to include "money previously paid in for stock, or as paid-in-surplus, or as a contribution to capital."

Mr. SULLIVAN. That is right.

Senator TOWNSEND. Now, is it the opinion of the Treasury experts that this language covers a debt of the corporation forgiven by the stockholders both as to principal and interest?

Mr. SULLIVAN. Would you repeat that, please?

Senator TOWNSEND. Is it the opinion of the Treasury that this language covers a debt of a corporation forgiven by the stockholders both as to principal and interest?

Mr. SULLIVAN. I should think it would, yes.

Senator TOWNSEND. Well, now, under regulation 101 of the Revenue Act of 1938, at page 31, it says:

> In general if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

The regulations limit the contribution to the principal of the debt, and, in addition, the rule is not absolute.

Now, if a corporation owed $10,000 to its principal stockholder and an additional sum of interest amounting to $2,500, and the stockholder forgave both, would that not amount to a contribution to capital to the full extent of the $12,500?

Mr. SULLIVAN. I think it would, sir.

Senator TOWNSEND. In view of the fact that a restricted interpretation has been put upon such a set of facts in the regulations, would it not be necessary to put a specific provision in the statute in order that both principal and interest of a debt forgiven be included as equity invested capital? In other words, would the following language accomplish this purpose, and would you be satisfied with it?:

At page 26, line 13, after the word "capital", a parenthesis and then the following:

> (including the amount of any obligation of a corporation, whether principal or interest, gratuitiously forgiven by a shareholder)

Mr. SULLIVAN. I should think offhand that would be all right, I would want to go over it, however, Senator.

Senator TOWNSEND. Well, now, one other question:

Will a company which has for a large number of years prior to 1940 expended large amounts of money solely in the development of implements of war for such an emergency as now exists, have any opportunity to recover its development and patent costs? This, assuming that all of the company's expenditures are represented by deficits. Such a company will have neither invested capital nor an earning base.

Mr. SULLIVAN. But they are allowed to earn a minimum on invested capital of 7 percent of the first $500,000, and 5 percent beyond that, regardless of their record before January 1, 1940.

Senator VANDENBERG. How much will this bill produce, Mr. Sullivan?

Mr. SULLIVAN. At 1940 income levels, we anticipate a $305,000,000 gross yield.

Senator VANDENBERG. How much would that be eaten into if the general exemption were raised from $5,000 to $25,000?

Mr. SULLIVAN. I don't know, I will get you that figure. I think it would be eaten into very substantially.

Senator VANDENBERG. I assume so.

Senator GEORGE. What do you estimate as subsequent years' earnings?

Mr. SULLIVAN. I haven't an estimate on subsequent years, but I have estimates where the income of each corporation is increased 10 percent, 15 percent, and 20 percent over the estimated calendar year 1940 levels.

Senator GEORGE. Would you mind putting those into the record?

Mr. SULLIVAN. For instance, if in 1941, corporate incomes increased 10 percent, we would estimate this bill would yield $530,000,000.

Senator CLARK. You mean general corporate incomes?

Mr. SULLIVAN. That is right.

Senator CLARK. What basis do you have for assuming they are going to increase?

Mr. SULLIVAN. I beg your pardon, I haven't assumed that. I said if the increase is 10 percent the yield will be $530,000,000.

Senator CLARK. I think it might be fair to say that these war babies would increase their income, but this bill includes everybody as I understand it.

Mr. SULLIVAN. That is correct.

Senator CLARK. It seems to me to be a very violent assumption to be basing your estimates of revenue on an assumed increase of business of 10 or 15 or 20 percent, because as far as other business other than the war babies are concerned, this bill is calculated to decrease their business and decrease their income, rather than increase it.

Mr. SULLIVAN. I don't share that view with you, sir. I think that any substantial prosperity that comes out of national defense to some degree or other, directly or indirectly, will reach most of the business of the country.

Senator CLARK. I think if you study the history of the last war you will find a good many businesses, not participants in the so-called war prosperity, were put out of business with the taxes they had to pay.

Mr. SULLIVAN. I think there were some, yes, but there were certainly a lot of other businesses, with no war contracts, that did marvelously well because of the money spent in the national-defense program.

Senator CLARK. It would be a very violent assumption that a tax bill is going to increase income 10 or 15 or 20 percent.

Mr. SULLIVAN. I am not anticipating anything, and I am not anticipating what the 1941 income will be. I am merely saying that if each corporation's income in 1941 shows an increase over 1940 of 10 percent, the bill will yield $530,000,000; if it shows an increase of 15 percent, the yield will be $640,000,000; and with an increase of 20 percent, this bill would yield $750,000,000.

Senator GEORGE. You mean an average increase?

Mr. SULLIVAN. Yes, sir; for each corporation.

Senator GEORGE. On the whole group?

Mr. SULLIVAN. Yes, sir.

Senator CLARK. I don't want to unduly detain you on this, but you can outline to the committee in a general way the changes which have been made in this bill since you testified before the House committee—at which the Senate committee attended—which brought about the increase in estimated revenue for this year?

Mr. SULLIVAN. Yes; I can.

Senator CLARK. What are the changes? You testified before the House committee?

Mr. SULLIVAN. Yes.

Senator CLARK. And stated that the bill, as it was then projected, would raise $190,000,000 this year?

Mr. SULLIVAN. That is correct for the net yield—the gross yield was $225,000,000.

Senator CLARK. How much is it estimated now?

Mr. SULLIVAN. $305,000,000 gross yield.

Senator CLARK. Can you briefly outline to the committee the changes in principal that brought about that increase?

Mr. SULLIVAN. Yes; I can. There were several changes on one side of the ledger that reduced the yield—relief of hardship cases, allowing a deficit year to be considered zero, and other relief provisions that were inserted into the bill which reduced revenue.

Then the rates were changed and under the bill as it now stands any corporation electing to use the average-earnings method must pay for that privilege an amount equal to 4.1 percent additional tax on its normal tax net income.

Then you will recall that in the bill, or the proposal that was being considered at the time that you referred to, the rates were based upon certain percentages of credits, and they went up like a flight of stairs. Now the rates run up in a straight line, and they are somewhat higher. That is where the additional revenue comes from.

Senator GEORGE. In other words, Mr. Sullivan, by changing these excess brackets—percentage of the increased earnings—to a flat amount, you step them up faster?

Mr. SULLIVAN. Yes, we did, sir; that is right. That, plus——

Senator GEORGE (interposing). That applies to both types of corporations, I mean whether they elect one formula or the other?

Mr. SULLIVAN. That is correct.

Senator GEORGE. So there is no discrimination there at least?

Mr. SULLIVAN. There is discrimination to this extent, Senator George, that the company that has elected to file under average earnings will pay 5 percent more tax than the company electing under invested capital.

Senator GEORGE. I was speaking now purely of the brackets.

Mr. SULLIVAN. The brackets are the same.

Senator GEORGE. And you fix a bracket on the basis of the amount in dollars?

Mr. SULLIVAN. That is correct.

Senator GEORGE. Not on percentage of earnings?

Mr. SULLIVAN. That is correct.

Senator GEORGE. Now, let me ask you, Mr. Sullivan, going back, you say very frankly that the legislative purpose of an excess-profits tax is to tax excess profits or excessive profits?

Mr. SULLIVAN. That is right.

Senator GEORGE. As you put it here?

Mr. SULLIVAN. That is right.

Senator GEORGE. But you have put at least two or three penalties on the corporations who elect to take their prior earnings, haven't you?

Mr. SULLIVAN. Yes, sir.

Senator GEORGE. You put a definite penalty on them?

Mr. SULLIVAN. That is correct.

Senator GEORGE. You first put a penalty of 4.1 percent?

Mr. SULLIVAN. Yes, sir.

Senator GEORGE. That is to say they will pay 25 percent on their normal tax, or 25 percent, if they elect that method?

Mr. SULLIVAN. Correct.

Senator GEORGE. And then you have readjusted those brackets, basing them on the amount of income which is, of course, applicable to both types of corporations, as I understood you to say?

Mr. SULLIVAN. That is right.

Senator GEORGE. Then you have increased the rate on the excess profits by 5 percent in each bracket?

Mr. SULLIVAN. That is right.

Senator GEORGE. On those who elect to pay on their prior earnings?

Mr. SULLIVAN. That is right.

Senator GEORGE. Rather than on the invested capital?

Mr. SULLIVAN. That is correct.

Senator GEORGE. Well, now, why wouldn't it be fairer to allow both types of corporations—or to allow a free elect'on, allowing the companies who had prior earnings that they wished to take as the basis rather than invested capital, and make a reasonable adjustment in the rates that you allow on the invested capital? Now, I am not speaking about how it is going to affect the revenue. I am perfectly willing to ask you that question next, and let you say. But why wouldn't that be fair?

Mr. SULLIVAN. You mean to have them treated more nearly alike?

Senator GEORGE. Well, they have the option; they can take either option. Presumably they would take the one most favorable to them.

Mr. SULLIVAN. Certainly. I believe that under the bill, as it now is, the company that elects to use average earnings will receive far more favorable treatment than the company that uses invested capital. The reason why the additional 4.1 percent normal tax was put on for the privilege of using the average earnings, and the reason why the rates were made 5 percent higher in any given bracket for those companies using average earnings, was because the committee felt, and we all felt, that there was such a tremendous advantage to the company that had very large earnings in the base period that it would have a competitive club to hold over the heads of other competitors in the same business whose earnings had not been substantial during the base period; that we would have to do something to put them on a more nearly equal footing. We believe that the company that will use average earnings is still in a far more favorable position than the ordinary company that will file under invested capital, and the further we go in bringing them onto an equal footing in the bill, I think the further we will go to increase the advantage of the company that is filing under average earnings.

Now, as to reduction in revenue, I haven't any figures but if you have any figures in mind as to rates, we will be very glad to get an estimate.

Senator GEORGE. I am not asking you that, but it seems to me—and you know my view, of course——

Mr. SULLIVAN (interposing). Yes, sir.

Senator GEORGE (continuing). It seems to me that the taxpaying corporation should be allowed to take its average earnings on a fair basis, or its invested capital on a fair rate of return on that invested capital, and that ought to put them relatively on a fair competitive basis, not absolutely, of course, because there are too many other things that enter into it, but relatively, they maintain relatively—certainly if you have got a fair rate of return on invested capital, you have got the same condition that you have got now in your economy.

Mr. SULLIVAN. That is correct.

Senator GEORGE. And of course a lot of things are built up on that economy and you have got a situation that seems to me ought not to be disturbed by putting these extraordinary penalties on the higher earning companies. I can't justify it in my own mind. If they had been earning so much over a period that we select, and their average earnings over that period, before any emergency arose or any expenditures were made, was that, they probably are in a class of companies in many instances that wouldn't be directly affected by the increased expenditure of Federal funds for defense purposes, although they may share in the general economy, of course, that is improved by that expenditure, if they have been earning a reasonable or an average earning over that period, their true excess profit is what they earn in excess of that amount after this period commences and after we pass this law.

Mr. SULLIVAN. Of course, the obvious objection to that, Senator George, is that we are building a definite ceiling over a new corporation or a corporation that has not been doing well in recent years, and we are saying, "Well, you have been making $3,000,000 over your base period, and when you get up above $3,000,000, we are going to start to take part of that away from you in excess-profits tax; whereas, your competitor who has been making $60,000,000 in the last 4 years, will still be able to make $60,000,000 before we take a cent away from him in excess-profits tax"—which is the only objection to it.

Senator GEORGE. Yes. Well, that is true, but that is true now, that is true under present law. What I am trying to avoid is substituting my judgment or the Treasury's judgment, or anybody's judgment for the business management and control of the corporation, and to say that we are now going to stop your profits at a point that we regard as excessive, we do say we are going to put higher taxes on you at a point where you are earning excess profits, but we are not going to undertake to control you further than that.

Mr. SULLIVAN. Yes, sir.

Senator GEORGE. Now, you allow—for new capital—say with a new corporation, you allow them 10 percent?

Mr. SULLIVAN. That is right, sir.

Senator GEORGE. That is 10 percent.

Mr. SULLIVAN. On the first half-million dollars.

Senator GEORGE. Yes.

Mr. SULLIVAN. Eight percent beyond that.

Senator GEORGE. And 8 percent beyond that?

Mr. SULLIVAN. Yes, sir.

Senator GEORGE. If you allowed a flat percent, Mr. Sullivan, couldn't you greatly simplify this bill, if you just allowed a flat 8 or 6 percent or whatever you say, 10 percent, on all corporations?

Mr. SULLIVAN. On current invested capital.

Senator GEORGE. Yes.

Mr. SULLIVAN. Regardless of previous years.

Senator GEORGE. Yes, sir.

Mr. SULLIVAN. That is the 1921 act.

Senator GEORGE. Yes.

Mr. SULLIVAN. It would simplify the bill a great deal. You mean eliminating the alternative proposals?

Senator GEORGE. Even if you kept the alternative proposal, if you used the 8 percent flat on the current year, or 10 percent?

Mr. SULLIVAN. Well, I wouldn't agree to that if the average earnings method alternative was to remain in the bill, Senator, that would be further penalizing the company that had to take invested capital. If they were not to have their choice that definitely would simplify the bill, but if they were to continue to have the power to file under average earnings, I think that you would be getting into trouble there.

Senator GEORGE. Well, now, you tax also on the 4.1 that the corporation is required to pay for its election, don't you?

Mr. SULLIVAN. You mean we tax on it?

Senator GEORGE. Yes; didn't you put a tax on that tax? In other words, the corporation has to pay 4.1 percent in order to elect its prior earnings?

Mr. SULLIVAN. That is right.

Senator GEORGE. And where do you start your excess profits? You include the amount paid out on 4.1——

Mr. SULLIVAN (interposing). Oh, no, sir.

Senator GEORGE. Are you sure?

Mr. SULLIVAN. You deduct your normal corporate tax.

Senator GEORGE. But this isn't normal?

Mr. SULLIVAN. Do you mean on the 4.1?

Senator GEORGE. Yes.

Mr. SULLIVAN. Oh, yes; the normal tax is all that is deducted in the way of taxation before the excess-profits tax applies.

Senator GEORGE. So the excess-profits tax really applied upon whatever amount is paid out on that 4.1 percent?

Mr. SULLIVAN. Yes.

Senator LODGE. Mr. Sullivan, could it be truthfully said that certain parts of this bill are more urgent from the time standpoint than others?

Mr. SULLIVAN. I am not one of those who share that opinion.

Senator LODGE. You do not think so?

Mr. SULLIVAN. No; I do not. I think if I were a manufacturer I would be just as interested in finding out what you were going to take away from me as I would be in finding out what you were going to give me with the other hand, and I don't know how I could bid intelligently on contracts unless I had some idea of what my tax liability was going to be. I think if they were separated, and I presume that is what you had in mind——

Senator LODGE (interposing). The suggestion has been made that some of these provisions could be enacted promptly, and others should be given further study.

Mr. SULLIVAN. I don't think it would solve the problem.

Senator VANDENBERG. In providing those figures for me, Mr. Sullivan, will you also provide a table showing what the reduction in revenue would be if the exemption is increased from $5,000 to $10,000; also to $15,000; to $20,000, and to $25,000?

Mr. SULLIVAN. Yes.

Senator HERRING. In the original suggestion of the Treasury, you provided for consolidated returns?

Mr. SULLIVAN. That is right.

Senator HERRING. That has been dropped, I see. Why is that?

Mr. SULLIVAN. It was one thing to do at that time under that one proposal. Now, there has been increasing demand for that. Given the time, a reasonable amount of time, and I think that we would have to consult Mr. Beaman and Mr. O'Brien to determine whether it would take an additional 2 or 3 or 4 days to do that; we think we could get into this bill a provision for permissive filing of consolidated returns. It would take a much longer time to draft the provisions for mandatory filing of consolidated returns.

Senator HERRING. Don't you think, by not permitting that, you are going to do injustice to certain corporations?

Mr. SULLIVAN. We may be doing some.

Senator HERRING. On the bottom of page 5 here it says, "for other corporations the invested capital method is mandatory." You mean by that, foreign corporations?

Mr. SULLIVAN. That is right.

Senator HERRING. It should say, "for other foreign corporations"?

Mr. SULLIVAN. That is right.

Senator BYRD. As I understand it, cash on hand is included in invested capital?

Mr. SULLIVAN. That is right.

Senator BYRD. Is there any restriction on a corporation not clearing a dividend and keeping that cash on hand in order to get a greater credit?

Mr. SULLIVAN. I am not so sure that I understand what you mean. A surplus that is put back into the business increases it.

Senator BYRD. Suppose the corporation thought it best for their company to keep the cash on hand——

Mr. SULLIVAN (interposing). Oh, section 102 will restrain them from doing that, if that money is not being used for the purpose of furthering the purposes of the business. If that money is used and put into a fund to provide for the erection of additional buildings, that is all right. If that money is used to just——

Senator BYRD (interposing). Section 102 is only appealed to in extreme cases?

Mr. SULLIVAN. That is correct.

Senator BYRD. But in the normal operation of business, the company could keep a half a million or a million dollars on hand, a big company, at their discretion, and if they thought it more advantageous to them not to declare dividends and have the cash on hand to be added to the invested capital, of course they could do that?

Mr. SULLIVAN. Yes, provided the business required it.

Senator BYRD. Isn't that theory in conflict with the Treasury Department's advocacy of the undistributed profits tax?

Mr. SULLIVAN. To that extent, yes.

Senator BYRD. In other words, this is an incentive not to declare dividends to a certain extent, while the undistributed profits tax is for the purpose of compelling corporations to declare dividends?

Mr. SULLIVAN. That is correct.

Senator BYRD. So you have got two principles of taxation somewhat in conflict.

Mr. SULLIVAN. That is right, but we are entering an era in which it is very much to the advantage of everyone to encourage expansion, Senator Byrd.

Senator BYRD. Why wasn't that era just as important when the Treasury advocated the undistributed profits tax, when business conditions where then not as good as they are today?

Mr. SULLIVAN. I don't know, sir, I wasn't here. [Laughter.]

Senator LODGE. Mr. Sullivan, there has been a great deal said about how complicated the language of this bill is and how practically nobody understands it. Isn't it possible to simplify this language without losing the essential subject matter?

Mr. SULLIVAN. That effort has been already made, sir.

Senator LODGE. It has been made?

Mr. SULLIVAN. Yes.

Senator LODGE. I am very glad to hear that.

Senator HERRING. Is this the result?

Mr. SULLIVAN. That is correct, sir. [Laughter.]

Senator LODGE. That is as simple as you can get it, is it?

Mr. SULLIVAN. I didn't say it was simple.

Senator LA FOLLETTE. That flows from the effort to combine these two different theories?

Mr. SULLIVAN. Oh, yes; either of these two plans would be far short.

The CHAIRMAN. We started out with an excess-profits tax and we find we are now taxing prosperous corporations. What is your reaction to putting a little additional percentage in excess-profits tax on those having war contracts?

Mr. SULLIVAN. You mean on the company that has a direct contract with either the War Department or the Navy Department?

The CHAIRMAN. Yes. What do you think about some differential on those corporations?

Mr. SULLIVAN. I assume you are now speaking of just the one company that has the contract with the War Department?

The CHAIRMAN. Well, I am talking about contractors and subcontractors who make excessive profits out of the large national defense expenditure; those are the ones I was led to believe we were going to collect excess profits taxes from, but I find that other prosperous corporations are penalized by higher taxes here, much higher than those that are going to assuredly make some money out of these expenditures we have made.

Mr. SULLIVAN. I don't know that that is true, Senator Harrison. The companies that have increased business and increased profits because of war contracts, are certainly going to get caught under this bill.

Senator BYRD. Is that true of the United States Steel Co.

Mr. SULLIVAN. Oh, yes.

Senator BYRD. Will they pay an excess-profits tax?

Mr. SULLIVAN. On something around $28,000,000 according to present indications.

Senator BYRD. Is that correct?

Mr. SULLIVAN. That is right, on the basis of tentative figures.

Senator BYRD. I understood their invested capital was so large that even though their earnings were greatly increased, they would pay no excess-profits tax?

Mr. SULLIVAN. I think Mr. Stam and I figured that they had an exemption of around $54,000,000.

Mr. STAM. About $65,000,000 now.

Mr. SULLIVAN. If their earnings are $80,000,000, as I understood they were estimated to be, that would make $15,000,000 subject to an excess-profits tax at a rate of about 45 percent.

Senator BYRD. Mr. Stam stated in executive session, as I understood it, $300 per share.

Mr. SULLIVAN. Under the bill we don't figure invested capital at the value per share.

Senator BYRD. I know you don't, but I understood that Mr. Stam said that was the amount of invested capital of the United States Steel.

Senator CLARK. I distinctly understood him to use the United States Steel Corporation as an example of a corporation which, under the Treasury plan, would not pay any tax at all. I assume that putting in an alternative is not going to make the United States Steel Co. pay any more tax if they choose the alternative.

Mr. SULLIVAN. Assuming Mr. Stam was correct in the first instance, but at that time I think he was figuring on their 1939 income.

Mr. STAM. I think they had about $40,000,000 in 1939, and they then wouldn't pay any tax.

Senator BYRD. I would like to ask a question about borrowed money.

What restrictions or limitations on the borrowing of money are there? Has it got to be for some purpose of expansion?

Mr. SULLIVAN. It has to be evidenced by a written evidence of the debt.

Senator BYRD. Such as a note, not a mortgage?

Mr. SULLIVAN. Such as a note.

Senator BYRD. Of course, there is a certain amount of discretion that would be vested in the management as to whether to borrow for operating expenses or not, and keep a surplus on hand.

Mr. SULLIVAN. That is right.

I don't think I have answered Senator Harrison's question, yet.

The CHAIRMAN. I don't think so either.

Mr. SULLIVAN. Once you get beyond the company that has a direct contract with the War or Navy Department, then you are getting into a good deal of difficulty. For instance, you have a company that is making one type of little screw that is used in airplanes for war purposes, is used in tanks, and used in a variety of other domestic uses entirely unrelated to war. To determine what part of their expense went into making those for the war contracts, is an exceedingly difficult thing. If you are going to restrict it to the fellow who has a direct contract with the War Department or the Navy Department, that would be much easier to work out, but I think we would want to discuss that with them and with the National Defense Council before making any recommendations to you on it.

The CHAIRMAN. Would that slow up this defense program?

Mr. SULLIVAN. I don't know, that is why I would like to discuss it with them, Senator.

The CHAIRMAN. I think that the American people who believe in the excess-profits tax felt that those who were going to make the biggest profits out of those contracts ought to pay a good part in excess-profits taxes, and they can't reconcile that we take the prosperous concerns and put an ordinary normal corporate tax on them by penalties both in the excess profits and on the normal corporate tax.

Mr. SULLIVAN. Do you want us to discuss that with them?

The CHAIRMAN. We will have to discuss it in executive session, I suppose, but I would like to have you ready to answer it.

Mr. SULLIVAN. We will.

Senator GEORGE. Mr. Sullivan, going back to the borrowed capital, do you exclude interest paid?

Mr. SULLIVAN. Well, we do it this way. If the borrowing is so small, the total invested capital is so small, that all of the borrowing is admitted to invested capital, we then exclude interest. If the borrowing is admitted 66⅔ percent, we admit one-third of the interest.

Senator GEORGE. You admit the same proportion of interest——

Mr. SULLIVAN (interposing). In reverse. We admit the interest on that part of the borrowing which is excluded from the base, that fraction.

Senator GEORGE. Would it be an unsound principle to allow all borrowed capital to go in, and exclude all interest?

Mr. SULLIVAN. Yes, I think it would, sir. A large company that can borrow money for 2¼ or 2½ percent, and then be allowed to earn 8 percent on it—that wouldn't be fair, sir.

Senator GEORGE. Well, I don't know, if they can earn 8 percent on it, that is the reason they borrow, they want to make money.

Mr. SULLIVAN. Yes; but they might not be increasing their profits 8 percent just because they had that additional money, but they would be allowed to make 8 percent.

Senator GEORGE. So that additional money is a part of their capital?

Mr. SULLIVAN. That is right, without paying any tax on it, whereas that money was only costing them 2¼ or 2½ percent.

Senator BYRD. Preferred stock is regarded, of course, as invested capital?

Mr. SULLIVAN. Yes, sir.

The CHAIRMAN. There was a great deal presented to the joint hearings about those who elected to go under the average earnings basis, that they might take three out of those four years?

Mr. SULLIVAN. Yes, sir.

The CHAIRMAN. Now, that was not objected to by the Treasury except on the theory that we might lose too much revenue?

Mr. SULLIVAN. Yes, that is correct, Senator Harrison. In fact, the power to elect any three out of the four years in the base period was part of the original Treasury proposal. But then we had all these other alternatives, I think at the time the question was asked, the revenue under the bill, the proposal, was down to $160,000,000, and we hadn't estimated how much it would reduce that if we allowed them to take three out of four, but we now find that it would have reduced it $60,000,000, or in other words, a little more than one-third.

The CHAIRMAN. But since you went into the process of these additional penalties on those selecting the average basis, and also the hoisting of those that elected to go under this invested capital, from 6 to 7 percent up to $500,000, and from 4 to 5 percent on those over that—that has increased the revenue so much. How much now would you say it would amount to if we should change the 3 to 4?

Mr. SULLIVAN. I don't know. We haven't that figured. I should think roughly if the same ratio applied it would be a third, but I will have that estimated.

The CHAIRMAN. How much loss of revenue?

Mr. SULLIVAN. We will get that for you.

The CHAIRMAN. What is your idea as to what this bill will produce in 1941? You have given us, of course, the figure if business increased so much. What is the idea of the Treasury now, if this bill should pass in its present form, for 1941, because we all realize that 1940 is not a very fair year for an estimate?

Mr. SULLIVAN. That is correct, Senator. But we don't know, it depends on so many factors, it depends upon the speed with which the national defense program gets going. It depends on domestic business. There are so many factors that enter, that anything we gave you would have to be termed a guess rather than an estimate.

The CHAIRMAN. Then your testimony as to $160,000,000 was merely a guess?

Mr. SULLIVAN. No, that was on 1940 income.

Senator TOWNSEND. That is $305,000,000?

Mr. SULLIVAN. That is right. But to anticipate what it is going to be a year from now——

Senator BYRD (interposing). I saw a newspaper report saying that the year 1941 would bring in $900,000,000; what have you to say about that?

Mr. SULLIVAN. I am sure I don't know, I saw the same report.

Senator LODGE. When does this bill go into effect?

Mr. SULLIVAN. As of January 1, 1940, it affects income earned during 1940.

Senator LODGE. Does all of the bill—I am talking about the bill as a whole?

Mr. SULLIVAN. Amortization goes back to facilities constructed after July 10. The Vinson-Trammell Act goes back to January 1, 1940.

Senator LODGE. And the rest of the bill takes effect on its passage?

Mr. SULLIVAN. I think I have covered the three parts of it.

The CHAIRMAN. Now, Mr. Sullivan, on the amortization feature, you go back to July 10?

Mr. SULLIVAN. Yes, sir.

The CHAIRMAN. It was stated before the joint hearings, I think by the Assistant Secretary of the Navy, that they had made some contracts prior to that date, but in the year 1940. Do you think it is fair to go back to the first day of this year—if we are going to impose the excess-profits taxes and they were led to believe, certain industries, that the amortization feature would be worked out. They acted in good faith with the Government and entered into some of these contracts—don't you think it is fair to put it back to January 1? I understand there are a few such cases.

Mr. SULLIVAN. I had understood that July 10 was selected because that was the first date upon which anybody indicated that special amortization would be allowed. That is why July 10 was taken.

The CHAIRMAN. I think July 10, as I understand, was selected because we had a conference and one of the members of the conference said that we agreed, so far as we were concerned, on that plan, and an announcement was made to that effect and that is why it was selected; but prior to that, the Defense Council had made some contracts——

Mr. SULLIVAN (interposing). I don't believe so, sir.

The CHAIRMAN. Or the Navy Department?

Mr. SULLIVAN. I think the Navy was interested in some contracts made prior to September 1939.

The CHAIRMAN. I wish you would investigate that thoroughly.

Mr. SULLIVAN. I will, sir.

The CHAIRMAN. We want to be fair with people and if they have gotten an impression that Congress is going to take care of the situation or they wouldn't have made these contracts, we should not discriminate against them.

Mr. SULLIVAN. I will look that up.

Senator CONNALLY. I have some information along that line about concerns that claim to have expanded their plants even before September 1939, and since that time, and under this bill they can't get any amortization until July 10, 1940, is that right?

Mr. SULLIVAN. That is right.

Senator GEORGE. They can't get the special amortization?

Senator CONNALLY. I mean the special amortization that is granted under this bill. That is what you were asking about, wasn't it, Mr. Chairman?

The CHAIRMAN. Yes.

Senator CONNALLY. I think we ought to look into that because I think we ought to treat them all alike.

Senator VANDENBERG. I wanted to ask what the $305,000,000 you were going to raise this fiscal year—what percentage of the estimated deficit for this fiscal year, the $305,000,000 is?

Mr. SULLIVAN. I don't have that figure here, sir.

Senator LODGE. At what date do you expect to get receipts as a result of this bill, what is the first date?

Mr. SULLIVAN. March 15.

Senator LODGE. Of 1941?

Mr. SULLIVAN. That is correct.

Senator LODGE. That is what I had in mind in my other question.

Mr. SULLIVAN. I misunderstood you.

Senator LODGE. From the standpoint of getting money into the Treasury, you won't start getting money until March 1941?

Mr. SULLIVAN. That is right.

Senator LODGE. And the Treasury contends that the advantage to the businessman in knowing promptly where he is, outweighs the potential advantage to the businessman in having a bill that was more carefully worked out and more carefully studied?

Mr. SULLIVAN. We could all of us work together on an excess-profits tax bill for years, and we wouldn't come out with anything on which we all agreed, or that wouldn't be subject to complaints of some character.

Senator VANDENBERG. But you think bad news is better than no news?

Mr. SULLIVAN. I think it depends on how bad it is, Senator Vandenberg.

Senator CLARK. Mr. Sullivan, you indicated before the Ways and Means Committee that the Treasury and the Defense Council were in some disagreement on this matter of amortization as to what would come—would become of this property that was to be amortized after the amortization period; that the Treasury thought it ought to be written into the law and the Defense Council thought they ought to be permitted to handle it by contract?

Mr. SULLIVAN. That is correct, it wasn't so much as to what became of the property but a difference of opinion as to how it should be handled.

Senator CLARK. That is the essential question, isn't it, what becomes of the property?

Mr. SULLIVAN. That is right.

Senator CLARK. In other words, if you permit corporation A, let us say, to go ahead and vastly expand their plant facilities, they receiving Government contracts during this period, they vastly expand their facilities, build a new plant, I mean practically build a new plant, and are permitted to amortize it for tax purposes over a period of 5 years, and also permit it to amortize it out of profits as to the actual cost over the period, which is practically what it amounts to—I understand some of the large corporations demanded that they be permitted to amortize profits out of the first contracts to be let—now, if you permit that, you have beaten the Government out of a large amount of taxes and at the same time, at Government expense, what in effect amounts to presenting corporation A with those facilities which they would own at the end of the period, and by which process they would be put in an impregnable position with regard to any competitor who hadn't received Government contracts. Isn't that a fact?

Mr. SULLIVAN. Yes; it is.

Senator CLARK. Don't you think that the matter of the disposition or the ownership of the property at the end of this period should be considered right along with the provision for the amortization of the taxes?

Mr. SULLIVAN. It very well might be.

Senator CLARK. And that was, as I understand, the original position of the Treasury, that it should be?

Mr. SULLIVAN. The position of the Treasury was this, that if they are to be allowed to have this special amortization, that then, in that event, when the emergency is terminated, they should not be allowed to demolish or alter those premises without getting the permission of the Secretary of War or the Secretary of the Navy, and if the Secretary of War or the Secretary of the Navy felt that that was a facility for which his department had a continuing need, he should then be allowed to buy that at the adjusted basis.

Senator CLARK. The point I am returning to is—don't you think that that ought to be written into the law? I have been advised of the plan which has been worked out by some of the experts of the Defense Council, and I think it is a very good plan, but they insist, as I understand it—and I certainly so understood your testimony, and I understood what they told me to the same effect—they want to do it by their own contract and their own regulations. The Defense Council is an unofficial body, it might be wiped out by a Presidential order at any moment, and some other body constituted, and it does seem to me that on a matter of that importance, as to the disposal of that property, that provision should be written into the law instead of having it left to contract.

Mr. SULLIVAN. I am in thorough accord with the statement and it is in the law.

Senator CLARK. I wasn't able to find it, I will be glad to have you point it out to me.

Senator GEORGE. If we increase the normal rate of tax on all corporations 3 percent——

Mr. SULLIVAN (interposing). The additional yield, you mean?

Senator GEORGE. Yes.

Mr. SULLIVAN. That would be about $225,000,000.

Senator GEORGE. And then under this bill as the Ways and Means Committee considered it on the report, it was estimated that this excess-profits bill would yield about $190,000,000, less $60,000,000, or, with some changes made in it, $190,000,000.

Senator TOWNSEND. $160,000,000, less $60,000,000.

Mr. SULLIVAN. There were different changes that went through at the last minute which brought the gross yield at estimated 1940 income levels to $305,000,000.

Senator GEORGE. It would produce, without the penalties, how much in your judgment now, without the penalty of 4.1 and the increase in the rate of the excess-profits tax?

Mr. SULLIVAN. You mean before the changes in rates were made?

Senator GEORGE. Yes.

Mr. SULLIVAN. I think it was down to about $160,000,000 net yield.

Senator GEORGE. Would you say $150,000,000? And a 3-percent increase on all corporate rates, normal, would produce about $225,000,000?

Mr. SULLIVAN. Now, you are talking about putting a 3 percent on the corporations that don't have to file under any excess-profits tax?

Senator GEORGE. Put it on all of them.

Mr. SULLIVAN. Even though their income is less than $5,000?

Senator GEORGE. Well, of course, we have got some graduations for the smaller corporations.

Mr. SULLIVAN. If it is on all of them it would be $225,000,000.

Senator BYRD. If this bill is enacted as it is, plus the other Federal taxes which corporations pay, what percent of the earnings on the average do you think they will be required to pay in Federal taxes?

Mr. SULLIVAN. We will get that figure for you.

Senator BYRD. I would like to know what percent of the earnings of the corporations will be paid in Federal taxes. I am informed on good authority that it will be from 30 to 35 percent.

Mr. SULLIVAN. We will find out and get it for you.

Senator GEORGE. You mean the effective tax rate?

Senator BYRD. I mean the total combined Federal taxes.

The CHAIRMAN. Are there any other questions?

Senator CLARK. I don't think this covers what I was driving at, this passage that you showed me from the proposed bill, but it is tied in with so many other provisions that it is very difficult, so I will have to come back to that later.

The CHAIRMAN. You are excused for not being able to understand it right off.

Senator GEORGE. Mr. Sullivan, before you go, will you please furnish, if you can furnish it, what the difference in the revenue would be if you based your brackets on the increased earnings and not on the amount?

Mr. SULLIVAN. You mean percentage, rather than in dollars?

Senator GEORGE. Yes.

Mr. SULLIVAN. We will get that for you.

Senator CLARK. This provision reads:

> Any taxpayer taking deductions for amortization of emergency facilities pursuant to the provisions of this section may not thereafter destroy, demolish, impair, or substantially alter such emergency facilities without the consent in writing of the Secretary of War or of the Secretary of the Navy. In the event that such consent is not given within a period of 90 days from the date of receipt of written request therefor, the Secretary of War or the Secretary of the Navy, as the case may be, shall and he is hereby directed to purchase such facilities at a price which he shall fix—

within certain limits.

Mr. SULLIVAN. That is right.

Senator CLARK. Suppose the manufacturer doesn't wish to demolish or impair or destroy, but he goes right on using it in his own business?

Mr. SULLIVAN. That is right, and it continues to be a facility upon which the Secretary of War can call.

Senator CLARK. And he has a tremednous advantage in any competition with any competitor because he has a new plant, built at Government expense, which he is permitted to continue just as long as he doesn't want to demolish it, which he naturally wouldn't want to do if he has got a new plant which can manufacture more efficiently than any competitor.

But until such time as he applies for permission to demolish this new plant which has been built at Government expense, then he can go right on using it.

Mr. SULLIVAN. That is right, and the Government is in a better position, too.

Senator CLARK. That is a matter of very serious dispute.

Mr. SULLIVAN. Just a minute. Doesn't it then have available for its use, if another emergency arises, facilities which are kept in good repair, which are operating, and the Government has no expense of maintaining them?

Senator CLARK. But the fortunate contractor who has obtained these Government contracts has a new plant, built at Government expense, which he is permitted to use, while any competitor would have to build a plant at his own expense, or if he has an old plant, would have to use it on an inefficient basis in competition with these favored contractors who have gotten these contracts and have been permitted to amortize them.

Mr. SULLIVAN. As between manufacturers, that statement is quite correct.

Senator CLARK. That very largely affects the industrial well-being of the United States, taken as a whole, doesn't it?

Mr. SULLIVAN. It does if the orders are restricted to a few in each industry; yes.

Senator CLARK. So the Government of the United States is in the position of having certain manufacturers, building them plants and turning them over to them at Government expense?

Mr. SULLIVAN. I surmise that most of these plants that are certified as necessary for national defense, will be plants in which war material alone is being manufactured.

Senator CLARK. Well, I don't know. The United States Steel, for instance, not to harp on my daughter too much, but the United States Steel, or Bethlehem Steel, make a good deal of war material. They could very readily use those plants for making other material than war material. It seems to us it will be a very serious question.

when we go to pass this amortization feature, to see exactly where it is going to land you.

Senator VANDENBERG. You say you understand the advantages to the Government are that the facilities are available to the Government after this emergency, for another emergency if one should arise?

Mr. SULLIVAN. Yes.

The CHAIRMAN. After the amortization, they would have to pay the full tax.

Mr. SULLIVAN. Yes.

Senator CLARK. But they would have a plant that the Government has just given them. I was advised by a representative of the National Defense Council that irrespective of the amortization features of this tax bill, that a great number of these armament manufacturers, or munitions purveyors, had demanded the right to amortize as to the actual cost out of profits in 1 year, that is out of the first order that they received. But when we get into the question of tax amortization, we are getting into some very closely affiliated questions as well.

Senator BYRD. In other words, the cost of the plant is added to the contract?

Mr. SULLIVAN. That is right.

Senator CLARK. They are very closely affiliated and it seems to me the two ought to be considered together.

The CHAIRMAN. Are there any other questions of Mr. Sullivan?

If not, suppose we meet at half-past one. Mr. Stam, we will hear you this afternoon and also Mr. Knudsen.

(Whereupon, at 11:50 recess was taken until 1:30 p. m. of the same day.)

AFTERNOON SESSION

(The committee resumed at 1:30 p. m.)

The CHAIRMAN. Mr. J. C. Roberts.

STATEMENT OF J. C. ROBERTS, TREASURER OF TEXTILES, INC., GASTONIA, N. C.

The CHAIRMAN. Mr. Roberts is from Gastonia, N. C., representing Textiles, Inc. Is that right?

Mr. ROBERTS. Yes, sir. My name is J. C. Roberts, treasurer of Textiles, Inc., owning and operating 16 fine-combed yarn mills in Gastonia, N. C

The textile industry, and especially the combed yarn part of the industry, is essentially a feast and famine operation with very short feasts and very long famines. For this reason I suggest that the excess-profits tax be based on cumulative income, that is, losses and unused credits should be the basis of adjustment of prior and/or subsequent returns.

Our company, a consolidation of June 1, 1931, was capitalized at values as at that date. There immediately followed a drop in cotton prices that cost us close to a million dollars. Since that time, due to sales of plants, adjustment of depreciation and several famines we have incurred a substantial deficit. However, our plants are now in a fine competitive condition and yet we will, under this proposed bill, be at a disadvantage in that we will be faced with higher taxes than our competitor who has not been faced with similar difficulties. Through our efficiency and also due to expenditures for revamping our mills, we can, at the same prices make a larger profit than we could last year, but any increase will not be termed excess and be taxable. This should be subject to relief by review by an independent board.

It is my belief that consolidated returns both for normal taxes and excess-profit taxes should be permitted. This is considered good accounting practice, is required by certain governmental regulatory bodies, and results in showing the net increment to the stockholders. It also eliminates any tax on unrealized profits on sales by one affiliate to another, the goods being in the inventory at the end of the tax period.

If consolidated returns are not allowed, I suggest that investments in affiliates be not eliminated as inadmissibles, but that intercompany dividends be entirely eliminated in the computation of normal tax, and that if such dividends are paid between the close of the tax year and the filing date of the return, then the dividends would be subject to the excess-profits tax of the parent corporation but used as a deduction in the excess-profits tax of the subsidiary.

One of our subsidiaries is financed with a very low capital and owes us a considerable sum of money on open account. Under the proposed bill they can only use as invested capital the sum of the equity capital plus certain percentages of borrowed capital provided such borrowed capital is represented by notes, bonds, and so forth. This open account would therefore be eliminated from their total invested capital and would react greatly to their detriment.

I suggest that 100 percent of borrowed capital be allowed and this should not be limited to debts represented by notes, bonds, and so forth, but should also include advances on open account.

It should be pointed out that the suggested base period, 1936–39, inclusive, contains years which have not been closed as far as income taxes are concerned. One cannot, therefore, accurately compute the base for comparison with 1940. Furthermore, in the election by a taxpayer as to the base under which he will be taxed he is at a great disadvantage because of the fact that while he has elected to take a certain base for the 1940 income, he may wish to use the other base after his normal income tax returns for prior years as well as 1940 have been examined by the Department. Permission to make this change in election should be included in the law.

I suggest that the rates of exemption are not adequate and believe more consideration should be given to that feature with the possible exemption of an amount equal to at least 10 percent of the sum of the equity capital plus 100 percent of the borrowed capital. I also believe that no larger exemption should be granted to a new company than that allowed an old company, as naturally this discrimination could certainly be considered as unfair competition with a company already established.

Senator VANDENBERG. You referred to the fact that some other regulatory bodies required consolidated returns. Do you have any in mind?

Mr. ROBERTS. The S. E. C. would be one.

Senator VANDENBERG. What?

Mr. ROBERTS. The S. E. C. would require that. I do know some of them are requiring it.

The CHAIRMAN. Thank you very much.

Mr. Livingston.

STATEMENT OF DONALD M. LIVINGSTON, PHILADELPHIA, PA., REPRESENTING LIVINGSTON, MONTGOMERY & CO.

The CHAIRMAN. Mr. Livingston is from Philadelphia and represents Livingston, Montgomery & Co. All right, Mr. Livingston.

Mr. LIVINGSTON. Mr. Chairman and Senators: I have some specific criticism of the particular bill that is involved and some general criticisms on the theory of the excess-profits tax. We have no experience except with the 1917 tax.

The CHAIRMAN. You have a brief, haven't you?

Mr. LIVINGSTON. No, sir; I have not.

The CHAIRMAN. If you want to elaborate on the points that you will make in these 10 minutes you may do so.

Mr. LIVINGSTON. All right, sir. Our experience is with the 1917 and 1918 excess-profits taxes, and during that period about 10 percent of the taxpayers who reported used the earnings base and the other 90 percent used the invested capital. Now since that time there have been a great many new commissions that have come in, the Federal Power Commission, various State utility commissions, and they have had a lot to say about the rate of return on invested capital.

The CHAIRMAN. What is this Livingston, Mongomery & Co? What business are you engaged in?

Mr. LIVINGSTON. Public accountants. The courts have invariably held in public utility cases that many elements besides original cost and the amounts paid in on stocks and bonds must be considered as a part of the invested capital. I do not believe that the act as passed by the House is constitutional and would get by the Supreme Court for that reason.

Now we have at the present time a rather high income tax, Federal income tax, and we have a lot of State taxes. I do not believe in 1940 that there is going to be much of an increase in general income. We are not at war, and I do not believe that the country is ready to see an excess-profits tax passed hurriedly. I think that they are quite willing to pay their share of whatever the cost of defense is, but that they would like a tax of this sort considered for a period of several months, so that a great deal of testimony could be put on the record as to the effect on business.

Now on the two bases proposed by the present bill, the earnings base provides for 4 years from 1936 to 1939, inclusive, and in our experience as public accountants we know of many cases where the taxpayer has earned no net profit since 1932, with the exception of 1 or 2 years.

If the taxpayer is restricted to zero earnings in years of deficits it simply means that anything he makes over zero will be subject to the excess-profits tax.

Now, specifically, on this present bill, the section which relates to borrowed capital as a portion of the invested capital attempts to equalize the invested capital as between corporations by limiting the amount of borrowed capital which goes in the base, two-thirds in one case and one-third in another and 100 percent in another. The cost of borrowed capital of the corporations varies materially. Many things enter into the credit risk and the determination of interest rate. Many of them must pay 6 percent, and some borrow for as little as 1 percent. For the Treasury Department to advocate an arbitrary rule would, I believe, work an injustice on many corporations.

Now, the purpose of the bill, as I see it, would be to accomplish two things: First, to do away with the profiteers who would make huge amounts on war contracts; second, to produce revenue. Mr. Sullivan testified this morning that the expected revenue would run around $305,000,000 for the first year. Now, under the defense program our cost of rearmament will probably run from 10 to 25 billion dollars, and with a sum like that it is probable that an individual buying a plant for $10,000 or $15,000, in most cases he would plan for it over a period of years, he would not assume he could pay for it out of 1 year's income. We are in somewhat the same position. If we want to put our house in order we will pay for it, but we should have a reasonable period of years in which to do it, and our method of payment should not be a hurried method which would lead to undue difficulty and make a field day for lawyers and accountants who should have better things to do on the defense program, than to wade through the courts on a tax bill that is not properly drawn.

I would ask long and earnest consideration before any such bill is approved by the Senate. That is all I have to say, Mr. Chairman. If you have questions I will be glad to answer them.

The CHAIRMAN. All right. Thank you, Mr. Livingston.

Mr. Leonard Zick.

STATEMENT OF LEONARD ZICK, REPRESENTING MASTIC ASPHALT CORPORATION, SOUTH BEND, IND.

Mr. ZICK. My name is Leonard Zick, vice president and director of the Mastic Asphalt Corporation of South Bend, Ind. I have made a few notes here that I would like to review.

Our company was incorporated in 1932. We acquired this company in 1934 for approximately $44,000, and when we acquired it it was practically bankrupt. Our first year of profit was in 1936. Our net income for the year 1936, before taxes, was $15,600, our tax was $3,800, and our net income after taxes was $11,800.

For the year 1937 our net income was $57,000, our taxes paid $11,631, and our net income after taxes was $45,943.

In 1938 our net income was $250,661 and our tax paid was $46,436, and our net income after taxes was $204,225.

In 1939 our net income was $444,235, our taxes paid was $78,817 and our net income after taxes was $365,418.

Our net income in the 4 years in which we made a profit, in a business which has been in business 8 years, we made $768,074, or an average in the last 4 years of $192,018. If our net income for the year 1940 equals that of 1939 we would be subject to excess-profits taxes, under the bill as enacted by the House, in the amount of $252,217, on which there is a $5,000 exemption, and as we have computed it under this bill our tax would be $201,444, on a net income of $444,000, or $122,627 in excess of what it was last year on the same income.

In other words, our tax paid in 1939 was $78,817, and under this bill, with the same income, our tax would be $201,444, or an increase of 156 percent.

The CHAIRMAN. You would probably take the invested capital, method would you not?

Mr. ZICK. No; our invested capital is under a million dollars, and it affords us absolutely no relief, and this bill would take 45.3 percent of our net income this year.

The CHAIRMAN. You say you bought this company for about $40,000?

Mr. ZICK. That is right, in 1934.

The CHAIRMAN. And you built this company up in 4 years to what it is today?

Mr. ZICK. In 1934 and 1935 we made nothing. It was largely experimental. In fact we lost quite a little money. 1936 was our first net income year. We made $15,000 in that year and paid a tax of $3,800. In 1937 we made $57,000; in 1938 we made $250,000, and in 1939 $444,000. We have been plowing that back into our business, and we propose to plow it back, but if 45.3 percent of our net income is going to be paid in taxes you can imagine what problem we have, particularly when we anticipate placing a plant on the east and west coasts to supply people with this product of ours.

Senator VANDENBERG. You would be out of the plowing business at any rate.

Mr. ZICK. Yes, sir. Incidentally, our business is manufacturing building material used for low cost housing, on which there has been considerable emphasis in the last few years. We are not engaged in any way in making anything for defense purposes, at the present time at least. We may be in a position to aid in building some barracks, or something of that sort, and applying our material in those places. We employ 175 people and our business has been expanding very rapidly, but we are afraid it is going to be stifled if this bill is going to be enacted as the House has passed it. We feel some relief should be given to the corporations that have invested capital of less than a million dollars and were started in business within the last 10 years. We feel there are a lot of medium-sized corporations that are not given any relief and that are very much discriminated against in this bill.

Senator VANDENBERG. Your need is obvious and the equity is obvious also. You are asked to bear more than your share of the burden.

Mr. ZICK. I would think so. From the testimony of Mr. Sullivan this morning, as I read it, or as I understood it, he said the bill this year would provide about $305,000,000. If that is true, our little company, which has been established in the last 8 years in this country, would pay one-half of 0.1 percent of that bill, and obviously this is inequitable and unfair. That is all I have.

The CHAIRMAN. Are there any questions? Thank you very much. Mr. John V. Lawrence. Mr. Lawrence represents the American Trucking Associations, Inc.

Mr. LAWRENCE. That is correct, sir.

The CHAIRMAN. All right, Mr. Lawrence. You have a brief. Point out to the committee the important points.

Mr. LAWRENCE. Yes, sir.

STATEMENT OF JOHN V. LAWRENCE, WASHINGTON, D. C., GENERAL MANAGER, AMERICAN TRUCKING ASSOCIATIONS, INC.

Mr. LAWRENCE. Mr. Chairman, and members of the committee, my name is John V. Lawrence. I am general manager of the American Trucking Associations, Inc., with offices at 1013 Sixteenth Street NW., Washington, D. C.

The association is a federation of 50 associations in the various States, the District of Columbia, and the Territory of Hawaii. Its membership represents every type of trucking service.

Members of the affiliated associations in the States are members of the national organization, exercising their franchise through their State or local association.

Power in the national organization lies in a board of directors, consisting of seven members from each State and each Federal district or Territory, drawn from different classes of operations.

The trucking industry, like all American industries, stands foursquare behind the program to rearm this country to insure our security.

As all other industries, and the whole people of the Nation, the trucking industry knows the bill must be paid, and that increased taxes are inevitable.

The trucking industry, private and for hire, pays all of the general business taxes that other industries or businesses pay.

In addition, the trucking industry has been paying over $100,000,000 annually of the excise taxes on automotive equipment, parts, fuels and lubricants, collected by the Federal Government. I might point out that no other form of transportation pays this special form of Federal tax.

Since July 1 the Federal gasoline tax, the major portion of these excise taxes, has been increased by 50 percent, and the other items have likewise been increased, still with other forms of transportation left scot free.

For the use of highways, all motor vehicles pay special taxes to the States—license fees, gasoline taxes, and so forth. The former Federal Coordinator of Transportation, Chairman Joseph B. Eastman of the Interstate Commerce Commission, recently issued a study on Public Aids to Transportation. The study showed that, without crediting motor-vehicle owners with Federal excise taxes or special motor taxes "legally diverted" by the States to nonhighway purposes, motor-vehicle owners overpaid their share of highway costs by $501,138,000 in the period from 1921 to 1937. The amount of overpayment was greatest in the later years, totaling $110,772,000 for 1937.

Mr. Eastman found that trucks more than paid their share of highway costs, by as much as $287 per vehicle per year on the largest for-hire vehicles.

Thus, the trucking industry not only more than pays for the highway use through State special taxes, but, in addition to paying general business taxes like all other enterprises, it pays special Federal excise taxes visited on few other businesses, and on no other form of transportation.

Proposals such as embodied in H. R. 10413 applied to our industry would retard greatly its continued service to the country's industrial, agricultural, and commercial life, and particularly to its national-defense program.

The motor-carrier industry is among the newest and largest of the country's industries, but it is composed in the main of small enterprises. Of more than 30,000 motor carriers subject to the jurisdiction of the Interstate Commerce Commission, only a few more than 1,100 are in class I, that is, doing a gross business of $100,000 or more per year. Even the largest concerns are not considered as big business enterprises by present-day standards.

Now to illustrate the nature of this industry—I could talk at great length but we are rather limited in time—I just merely would like to quote from a concurring opinion of Commissioner Joseph B. Eastman in a recent case decided by the Commission, which I think is descriptive of the industry. It is found in MC-F-1108, Keeshin Freight Lines, Inc.—Issuance of Notes, decided by the Interstate Commerce Commission on February 3, 1940. In his concurring opinion, Commissioner Eastman said:

> It should be borne in mind, also, that motor carrier operations differ radically from railroad operations in a respect which is here pertinent. Railroads require a heavy investment in permanent or long-lived property. Even railroad locomotives and cars have comparatively long lives. Motor carriers, on the other hand, require a relatively insignificant investment, and for the most part it goes into automotive vehicles which have short lives and depreciate very rapidly. The tangible assets of a motor carrier, in the event of liquidation, can be depended upon for little in the way of value. The financial soundness of such a carrier has, therefore, a small relation to its tangible assets but is dependent upon the skill with which operations are conducted and the market which is thus created for its services. Those engaged in the business are accustomed to reckon the profits which mark financial success, not in terms of the percentage return realized upon the depreciated value of tangible assets, but in terms of the percentage of gross revenue which is earned. Yet the percentage of gross which brings financial success is small compared with the like percentage which is necessary to produce as much as a 6-percent return on railroad investment. A motor carrier with an operating ratio of 90 normally is prosperous, whereas for similar prosperity a railroad needs an operation ratio of 70 or better.

Motor carriers came under Federal regulation in 1935. Opponents of the measure in Congress predicted increased motor freight rates from the measure. But the result was just the opposite. On April 1, 1936, interstate motor freight rates, filed with the Interstate Commerce Commission, became known publicly. An orgy of rate reductions ensued, as between motor carriers, and as between motor carriers and other carriers, continuing through 1937 with little abatement. Motor carriers had progressively descended to the plane of the rail carriers, who had been through the depression importuning the Congress and the people to save them from financial collapse.

Then, in the fall of 1937, with the bottom dropping out of business activity, rail carriers petitioned the Interstate Commerce Commission for a flat increase of 15 percent in rates. Motor carriers and other carriers joined in this petition. The Commission granted a 10-percent increase in rates, 5 percent on agricultural and certain bulk commodities. As a result, while returns to the carriers in 1938 were poor, the country's transportation agencies had been saved.

Let me show the story in specific terms. In the *Fifteen Percent Rate Increase Case*, ex parte 123, before the Interstate Commerce Commission, a witness for our association testified that for 1935, 389 motor carriers reported an operating ratio of expense to income of

96.16 percent; 434 carriers reported an operating ratio of 97.52 percent in 1936, and an operating ratio of 99.65 percent for the first 9 months of 1937. Statement Q-800 of the Interstate Commerce Commission shows an operating ratio of 99.08 percent for 883 class I carriers in 1937.

Corresponding operating ratios based on reports of class I carriers to the Interstate Commerce Commission were 97.26 percent in 1938 and 95.14 percent in 1939. Compared with the 90-percent figure quoted by Chairman Eastman, of the Interstate Commerce Commission, as signifying prosperous conditions for a motor carrier, what have we in the base period here proposed?

While in 1935 motor-carrier earnings were "fair," in 1936 they were "poor"; in the first 9 months of 1937 they were "dreadful," and in the full year they were "calamitous"; in 1938 they were "poor"; and in 1939 they were "fair."

Thus, using this 4-year period as a base period, credits from excess profits levies allowed would be on the basis of some average between "poor" and "fair." "Good" earnings would be subject to excess-profits taxes and the penalty on "prosperous conditions" would be appalling.

From a general view of business conditions over the 1936-39 period, therefore, it would appear that in all fairness the base period should be reduced to any 2 of the 4 years 1936-39. We do not ask this for our own industry alone. We feel that many other industries similar in character are in the same boat.

In H. R. 10413, such penalties are placed on the average earnings basis as to practically preclude its use. We ask that these penalties be removed.

In addition, many of our carriers were building up their businesses during the base period and either alternative would create hardship. Many other businesses are situated similarly. We ask that special relief provisions somewhat along the lines of special assessment under the old laws be provided for this type of corporation as a third alternative.

We ask that where the invested capital basis is used that it be on a flat percentage of not less than 8 percent.

We ask that the taxpayer be permitted to include all borrowed capital in invested capital, eliminating all interest deduction on the indebtedness.

We ask that consolidated returns be permitted for both normal and excess-profits taxes.

We ask that no excess-profits levy will be made until after preferred stock dividend requirements are earned.

We ask that adjustments be allowed to measure excess profits over a 3-year period with a net loss carry forward and back; a deficiency income carry forward; and excess profits carry forward.

While labeled an excess-profits tax, such provisions in H. R. 10413 impress us more as a revenue-raising measure. We ask that if the Senate should pass such a bill that everything be done to prevent the imposition of taxes that will be punitive on normal incomes, particularly on those least able to bear them.

Mr. Chairman, I want to express our appreciation for the opportunity to present our statement.

The CHAIRMAN. Thank you very much. Mr. Knudsen, we set 2 o'clock for you to be heard. If you are ready to proceed, we will hear you now.

STATEMENT OF HON. WILLIAM S. KNUDSEN, THE ADVISORY COMMISSION TO THE COUNCIL OF NATIONAL DEFENSE

The CHAIRMAN. Just proceed in your own way, Mr. Knudsen. Some of us heard you and others of us read your statement when you appeared before the joint hearings of this committee and the Ways and Means Committee. We liked you so well that we want to hear you here.

Mr. KNUDSEN. First, Mr. Chairman, I have a letter here from the Advisory Commission to the Council of National Defense that I would like to read.

The CHAIRMAN. Yes.

Mr. KNUDSEN. This is to the Honorable Pat Harrison, United States Senate."

MY DEAR SENATOR HARRISON: After most careful consideration, the Advisory Commission to the Council of National Defense unanimously and urgently recommends to your committee that subsections (i), (j), and (k) of the Second Revenue Act of 1940 be deleted and that there not be included in the bill any provision limiting or restricting the use which a taxpayer may make of facilities against which amortization or accelerated depreciation has been charged.

The CHAIRMAN. What section is that?

Mr. KNUDSEN. Subsections (i), (j), and (k) on page 91 and 92.

The CHAIRMAN. Some of us are not so familiar with this bill as others are. Now read what you want struck out.

Mr. KNUDSEN (reading):

subsections (i), (j), and (k) of the Second Revenue Act of 1940 be deleted and that there not be included in the bill any provision limiting or restricting the use which a taxpayer may make of facilities against which amortization or accelerated depreciation has been charged.

The Commission is in full accord with the objective of most adequately protecting the interests of the United States Government with respect to its direct or indirect contribution toward the creation of new facilities to meet the emergency defense needs. The Commission believes, however, that this can be best and most practically accomplished through the medium of standard clauses in the form of contract.

A committee of the Commission has been working on these provisions for several weeks past, and its recommendations have been approved by the Commission. These recommendations have been accepted in principal by the Secretaries of War and the Navy and the Comptroller General. If you desire we should be glad to have a member of the Commission present and explain to your Committee these protective contract provisions.

The Commission feels that the protection of the Government's interest through contract provisions is logical and proper, but that to introduce such provisions by amendment to the tax law is illogical and cannot result in equitable application to all the different situations which will develop.

The CHAIRMAN. Let me ask you, "Did a member of the Advisory Commission appear before the Ways and Means Committee with reference to that?"

Mr. BIGGERS (of the Advisory Commission). There was a letter presented, Mr. Senator.

The CHAIRMAN. I recall the letter. I just wondered if any witness or anyone representing the Advisory Commission appeared before the Ways and Means Committee. I understood someone was going to appear.

Mr. BIGGERS. I appeared before the subcommittee.

The CHAIRMAN. That was before the subcommittee. You appeared in the beginning before Subcommittee of the Ways and Means Committee, but I mean after that.

Mr. BIGGERS. In their executive sessions only.

The CHAIRMAN. I understood after that, that a request came for somebody to be heard.

Mr. BIGGERS. The Commission made the request, but they were never asked to appear.

The CHAIRMAN. Proceed, Mr. Knudsen.

Mr. KNUDSEN (reading):

The Commission is convinced that inclusion of such provisions in the proposed tax measure will tend to defeat the very purpose of the bill and thereby impede the defense program.

Sincerely,

WILLIAM H. MCREYNOLDS, *Secretary.*

The CHAIRMAN. Do you know what the views of the Treasury are with reference to the provisions of the bill in that you request be stricken out?

Mr. KNUDSEN. Yes; I do.

The CHAIRMAN. Will it cause any ill feeling? Will you tell us that? Just what are the facts?

Mr. KNUDSEN. Yes, sir; I feel that that will retard the program very materially, Senator Harrison.

The CHAIRMAN. All right.

Mr. KNUDSEN. Particularly that particular section. Now, if you please, I have a statement to read.

The CHAIRMAN. All right.

Mr. KNUDSEN. On July 10, 1940, an announcement was made from the White House that the principle of rapid depreciation or amortization of new emergency facilities had been approved by the President, the Secretary of the Treasury, the leaders of the Senate Finance Committee, and the House Ways and Means Committe and also the Advisory Commission.

The statement in general terms was that required new facilities should be depreciated for tax purposes over a period of 5 years.

The Advisory Commission informed a subcommittee of the Committee on Ways and Means that substantial amounts of private capital would not in the Commission's opinion be invested in the construction of such facilities unless corporations were assured that they would be permitted to amortize the cost thereof over a shorter period than would be permitted under the present depreciation provisions.

The subcommittee of the Committee on Ways and Means recommended to the Ways and Means Committee satisfactory provisions which carried out and gave effect to the White House statement. The report of the subcommittee came to my attention about a month ago and my recollection is that I testified the following day, August 9, before the joint meeting of the Committee on Ways and Means and the Senate Finance Committee that the recommendations of the subcommittee would induce many manufacturers to expand their facilities for defense purposes without relying on Government funds or Government guaranties of reimbursement.

It has come to my attention since my return from an airplane-inspection trip to the west coast that the present bill has had certain additional provisions added which contain a marked departure from the substance of the recommendations concerning which I previously testified. The provisions to which I refer are to be found in subsections (i), (j), and (k) on pages 91 and 92 of the bill.

As I understand the effect of the added provisions, any business which expended its private funds for the erection or construction of required new facilities would, in order to secure the deductions recommended by the subcommittee, be compelled to give a consent that it would not destroy, demolish, impair, or substantially alter such emergency facilities without the consent in writing of the Secretary of War or of the Secretary of the Navy. Further, by refusing consent, the Government would be in a position to acquire the property at not the then fair value to the private business, but at the so-called "adjusted" basis, which is the original cost less tax deductions, and which in many cases would be some nominal sum not less than a dollar. This is a radically new departure and must come as a blow to the public, which had considered the report of the Subcommittee on Taxation as accurately reflecting the original official announcement.

These new additions, moreover, will tend to:

(*a*) Place the disposition of privately owned property constructed with private funds directly under the control of the Government if the owners of such property are to obtain that which all have agreed and announced as proper tax treatment for emergency facilities;

(*b*) Lead to a dearth of help from private capital and a consequent additional and otherwise unnecessary drain on Governmental funds; and

(*c*) Severely undermine the advantages gained by the White House announcement that amortization provisions would be enacted.

If, at the end of the emergency, it turns out that plant facilities are useful for productive purposes during the emergency period only, the taxpayer is being only fairly dealt with by allowing him to charge off his plant against taxable income during the emergency period. If, however, the plant has productive use after the emergency period is terminated, there is no over-all advantage to the taxpayer in the rapid amortization because during the period after the emergency it will no longer be able to deduct depreciation or amortization on the plant, it having already been completely written off for tax purposes.

After most careful consideration, the Advisory Commission to the Council of National Defense has unanimously voted to recommend to your committee that there not be included in the bill any provision limiting or restricting the use which a taxpayer may make of the facilities against which amortization or accelerated depreciation has been charged pursuant to the terms of the bill.

The Commission is in full accord with the Treasury Department in the objective of most adequately protecting the interests of the United States with respect to its direct to indirect contribution toward the creation of new facilities to meet the emergency defense needs. The Commission believes, however, that this can most practically be accomplished through the medium of contract provisions. This provides for the necessary flexibility in the handling of this highly complicated problem. The Commission, with the War and Navy

Department's cooperation, devised forms of contracts which protect the Government's interest in this regard.

The Commission feels that protection of the Government's interests through the contract provisions is logical and proper, but that to introduce such provisions by an addition to the recommendations made by the subcommittee is illogical and cannot result in equitable application to all of the different situations which will develop.

Moreover, the Commission is convinced that inclusion of such provisions in the proposed tax measure will tend to defeat the very purpose of the amortization provisions in the bill and thereby impede the defense program.

Certain of my associates, particularly Mr. Biggers, chairman of the Commission's committee on taxation and finance, and his co-members, Messrs. Leon Henderson and Donald Nelson, have given this matter careful and thorough consideration, and I would be pleased, if you desire, to have them elaborate the reasons why we all believe the provisions to which I have referred should be deleted from the bill.

I have one more statement, Senator Harrison, giving my views on the excess-profits tax, if you will permit me to read that.

The CHAIRMAN. We will be glad to get your views.

Mr. KNUDSEN. The defense Commission decided that the excess-profits-tax bill, while very important, had no direct effect on the prosecution of the defense program; therefore, was not an appropriate subject for Defense Commission comment or recommendations.

Consequently, you will realize that anything I say here is purely personal—just an expression of my own ideas.

I consider the defense program good insurance for our country in these uncertain times. I believe that a substantial part of the cost should be assessed against us now by equitable taxation of individuals and corporations.

I assume that you intend this to be an excess-profits-tax law, as its name implies. That seems to me to mean a tax on the excess profits which may flow to various companies directly or indirectly as a result of the defense program. Consequently, it seems fair that this should be a tax on earnings above their normal past record and not a tax based solely or largely on earnings above some arbitrary percent or standard. I do not think a penalty tax should be imposed on normal earnings. If the Government needs more revenue, why not obtain it by a flat increase in the corporation tax rate.

You, of course, appreciate that I have had no opportunity to study the detailed provisions of this very complex bill, so I hope you will excuse me from making any comments other than this broad general statement.

The CHAIRMAN. Gentlemen, are there any questions?

Senator VANDENBERG. Mr. Knudsen, I would like to be sure I understand the first paragraph in your final statement. As I understand it, it is your point of view that the excess-profits-tax section of this bill is unrelated to your immediate defense problems?

Mr. KNUDSEN. That is correct, sir.

Senator VANDENBERG. And that if the two things were separated and a little more deliberate time given on this tax, that cannot be collected by March 15, would you not feel better about it?

Mr. KNUDSEN. I am not expert enough to tell you about that, Senator, but I do know this: Having been around and seen a lot of manufacturers lately, I do know that this amortization feature is one of the most important in our work today.

Senator BARKLEY. Mr. Knudsen, let me ask you this: You said in your last paragraph that the Government needed more revenue, there ought to be more revenue in taxes. You mean considering the defense program, or without regard to the defense program, that the Government needs more money either for that or other purposes, and there ought to be a flat increase.

Mr. KNUDSEN. I think you would have to find another means of raising the tax; yes.

Senator BARKLEY. In other words, the excess-profits tax will not alone raise enough money to pay for the defense program?

Mr. KNUDSEN. I think that is generally conceded.

Senator CLARK. Mr. Knudsen, I would like to ask you something about this matter of amortization. It was testified some time ago, I think the same day you testified before the Ways and Means Committee, or possibly a day or two later, by Assistant Secretary Sullivan, that there had been some disagreement, some differences of opinion, perhaps I should say, between the Treasury Department and the Defense Council as to amortization, and it was the opinion of Mr. Sullivan, I mean I asked the question as to what was going to happen to these facilities that had been amortized over a period of 5 years, or any other period, for the purposes of taxation, and also amortize out of profits, as to the cost of construction at the close of the period of use for the Government. Mr. Sullivan at that time testified as to the difference of opinion between the Treasury Department and the Defense Council as to whether that should be regulated by law or left to the discretion of the Defense Council and be written in the contract. He said this morning that the provisions of this bill took care of that difference of opinion by writing it into the law, but the provision to which he referred provided only as follows—and this is on page 91, subsection (i)—

> Any taxpayer taking deductions for amortization of emergency facilities pursuant to the provisions of this section may not thereafter destroy, demolish, impair, or substantially alter such emergency facilities without the consent in writing of the Secretary of War or of the Secretary of the Navy. In the event such consent is not given within a period of ninety days from the date of receipt of written request therefor, the Secretary of War or the Secretary of the Navy, as the case may be, shall and he is hereby directed to purchase such facilities at a price which he shall fix not to exceed the adjusted basis but not to be less than $1.00.

Apparently all that section has to deal with is a case in which the receiver, or the manufacturer, or the industry which has taken advantage of this amortization feature desires to destroy or remove that facility, but has no reference to a situation in which the manufacturer might desire to just keep it.

Mr. KNUDSEN. Yes.

Senator CLARK. Would not that result in the Government having built, at Government cost—both for the purpose of tax amortization and for the purpose of cost amortization—built at Government cost a manufacturing facility which would be given as a bonus or free to the manufacturer?

Mr. KNUDSEN. Yes.

Senator CLARK. And would that not result in an intolerable and inescapably unfair competitive condition as against the manufacturer who has not been receiving a Government war contract? In other words, let me make myself perhaps more clear. We will assume two companies, we will call them Corporation A and Corporation B, and they are engaged in the manufacture or the production of similar things; Corporation A is awarded a contract at the present time under the defense program and builds large plant facilities, perhaps a new factory, or tremendous additions to the old factory which they already have; they are permitted to amortize for tax purposes over the period of 5 years in this bill, and for a period to be fixed in the discretion of the Defense Council, apparently, for cost.

I understood from some representatives on the Defense Council that some manufacturers insisted on being permitted to amortize out of profits the cost of the facility, out of the first contract to be awarded, but whatever may be the policy as to that, if at the end of the time, Corporation A is left in possession of this modern plant, set up and paid for practically at Government expense, by Government subsidy either in the matter of amortization of taxes or amortization of cost, Corporation B, which was not awarded any of these war contracts, did not have a new factory, and would not they be placed at a hopeless disadvantage from a competitive standpoint?

Mr. KNUDSEN. Making the same article?

Senator CLARK. Yes.

Mr. KNUDSEN. Well, he would be certified for amortization purposes if he added any facilities to it. If factory B added facilities, he should be certified by the Defense Commission.

Senator CLARK. Everybody knows certain companies do get contracts in time of war and certain companies do not, for one reason or another. The company which did not build a new plant at Government expense would be left in a hopeless competitive position in relation to the company which did build a new plant at Government expense, if the plant of Corporation A, as I have used it, was permitted to remain in possession.

Mr. KNUDSEN. Theoretically you are right. Practically, I could not figure out a situation where that could happen.

Senator CLARK. There is no question about it being true, if plant B was not awarded Government contracts and plant A was.

Mr. KNUDSEN. They would have to do the same thing in order for them to be in competition.

Senator CLARK. Suppose they were in competition originally, though, and by the construction of a new and improved plant, which is paid for, amortized out of Government contracts—and I assume there is no question but that the contracts which you let propose to provide for the amortization of the cost of the plants as distinguished from the taxes on them. You amortize the costs over a period of years, do you not?

Mr. KNUDSEN. Yes; the Government would get the benefit of the amortization.

Senator CLARK. What I want to find out is as to whether there is any provision in this law, or any other proposal, with regard to that.

Mr. KNUDSEN. In other words, you tell me that everybody ought to have a Government contract.

Senator CLARK. No; I do not think everybody ought to have a Government contract. I am telling you that the facilities that the Government pays for ought to go to the Government or the manufacturer ought to pay the Government for those facilities.

Mr. HENDERSON (of the Advisory Commission). Mr. Chairman, I think Mr. Biggers, the chairman of our Taxation and Finance Committee, could explain very clearly the three types of situations for financing of the expanded facilities. I think that might clear up some of the confusion, particularly as to the ownership of the residual value, which is what you are concerned with.

Senator CLARK. I was furnished a memorandum by yourself, Mr. Henderson, which I approve, but I think it ought to be written in the law instead of being left to the discretion of some council or body which, after all, might be abolished by Presidential order at any time, or changed in some way. I think a matter of that importance should be written into the law instead of being left to the discretion of any body, organized or unorganized.

The CHAIRMAN. The Senator does not criticize Mr. Knudsen?

Senator CLARK. This is not criticism, Mr. Knudsen. It seems to me it is an extremely important matter, which I know has been under consideration by the Defense Council.

Mr. KNUDSEN. I just want to point out that the contracting officer of the Government has got that privilege, when there is not any emergency.

Senator CLARK. He has not got the privilege of amortizing the ordinary factories.

Mr. KNUDSEN. He has got the privilege of making a contract with the manufacturer.

Senator CLARK. Then why do you need this law? If you already have the authority, why are you asking the Congress for the law?

Mr. KNUDSEN. Because, under the old regulations of the Treasury, it took a considerably longer time.

Senator CLARK. If the Government already has this authority, what did Mr. Biggers mean the other day by giving out and saying the whole defense program was being held up by the dilatory tactics of Congress? If you already have got the authority, why has the thing been delayed for one moment because Congress has not specifically acted?

I do not wish to interrupt Mr. Knudsen, except I desired to enter into this discussion with Mr. Kundsen before somebody else testified. I have no disposition to interfere with his testimony.

The CHAIRMAN. Does anyone else wish to ask him any more questions?

Senator BARKLEY. I got in a little late, and I did not get to hear your full statement, Mr. Knudsen, but I understand you recommend the elimination of subsections (i), and (j).

Senator GEORGE. And (k).

Senator BARKLEY. And (k). Did you go into detail as to the reasons for it in your statement?

Mr. KNUDSEN. No; the other gentlemen here will explain that.

Senator BARKLEY. In a word, why do you recommend that, Mr. Knudsen?

Mr. KNUDSEN. Because with only the Government stake in the facilities being a tax saving, you are asking for control over the entire amount spent for the facilities. The only stake you have in the bill is the tax saved; which is only 21 percent of whatever is amortized.

Senator BARKLEY. Is that really the only stake the Government has in it?

Mr. KNUDSEN. Yes; the rest of the Government's interest is taken care of through the contract provisions.

Senator BARKLEY. I see.

Mr. KNUDSEN. There has never been any disposition on our part, the Defense Commission, to give plants away. That is out of the question. We feel that the entire Government equity, if we may call it that, can be handled by contract provisions. The fact that you have a credit in taxes amounting to, say, 20 percent of the total should not give the Government control of the facilities.

Senator BARKLEY. You think the elimination of these three subsections would facilitate the program?

Mr. KNUDSEN. I am quite sure it would.

Senator BARKLEY. The entering into of contracts?

Mr. KNUDSEN. I am quite sure it would.

Senator BARKLEY. And speeding up the work?

Mr. KNUDSEN. And speeding up the work, sir. I have just come back from a trip out in the field, and I have heard these questions brought up all the time about amortization and accelerated depreciation, "Could we pay for the plant?" and that sort of thing. It all centers around this: If we have a 5-year plan that will work, we will not have trouble to get people to work, to furnish capital, or do anything we want them to do.

The CHAIRMAN. Are there any other questions?

Senator CONNALLY. That is based on the assumption that they will make enough profit out of these contracts to pay for their plant?

Mr. KNUDSEN. That is not the question at all.

Senator CONNALLY. If they do not, then there is no amortization. The amortization comes out of what they make, what they can deduct.

Mr. KNUDSEN. That is true, but there is no profit in there. There would not be any profit unless the facilities had full value when they got through with them.

Senator CONNALLY. You do not think anybody is going to do work for the Government and simply get their money back?

Mr. KNUDSEN. On the contrary, sir, I find quite a few people making that statement.

Senator CONNALLY. What?

Mr. KNUDSEN. I find quite a few people making that statement, that they are satisfied to get their money back, but they are worried about whether they are not going to get their money back.

Senator CONNALLY. I wish to do business with some of them.

Mr. KNUDSEN. What is that?

Senator CONNALLY. I wish to do business with some of them. I am not critical. Here is the point on this amortization question: A concern doing business with the Government, making a contract with the Government, it expects to get back, through amortization, it expects to get back profits enough to pay for the plant and then something over. They want to make something out of it.

Mr. KNUDSEN. Of course, he does not know that until he has finished.

Senator CONNALLY. No; but they make a figure on which they estimate it. You talk about the Government having an advantage through its Contract Division—the Contract Division cannot make a man take a contract unless he wants it.

Mr. KNUDSEN. That is right.

Senator CONNALLY. A man who is going to take the contract is going to figure if he expands his plant he will not only get payment, deduct enough profit out of the contract to pay for his plant, but to have some profit over. That is the normal reaction.

Mr. KNUDSEN. That is right.

Senator CONNALLY. That is all I have.

Senator CLARK. Mr. Knudsen, these manufacturers that you speak of, who are willing to do this work for the Government simply to do it to get the money back, are closely analogous to the much discredited class of volunteers, from the military standpoint, are they not?

In other words, they are very much in the minority, considering the Government cannot depend entirely on the volunteers, as it has been decided by the Administration.

Mr. KNUDSEN. Senator Clark, some of the concerns are so large it only means a few percent risk.

Senator CLARK. Some of the volunteers for the Army are large, too.

Senator BARKLEY. Some might be discarded after a physical examination, too.

Senator CLARK. Some of the plants might be discarded for the same reason.

The CHAIRMAN. Mr. Knudsen, I want to ask you this question: This bill has come to us from the House. You have studied the various features with reference to the excess-profits tax, I presume?

Mr. KNUDSEN. Yes.

The CHAIRMAN. It has turned out, in the study of it, that there are certain discriminations, or punitive taxes, perhaps, in order to force corporations into one or the other of the two plans which we say they can take, either the average earnings theory or the invested capital theory, and those that go into the first of the two methods are, by this bill, penalized about 4.1 percent on the normal taxes that the company must pay, and also an additional 5 percent in the excess-profits tax that it would have to pay.

Now the thought has been that those that were going to make profits out of these contracts with the Government, and those that were to get large profits by virtue of these large expenditures, were going to pay excess profits in larger amounts than the other class of corporations would have to pay. Now under the bill there is no additional tax in excess profits paid by that group. In studying this question when we go into executive session, if the committee should decide to recommend that a larger percent, a reasonable percent on those that get war contracts or make profits out of the contracts should be imposed, would that in any way slow up your program?

Mr. KNUDSEN. I think it would be a very difficult question to decide.

The CHAIRMAN. It is a difficult question.

Mr. KNUDSEN. Because the ramifications of the program are such that practically every avenue of income of the United States would be hit with it before we are through.

The CHAIRMAN. Yes; we all realize every question in this bill is difficult. I do not know whether anybody agrees with every feature, but I believe that an excess profits bill that carried that philosophy would be pretty much welcomed by the country, and I want to know particularly whether or not it might slow up your program, because I do not want to see your program slowed up.

Mr. KNUDSEN. I think it would, sir.

The CHAIRMAN. What?

Mr. KNUDSEN. I think it would, I think it would slow it up. I really feel it would; if you single out the war material for taxation. Some contractor might not be as efficient as others and might lose money. If the program is spread over the entire business life of the country, if it can be thoroughly absorbed by every branch of business, then I think the program would be a success. The minute you distinguish one thing from another, whether one fellow makes shells and another fellow makes shoes, then I think you will have difficulty. I am afraid I am not capable of indulging in a discussion on that point.

Senator BARKLEY. You think, you have a right to presume, that if any manufacturing concern, or any industry, makes more than the average for the normal period which is fixed in the bill, we have a right to presume that that has been occasioned, in part at least, by the defense program, and therefore such concern ought to bear his proportion of the taxes, rather than singling out those who have contracts with the Government for materials out of which they make a profit. Is that your theory?

Mr. KNUDSEN. I think it would be very difficult to do it. I do not understand how it could be done, to be perfectly frank with you. I have to say, in justice, I am not much of an expert on that question.

Senator BARKLEY. I do not know of anybody who is, so you have got a lot of company.

The CHAIRMAN. Are there any other questions? All right, thank you, Mr. Knudsen. Mr. Biggers, we will be glad to hear you on these questions which have been raised.

STATEMENT OF JOHN D. BIGGERS, CHAIRMAN OF THE COMMITTEE ON TAXATION AND FINANCE, THE ADVISORY COMMISSION TO THE COUNCIL OF NATIONAL DEFENSE

Mr. BIGGERS. I would like first to attempt to answer the question asked by Senator Clark.

Senator CONNALLY. If you start answering questions you will never get to your statement. You may know more about taxes than we do, but you do not know as much about questions. [Laughter.]

Mr. BIGGERS. Mr. Chairman, I made no attempt to have a completely formal statement.

Senator CONNALLY. Go ahead and make it. I withdraw my objection.

Mr. BIGGERS. I intended to supplement what Mr. Knudsen said. If you ask detailed questions as to the operation of this plan I will endeavor to answer them.

Senator CONNALLY. All right, Mr. Chairman, I withdraw my objections. He will be sorry, of course. He can go ahead, but he will be sorry before he gets through.

Mr. BIGGERS. I appreciate your advice, Senator Connally. The sole purpose in recommending this amortization section, which is now a part of the tax bill, was to encourage the use of private capital in the construction of defense facilities.

Some of us have been working day and night for 13 weeks on it. While Mr. Knudsen has been working on the more important problems of production some of us have been working on exactly the things that Senator Clark has in mind, and that is to safeguard the Government's interest in these plants which are provided by various means to meet the emergency, and we have evolved from our contact with the different situations three main lines of approach. One, those plants which will be financed through the aid and encouragement of this amendment wholly by private capital without any Government funds or Government obligation whatsoever. Now that we hope will cover a very important segment of the defense program, particularly those companies that make articles that have some future potential use in normal industry, such as a turbine for a ship, and many other similar articles. We think that those manufacturers, if given this tax en-encouragement would, with their own money and without any Government obligation for reimbursement and without any inflation of price to take care of the cost of new facilities, be induced by this provision to go ahead and expand their own facilities.

To answer your question, Senator Connally, if I may take that liberty, most companies will expand existing facilities, and therefore they will have perhaps substantial sources of income other than those derived from the new facilities, and therefore their profit on the new facilities is not the only profit against which they may assess this depreciation for tax purposes.

Senator CONNALLY. Well now, you are not going to give them 20 percent on the existing plant and 20 percent on the new plant too?

Mr. BIGGERS. Not at all; sir. But suppose a company has a number of different plants and is manufacturing many peacetime products and adds a million-dollar plant to manufacture some defense products, that is only a small part of their total business. Their profits on that may be negligible, but their profits on their total business may be substantial. They would be permitted, as I understand it, under the provisions of this amortization feature of the tax bill, to deduct 20 percent of the cost of these newly created facilities from their total taxable income. In other words, if they built a million-dollar plant they would be able to deduct $200,000 a year from taxable income. Now I think that is the point we would like to make clear. In no sense is the Government, under this provision, reimbursing the taxpayer for his investment.

Senator CLARK. That is true, but that is done if the Government pays an increase in the price for the goods, is it not?

Mr. BIGGERS. Yes and that is exactly what we are trying our very best to guard against.

Senator CLARK. I did not mean to interrupt you. You were going on to the second section.

Mr. BIGGERS. This that I outlined is plan 1.

Let me explain what happens to the $200,000. On the assumed million-dollar plant, $200,000 depreciation is chargeable under this section. Under the existing law the corporation would be assessed with a tax of 20.9 percent, say 21 percent, so that their tax saving on that $200,000 depreciation would be $42,000, roughly. Under regular procedure, without this tax help they would presumably, on the average, charge off 6 percent depreciation, approximately, instead of 21 percent. Six percent on a million dollars would be $60,000, and 21 percent of that would be $12,600. So their net saving under this provision would be the difference between $42,000 and $12,600, or $29,400 a year, or in the course of 5 years $147,000.

Now that is all leaving out the question of the extent to which an excess-profits tax might affect that situation. That would be the benefit to the taxpayer under the existing normal tax.

We feel that would be an adequate incentive to induce a number of companies on the border line between peacetime production and defense production to come in and finance their new facilities out of their own capital, without any contract obligation for reimbursement from the Government, and without any inflation of price to cover those facilities, and the one thing we are most anxious to guard against, all of us, is inflation of price.

We think it is very unsound for the Government to pay a price which includes any abnormal amortization or depreciation of plant facilities. I fully agree with you. We have been working for 13 weeks on it.

Senator CLARK. I know that is a fact.

Mr. BIGGERS. We have the approval of the Comptroller General as to our contract procedure, we have the concurrence of the Secretaries of War and Navy and their assurance that their people will follow this procedure for the protection of the Government's interests.

Senator BARKLEY. May I ask you a question?

Mr. BIGGERS. Certainly.

Senator BARKLEY. Take a case where some concern puts a million dollars in for a new facility, or for an expansion, with its own money, no Government money involved either by law or otherwise, during the 5-year period they are able to save in taxes, because of this provision, approximately $30,000 a year, we will say, and over a 5-year period it will be approximately $150,000 that they have saved.

Mr. BIGGERS. Yes.

Senator BARKLEY. Now the 5-year period is up and the company has its own money invested, it still has $850,000 of its own money invested there after deducting the $150,000 that it might have saved over the 5-year period in taxes as compared to normal years. At the end of the 5 years what happens to the plant, or to the increase, or to the condition of the company?

I ask that question because there seems to be a misapprehension among a lot of people in the country that what the Government is doing is giving back to the concern its million dollars that it has invested in the plant, which is not true, of course.

Mr. BIGGERS. Quite so.

Senator BARKLEY. If it turns out in the future the million-dollar investment is worth nothing for the production of normal products not needed by the Government, the company may stand to lose that extra investment unless it may utilize it for some future peace purposes, as I understand.

Mr. BIGGERS. Yes.

Senator BARKLEY. Is that a fair picture of the situation?

Mr. BIGGERS. That is a very fair picture of the situation. In that case if that company were able to adapt its facilities to peacetime use and went on operating them it would be able to charge no further depreciation against its taxable income, and if the tax rate is advanced that company would be out of luck.

Senator BARKLEY. That increase in facilities would be merged with its plant and in the future would be part of it and would be entitled to no more depreciation than if it had never been granted this 5-year privilege.

Mr. BIGGERS. Yes, sir; as we see it, it is all a question of the rapidity of the depreciation. All facilities theoretically are depreciated against taxes during their life, and the Treasury and the Defense Commission agree that there is a probability that many of these facilities will enjoy a short life only.

Senator BARKLEY. In the case I have illustrated, if the company were unable to absorb its new facility, or its expansion, in its ordinary peacetime business, the result would practically be a loss of the amount invested; would it not?

Mr. BIGGERS. Yes; and therefore a company will not elect this option, will not proceed at its own risk under this tax incentive unless it feels reasonably sure that it can adapt or utilize its facilities after the emergency is over.

Senator CLARK. In that case, in the case stated by Senator Barkley, the company is simply gambling $850,000 against $150,000 on its judgment that this property will be valuable to them in their own business after the emergency, the 5-year period, is past. That is practically what they are doing.

Mr. BIGGERS. Yes; that is true.

Senator CLARK. In its turn the Government is simply paying them a bonus of $150,000 because they want the facilities built now.

Mr. BIGGERS. Senator, I do not think you can quite say they are paying them a bonus.

Senator CLARK. That is what it amounts to. If they cut the tax bill down that much, that amounts to a bonus. You can call it what you please.

Mr. BIGGERS. All the Government is doing is allowing them to take the depreciation more rapidly than under the normal regulation and existing law, and if they take it more rapidly and if tax rates continue to advance it is quite possible that that company will have made a mistake and that the Government, in the long run, will benefit. The Government will lose some income under this plan during the next 5 years, but in the aggregate it is our expectation that the Government will not lose taxable income under this plan. We think a good many companies, perhaps, after starting out to depreciate at the rate of 20 percent, seeing tax rates go up will change their mind and will not take advantage of this. This is an encouragement to the use of private capital and to that extent minimizes the drain on Government credit.

If I may proceed to plan 2——

Senator BARKLEY. Before you proceed to that, instead of paying a bonus by the Government, if it is a bonus, the result is that the Government pays in the difference in the taxes involved if the company had expanded normally and not on account of the emergency, the Government pays over the period of 5 years $150,000 for the use of a million dollars represented in the expansion, which, if calculated in the terms of interest, would be about 3 percent on the million dollars if the Government had to use it itself, or borrow it.

Senator CLARK. It is true, Mr. Biggers, in class 1, in which case you say that the company which puts up the money winds up with the plant, in full possession of the plant, just as though they went out and built it in the first place.

Mr. BIGGERS. Just the same as though they took normal depreciation.

Senator CLARK. When Senator Barkley said the Government is paying 3 percent on the funds——

Senator BARKLEY. That is what it amounts to.

Mr. BIGGERS. I may emphasize, as Mr. Reynolds' letter did, that the Defense Commission is a unit in unanimously opposing the inclusion of these three subsections (i), (j), and (k), which tie a string on the subsequent use of privately constructed facilities, and we feel that in so doing Congress will largely, if not wholly, nullify, if those amendments prevail, the effect of inducing private capital to come in under this plan without Government guaranty, without price inflation, and without Government reimbursement.

The CHAIRMAN. I received a copy of the letter which was sent to Mr. Doughton. I would like for it to go in at this time in this record, because it was in the other record.

Mr. BIGGERS. This letter which Mr. Knudsen read is an up-to-date statement of the Commission's attitude, signed by the secretary of the Commission, and is in your papers, Mr. Chairman.

Now under plan 2——

Senator BAILEY. Mr. Biggers, before you leave plan 1, it would appear that amortization by way of incentive to the investor of private capital is based on the 5-year proposition, but suppose a contractor made an extraordinary profit, or the use of an unusual plant lasted only 2 years, what provision is there for that?

Mr. BIGGERS. The provision under this amendment is in the event that the emergency ends in less than 5 years, that the taxpayer may, if I remember the wording correctly, Mr. Sullivan, assess the depreciation on his facilities against the period of use.

Senator BAILEY. That is contingent on the circumstances.

Mr. BIGGERS. If it lasts less than 5 years.

Senator BAILEY. I have assumed it would last less than 5 years. He might get a contract tomorrow for 6 months. What assurance has he that he would get back what he has paid in?

Mr. BIGGERS. There is not any under this law.

Senator BAILEY. What would be my remedy in the way of amortization?

Mr. BIGGERS. You would only be privileged to continue the 20-percent rate during the pendency of the emergency, so long as the national emergency lasts, the state of emergency recognized by Presidential proclamation.

Senator BAILEY. Then this plan would be of value only in event that private capital for expanding the plant would be sure of a contract during the 5-year period. Am I right about that?

Mr. BIGGERS. Excuse me; would you state that again?

Senator BAILEY. I think you are running into the promise made by the Senator from Texas, that there would be trouble in these questions. I say in that event, this incentive proposition, on the basis of inducing private capital, would be of value only in instances in which the unusual plant was assured of getting contracts for a 5-year period, because 20 percent a year for 5 years is 100 percent. Would not you have to get at it that way?

Mr. BIGGERS. I think, sir, you are right. The average manufacturer would not elect to proceed under this, which is the most precarious method of serving the Government, unless he made a product for which he thought there would be continued Government demand, or at the end of the Government demand, a peacetime demand. Of course, he would not get a certificate unless his plant was designated by the Secretary of War, the Secretary of the Navy, and the Defense Commission as being necessary for the emergency.

Senator BAILEY. How are you going to get an assurance that there will be this unusual business for 5 years? I think it is likely to be forever, I do not know, but we do not know what is going to happen. That being so, Mr. Biggers, of course we do not know, we cannot be assured of the 5-year period; therefore, we cannot be sure of the 100 percent amortization recovery. What inducement would there be to private capital to invest?

Mr. BIGGERS. We think in many of the borderline cases, private capital will invest under this plan, and if they do, it means, in our judgment, that the Government gets the creation of those facilities and the availability of those facilities to meet Government needs at the least possible risk to the Government and the least possible cost to the Government.

Senator BAILEY. I was thinking about the other side of it, about the other end of it. I am getting at the incentive to invest capital.

Mr. BIGGERS. Plan 2, which I would like to explain, will take care of the situation where the man, the manufacturer, does not feel that he can take the risks that you just stated. This plan has been carefully worked out as a contract procedure, in cases where a defense plant can and will be financed by private capital.

Senator CLARK. This is class 2, is it?

Mr. BIGGERS. Plan 2, yes, sir; or class 2. The private contractor is able to obtain a firm, bankable contract from the War and Navy Departments. The detail of this has been worked out and the principle has been approved by the Comptroller General and by the Secretaries of War and Navy. In such case the Government will reimburse the manufacturer specifically and directly and not as a part of price for the cost of its facilities at the rate of 20 percent a year, and if the emergency ends, or the Government contracts end at an earlier date, in that case the Government would pay up the remainder of its reimbursement obligation at the date of termination of the contract.

Senator BAILEY. There would be an immediate deduction?

Mr. BIGGERS. In that case the contractor would have the protection that you envision.

Senator CLARK. Would the Government take the facility in that case?

Mr. BIGGERS. In our provision, in order to protect the Government's interest and to prevent the practice that prevailed in the last war, where the cost of many plants was included in the price of the product and the contractor ended up with the ownership of a plant which the Government had really paid for, to prevent that we have provided that at the end of the emergency or at the termination of the contract, as the case may be, a board of appraisers or arbitrators will determine the then fair value of the facilities, and the contractor will have to pay the Government that fair value as determined by the arbitrators if he wants to keep the plant, and if he is unable to pay the fair value or disagrees with its fairness, then he must assign the plant to the Government for such use and disposition as it chooses to make of it.

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Senator BAILEY. He would have to sell the land, too?

Mr. BIGGERS. Yes; he would have to sell the land, too, if it was built on his own land.

Senator CLARK. That being the case, say a man started the construction of a battleship that would take 5 years, that would be a contract for 5 years.

Mr. BIGGERS. Yes.

Senator CLARK. If a shipbuilder would go to work constructing the necessary facility, he would do so without reimbursement from the Government as to price?

Mr. BIGGERS. Yes.

Senator CLARK. If at the end of 3 years we had another naval conference, like we had at the end of the last war, and decided to junk that ship, three-fifths completed, let us say, if the shipbuilder wanted to pay the fair price he would have that facility, the Government would pay him the unamortized portion of the original price and the man would go ahead and have his shipbuilding company.

On the other hand, if he did not want to pay the Government the part that the Government had to pay him by way of amortization, then the Government would take it and pay him the difference. Is that the way it would work?

Mr. BIGGERS. The Government would pay him his investment and take the facility and keep it for its own use, so no one would get free facilities out of the Government.

This contract plan, too, provides that the cost of facilities would be accurately determined and audited in advance, and that that cost would be paid the contractor ratably each year, separate from price, so it would not be hidden off and confused with price, and so it would not have a tendency to start a spiraling of prices, which is one thing that Mr. Henderson can speak on better than I, but which we are all so anxious to avoid as one of the outcomes of this emergency.

Senator BARKLEY. Is your plan No. 2 a substitute for plan No. 1, or may they both operate together?

Mr. BIGGERS. All three of these plans may operate together, but one can be applied to certain cases and the others to other cases.

Senator BARKLEY. Depending, in some cases, on the option of the contractor or the Government?

Mr. BIGGERS. Yes; it would really be at the preference of the contractor but the option of the Government. The contractor might prefer one or the other, but the Government would have the final say as to which plan would apply, which plan would be accepted.

Senator BYRD. Mr. Biggers, does the contractor have the first option to purchase this plant at its appraised value?

Mr. BIGGERS. Yes.

Senator BYRD. If he does not choose to purchase it, the Government could sell it to anyone else?

Mr. BIGGERS. Yes; after the Government acquired it the Government could dispose of it. Take an airplane engine company, it has used all of its own engineering ability, all of its organization talent, its patents, inventions, equipment, and so forth, to manufacture airplane engines, and therefore we feel at the end of the emergency it would not be fair for the Government to sell that plant to a competitor, that we must first give an option to the original creator.

Senator BYRD. It is merely an addition.

Mr. Biggers. You are right. In the case of what we call scrambled facilities, where it is an addition to a man's plant and there is an involvement of equipment, it is almost indispensable, it is logical, thoroughly logical that the original creator of those facilities should be given the option to buy. If he does not buy, even in those cases the Government may take that machinery and keep the plant available.

The details of this contract, in all of its aspects, are so completely understood by Mr. Donald Nelson, the coordinator of purchases, who is also with me, that if you wish to ask any questions, I think he will be better able to answer them than I. Mr. Henderson, Mr. Nelson, Mr. McReynolds, as secretary of the Commission, and Mr. Adams, representing Mr. Stettinius' division, worked with me on these particular problems.

The Chairman. The Advisory Council are all together on that proposition?

Mr. Biggers. They are in absolute unity, sir, unanimously on that proposition.

Senator Byrd. Mr. Biggers, is most of the expansion being done by Government loans or the contractor or manufacturer putting up his own money?

Mr. Biggers. Sir, as we started out, without this amortization provision which you are now considering and without the contract procedure that we have now evolved, no matter where negotiation started, it always ended up with the Government or the R. F. C. putting up the money, because of the uncertainties that existed and that could not be settled. Now it was to avert that that these other plans were evolved and these other recommendations made, because we feel it is to the national interest to utilize a maximum amount of private capital and to minimize the call upon Government credit.

Now plan 3——

The Chairman. Before you come to that, may I ask you, in this connection, you are asking us to strike out certain provisions. Is the question so elastic that you feel you can do it by contracts rather that to follow absolutely the statutory provisions?

Mr. Biggers. Yes, sir; we do.

The Chairman. And the Treasury's position is that it ought to be written into the law?

Mr. Biggers. The Treasury's suggestion is it ought to be written into the law. I would rather have Mr. Henderson, who has a broader view of the economic aspects of this situation, perhaps, than I, I would rather have him answer that question.

Senator Clark. Would you give us class 3 first, and then go into the discussion of whether it ought to be written into the law?

The Chairman. I just asked whether there might be some difference between the Treasury and the Defense Council on this proposition.

Mr. Biggers. There is. The Treasury thinks that this control over facilities under plan 1 should be written into the tax law. The Defense Commission unanimously believes that it will restrict, if not completely nullify, the use of private funds.

Senator Byrd. Plan 1 is the depreciation?

Mr. Biggers. Plan 1 is the use of private capital without any Government guaranties at all, and the only Government inducement is the amortization.

Now plan 3 is outright Government ownership of certain facilities that are clearly and obviously required for the production of war materials or defense materials for which there will be no future use. That plan has been applied without any hesitation to the creation of powder plants, to the creation of a tank arsenal, and similar situations to that. The Army and Navy feel that they want those facilities, that there is no probability of private use for a tank plant, we hope, after this emergency, and therefore the Government builds it and they employ the best and most competent contractor to operate it.

Senator CLARK. And then the Government owns it?

Mr. BIGGERS. The Government owns it from the outset and in perpetuity.

Senator CLARK. Just like the naval gun factories that we have now?

Mr. BIGGERS. Yes. The amortization features, of course, do not apply to that at all. The amortization feature in the tax law only applies to plan 2, to the extent that if the Treasury considers that the Government's annual amortization payment under plan 2 is income, then the 20 percent deduction would offset that income, it would wash itself out, but otherwise the contract would be so worded that there would be no benefit. If the Government amortization is not income, then the contract would be so worded that there be no benefit under the amortization provision under plan 2.

But it is very important, and to our minds a vital incentive under plan 1. We feel if a man puts up his own capital, with no commitment from the Government, that there is no justifiable reason for the Government tying this string to his facilities and saying to him that he cannot, at the expiration of the emergency, modify or substantially alter his own facilities, and we feel if that string is tied to it, that the private manufacturer, with the other uncertainties existing, will certainly not avail himself of that plan, and the whole load will fall more heavily on the Government under plans 2 or 3.

Senator BARKLEY. I understand in plan 1 the amortization applies in toto; in plan 2 it may apply——

Mr. BIGGERS. As an offset.

Senator BARKLEY. It may apply, depending on what happens, and in plan 3 that it does not apply at all.

Mr. BIGGERS. Yes.

Senator BYRD. There can be a combination of plans 1 and 2, of course.

Mr. BIGGERS. How is that; sir?

Senator BYRD. Suppose, for instance, they have a new facility under contract for a million dollars, then you could take the amortization off that for tax purposes and likewise recover that full amount from the Government in the contract with the Government.

Mr. BIGGERS. If you had a contract from the Government, the rapid depreciation or amortization would offset the Government reimbursement. They would offset one another. We checked that very carefully.

Senator BYRD. Is the reimbursement in lieu of the tax, the amortization for tax purposes?

Mr. BIGGERS. Would you like to explain that, Mr. Henderson?

Mr. HENDERSON. I did not catch the question.

Senator BYRD. The question I asked, could not there be a combination of plans 1 and 2? Namely, if the Government made a contract for the erection of a plant for a million dollars, the contractor may collect the million dollars back from the Government and at the same time get amortization or relief from taxes during the operation?

Mr. HENDERSON. One would offset the other.

Senator BYRD. It would not be an offset, it would be a combination.

Mr. HENDERSON. That is plan 2, Senator. If the Treasury chooses to treat those 20-percent payments for capital expansion as income, then the 20-percent rapid depreciation for tax purposes would be an offset, of course, and that is the contemplation of plan 2.

Senator CLARK. Is not this a fact, Mr. Henderson, that in practically, I will not say every case, but in the great majority of cases with which you had to deal with contracts—I am leaving out now entirely the element of tax amortization, but is not it true in a great measure that contractors demanded the right to amortize the cost of new facilities and an increased cost to the Government? The gentleman that you sent up to talk to me said in many cases the contractor had insisted on amortizing the whole cost of the construction of his facilities in the first contract he had with the Government, even though it extended only over a year?

Mr. HENDERSON. Senator Clark, that has been the contracting procedure in Army and Navy procurement for quite a long time. In most cases that has been sound from an accounting standpoint, because that is a cost. The normal depreciation rate assumes, that is, that a certain part of the cost of the plant will be assessed against the product, and in the case of taxation it is put on an annual basis. The normal depreciation rate assumes, and we have come to know, that industrial machinery and plant has a certain life, and the Treasury schedule, I think, for normal industrial purposes, was pretty well worked out. Now if that particular facility, which is erected to meet a defense or a wartime need, has only the limited life and usefulness of that particular contract, then it is a proper accounting charge against that contract. It runs the cost of the Government up tremendously in those cases, but you might have a contract in which the cost of increased facilities was far and beyond the profit that was made on the contract, in which case if the facilities had no further use, the contractor would be contracting for a sure loss.

Senator CLARK. Suppose you had such a facility as a shoe factory—now shoes are just as essential as a gun or tanks or anything else. There has been a shortage, I understand, of Army shoes. You take in the case of blankets, I happen to know there has been a shortage in the case of blankets, because I heard from some of the men in the field, that have been in the recent maneuvers, to that effect.

Suppose a fellow says, "All right, I will build a blanket factory here which I may not need after the war is over, but I have got to amortize, or get an increase in profits, of 20 percent"? As you say, that has been the practice in the past. President Roosevelt states that he is not going to permit any war millionnaires. I do not see how we are going to prevent it, unless we have very drastic amortization features along tax lines. The plan which Mr. Biggers has outlined, the three classes, was in accordance with the memorandum you suggested to me, and it is fine, with the inclusion of the provisions of classes 1 and 2, as you have put them together. Without increasing the price, how are you going to protect them?

Mr. HENDERSON. In the first one, there will be no increase in price.

Senator CLARK. You provided in both class 1 and class 2 that there should be no increase in price?

Mr. HENDERSON. In plans 1 and 2 there is no increase in price.

Senator CLARK. In class 3, the price does not enter?

Mr. HENDERSON. Let us take the case of the blanket manufacturer, for example; let us say that the Government is not able to get a sufficient supply, within the demand period, of blankets, and it had to enter into contracts for an expansion of facilities, then contractors would have, presumably, the option of either plan 1 or plan 2. The price in each case would be $6, for example.

Senator CLARK. What I am trying to get at is, how you would insure that? That is what I am interested in.

Mr. HENDERSON. The contracting procedure is the best assurance of that. I think the contracting procedure is the best assurance of that, because, under the existing arrangement, there is a pretty good knowledge as to whether or not all the capacity of an industry for making a needed article has been taken up. You know, through the information which the Army and Navy have been collecting, what the capacity is.

Senator CLARK. They have had some years, now, in dealing with that. What greater assurance are we going to have that they are going to exercise a different course in this emergency than you say they have exercised over a long period of years?

Mr. HENDERSON. I say over a long period of years what they have paid for in increased prices have been machinery and facilities supposedly needed for only governmental purposes. Where the vice has come, and did come in the last war, with which I have some familiarity, and I think that is the thing you are trying to get at and what we are trying to get at, is when the contractor was left with a facility that did have a useful value in ordinary business.

Senator CLARK. That had already been paid for by an increase in price. That is exactly what I am trying to get at.

Mr. HENDERSON. That is exactly what we are trying to provide against under these three plans for financing the expansion facilities.

Senator CLARK. What I am trying to find out is why you insist it ought to be left to the discretion of a transitory set of Government officials rather than written into the law.

Mr. HENDERSON. Let me say this: If (i), (j), and (k) were left in, as far as the possibility of the use of plan 1 is concerned, I believe you might just as well drop this whole rapid amortization out of the picture, because what you are in effect saying under (i), (j), and (k), is that a manufacturer having paid for facilities out of his own funds, has got to surrender those, in effect, to the Government.

Now you take in this case of the $1,000,000 increase in facilities which the manufacturer put up under the example given by Mr. Biggers, in which there is a recapture of $150,000 for tax allowances, now all of it has been depreciated, has it not, at $200,000 a year?

Mr. BIGGERS. Yes.

Mr. HENDERSON. And under the circumstances existing here, the Government can recapture that for about a dollar. It is not the Government's property, Senator Clark, it is a plain question of whose property this is. There is just absolutely no reason in the world for passing this rapid amortization feature as any kind of encouragement to the use of private capital if you leave subsections (i), (j), and (k) in.

Senator CLARK. Suppose, in addition to the case you cited, they also had increased the price 20 percent? I agree if they do not raise their prices that the Government shall not seize their property simply for the tax concession given in this bill. I think everybody would agree with the fairness of that proposition. But if they get their tax concession and in addition to that, as most manufacturers in the past have done, unless there is a revolution of the whole history of such events, suppose they also get paid for their plant out of hiking their prices, whom does the plant belong to then?

Mr. HENDERSON. I do not agree, Senator, that we have got to have a revolution in order to prevent contractors from stealing the Government Treasury, but I do think that there will be and there is a prospect of considerably sharper negotiation on the Government side than there has been in the past, certainly than there was in the last war. The knowledge of markets, the knowledge of contract procedure, the knowledge of purchasing technique available at the present time to the Government is considerably in excess of any time when there was any large purchasing program. For example, I know that with the aid of the coordinator of purchases the Government has gotten two articles already in large amounts at less price than the Government has ever gotten them before. That is, the Government is getting an advantage on some of the large-scale purchases, whereas, on many past occasions the mere presence of that large Government order in the market was responsible for an increase in price. There has been, and I believe will continue to be an alert procedure from which we will get the benefit.

I cannot give you any guaranty against somebody stealing part of the Public Treasury; I can give you a sense of a great deal more attention being paid to proper negotiations.

Senator CLARK. Mr. Henderson, I understand perfectly that you cannot write into the statute every detail of negotiations. In spite of the very complex details we have in the tax bills, we still have a good deal of regulation. It seems to me that the Congress at least ought to write the rules into the statute; in other words, the classifications at least which the Defense Council itself has made, which are presented to us by Mr. Biggers. They ought to be written into the statute.

Mr. HENDERSON. Well, I see a great deal of difficulty under that Procrustean bed, in negotiating that kind of contract, to negotiate for the thousands of articles that there are.

Senator CLARK. That is not any more a Procrustean bed to the Congress than it is to the Defense Council, to lay down the rules.

Mr. HENDERSON. I disagree with you.

Senator CLARK. You mean to say that the Defense Council can depart from rules laid down by itself? I think that is true.

Mr. HENDERSON. I think they should. If they do their work honestly, I think they should, because what is needed in the instant years is to get the matériel at the lowest price.

Senator CLARK. That has always been the excuse for the war contractor to gouge the Government.

Senator BARKLEY. You have got to be able to deviate now and then from the rules in order to prevent the other fellow from having the biggest end of the skid pole.

Mr. HENDERSON. I think, Senator Clark, that this Commission, as I have seen it in action, wants to learn from the experience of the Nye committee and the Graham committee, and I think it has plunged itself assiduously into it.

Senator CLARK. I do not want to reflect on the Defense Council. I know they are conscientious, public-spirited men who have devoted great talents and great sacrifice in the interest of the Government. On the other hand, that same thing was true during the last war. A number of extremely high-class, patriotic men were doing the same thing. I do not think we ought to very specifically pass a lot of legislation here to authorize that same thing to happen again.

Mr. BIGGERS. Mr. Chairman, if I may interrupt, I think the only benefit we have over the gentlemen who attempted to do the right thing in the last war is the record of their experience, and if we cannot profit by that, then we are all wrong. I do not believe by law you can make anybody honest or efficient, but I believe, sir, that the War Department and the Navy, in their present spirit and attitude, with the guidance and help of the coordinator of purchases and the Defense Council, and with the knowledge that they have, can and will, under contract procedure, do all that is humanly in their power to adequately protect the interest of this Government, profiting by past experience. But we do not believe you can write a provision in a tax law without nullifying this feature of the law and to some extent impeding the whole program.

We are absolutely in accord with your committee and the Treasury in the objectives, and the only difference we have with the Treasury is as to the procedure.

I would like to say one word, if I may, Senator Clark, in regard to something that you mentioned earlier. I made no statement charging or criticizing the Congress for delay.

Senator CLARK. I do not believe everything I read in the newspapers.

Mr. BIGGERS. I am glad to know that, because at the request of our Commission, our committee of five met with the press and a statement was asked whether this contract plan that we evolved, which is plan 2, would solve the problem or whether other things were necessary, and I made the answer, which these gentlemen, some of the press, may remember, that our plan was only a one-legged horse, that to run it required the appropriation bill and the elimination of the Vinson-Trammell limitations, and all the bothersome cost accounting that it imposes upon the subcontractor, particularly, and the amortization bill. I have implied nothing, no criticism of anyone, and only one newspaper so interpreted the remark, and that in the headline and not the quotation, so I hope you will excuse me.

Of course, I knew what Congress had been struggling with.

The CHAIRMAN. Senator Lodge would like to ask a question.

Senator LODGE. Have the War and Navy Departments approved your recommendation regarding subsections (i), (j), and (k)?

Mr. BIGGERS. I do not know, Senator, whether it has ever been specifically submitted to them. I know that they do in principle, but I do not think they have ever been asked for an expression formally. That can easily be done.

The CHAIRMAN. Senator Lodge, what was the question?

Senator LODGE. I wanted to know whether the War and Navy Departments had approved these recommendations regarding subsections (i), (j), and (k).

I have another question that I would like to ask, and in order to ask it I would like to summarize the impression that you gave me of these three plans, and I hope you will correct me if I have not summarized them rightly.

The first plan is that this expansion would be financed entirely with private funds?

Mr. BIGGERS. Yes.

Senator LODGE. The second is that the expansion would be financed with Government funds, with ownership eventually reverting in the contractor?

Mr. BIGGERS. No; with private funds, but with Government reimbursement and eventual Government ownership unless the private contractor compensated the Government for its equity.

Senator LODGE. That is right. The third plan is complete financing and ownership in perpetuity by the Government?

Mr. BIGGERS. Yes.

Senator LODGE. Now, could you give the committee a rough estimate—it would have to be very rough, I appreciate that—of what proportion of these war orders would be in that first category, of these national-defense orders?

Mr. BIGGERS. Mr. Chairman, and Senator, I believe it would be presumptious for me to guess. I haven't any idea. We think, and I believe Mr. Nelson or Mr. Henderson will bear me out, we think that the amendment as originally devised and reported by the House subcommittee, without sections (i), (j), and (k), will encourage a very considerable amount of such financing, but it is almost impossible to tell, it would just be an a fully rough guess.

Senator LODGE. May I put it to you this way: There is a plan that the War Department has had for a long time, where they classify materials of war as critical and noncritical, and, as I understand it, the critical items are the ones for which there is no real peacetime use; the other items are the ones like boots, blankets, and so forth, for which there is a peacetime use. Have you any idea as to what proportion of these national defense orders will be in critical items and noncritical items?

Senator CONNALLY. If it is for national defense, they are all critical.

Senator LODGE. I mean the critical item that is not needed in time of peace, like the bombs, or something like that.

Senator CONNALLY. We might need them in time of peace.

Senator LODGE. That is true. I am just taking the War Department's definition.

Mr. BIGGERS. One of the officials of a company made to me the statement that if the amortization provision of this bill went through in its original form without subsections (i), (j), and (k), that they would, in all probability, or that they felt inclined to go ahead on that basis without Government commitments or Government reimbursement, they might use their own capital for the construction of a very large and costly addition to their turbine manufacturing facilities, assuming the Navy would use the turbines in their new ship program over reasonably 4 or 5 years, and that the probable peacetime demand for them would be sufficient to justify the plant expansion at the end of the emergency, but that same company said that on superchargers for airplanes, where they were being asked to increase their facilities 1,000 percent, that they could not envision any peacetime requirement for those greatly expanded facilities, and they would probably want to resort to plan 2.

Senator LODGE. Now, tanks, for instance, are entirely critical items.

Mr. BIGGERS. Tanks we consider under plan 3, which is Government ownership of facilities.

Senator LODGE. Thank you.

Senator VANDENBERG. Mr. Biggers, did your tax committee give any consideration to the question of whether or not the Treasury Department has authority under the existing law to write any kind of amortization or depreciation contracts that it wants to?

Mr. BIGGERS. We did not consider that our province, because we understood that the Treasury Department thought that amendatory legislation was necessary, and so we assumed it was.

Senator BYRD. Mr. Biggers, have you got copies of those contracts that could be filed, copies of the contract forms?

Mr. BIGGERS. Yes, sir; I can submit those to the committee, or to any individual member.

The CHAIRMAN. I wish you would put them in the record.

Mr. BIGGERS. Sir?

The CHAIRMAN. Put in the record some copies of contiacts, so we can study them.

Mr. BIGGERS. We have got an outline showing the conditions under which plans 1, 2, and 3 would apply, and we also have a 3-page summary of the general provisions which Mr. Nelson has, that we can put in the record at the moment.

Senator BYRD. I would like to have it available. Put in an exact copy of the proposed contract that the Army and Navy are making.

Senator CONNALLY. You mean the proposed contract recommended by the Council, or the one that the Army and Navy are now using? Which one do you want?

Mr. BIGGERS. The Army and Navy have agreed to use this type of procedure.

Senator CONNALLY. Have you used any of them?

Mr. BIGGERS. They are working on it right now.

Senator CONNALLY. I would like to see what they have been doing.

Mr. BIGGERS. This has just been formulated.

Senator CONNALLY. I understand that.

Mr. BIGGERS. They have indicated their intention and they are negotiating on this basis right at this moment. One very important contract which was negotiated previously on a somewhat more favorable basis to the contractor will be changed to this basis, because the contractor was persuaded that it was fair and good public policy for him to voluntarily agree to the change, in spite of the fact that he had a commitment on another and a more favorable basis.

Senator BARKLEY. You can put in both forms, the one they have been using and the new one.

Mr. BIGGERS. You cannot tell by the form, sir, because in the main, in the past, the cost of a new facility has been included in the price and would not show up in the form of the contract. It is the spirit and approach to it, and I agree with Senator Clark that in the last analysis it depends on the attitude of the War and Navy Departments and the instructions to the contracting officer and the extent to which the Coordinator of Purchases in the Defense Commission can supervise and effectuate this policy.

But that applies to almost any situation. You have to eventually trust someone to carry out a policy.

(The matter referred to is as follows:)

MEMORANDUM

Re Financing and disposition of emergency plant facilities.

1. *Scope.*—In certain cases new plant facilities requisite to the defense program will be built by the Government and leased to private industry. In other cases additional capacity will be made available by private industry as a result of normal expansion in the ordinary course of business, without cost and without risk of any kind to the Government. But midway are the cases in which emergency plant facilities, whether built with the aid of public or private capital, will be paid for by the Government through an increase in the unit price of the product. These are the cases dealt with in this memorandum.

2. *General principle.*—In such facilities the Government has an interest. As a matter of procedure the cost of construction should be segregated from the cost of supplies, and reimbursement for the cost of construction made over a period of 5 years in five equal annual installments rather than in additions to the unit price. If the first contract for supplies runs for 5 years, the contractor will thus be fully reimbursed for the cost of additional plant upon completion of that contract. If the first contract runs for less than 5 years (as it will in most cases) and no further contracts are placed, the contractor will be promptly reimbursed for the entire cost of construction.

3. *Contractor's option to purchase Government's interest.*—Upon completion or termination of the contract three appraisers shall be appointed to determine the then fair value of the facilities: one appraiser shall be appointed by the contractor; a second by the Government, and a third by the senior circuit judge of the circuit court of appeals of the circuit in which the facilities are located, or by some other equally disinterested and responsible person. The decision of any two appraisers shall be controlling, but if no two agree, the decision of the third appraiser shall be final.

The contractor may pay to the Government the fair value of the facilities as so determined and thereafter the Government shall have no interest in the facilities. The contractor shall have the further option of purchasing the Government's interest in any such facilities, without appraisal, at their original cost less normal depreciation, which sum shall also be regarded as their fair value. In either case, if the Government has not completely reimbursed the contractor for construction costs the sum to be paid by the contractor shall be reduced by the balance of the cost of construction.

If the contractor does not wish to retain the facilities he may transfer them to the Government, in which case the alternatives set forth below shall be available to the contractor and to the Government. If the facilities are transferred to the Government, the Government shall reimburse the contractor for the entire unpaid balance of his costs. In the event of termination, annual payments by the Government will continue until after settlement so that the contractor will not be embarrassed if he has obligations to meet out of such payments.

4. *Meaning of fair value.*—For contract purposes fair value means the value which the facilities have to the contractor without regard to their original cost and considering only the prospective earning power which they will add to the contractor's entire plant, making due allowance for the expense which the contractor must incur if they are to be adapted or converted to the contractor's normal peacetime activities; provided that if the appraisers find as a fact that any removable facilities have a higher value in an open-market sale than under the foregoing standard, such items may be valued at such open-market value.

5. *Options available to the Government.*—If the contractor is for any reason unwilling to purchase the Government's interest or retain the facilities he may trans-

fer them to the Government. Thereupon, the Government shall exercise one of the following options:

(1) With respect to such part of the facilities as constitute easily separable or isolated units, as distinct from intermingled facilities, located on the contractor's land, the Government may—

(a) Remove such facilities restoring the contractor's premises to their precontract condition; or

(b) Purchase the land on which the facilities are located from the contractor at a price determined by arbitration, as set forth above.

(2) With respect to such part of the facilities as are intermingled with the contractor's plant, the Government may—

(a) Remove such facilities, restoring the contractor's premises to their precontract condition;

(b) Purchase the contractor's interest in the entire plant at its appraised fair value, as set forth above, provided that the amount paid to the contractor shall in no event be less than his actual investment less ordinary depreciation; or

(NOTE.—This provision will be used only if it is apparent to the contracting officer that the emergency plant facilities contracted for will contribute 50 percent or more to the investment in the entire plant.)

(c) Leave the whole or any part of such facilities in place, provided that such facilities do not materially impede the contractor's operations under precontract conditions. If there is at any time disagreement as to whether the operations of the contractor are materially impeded this question shall be submitted to arbitration, in like manner as that provided for appraisal above. The contractor shall have the right to use such facilities left in place if and to the extent that such facilities have replaced other facilities of the contractor and are necessary to enable him to conduct operations under pre-contract conditions. The contractor shall maintain and care for such facilities as stand-by capacity, but all expenses including accounting, maintenance, taxes and insurance, other than such expense incident to the use of such facilities by the contractor, shall be paid by the Government. Facilities left in place may be removed by the Government at any time upon restoring the contractor's premises to their pre-contract conditions.

6. *Requirement of price justification.*—If new facilities are to be constructed for purposes of a supplies contract, and the contractor does not purport to seek reimbursement of cost through price, or protection against loss on such construction in the event of termination, the contractor may nevertheless be required by the contracting officer to demonstrate that the price of the article does not include an extraordinary amount to reimburse the contractor for the cost of new facilities.

The CHAIRMAN. Let me see if I understand what you want. You want these three provisions stricken from the bill that passed the House?

Mr. BIGGERS. That is the strong recommendation of the Commission.

The CHAIRMAN. What do you want to take care of it? You think you have the power to make these contracts that are more elastic?

Mr. BIGGERS. We think the same thing can be accomplished by the contract plan.

The CHAIRMAN. So you do not need any new statute on that?

Mr. BIGGERS. We recommend no substitute for those provisions.

Senator LODGE. Would you care to express an opinion on the excess-profits-tax provision in this bill?

Mr. BIGGERS. I would rather not, if you please, because I am still associated with a private company that is interested, one way or the other, in the excess-profits-tax bill. The Commission has taken no position, and I would rather not express an opinion.

Senator CONNALLY. The Commission favors the amortization feature in the act?

Mr. BIGGERS. Yes. We speak of that as being separate from excess profits.

Senator CONNALLY. I understand that. You were asked a moment ago about the amortization feature.

Mr. BIGGERS. Mr. Nelson has been a very valuable member of our committee. I regret that he did not have the opportunity of answering some of the questions that were directed at me. Is there anything you would like to add, with the chairman's permission?

Mr. NELSON (of the Advisory Commission). Nothing at all, sir.

The CHAIRMAN. Is there anything you gentlemen want to add, in addition to what you have already said?

Senator CONNALLY. Mr. Chairman, we ought to hear Mr. Nelson, if he is here.

The CHAIRMAN. Mr. Nelson, is there anything you desire to say?

Mr. NELSON. I have nothing, Mr. Chairman, to add. I think Mr. Biggers covered it fully. I think the whole point at issue is the question that Senator Clark brought out, as to what is the price you pay. I do not know any way that you can legislate by law how a negotiator shall fix a price, because it depends on his knowledge of costs, it depends on his knowledge of fair prices, it depends on his knowledge of competitive conditions. I do not know of any way, having been in the buying business, buying merchandise for the last 25 years, I do not know how to legislate any buying practice.

I think what Mr. Biggers said is a thing that would help carry out, separate from price, the cost of amortization. It has been my experience that the principal difficulty in negotiating a price is where you have the cost of amortizing the facilities in it, Mr. Senator, and then it makes it difficult.

Senator CLARK. If we are going to amortize, we ought to do it in one place. If we are going to pay for it in another way, if we are going to grant a subsidy, we ought to do that, but we ought not to pay for it by paying two or three times through the nose, through increased prices. We ought to protect this Government, whether by law, or regulation, or contract.

Mr. BIGGERS. If we could do the thing by law, I would recommend it.

Senator CLARK. We have been attempting to write formulas on a good many kinds of laws, and I know it is very difficult.

The CHAIRMAN. Mr. Knudsen, let me ask you, it has been said through the papers and through speeches by various types of people, that we have not passed this legislation quick enough, and other people have charged that Congress was at fault. You can appreciate what we are up against.

Mr. KNUDSEN. Absolutely.

The CHAIRMAN. I am sorry we have not been able to do it earlier, and get this thing through. We are going to try to do it as quickly as we can.

Do you think people have acted very cooperatively?

Mr. KNUDSEN. Yes, I think so, sir.

The CHAIRMAN. All right.

Mr. KNUDSEN. In other words, we cannot lick this problem by starting to get mad at each other. [Laughter.]

The CHAIRMAN. That is right.

(Subsequently the following letter and memorandum were submitted to the committee by Mr. Biggers:)

THE ADVISORY COMMISSION TO THE
COUNCIL OF NATIONAL DEFENSE,
FEDERAL RESERVE BUILDING,
Washington, D. C., September 5, 1940.

Hon. PAT HARRISON,
United States Senate, Washington, D. C.

DEAR SENATOR HARRISON: This is with further reference to the position of the Advisory Commission to the Council of National Defense regarding subsections (i), (j), and (k) of the amortization provisions contained in title II of the Second Revenue Act of 1940. Although spokesmen for the Commission have already appeared before the Senate Finance Committee, and have outlined in general the views of the Commission, the tax and finance committee of the Commission herewith submits, for your consideration and approval, a somewhat more detailed analysis of the operation of these subsections.

As you are aware, title II adds two sections, section 124 and section 24 (t), to the Internal Revenue Code, which together authorize the allowance of a tax deduction for the cost of certain facilities necessary in the interest of national defense during the present emergency. Generally speaking, this allowance takes the form of a deduction for amortization, which in the present context means nothing more than accelerated depreciation, so that the cost of emergency facilities, certified by the Advisory Commission and either the Secretary of War or the Secretary of the Navy, may be written off for tax purposes over a period of five years rather than over the estimated life of the property. Justification for the allowance is found in the emergency character of the facilities and the loss of useful value which will in many cases follow the close of the emergency.

On July 10, 1940, as Mr. Knudsen has testified, an announcement was made from the White House that the principle of accelerated depreciation for emergency facilities had been accepted by the President, by the Secretary of the Treasury, the chairman of the Senate Finance Committee, and the chairman of the House Ways and Means Committee. The Advisory Commission, I might point out, had theretofore been active in securing assent to the principle on the ground that it would enlist the participation of substantial amounts of private capital in the defense effort, thereby conserving public funds and credit. That this justification was accepted by the House is already indicated in the statement contained in the House report on H. R. 10413 that "it is considered desirable to provide special amortization with respect to the facilities necessary in the national defense, in order to encourage the participation of private enterprise in the rearmament program." (H. R. 2894, 76th Cong., 3d sess.)

In our view, however, subsections (i), (j), and (k) will defeat this beneficent purpose.

The following analysis may help clarify our position:

(*a*) In the first place, and of primary importance, is the fact that the prohibitions of subsection (i) extend to all emergency facilities regardless of whether such facilities are financed by the Government or are financed by private capital without reimbursement of cost by the Government through the price of the product or otherwise. Undoubtedly many facilities will be constructed by private enterprise and paid for, directly or indirectly, by the Government. In such facilities the Government obviously has an interest which we have, through our contracts, made every effort to identify, protect, and value. On the other hand, many facilities will be built by private capital without Government aid of any kind. These will be cases ordinarily in which the contractor foresees a normal peacetime demand for his product and anticipates that he will need the new facilities in the ordinary course of business expansion. Toward such construction the Government will make no advanced of capital, nor will it reimburse the contractor indirectly through an increase in the price of supplies. Subsection (i) makes no distinction between these two categories of new facilities.

(*b*) Under subsection (i) the taxpayer is forbidden not only to "destroy" or "demolish" any emergency facilities, but without the written consent of the Secretary of War or the Secretary of the Navy, he may not convert or adapt them to ordinary commercial pursuits, for he is also forbidden to "impair" or "substantially alter" such facilities. Thus although the taxpayer has built an addition to his own plant or purchased new machinery with his own capital, without Government participation of any kind, he may not, without the prior approval of the Army or the Navy, transform his own property to meet civilian needs. Emphasis on the prohibition against demolition is misleading; the real question is whether the taxpayer's right to alter his own property should be circumscribed by rigid statutory prohibition. If the property is worthless to him and so ready for demolition, but useful to the Government, it could easily enough be given to the Government or sold to the Government at its salvage value. The demolition prohibition, therefore, taken alone, gives rise to no insuperable problems.

(*c*) The second sentence of subsection (i) provides in addition, that if consent to the alteration or demolition is denied, the Secretary of War or the Secretary of the Navy as the case may be "shall and he is hereby directed to purchase such facilities at a price which he shall fix not to exceed the adjusted basis but not to be less than $1." This simply means that if the property has been fully or substantially amortized for tax purposes, it may be purchased by the Army or the Navy for a nominal sum, in the event that the taxpayer's petition for alteration, etc., is denied. Thus the taxpayer who has invested his own money in new plant and equipment and who has not asked the Government to bear the costs of expansion may be required to transfer that plant and equipment to the Government in consideration of a dollar, notwithstanding the fact that it may be worth far more on the market, or as a going enterprise in his own hands.

(*d*) Of interest is the manner in which subsection (i) will operate. If once the taxpayer makes application to the Secretary of War or the Secretary of the Navy for permission to transfer his property, and that permission is refused, his ownership is then necessarily terminated. For it is thereafter mandatory on the Secretary of War or the Secretary of the Navy to fix a price and take over the property. Obviously, no taxpayer will ever ask permission to transform or adapt his property, for the consequences of denial are not only loss of ownership, but loss of ownership in consideration of a sum which may have no relationship whatsoever to the value of his property.

(*e*) Since the fifth amendment to the Constitution prohibits the taking of private property for public use without the payment of "just compensation," and since there is serious question whether the "adjusted-basis-or-$1" formula constitutes just compensation, the taxpayer is required under subsection (j) to file a sworn statement "acknowledging, and consenting to the application of, the provisions of subsection (i)." Whether this enforced consent avoids the constitutional prohibition may perhaps be open to dispute; but that it will not enlist the wholehearted cooperation of private capital is hardly open to question. Rarely, we suspect, would anybody risk his own capital in new plant and machinery, without Government reimbursement or guaranty, if he knew that that property would thereafter be irrevocably committed to production for Government purposes, and could thereafter be taken from him, if he failed to secure the necessary consent to alteration or demolition, at an arbitrary figure which had no relation whatsoever to his investment or to the value of his property.

(*f*) One last point deserves mention. If the Secretary of War or the Secretary of the Navy certifies to the Secretary of the Treasury that a taxpayer subject to the provisions of subsection (*i*) "has wilfully destroyed, demolished, impaired, or altered substantially any emergency facility" without having first obtained the necessary consents, the taxpayer is liable, under subsection (*k*), "to a penalty in an amount equal to the unadjusted basis of such facility in the hands of the taxpayer for the purpose of computing gain." In other words, the penalty for proceeding without the consent of the Secretary of War or the Secretary of the Navy, is a sum equal to the original cost of the facility; and the judges authorized to determine whether a violation has occurred are the Secretary of War or the Secretary of the Navy. Thus if a taxpayer cooperates with the Government to the extent of investing $5,000,000 of his own money in new plant and equipment, he may thereafter be penalized $5,000,000 if he ventures to alter such facilities without first securing the appropriate consents. The amount of the penalty, therefore, increases with the degree of cooperation.

In our view these subsections, if they become law, will seriously deter the use of private capital in the defense program with the result that new and vastly enlarged responsibilities will be placed upon the Reconstruction Finance Corporation and the Treasury, and thus indirectly upon the taxpayer. To the extent that private capital does participate in the program, the risks and burdens laid upon the contractor by these subsections will surely be reflected in the increased cost of supplies to the Government.

Our concurrence in the objectives of the provisions has already been recorded. It is fair and proper that all emergency facilities directly or indirectly financed by the Government should be preserved, so far as may be necessary or appropriate, for national defense. Indeed, we would extend this principle, to all such facilities, whether or not special tax benefits are conferred or obtained. We are firmly of the opinion, however, that these objectives can best be achieved by appropriate safeguards in individual contracts for supplies and facilities. With the cooperation of the War Department, the Navy Department, and the Reconstruction Finance Corporation we have already undertaken to see to it that such safeguards for the protection of the Government's interests are included in all future supplies and construction contracts.

In conclusion, may we repeat that our differences with the Treasury on this subsidiary question have been differences of method, not principle. With your permission, we should like to send Mr. Sullivan a copy of this letter. We should be grateful, too, if you would forward a copy, herewith attached, to Senator Barkley.

Yours sincerely,

John D. Biggers,
Chairman, Tax and Finance Committee.
Donald M. Nelson,
Leon Henderson,
Wm. H. McReynolds,
C. E. Adams.

Recommended Methods of Procuring New Facilities

PLAN I.—PRIVATE OWNERSHIP WITH NO GOVERNMENT INTEREST

Purpose: When manufacturer desires to own the facilities at all times and does not include in the product price an abnormal amount for depreciation or amortization.

Financing: Private, including Reconstruction Finance Corporation loans.

Title: Vested in manufacturer.

Methods of operation: By manufacturer in the normal way.

Reimbursement: None other than by way of normal depreciation.

Amortization: Certified for tax purposes as needed for national defense.

Termination: No protection for contractor.

Provision for subsequent use by manufacturer: Continued use by the contractor.

PLAN II.—PRIVATE OWNERSHIP WITH GOVERNMENT INTEREST

Purpose: For plants in which the manufacturer desires to preserve a future interest.

Financing: Private, including Reconstruction Finance Corporation loan.

Title: Vested in the manufacturer.

Method of operation: By manufacturer.

Reimbursement: Cost to be repaid to manufacturer in five equal annual installments. Payments to be subject to acceleration if supply contracts run out.

Amortization: Certified for tax purposes as required for national defense.

Termination: At end of 5-year period, or earlier termination of the emergency, the manufacturer may continue to use the facilities if he pays to the Government the then fair value thereof as determined by arbitrators; otherwise contractor transfers title to the new facilities to the Government.

Provision for subsequent use by manufacturer: No right to use unless payment made as set forth under heading "Termination" above.

PLAN III.—GOVERNMENT OWNERSHIP

Purpose: For plant in which Government desires to have permanent interest or in which the manufacturer has no future interest.

Financing: Government funds, either Reconstruction Finance Corporation Defense Corporation, Army or Navy.

Title: Vested in the Government.

Method of operation: Leased to the manufacturer.

Reimbursement: Not applicable (Government owned).

Amortization for tax purposes: Not applicable (Government owned).

Termination: Government will take over facilities whenever lease terminates.

Provision for subsequent use by manufacturer: None.

DESIGN OF FACILITIES AND SUPERVISION OF THEIR CONSTRUCTION

To insure proper facilities for the work and expedite placing such facilities in production, the manufacturer should supervise their design and construction, even in case plan III is followed. In connection with plans II and III, the Government departments concerned should review the building plans and the cost estimates to determine whether the facilities proposed and the cost of the same are reasonable for the purpose prior to any commitments.

COMBINATION OF PLANS

Machinery, for instance, may be Government furnished by plan III, while the plant may be provided by plans I or II should this be desired.

SEPTEMBER 5, 1940.

The CHAIRMAN. Mr. Stam.

STATEMENT OF COLIN F. STAM, CHIEF OF STAFF OF THE JOINT COMMITTEE ON INTERNAL-REVENUE TAXATION

The CHAIRMAN. Mr. Stam, proceed and present to the committee an analysis of this bill in your own way.

Mr. STAM. Mr. Chairman and gentlemen of the committee, I have prepared a statement giving in detail an explanation of the technical features of the bill. I will be glad to read that statement and answer any questions that come up as we go along.

The CHAIRMAN. All right, proceed.

Mr. STAM. The excess-profits tax under the bill applies to each taxable year beginning after December 31, 1939 (sec. 710 (a)). Thus, a corporation on the calendar-year basis will pay an excess-profits tax, beginning with the calendar year 1940. A corporation on a fiscal-year basis will pay an excess-profits tax for the first fiscal year beginning after December 31, 1939. For example, a corporation filing its income-tax returns as of the fiscal year ending June 30 will pay its first excess-profits tax for the fiscal year ending June 30, 1941.

The bill provides two different methods for computing both the excess-profits credit and the excess-profits tax, and allows the taxpayer which was in existence for the whole of the base period to elect the one to apply in its case. Each method is separately considered. For the purposes of this discussion, one is referred to as the "average earnings method," and the other, as the "invested capital method." A description of each method follows.

A. *Average earnings method.*—The average earnings method determines excess profits by comparing the average income for a base period with the income of the taxable year. In general, where the income for the taxable year is in excess of the average income for the base period, such excess is deemed to be excess profits. The base period consists of the taxable years of the taxpayer beginning after December 31, 1935, and before January 1, 1940. In case a corporation is on the calendar-year basis, the base period will embrace the calendar years 1936, 1937, 1938, and 1939. In case the corporation is on a fiscal-year basis, the base period will embrace the fiscal years beginning after December 31, 1935, and before January 1, 1940. For example, if a corporation filed its income-tax returns on the basis of a fiscal year ending June 30, its base period will consist of the fiscal years ending June 30, 1937; June 30, 1938; June 30, 1939; and June 30, 1940.

The CHAIRMAN. Can that be simplified so a layman can read it and sometimes understand it?

Mr. STAM. I think so.

The CHAIRMAN. You think it can be?

Mr. STAM. Of course, as far as the average earnings method is concerned, you merely take your average earnings for the base period and you compare that with your earnings for the taxable year, and if there is any excess in the taxable year over the base period, that is the excess which is subject to the excess-profits tax, except for an additional credit of $5,000.

The CHAIRMAN. Now the other method, can it be simplified a little bit?

Mr. STAM. I think so.

The CHAIRMAN. Let us have that.

Mr. STAM. I have not come to that yet.

The CHAIRMAN. All right.

Senator VANDENBERG. Mr. Stam, you have heard a number of these witnesses during the last 2 days who have indicated that their use of this 4-year base results in a tax that definitely would invade regular earnings and not excess earnings. Is not that true?

Mr. STAM. That is true.

Senator VANDENBERG. Is that situation satisfactory?

Mr. STAM. Of course, that depends upon the approach.

Senator VANDENBERG. I understand that.

Mr. STAM. If you are merely dealing with the profits due to the defense program, either directly or indirectly, by an expenditure of this money, then, of course, the average earnings basis is the proper basis to tax those excess profits. On the other hand, if you want to levy a tax based on the excessiveness of the profit over a standard like invested capital, which has nothing to do with the defense program, then you choose the other method of levying on excess profits by comparing those profits with a certain standard.

Senator VANDENBERG. I understand that. For instance, did you hear the testimony of Mr. Zick from northern Indiana a few hours ago, that indicated a perfectly confiscatory tax as the result of a reliance on the base?

Mr. STAM. I think he was complaining particularly about the penalty for the privilege of electing the average-earnings base. In other words, a taxpayer that cannot take the invested-capital base because he has very little invested capital and is forced to take the average-earnings base, has to pay in addition to an increased rate schedule, a penalty tax of 4.1 percent, and, as I remember his testimony, he had very little invested capital and fairly high earnings in the base period, but he would have to pay this high tax because of the penalty provision and the increase in rates.

Senator VANDENBERG. I understand that. What I am asking you is, whether he did not present a situation which is clearly inequitable and ought to have relief?

Mr. STAM. Well, I think so. Of course, the whole trouble with any plan of this sort is that certain companies are benefited under one plan and other companies are benefited under another plan. That is, the invested-capital plan is going to help companies with low earnings, and the average-earnings plan is going to help companies that have good earnings in the base period.

Now, the subcommittee, when they adopted their original plan, felt that it was proper to allow the corporation to elect whichever plan it wanted to.

Senator VANDENBERG. Yes; but if neither plan brings them within a rule of reason, what can we do about it?

Mr. STAM. The only thing you can do if neither plan brings them within a rule of reason is to have some other alternative to take care of their unusual situation.

Senator VANDENBERG. Now, have we any such an alternative?

Mr. STAM. We do not have any such thing in the bill now.

The CHAIRMAN. Mr. Stam, let me ask you, was not one of the big faults in the original recommendation of the subcommittee of the Ways and Means Committee, that there were so many distress cases there that they did not provide for relief, to take care of the relief cases? If there had been in the bill the same authority given to the Commissioner of Internal Revenue as there was in the 1921 act, would not that have eliminated a good many of the distress cases?

Mr. STAM. The Ways and Means Committee, in drafting the bill after the hearings, made an attempt to take care of a lot of these hard cases, but, of course, they did not take care of all of them. In any tax of this sort, you are bound to have hard cases that you cannot cover by the statute. Of course, the 1918 law contained a general provision to take care of the abnormal cases. The British law contains a special provision to take care of hard cases, the Canadian law contains a special provision to take care of hard cases. In other words, it is almost impossible to enumerate in the statute specific rules to cover all the harsh situations that might arise in an excess-profits tax.

Senator VANDENBERG. But we have no provision to take care of the hard cases.

Mr. STAM. You have a certain particular case or cases that are enumerated in the statute, and that is all. For example, you have cases where a corporation has incurred a loss due to fire, storm, or shipwreck in the base period. Of course, they have taken a deduction for that loss in computing the income tax and that naturally reduces the base-period income. We have a provision in this bill which permits the corporation to restore that loss to its income for the purpose of the excess-profits tax, giving it a higher base-period income.

We have attempted also to take care of the case where a corporation has been required to reimburse to its customers a large amount collected as processing taxes. That also created an abnormal situation in the base period income of the corporation, and we permitted that particular deduction to be restored to income and thereby increased the base period income of the corporation.

Senator RADCLIFFE. Mr. Stam, you have referred to several suggestions which have been covered by specific provisions providing for relief. Have you attempted to draft any language, in a general way, which might cover different situations than that, or is there any difficulty in framing such a general provision?

Mr. STAM. There is no general provision in the bill that is now pending before you that covers that. We have a general provision in the 1918 and 1921 act that vested discretionary power in the Commissioner to apply relief where the taxpayer had an abnormality in income or capital.

Senator RADCLIFFE. Is there any opinion that that discretion was abused in the operation of the 1921 law?

Mr. STAM. There was a lot of criticism of that old provision. Taxpayers contended, for example, that the Commissioner arrived at what relief they got by comparing the rate of tax applicable to other corporations similarly situated. Of course, a lot of the taxpayers did not know exactly what comparatives the Commissioner was selecting for the purpose of determining whether or not they were entitled to relief. There was some criticism of the way that particular provision was administered under the old law.

Senator RADCLIFFE. Could not general language be drafted in such a way that it would guard at least against some such abuses of discretion?

Mr. STAM. I think it could, and we are working on the proposition now, to see if we can draft some sort of general provision to take care of some of these unusual situations.

Senator CONNALLY. Mr. Stam, there was a clause in one of the old acts, I do not know whether it was 1918 or 1921, providing for special assessments.

Mr. STAM. That is the one I refer to.

Senator CONNALLY. That is the one you are talking about?

Mr. STAM. Yes.

Senator CONNALLY. In which the Commissioner had authority to make a special adjudication in any particular case?

Mr. STAM. And his decision was final, except upon review by the Board of Tax Appeals. A taxpayer could not go to court on any decision by the Commissioner on special assessments.

Senator LODGE. Mr. Stam, for the record I would like to bring up a matter I just mentioned to you, on the question of amortization. I have been told that the 5-year amortization principle should be effective for expenses incurred since January 1, that there are many companies who, on their own initiative, started expansion early in this year, anticipating needs that they felt sure would come, and these concerns would be treated unfairly unless the amortization was changed as suggested. Could you comment on that?

Mr. STAM. Under the bill the facility has to be constructed after July 10, 1940. The reason for that, as I understand it, is that was the date on which taxpayers were put on notice that they were to receive an amortization allowance. Those corporations that went ahead and constructed their facilities prior to July 10, 1940, did not do so on the inducement that they were going to get amortization. Now, of course, it may be unfair to penalize a corporation that went ahead on its own motion and erected its plant prior to July 10, 1940, if we are going to make the excess-profits tax retroactive to January 1. I think Senator Harrison raised that point this morning in connection with a conversation with Mr. Sullivan, and we were going to look into that and report back on it a little later.

Senator LODGE. You have no objection, on the basis of your present study?

Mr. STAM. No; we have not.

Senator LODGE. May I offer this telegram from Mr. Booth, that I received this morning?

The CHAIRMAN. It may be inserted in the record.

(The telegram referred to is as follows:)

[Telegram]

WORCESTER, MASS.,
September 3, 1940.

HON. HENRY C. LODGE,
United States Senate, Washington, D. C.

In view of tax bill falling heavily on many moderate-sized industrial companies, which are numerous hereabouts, strongly urge that 5-year amortization principle be effective for expenses incurred since January 1. Many patriotic companies, including some of our best concerns in this county, on their own initiative started expansion early this year anticipating needs they felt sure would come. These concerns would be treated unfairly unless amortization changed as suggested. Hope you will use your influence to this effect.

GEORGE F. BOOTH.

Senator VANDENBERG. Mr. Stam, you also referred to processing taxes. I understand you are giving that subject further study.

Mr. STAM. We are, that is right.

The average earnings method has a great advantage in its simplicity. The corporation uses as its excess-profits tax net income the same net income for both the base period and the taxable year as is used for normal income-tax purposes, subject to the following adjustments (sec. 711 (a)):

(1) The normal corporate income tax payable for the taxable year is allowed as a deduction (sec. 711 (a) (1)).

(2) Gains or losses from the sale or exchange of assets held over a period of 18 months (depreciable or nondepreciable) are eliminated from income for the purpose of the excess-profits tax (sec. 711 (a) (2)).

(3) There is excluded income derived from the retirement or discharge of any of the bonds, debentures, notes, or certificates, or other evidences of indebtedness of a corporation, which have been outstanding for more than 18 months (sec. 711 (a) (3)).

In addition, the following adjustments are also allowed for the base period, but not for the taxable year:

(1) Deductions for losses arising from fires, storms, shipwreck, or other casualty, or from theft, not compensated for by insurance or otherwise, are excluded.

(2) Deductions for expenses are diminished by payments to vendees of reimbursements to them of processing and other taxes under the Agricultural Adjustment Act of 1933.

Now, these adjustments are in the form of relief provisions that I was talking about. Capital gains under the existing income-tax law are now subject to a corporate tax rate of 20.9 percent. In view of the fact that an individual under the existing income-tax law does not have to pay a higher rate on a capital gain than 20 percent, there is no reason why, for the purpose of excess-profits tax, we should tax the capital gains of corporations at a higher rate than the tax which applies to individuals. Therefore, we exempted gains or losses from the sale or exchange of assets held over a period of 18 months from the excess-profits tax.

Senator VANDENBERG. Referring back to your first relief, the income-tax deduction, why did not you also allow deduction on the 4.1-percent tax? As the thing now stands, you tax a tax, don't you?

Mr. STAM. The reason why the 4.1 percent tax was not allowed as a deduction is it is not regarded as a part of the normal tax. It is a tax for the privilege of electing the average earnings method, and is treated as an excess-profits tax exactly like the other portion of the excess-profits tax. That is the theory back of it.

Senator VANDENBERG. Do you approve that theory?

Mr. STAM. Well, I think it is a little severe, myself. [Laughter.]

Income derived from the retirement or discharge of any bonds, notes, or certificates of indebtedness of a corporation which have been outstanding for more than 18 months is also excluded from income. This applies where a corporation retires its own bonds, for example, at less than the par or the face value of the bonds. In certain decisions of the Supreme Court, it was held that the corporation realized income from such a transaction. We took care of that abnormal situation by a special provision in the bill. That is a special relief provision.

Senator VANDENBERG. What are those deductions again, please?

Mr. STAM. Income derived from the retirement or discharge of any bonds or other evidence of indebtedness which have been outstanding for more than 18 months.

Senator CONNALLY. In other words, if the corporation bought its bonds at 75 cents on the dollar, under the holding of the court they made 25 percent, but under this that is disregarded?

Mr. STAM. It is not subject to the excess-profits tax.

Senator CONNALLY. You disregard it as to the excess-profits tax because it is an unusual profit?

Mr. STAM. It is an abnormal transaction that does not often occur.

Senator RADCLIFFE. Could I ask you one question about the word "assets"? Would that include a claim that has been asserted but not in any way reduced to judgment?

Mr. STAM. This is the retirement or discharge of any bonds.

Senator RADCLIFFE. I was referring to No. 2, for the sale or exchange of assets.

Mr. STAM. A claim that was not reduced to judgment, could that be sold or exchanged?

Senator RADCLIFFE. It might be; yes.

Mr. STAM. It might come under additional capital assets for what it was worth.

Deductions for losses arising from fires, storms, shipwreck, or other casualty, or from theft, not compensated for by insurance or otherwise, are excluded.

Deductions for expenses are diminished by payments to vendees of reimbursements to them of processing and other taxes under the Agricultural Adjustment Act of 1933.

In regard to losses by fire, and so forth, a situation like that, of course, is where the Ohio flood a few years ago destroyed a lot of business properties and corporations sustained heavy losses. That is an unusual transaction and will not occur very often, and we did not feel that it was fair to force the corporation to reduce its base period income by the loss taken for income tax purposes, so we allowed that loss to be restored to income.

I have already mentioned the processing-tax problem. If a corporation has a deficit for 1 year in the base period, the income for the other years of the base period is not reduced in arriving at the average base-period income. If there are deficits in more than 1 year in the base period, the aggregate income for the other years is reduced by all such deficits, except the one for the year in which the greatest deficit occurred.

That merely means, of course, if a corporation has a deficit in 1 year of the base period, it can throw out that deficit and count that year as zero in arriving at its average income for the base period. If it has a deficit in 2 years in the base period, it has to throw out the greater deficit and keep the smaller deficit. Of course, the smaller deficit will reduce the income for the other years in the base period.

Senator VANDENBERG. Why should not they have credit for all the deficits? If you are trying to get a true picture of the base period, why should not they have credit for all deficits?

Mr. STAM. One of the difficulties about that would be—it would be a little unfair, for example, if a corporation had merely, say, $1 of income in a certain year, you see, they would be required to divide their year by four, the total year, to get their average and put this $1 in. Whereas, if you eliminate all deficits from the picture and eliminate the years themselves and merely divide by the income years, you would be giving, it seems to me, the corporation which had the deficit an advantage over the other corporation which just had a small amount of income. That is one of the difficulties we are confronted with.

The CHAIRMAN. Do you favor taking 3 of the 4 years of the base period?

Mr. STAM. I think that is a very good idea. Both Mr. Sullivan and myself suggested before the Ways and Means Committee, that a corporation be permitted to select 3 out of the 4 years in the base period. The reason why the Ways and Means Committee failed to adopt that suggestion was due to the loss in revenue involved from such an amendment.

Senator VANDENBERG. What was the loss as estimated?

Mr. STAM. At that time it was estimated to be around $80,000,000.

Senator BYRD. Mr. Stam, did your estimates of the revenue agree with the Treasury's estimates?

Mr. STAM. There was some difference between our estimates and the Treasury estimates on the subcommittee bill which was originally adopted. We have not made any estimates on the pending bill at the present time.

The CHAIRMAN. Well, give us those differences between the views of the Treasury and yourself as to the estimates on those two questions. Let us have the whole picture.

Mr. STAM. Well, under the original subcommittee bill, we estimated that the yield for 1940 would be approximately $300,000,000. Under the Treasury estimate in the subcommittee bill, they estimated roughly the yield would be around $190,000,000.

The CHAIRMAN. First they estimated $225,000,000, then they figured out that they would deny the distributions and collections of the tax until the dividends were paid out, which reduced it $35,000,000 more, is that right?

Mr. STAM. They estimated a gross revenue of $225,000,000 under the subcommittee bill.

The CHAIRMAN. For 1940?

Mr. STAM For 1940. That was reduced by $35,000,000, which was estimated to be the loss in the tax, in the individual tax by reason of the failure of the corporation to pay out dividends because of this excess-profits tax. That reduced their estimate down to $190,000,000. Then when we put in this relief provision which permitted a corporation in the base period to count 1 year as zero, that further reduced their estimate to about $160,000,000. So the final Treasury estimate under the subcommittee bill was $160,000,000.

The CHAIRMAN. But the Treasury gave no estimate on the presentation of that question for 1941?

Mr. STAM. The Treasury did not estimate, did not give any figures for 1941, and we estimated a figure of between $450,000,000 and $500,000,000 for 1941 under the subcommittee bill.

The CHAIRMAN. How much did you estimate on your bill for 1941, under your theory of average earnings?

Mr. STAM. Under the average earnings theory, we had a relief provision which provided for the invested capital method. We let the taxpayers take the invested capital method if they wanted to, and we gave them a certain fixed return on their invested capital. Now under that particular plan, we estimated around about $500,000,000 additional revenue for 1941.

The CHAIRMAN. The Treasury gave no figures on it?

Mr. STAM. The Treasury gave no figures for 1941.

Senator BYRD. Mr. Stam, assuming this penalty for exercising the average earnings privilege was cut out, how much loss do you think there would be in that?

Mr. STAM. I haven't got the figure on that. I am working on that right now. We hope we will have something for you very shortly.

Now under this average earnings plan, the bill also allows a taxpayer to increase his base period exemption by 8 percent of net additions to capital after his first taxable year. In other words, if, in 1940, a corporation issues some stock and gets in some new capital and that new capital is employed in the business, the corporation can take 8 percent of such new capital and add it to its base period income. That will give it further additional credit.

Every corporation electing the average-earnings method must pay an additional excess-profits tax of 4.1 percent on its normal tax net income. Now that 4.1 percent is figured on the same income that the 20.9 tax is figured, that is, the normal tax net income. The corporation does not get any deduction in computing its excess-profits tax for that 4.1 percent tax under the bill.

Senator CONNALLY. How did they arrive at that 4.1? Is not that pretty high, a pretty heavy rate?

Mr. STAM. It makes the total normal and excess profits tax at least 25 percent.

Senator CONNALLY. I get that. Why is it exactly 4.1 percent? You are putting a pretty heavy tax on a man that wants to take this other route.

Mr. STAM. The committee was of the opinion that taxpayers electing the average-earnings method had an advantage over the taxpayers electing the invested-capital method.

Senator CONNALLY. Is that your opinion?

Mr. STAM. That is its opinion.

Senator CONNALLY. I say, is that your opinion?

Mr. STAM. I would not say it is my opinion.

The Ways and Means Committee felt they had to put some additional tax on to equalize the situation between corporations electing the average earnings method and those electing the invested capital method.

Senator CONNALLY. Of course, you put the 4.1 percent on every man that elects that method. One man might get 2 percent by electing that method, and another man might get 10 percent by electing, but they will both pay the same price.

Mr. STAM. It would have the effect of forcing a great many corporations that would ordinarily take average earnings as a basis, to go over into the invested capital method; but where, of course, earnings are very high, above, say, 17 percent, a lot of the corporations will still have some advantage by electing the average earnings method. Of course, after they elect the average earnings method, we have a different rate schedule for those corporations from that for the corporations electing the invested capital method.

Senator BYRD. In other words, you penalize the two cases, one on the excess profit rate and the other on the 25 percent additional normal rate.

Mr. STAM. There is a 5 percent increase in each bracket schedule for those electing the average earnings method.

Senator BYRD. All of them?

Mr. STAM. All of them, that is right, little and big.

Now if the taxpayer elects the invested capital method under the bill, the thing that he does, he takes his base period earnings and compares them with his base period invested capital and gets a certain rate of return in that base period. For example, if he compared his base period invested capital with his base period income and got a return there of, say, 8 percent, that would be the amount of the credit that he was going to get in the taxable year 1940, to be applied against his invested capital for the taxable year 1940. For example, if he made 8 percent on the base period, on the basis of the invested capital in the base period, and his invested capital for the taxable year 1940 was $100,000, then he would get $8,000 as a credit against his excess-profits tax net income for 1940 before the excess-profits tax would be applied.

The CHAIRMAN. Do you think that simplifies the business, to make it say 8 percent, instead of having them go into all this figuring?

Mr. STAM. Of course, the system under the 1918 and 1921 acts, where the credit was made to depend not upon the earnings in the base period but you were merely given a certain percentage of your invested capital for the taxable year, that was a much simpler policy, and of course the law was much less complicated by merely basing the credit on a certain percentage of the invested capital for the taxable year.

The CHAIRMAN. Is it very difficult to do that in this bill?

Mr. STAM. It is not difficult to do it.

The CHAIRMAN. Would that simplify it?

Mr. STAM. I think it would.

The CHAIRMAN. Don't you think we ought to simplify it in one respect? [Laughter.]

Mr. STAM. Corporations with low earnings in the base period that had a return of less than 7 percent on the first $500,000 and 5 percent on the capital above that, are allowed, under the bill, a minimum return of 7 percent on their invested capital for the taxable year not exceeding $500,000, and 5 percent on the balance. Of course, that helps the corporation that has had deficits in the base period, or the struggling corporation that will be forced to take the invested capital method. In addition, this method allows a further minimum tax-free return with respect to new capital acquired after the beginning of the taxpayer's first taxable year, of 10 percent to the extent such new capital does not cause the total invested capital to exceed $500,000, and 8 percent on new capital in excess of that figure.

One reason why the bill is so complicated is because it tries to take care of these small corporations by having these differentials of 7 percent on the first $500,000 of invested capital, and 5 percent on the balance, and in the case of new corporations, by having 10 percent up to the first $500,000 of invested capital, and 8 percent thereafter, and also certain distinctions in the case of borrowed capital. Those provisions have made the bill very complicated, because we have had to work out a lot of complicated provisions.

Senator GEORGE. Those three provisions?

Mr. STAM. Those three provisions.

Senator GEORGE. Of course, the Treasury said this morning, if you remember, that it was necessary to get the average rate of earnings on the invested capital, to use it as a base so as to give still more relief to the invested-capital group.

Mr. STAM. That is right.

Senator GEORGE. There would not be any question about that if you let them make 10 percent. That is the ceiling, anyway.

Mr. STAM. That is the ceiling, that is right.

Senator GEORGE. In other words, if you fix that at 10 percent, flat earnings of 10 percent on all your invested capital, why, there would not be any use to have any computation in the bill at all.

Mr. STAM. Now, of course, under the invested-capital method a corporation which was not in existence during the entire base period is given a constructive existence for that part of the base period during which it was not in existence. For example, if a corporation was organized on January 1, 1938, and in that particular year they had an invested capital of $650,000 and an excess-profits tax net income of $45,500, in 1939 they had an invested capital of $700,000 and excess profits net income of $63,000, there we go back and fill in the years 1937 and 1936, and that is done by taking the invested capital as of the beginning of the taxable year 1940 and apply to that the rates applicable to new capital. That is 10 percent on the first $500,000 and 8 percent on the balance.

Now, if that corporation had an invested capital in 1940 of $800,000, we would say that that invested capital was its invested capital for 1936, arbitrarily, and assign that an income of $74,000, which was arrived at by taking 10 percent on the first $500,000, and 8 percent on the balance.

Senator GEORGE. Mr. Stam, right there, I don't want to anticipate you, but there is a provision in the bill, isn't there, for newly formed corporations, out of reorganization?

Mr. STAM. Yes.

Senator GEORGE. Well, let me ask you right on this point. I am anticipating you, but I would just like to get it cleared up because Senator Bankhead sent me over a memorandum about that.

In the case of a copartnership existing through a long period of years, converted into a corporation, say, on January 1, 1938, with the relative ownership the same, the members of the copartnership now holding stock in the corporation in the same ratio, but the only thing that that corporation could do would be to reconstruct its earnings for the previous years in the base period.

Mr. STAM. That corporation would have to take the invested capital method, of course, because it was not in existence as a corporation during the entire base period.

Now, being forced to take the invested capital method, it would have to reconstruct its invested capital and earnings for those years during which it was not in existence and that would be an arbitrary construction, based on its invested capital for the taxable year.

Senator GEORGE. But that only gives relief to the invested-capital type of corporation, or taxpayer?

Mr. STAM. That is right.

Senator GEORGE. There is nothing in the bill that would allow the same business, changing merely from a copartnership to a corporate form, to retain its prior earnings during its copartnership form for 1 year, even, out of the base period?

Mr. STAM. One of the difficulties with that, of course, is that your income for the purposes of a partnership is different from your income for corporate purposes.

Senator GEORGE. I say there is nothing in the bill that will reach that situation—I am asking for information.

Mr. STAM. That is right.

Senator GEORGE. And in that case the corporation would simply be compelled to go on the invested-capital basis?

Mr. STAM. That is right.

Senator CONNALLY. Mr. Stam, while you are on that, suppose two or three corporations merge or reorganize, is there any provision in the bill that allows the new corporation to take the consolidated earnings of the two or three during the base period?

Mr. STAM. There is, assuming it is a tax-free merger under the income-tax law.

Senator CONNALLY. Of course, if it is a taxable merger, it is a different proposition.

Mr. STAM. Yes. Now, I have quite a long explanation. I don't know whether you want me to go into more detail or not in discussing these items; of course, they are very technical and we have quite a long write-up.

The CHAIRMAN. They are not any more so than what you have been discussing, are they? [Laughter.]

Senator DAVIS. It might be wise to put it in the record, and we could read it and get one or two experts to pin it down.

Senator CONNALLY. Isn't the difficulty about this whole bill the vice of establishing two standards, one the invested capital and the other the base period, and naturally when you have got two you have got all sorts of situations arising, and you have had to devise all these hook-a-macrooks to give the taxpayer what he thinks is some advantage, and yet not "skin" the Government in the process?

Mr. STAM. I don't think it is so much a combination of the two plans as it is an effort made to provide certain relief provisions for certain types of new companies, and small companies.

Senator CONNALLY. Well, if we base the whole tax on the invested-capital theory, as we did in the former laws, it would be much simpler, wouldn't it?

Mr. STAM. If you based the tax entirely on the invested-capital method, you would have a simpler bill.

Senator CONNALLY. You would, of course, have to make some exceptions in the case of personal-service corporations and things of that kind, but I am speaking about a corporation that has a regular business and is going on with it, and you base all the excess profits on the invested-capital theory, allowing them 6 or 7 or 8 percent, and then graduating the taxes above that—it would be very much simpler than this bill, would it not? It might not be as equitable.

Mr. STAM. It would be a simpler bill, but it wouldn't be as fair and equitable as this bill, because a lot of corporations have a very small invested capital.

Senator CONNALLY. If that is all they have in the business, what right have they to have a big return?

Mr. STAM. You remember we discussed that point some time ago, about change in the stockholders of the corporation, in other words you take a corporation and look back and see what the original stockholder paid into the corporation, and he might pay a very small amount. Now, the existing stockholders at the present time have paid a lot more than that original investment, and of course the invested capital method would penalize the existing stockholders who paid a very much larger amount for their stock than the original stockholders invested in the corporation.

Senator CONNALLY. Well, we could change that law.

Mr. STAM. That is a fundamental part of the invested capital system. Of course, the invested capital system does, to a certain extent, benefit the very large corporation, because the large corporation is the corporation with a large amount of invested capital.

Senator CONNALLY. Of course, it is or it wouldn't be large.

Mr. STAM. That is right. And your small corporation, where capital is not so important, but it is built up by good management on the part of the owners, would be very severely penalized under a straight invested capital method.

Senator GERRY. Mr. Stam, would it simplify the bill if the graduated percentages of excess-profits tax income were based upon a certain percentage of invested capital or excess profit credit as contained in the House subcommittee's report, rather than specific amounts as contained in the House bill?

Mr. STAM. Well, the reason the change in the rate schedule was made by the Ways and Means Committee was that under the original subcommittee plan, a corporation, a very large corporation, would get a very large credit, you see, because it had a very large amount of invested capital; and by computing it on the basis of the credit, that particular corporation would have more income in the first bracket than a smaller corporation. A smaller corporation would come out of the first bracket much quicker than a large corporation.

So therefore it was thought best that after you determined a certain amount of credit for excess-profits tax, and got your excess-profits tax net income, that every dollar of excess profit net income thereafter should be treated alike and subject to the same rates.

Senator GERRY. I have got a couple of questions I have been asked to put.

Would the House bill not be simplified a great deal by permitting all of borrowed capital to be included as invested capital? Would this not eliminate provisions for preferential amounts of invested capital and lowest invested capital?

Mr. STAM. Well, it would eliminate some of the technicalities on the bill, of course, but there again we make those distinctions in the case of borrowed capital, to take care of the small corporation which is supposed to have to pay a higher rate of interest for its money than the large corporation.

So, where the smaller corporation borrows, say, $50,000, and has an invested capital of only $50,000, it can take in that $50,000 at

100 percent in its invested capital. Where its invested capital is over $100,000, and not over $1,000,000, then it can take in two-thirds of its borrowed capital.

Senator GERRY. That really helps the small corporation?

Mr. STAM. It helps the small corporation.

Senator GERRY. I have got one more question. If the bill contained a provision authorizing the Treasury Department to permit or require consolidated returns, would not a large part of the complicated provisions contained in the House bill, with reference to reorganizations, be eliminated?

Mr. STAM. A lot of that would be simplified greatly, I think, if that were permitted.

Senator BYRD. The reason they didn't have the consolidated return was because of the difficulty of drafting it?

Mr. STAM. That was one of the main reasons.

Senator GERRY. Is it more equitable?

Mr. STAM. Of course, it is more equitable when you look at a consolidated group and find out whether that consolidated business, which is one economic unit, has an excess profit. In other words, you take in the losses of the subsidiaries and the income of some of the operating companies, and offset one against the other, and you find out whether or not that particular group as a whole has an excess profit.

We did require the consolidated return under the 1918 act and the 1921 act.

Senator GERRY. Because we thought it was more equitable and that is why it was put in the 1918 act.

Mr. STAM. That is right.

Senator BYRD. Why is it so difficult to draft the language? Somebody said it would take 6 weeks.

Mr. STAM. One of the main difficulties is, of course, this base-period experience. You have consolidated corporations in the base period, and they keep changing, some of them go out of the affiliation and some come in, and it makes rather a complicated proposition.

Senator BYRD. It oughtn't to take that length of time, should it?

Mr. STAM. Well, it is quite a problem. Now, we permit a personal-service corporation to elect to be taxed like a partnership. That is the corporation where capital is not a material income producing factor, and where most of the income is derived from the personal efforts of the stockholders.

Senator GEORGE. Mr. Stam, before you get to that and going back just 1 minute to the borrowed capital, suppose the taxpayer were given an option to include all of his borrowed capital, and exclude interest, or to exclude all borrowed capital and include the interest—would that operate unfairly to the small corporation?

Mr. STAM. Well, you mean if they were given the option to include—if they didn't have to do it unless they wanted to, or are they required to do it?

Senator GEORGE. No; they are given the option to include all the borrowed capital but exclude interest, or to exclude all borrowed capital and include interest. You can think that over if you have not got a ready answer.

Mr. STAM. I will have to think it over.

Senator GEORGE. I would like to know if that would affect adversely the small corporations that had to pay a higher rate.

Mr. STAM. That is right.

Senator GEORGE. The Treasury said this morning, you will recall, that that provision was in here, I mean the borrowed capital provision, because the large corporations, with well-established credit, borrowed at a very low rate and could get 6 or 8 or 9 percent, whatever prior earnings were authorized, on the invested capital basis.

The CHAIRMAN. Mr. Stam, that question was asked of Mr. Sullivan about taxing under both systems, the average earnings provision or the capital invested plan, and, say, put a corporate tax of 3 percent on all of them, that would include all the corporations. How much money would you get from that?

Mr. STAM. You would get about 200 and something million from just the 3-percent tax on all corporations; is that what you mean?

The CHAIRMAN. Yes.

Mr. STAM. You would get about $234,000,000.

Senator GEORGE. Increasing the normal by that?

Mr. STAM. That is right.

The CHAIRMAN. Would we get about as much money that way as some other little changes which I don't think would count much, and get as much revenue as this House bill?

Mr. STAM. I think you probably would. If you had a 3-percent increase in normal, and eliminated, you mean, your 4.1?

The CHAIRMAN. Yes.

Mr. STAM. I think you would.

The CHAIRMAN. On the same basis as the capital invested corporations?

Mr. STAM. That is right.

Senator DAVIS. How much revenue will this bill raise as it is now?

Mr. STAM. It is estimated by the Treasury to raise about $305,000,000 for 1940. They gave no estimate for 1941.

Senator DAVIS. What is their estimate for 1941?

Mr. STAM. They have given none.

The CHAIRMAN. What is your estimate for 1941?

Mr. STAM. If business picks up around 20 percent, between 18 and 20 percent, which it looks like it is going to do now, we figure that you ought to get at least $700,000,000 for 1941, out of this bill.

The CHAIRMAN. You say "We"; who do you mean by "We"?

Mr. STAM. The staff of the committee.

Senator GEORGE. The Treasury, while it didn't estimate the revenue under this bill for 1941, did submit an estimate that if there was an increase in business of 10 percent, 15 percent, and 20 percent, the results would be so much.

Mr. STAM. The Treasury gave this statement that if there is a 10 percent increase in statutory net income of each corporation in 1941 over 1940, that the bill will produce $530,000,000; if there is an increase of 15 percent, it will produce $640,000,000; and if there is an increase of 20 percent, it will produce about $750,000,000.

The CHAIRMAN. Do you think those are conservative figures?

Mr. STAM. I think they are fairly conservative. But from such an analysis as we have been able to make it looks like there will be about a 15 to 18 percent increase in 1941, and therefore we feel that the bill should produce somewhere in the neighborhood of $700,000,000 in 1941.

Senator DAVIS. Considering the expenditures of today, and how free we are for voting it out, that doesn't mean anything compared to the tremendous outgo.

Mr. STAM. Of course, that is going to increase in 1942 over 1941, because everything is on the upward trend, you see, and 1942 is going to be much greater than 1941.

Senator BYRD. You mean by that, that the total of the net taxable income of course will be increased by 18 percent?

Mr. STAM. Yes; assuming an arbitrary increase.

Senator BYRD. I mean do you agree with that statement?

Mr. STAM. An increase in net income of each corporation, of the corporations, your statutory net income; if that is increased by these percentages, then they say you will get that much from the bill.

Senator BYRD. But I understood you to say that you thought the increase would be from 15 to 18 percent?

Mr. STAM. That is right. The Treasury has not given any figure on that because they are not saying whether that increase is going to occur in 1941 or 1942.

Senator BYRD. Based on 20 percent it will bring in $750,000,000 a year?

Mr. STAM. Based on 20 percent; that is right.

Senator BYRD. Of course, I don't suppose you could calculate this but what percentage of these so-called war industries is going to be completely exempt from this excess-profits tax by reason of the amortization provision? I am perfectly willing to vote for an excess-profits tax that is placed on those that make profit, but as I see it, quite a large percentage is going to be exempted?

Mr. STAM. I don't think so many of them will be exempt because I think they are going to make profit in excess of the amortization allowance in the next few years.

Senator BYRD. But they will be exempted to the extent of 20 percent of their plant investment?

Mr. STAM. Yes; but we had a 25-percent allowance under the 1918 act by regulation, and we allowed 25 percent of the cost to be taken off annually for amortization; and in spite of that we secured a lot of money out of the excess-profits tax. So I feel that we are going to get quite a lot of money from——

Senator BYRD (interposing). Do you think by reason of the different methods of making these contracts—and it was said here today that they were not going to pay an exorbitant price on any contract—that the profits would be considerably in excess of the amount of the amortization?

Mr. STAM. That is a mere guess, but it looks to me as if we would get quite a lot of money in the next 5 years even from the Government contracts.

Senator BYRD. You think that difference is due to the war profits?

Mr. STAM. Well, I think to some extent.

Senator BYRD. The United States Steel Corporation has been brought up before. Their excess profits tax will not be very large, will it, because they have such a large invested capital?

Mr. STAM. I have just seen Moody's, I haven't got any official figures, but it looks to me as if the United States Steel Corporation invested capital is somewhere around $1,300,000,000, which would make about $65,000,000 exemption before the tax applied.

The CHAIRMAN. What do you think of the idea of putting an additional excess-profits tax on those that are going to make the profits out of these large expenditures we have authorized, or war contracts with the Government?

Mr. STAM. Well, that is something that we did in 1918 and 1921, we had a special higher rate on the income arising from Government contracts.

The CHAIRMAN. How much higher, 10 percent, wasn't it?

Mr. STAM. It was much higher than that; you had a war-profits tax——

The CHAIRMAN (interposing). Insert in the record in this connection that provision of the law.

Mr. STAM. I will be glad to.

We took the income of the corporation and we allocated that part of the income which was derived from Government contracts, and then we applied a certain rate of tax to the allocated income from the Government contracts, which of course taxed them at a much higher rate than the income from ordinary business. This provision, found in section 301 (c) of the Revenue Act of 1918, imposes upon the income from Government contracts so allocated a tax at rates graduated from 30 to 80 percent.

(Sec. 301, Revenue Act of 1918, is as follows:)

SEC. 301. (a) That in lieu of the tax imposed by Title II of the Revenue Act of 1917, but in addition to the other taxes imposed by this Act, there shall be levied, collected, and paid for the taxable year 1918 upon the net income of every corporation a tax equal to the sum of the following:

FIRST BRACKET

30 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET

65 per centum of the amount of the net income in excess of 20 per centum of the invested capital;

THIRD BRACKET

The sum, if any, by which 80 per centum of the amount of the net income in excess of the war-profits credit (determined under section 311) exceeds the amount of the tax computed under the first and second brackets.

(b) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation (except corporations taxable under subdivision (c) of this section) a tax equal to the sum of the following:

FIRST BRACKET

20 per centum of the amount of the net income in excess of the excess-profits credit (determined under sec. 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET

40 per centum of the amount of the net income in excess of 20 per centum of the invested capital.

(c) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation which derives in such year a net income of more than $10,000 from any Government contract or contracts made beeteen April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in subdivision (a) as the part of the net income attributable to such Government contract or contracts bears to the entire net income. In computing such tax the excess-profits credit and the war-profits credit applicable to the taxable year shall be used;

(2) Such a portion of a tax computed at the rates specified in subdivision (b) as the part of the net income not attributable to such Government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such Government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such Government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

Senator ADAMS I wanted to inquire whether or not in your hearings you have had any presentation of the problems that arise out of the development of mining properties? We have, for instance, in our State——

The CHAIRMAN. We have some gentleman who is coming in to discuss that tomorrow.

Senator ADAMS. There is one man here who happens to be an owner of one of the properties and has the matter in hand. Would there be an opportunity for him to be heard?

The CHAIRMAN. What is his name?

Senator ADAMS. Mr. Ward E. Terry.

The CHAIRMAN. We heard several on that subject in the joint hearings before.

Senator ADAMS. Mr. Terry was not heard before, and he is in the room and that is the reason I am asking. He is from Colorado.

The CHAIRMAN. We will try to get to Mr. Terry tomorrow. We have about 45 listed, but we will try to work him in. I presume he is going to be as brief as possible.

Senator ADAMS. More than that, sir. [Laughter.]

Mr. STAM. Now, if a corporation has a net income of not more than $5,000 for its full taxable year, it will pay no excess-profits tax at all. This will exempt all but approximately 70,000 corporations of the country. Corporations exempt from the income tax, that is religious corporations, charitable corporations, and educational organizations, don't have to pay this tax. They are exempt.

Personal holding companies are exempt from the excess-profits tax.

Now, those corporations are already subject to very high surtax rates on their undistributed income.

The CHAIRMAN. I don't think you need to discuss that, I think the committee understands that.

Are there some questions particularly that any member of the committee would like to ask Mr. Stam?

Senator GEORGE: I would like to have Mr. Stam's statement put into the record in full.

The CHAIRMAN. Of course. Are there any particular points in there further that you think ought to be stressed?

Mr. STAM. I don't think so. We have taken up the amortization provision pretty thoroughly and discussed that, and we have discussed in a general way the reorganization provisions; we will put a statement on that in the record.

So that will be all.

The CHAIRMAN. The complete statement of Mr. Stam will be inserted in the record at this point.

(The statement is as follows:)

STATEMENT OF COLIN F. STAM, CHIEF OF STAFF OF THE JOINT COMMITTEE ON INTERNAL-REVENUE TAXATION, BEFORE THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE, SEPTEMBER 4, 1940

1. *Excess-profits tax.*—The excess-profits tax under the bill applies to each taxable year beginning after December 31, 1939 (sec. 710 (a)). Thus, a corporation on the calendar-year basis will pay an excess-profits tax, beginning with the calendar year 1940. A corporation on a fiscal-year basis will pay an excess-profits tax for the first fiscal year beginning after December 31, 1939. For example, a corporation filing its income-tax returns as of the fiscal year ending June 30 will pay its first excess-profits tax for the fiscal year ending June 30, 1941.

The bill provides two different methods for computing both the excess-profits credit and the excess-profits tax, and allows the taxpayer which was in existence for the whole of the base period to elect the one to apply to its case. Each method is separately considered. For the purposes of this discussion, one is referred to as the "average earnings method" and the other, as the "invested capital method." A description of each method follows.

A. *Average-earnings method.*—The average-earnings method determines excess-profits by comparing the average income for a base period with the income of the taxable year. In general, where the income for the taxable year is in excess of the average income for the base period, such excess is deemed to be excess profits. The base period consists of the taxable years of the taxpayer beginning after December 31, 1935, and before January 1, 1940. In case a corporation is on the calendar-year basis, the base period will embrace the calendar years 1936, 1937, 1938, and 1939. In case the corporation is on a fiscal-year basis, the base period will embrace the fiscal years beginning after December 31, 1935, and before January 1, 1940. For example, if a corporation filed its income-tax returns on the basis of a fiscal year ending June 30, its base period will consist of the fiscal years ending June 30, 1937; June 30, 1938; June 30, 1939; and June 30, 1940.

This method has a great advantage in its simplicity. The corporation uses as its excess-profits-tax net income the same net income for both the base period and the taxable year as is used for normal income-tax purposes, subject to the following adjustments (sec. 711 (a)):

(1) The normal corporate income tax payable for the taxable year is allowed as a deduction (sec. 711 (a) (1))

(2) Gains or losses from the sale or exchange of assets held over a period of 18 months (depreciable or nondepreciable) are eliminated from income for the purpose of the excess-profits tax (sec. 711 (a) (2)).

(3) There is excluded income derived from the retirement or discharge of any of the bonds, debentures, notes, or certificates, or other evidences of indebtedness of a corporation, which have been outstanding for more than 18 months (sec. 711 (a) (3)).

In addition, the following adjustments are also allowed for the base period, but not for the taxable year:

(1) Deductions for losses arising from fires, storms, shipwreck, or other casualty, or from theft, not compensated for by insurance or otherwise are excluded.

(2) Deductions for expenses are diminished by payments to vendees of reimbursements to them of processing and other taxes under the Agricultural Adjustment Act of 1933.

The adjustments with respect to these abnormal nonrecurring items operate for the benefit of the taxpayer, since they increase the excess-profits-tax net income in the base period, thereby producing a greater excess-profits credit.

If a corporation has a deficit for 1 year in the base period, the income for the other years of the base period is not reduced in arriving at the average base period income. If there are deficits in more than 1 year in the base period, the aggregate income for the others years is reduced by all such deficits, except the one for the year in which the greatest deficit occurred. But in all such cases, the aggregate so determined is divided by the total number of years in the base period. For example, corporation "X" showed the following in the base period:

1936, excess-profits net income	$300,000
1937, excess-profits net income	200,000
1938, deficit	−150,000
1939, deficit	−100,000

By eliminating the greatest deficit, namely $150,000, it is found that the aggregate net income for the base period is $400,000. Dividing this amount by the number of years in the base period, the average excess-profits tax net income for the base period is $100,000.

Corporations entitled to the average earnings methods are also entitled to have their average base period net income (the excess-profits credit) increased by 8 percent of the net additions to capital, but they must also reduce this figure by 6 percent of the net capital reductions. This provision is designed to encourage capital additions. It is similar to provisions contained in Great Britain and Canada where the average earnings plan is applied.

Capital for this purpose includes the aggregate of the amounts of money and property paid in for stock, or as paid-in surplus, or as a contribution to capital after the beginning of the first taxable excess-profits tax year. It does not include earnings or profits reinvested in the business. This allowance for new capital is denied where such capital is invested in obligations any part of the interest of which is excludible from gross income or allowable as a credit against net income. It also does not apply to corporate stock since dividends therefor are excluded from income. Capital reductions are defined as distributions to shareholders which are not out of earnings or profits. For example, if a corporation raises capital by the issuance of stock, it will be able to increase its base period net income by the amount of such capital, less any distribution to the shareholders not out of earnings or profits.

The taxpayer's excess-profits-tax net income for the taxable year is reduced by the following:

(1) The average base period net income (the excess-profits credit), and

(2) A specific exemption of $5,000.

The result is defined by the bill as the adjusted excess-profits net income, which is the base upon which the tax is computed.

For the privilege of electing the average earnings method, the taxpayer is required to pay higher rates of tax.

Every corporation electing the average earnings method must pay an additional excess-profits tax of 4.1 percent on its normal-tax net income. In arriving at its excess-profits-tax net income, the taxpayer is allowed to deduct the normal tax. However, the tax resulting from the application of this 4.1 percent rate is not deductible in computing the excess-profits-tax net income.

In addition to the tax of 4.1 percent, a higher rate schedule is applied to corporations electing the average earnings method than is applied to corporations electing the invested capital method. The following tables show the difference in the rate schedules under the two methods:

Adjusted excess profits net income	Average earnings method	Invested capital method	Adjusted excess profits net income	Average earnings method	Invested capital method
	Percent	*Percent*		*Percent*	*Percent*
First $20,000	25	20	Next $150,000	40	35
Next $30,000	30	25	Next $250,000	45	40
Next $50,000	35	30	Over $500,000	50	45

It will be seen that in addition to the 4.1 percent tax imposed for the privilege of electing the average earnings method, the taxpayer electing this method is subject to an increase of 5 percent in each rate bracket. The following example will show how the tax is computed under the average earnings method:

Normal-tax net income		$3,000,000
Excess-profits tax net income		2,000,000
Base period average net income	$500,000	
Specific exemption	5,000	
		505,000
Adjusted excess-profits net income		1,495,000
Excess-profits tax:		
Under graduated schedule:		
25 percent of $20,000	$5,000	
30 percent of $30,000	9,000	
35 percent of $50,000	17,500	
40 percent of $150,000	60,000	
45 percent of $250,000	112,500	
50 percent of $995,000	497,500	
		701,500
Under flat rate (4.1 percent of $3,000,000)		123,000
Normal tax (20.9 percent of $3,000,000)		627,000
Total income and excess-profits tax		1,451,500

B. *Invested capital method.*—If the taxpayer elects, or, in the case of a taxpayer not having the election privilege, is forced to use the invested capital method of computing its excess-profits credit, it determines the portion of its earnings to be considered "excess profits" by comparing the ratio of earnings to invested capital for the taxable year with a similar ratio during the base period. If a corporation earned 8 percent on its invested capital during the base period, it is allowed a tax-free return of 8 percent on its invested capital for the taxable year. If, however, its earnings for the base period exceeded 10 percent of its invested capital, its tax-free return for the taxable year cannot be greater than 10 percent of its invested capital for such year.

For corporations with low earnings during the base period, a floor is established by permitting a minimum tax-free return of 7 percent on the first $500,000 of invested capital for the taxable year and 5 percent on such capital above $500,000. In addition, this method allows a further minimum tax-free return with respect to new capital acquired after the beginning of the taxpayer's first taxable year, of 10 percent to the extent such new capital does not cause the total invested capital to exceed $500,000, and 8 percent on new capital in excess of that figure.

For the purpose of measuring this new capital, the bill establishes a figure termed the "lowest invested capital," which is the invested capital as of the beginning of the taxpayer's first taxable year or, if the invested capital for any subsequent year is lower, the invested capital for such subsequent year.

For example, a corporation on a calendar-year basis had on January 1, 1940, the beginning of its first taxable year under the excess-profits tax, an invested capital of $100,000. In 1941 its invested capital had increased to $150,000. This $50,000 increase would be considered as new capital and allowed a return of 10 percent. In 1942 its invested capital was $130,000, or $20,000 less than 1941, but still $30,000 more than in 1940. This $30,000 would still be regarded as new capital as it is in excess of the measure established by 1940. However, if in 1943 the invested capital were to be reduced to $65,000 this figure would replace the $100,000 figure for 1940 as the measurement of new capital. That is, for years subsequent to 1943 any invested capital in excess of $75,000 will be considered as new capital until a new low is established. The somewhat complicated language on pages 18, 19, and 20 of the bill is simply effectuating these rules. The method of statement used, while it may be a little confusing to the person reading the bill as a whole, is justified by the draftsmen on the grounds that it will be much easier for the taxpayer as it can, by reference to the various combinations of variables given, ascertian immediately the one in which its own case falls and need look no further.

A corporation which was in existence during its entire base period ascertains the ratio of its base period earnings to its base period invested capital by taking the totals of each for the entire period. Where the corporation was in existence during only a part of its base period, the necessary factors for the part during which it was not in existence are supplied by filling in the blank years with the same invested capital with which the corporation began its first taxable year in 1940, and by giving it a hypothetical return on such supplied invested capital equal to 10 percent on the first $500,000 thereof and 8 percent on the balance. This hypothetical experience for the portion of the base period in which the taxpayer was not in existence is then added to its actual experience for the portion in which it was in existence for the purpose of determining the ratio of its earnings to its invested capital.

For example, corporation A came into existence on January 1, 1938. It had an invested capital as of January 1, 1940, of $800,000 and keeps its books and accounts on a calendar-year basis. It had an average invested capital and excess-profits net income for the portion of the base period during which it was actually in existence as indicated. These factors for the portion of the base period during which it was not in existence are supplied as follows:

Year	Invested capital	Excess profits net income	Base-period percentage
1936	*$800,000	*$74,000	
1937	*800,000	*74,000	
1938	650,000	45,500	
1939	700,000	63,000	
Total	2,950,000	256,500	8.7
1940	800,000		

The amounts marked by an asterisk (*) do not represent the actual experience of the corporation but have been supplied by the invested capital for 1940, upon which a yield of 10 percent for the first $500,000 and 8 percent on the balance is assumed.

Thus, the portion of the earnings for the taxable year in excess of an amount equal to 8.7 percent of the invested capital for the taxable year is considered excess profits and, after being reduced by the specific exemption of $5,000, is subject to tax.

Where in one of the years in the base period a corporation had a deficit (that is, where the deductions plus the credit for dividends received, exceed the gross income) the base period earnings are not reduced thereby.

If there were deficits in more than one year, only the greatest of such deficits is so disregarded.

The excess-profits net income for the purposes of the invested capital method is the same as that used for the average earnings method except two further adjustments are added to those already described.

Where the invested capital method is used, both for the years in the base period and the taxable year, the normal tax net income is further adjusted by—

(1) Increasing the credit for dividends received to 100 percent and making it applicable to dividends on stock of all corporations, whether domestic or foreign, except dividends (actual or constructive) on stock of foreign personal holding companies, and

(2) Reducing the reduction for interest paid or accrued by an amount which is the same percentage of so much of such interest as represents interest on borrowed capital (as defined in the bill) as the borrowed invested capital (as defined in the bill) is of the total borrowed capital.

The purpose of this latter provision is to exclude from the interest deductions the interest on the portion of the borrowed capital which is to be included in invested capital.

The excess-profits net income, which is the result of all of these adjustments to the normal-tax income, is then reduced by:

(1) The excess-profits credit, and

(2) A specific exemption of $5,000.

The result is defined as the adjusted excess-profits net income and is the figure to which the tax applies.

Under the invested capital method, the graduated rates are 5 percent smaller in each bracket than the rates applicable under the average earnings method. In addition, a taxpayer using this method is not required to pay the additional

4.1 percent on its normal-tax net income as must the taxpayer choosing the average earnings method.

The following example will demonstrate the computation of tax under the invested-capital method:

Normal-tax net income		$3,000,000
Excess-profits net income		2,000,000
Invested capital	$6,250,000	
Base period percentage	×8	
Excess-profits credit	$500,000	
Specific exemption	5,000	
		505,000
Adjusted excess-profits net income		1,594,000
Excess-profits tax:		
20 percent of $20,000	$4,000	
25 percent of $30,000	7,500	
30 percent of $50,000	15,000	
35 percent of $150,000	52,500	
40 percent of $250,000	100,000	
45 percent of $995,000	447,750	
		626,750
Normal tax (20.9 percent of $3,000,000)		627,000
Total income and excess-profits tax		1,253,750

Invested capital.—The bill provides a computation of invested capital on a daily basis. While this means that the invested capital for each day must be ascertained, it does not require as many bookkeeping details as at first appear likely. The factors involved are of a fairly constant nature and corporation records should prove adequate to enable a daily computation to be effected at the close of the year. The daily method is used because it more clearly reflects the average for the year. In addition, it prevents tax avoidance through the building up of artificial peaks of invested capital which could be done effectively if such capital were measured at certain arbitrary dates throughout the year.

The daily invested capital is the sum of the following items:

(1) Money paid in for stock, or as paid-in surplus, or a contribution to capital.

(2) Property likewise paid in. For the purpose of measuring the investment made by the paying in of property, such property is taken at its unadjusted basis for determining loss upon sale or exchange. The unadjusted basis is used because the adjustments to basis, principally the item of depreciation, are already reflected in the earnings and profits account of the corporation. For this reason, adjustments made prior to the time the property was paid in are allowed, while those made subsequently are disregarded. In order that all transactions involving the paying in of property may be treated alike, regardless of the time paid in and regardless of the provisions of the tax laws then applicable, the basis of such property is taken at cost, without regard to valuations as of March 1, 1913. Moreover, to insure measurement by a constant standard, it is assumed that the property so paid in has never been disposed of so that the present revenue law applies a constant standard of treatment regardless of the rules which may have been in effect when the property was actually disposed of.

(3) Taxable stock dividends, to the extent they have diminished the earnings and profits other than earnings and profits of the taxable year, are included in invested capital. In order to have diminished the earnings and profits account such dividends must have been taxable to the recipient; otherwise they are still reflected in earnings and profits and do not have to be added as paid-in capital in order to be included in invested capital. Such dividends are, in effect, a reinvestment by their recipient in the corporate business.

(4) The accumulated earnings and profits as of the beginning of the taxable year. Those stock dividends, which under the income-tax law do not diminish this account, are, thus, continued to be included and to count them again under (3) would be a duplication. If there is a deficit in the earnings and profits account as of the beginning of the year, the invested capital is not reduced thereby.

The sum of these four items is then reduced by the following amounts: (a) Distribution made during previous years which were not out of accumulated earnings and profits, and (b) distributions previously made during the taxable year not out of the earnings and profits of such year.

In order to plug an obvious loophole, the bill provides that distribution made during the first 60 days of any taxable year after 1940, to the extent they do not exceed the accumulated earnings and profits as of the beginning of such year, are considered to have been made on the last day of the preceding taxable year.

The result of these computations constitutes the equity invested capital for any day. To such figure is added the amount of the borrowed invested capital for such day. Borrowed capital is so much of the taxpayer's indebtedness as is evidenced by a written promise to pay. The amount of such borrowed capital which may be included in invested capital is limited to a series of percentages of such capital, depending upon the amount of the equity invested capital. These percentages are as follows:

(1) Where the equity invested capital is less than $100,000, there may be included 100 percent of that portion of the borrowed capital necessary to bring the invested capital to $100,000; 66⅔ percent of the next $900,000 of borrowed capital, and 33⅓ percent of the remainder.

(2) Where the equity invested capital is $100,000 or more, but less than $1,000,000, 66⅔ percent of that portion of the borrowed capital which does not exceed the difference between the equity invested capital and $1,000,000, and 33⅓ percent of the remainder of the borrowed capital.

(3) Where the equity invested capital is $1,000,000 or more, 33⅓ percent of the borrowed capital.

For example, if the equity invested capital of a corporation is $60,000, it is allowed to include $40,000 of its borrowed capital at 100 percent, $900,000 at 66⅔ percent, and all remaining borrowed capital at 33⅓ percent.

If the equity invested capital is $400,000, the taxpayer may include $600,000 of its borrowed capital at 66⅔ percent, and the remainder at 33⅓ percent.

If the equity invested capital is $1,000,000 or more, all borrowed capital is included at 33⅓ percent.

The amount of the borrowed capital so allowed to be included in the invested capital is defined by the bill as the "borrowed invested capital."

Average invested capital.—Thus, the invested capital for any day is ascertained by adding together the equity invested capital and the borrowed invested capital for such day. For the purpose of determining the average invested capital for the taxable year, these daily amounts for each day in the year are added and the result is divided by the number of days in the year.

Admissible and inadmissible assets.—The average invested capital so computed is reduced by an amount which is the same percentage of the average invested capital as the "inadmissible assets" are of the total of admissible and inadmissible assets.

"Inadmissible assets" are those assets, the income from which is not included in the excess-profits net income. These include (1) corporate stocks, and (2) governmental securities. Since the yield from such assets is not subject to excess-profits tax it is thought that the assets themselves should be excluded from invested capital. They are not deducted directly, however, for the reason that the total of admissible and inadmissible assets is not ordinarily equal to the invested capital.

As an example of the application of the inadmissible assets ratio, assume corporation A has the following:

Average invested capital		$2,000,000
Inadmissible assets	$600,000	
Admissible assets	1,200,000	
Total assets	1,800,000	
Ratio of inadmissible assets to total assets, one-third.		
The average invested capital would, thus, be reduced by one-third or		666,667
Invested capital		1,333,333

If a short-term capital gain is realized during the year with respect to the sale of an inadmissible asset, such gain, of course, is included in income for excess-profits tax purposes. In such cases an adjustment is made which, in effect, divides such asset into two parts. The portion to which the taxable income is allocable is deemed to be admissible and the portion to which the nontaxable income is allocable is deemed to be inadmissible.

For example—Corporation A, in the middle of its taxable year, sells a share of corporate stock upon which a short-term capital gain of $6 is realized. During the portion of the taxable year before such sale a dividend of $4 on this share of stock was received. Corporation A's income from this stock for the year is, thus, $10—$6 of which is taxable and $4 of which is nontaxable. Assume that the adjusted basis of such stock is $100. Then, $60 thereof would be admissible and $40 inadmissible.

Foreign corporations.—The bill applies special rules to foreign corporations.

(1) A foreign corporation not engaged in trade or business in the United States and not having an office or place of business therein is not subject to the excess-profits tax. Under existing law, these corporations are taxable only upon their dividends, interest, or other fixed or determinable periodical or annual income, and they are subject to a tax of 16½ on such income. This is subject to existing treaty provisions. Since this tax is withheld at the source, it is difficult to measure the excess-profits tax on these corporations.

(2) A foreign corporation engaged in trade or business within the United States or having an office or place of business therein is subject to the excess-profits tax. Under existing law, the rate of normal income tax on these corporations is 20.9 percent. In the case of such corporations which were in existence during the entire base period, they are required to take the average earnings plan. However, such corporations are not permitted any adjustments for additions to or reduction in capital.

If a foreign corporation was not in existence during the entire base period, the tax is computed under the invested capital method but only such assets as the corporation has in the United States are taken into account, since such a foreign corporation is taxed only upon its income from source within the United States.

Domestic corporations not engaged in business within the United States.—A special rule is applied to a domestic corporation if 95 percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year was derived from sources outside the United States and if 50 percent or more of its gross income for such period was derived from the active conduct of a trade or business. Such a corporation is exempt from the excess-profits tax.

Air-mail contracts.—A special provision was also applied to air-mail companies which transport air mail. Under the present law, these companies are paid by the United States on a scale determined with reference to their earnings from other sources. These air-mail subsidy amounts, when included in gross income, might result in their having an excess-profits net income. The amendment exempts these companies for the excess-profits tax, if by excluding the subsidy in any year, they would have no excess-profits tax to pay for that year.

Special cases.—In cases where the equity invested capital cannot be determined, because, for example, the corporate records have been destroyed by fire and cannot be satisfactorily reconstructed, section 721 of the bill provides that the equity invested capital may be ascertained by reference to the adjusted basis of the assets, plus cash, then held by the taxpayer, reduced by the amount of the outstanding indebtedness.

Personal-service corporations.—The bill defines a personal-service corporation to be "a corporation whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the owners at all times during the taxable year at at least 80 percent in value of all of the stock of the corporation, and in which capital is not a material income-producing factor." These corporations are further limited by the exclusion of foreign corporations and other corporations 50 percent or more of whose gross income consists of gains, profits, or income derived from trading as a principal.

For the purposes of determining the relation between the stock ownership and the activities of the shareholders in the corporate business, the stock owned by the wife or minor children of an individual engaged in the active conduct of the affairs of the company, is considered as being owned by such individual.

Credit for foreign taxes.—The bill also allows a corporation a credit for foreign taxes paid or accrued during the taxable year to any foreign country or possession of the United States. This credit is now allowed for income-tax purposes, but only to the extent of the American tax upon the income from such country or possession. If the American-tax rate is 20.9 percent and the foreign-tax rate is 25 percent only a part of the foreign tax is allowed. Such a credit is believed necessary to place our American corporations on an equal competitive basis with foreign corporations located abroad.

Merchant marine provisions.—Under section 508 of the Merchant Marine Act, as amended, profits in excess of 10 percent of the total contract price of contracts and subcontracts completed within the taxable year by shipbuilders are recaptured by the Maritime Commission. This excess is placed in a revolving construction fund which is available for further ship construction. This has the effect of reducing amounts which otherwise would be required to be appropriated from time to time by Congress for Maritime Commission shipbuilding.

In order to protect shipbuilders, machinery manufacturers, and others engaged on Maritime Commission contracts from being subject both to the profit-limiting provisions of the Merchant Marine Act and the excess-profits tax, the taxpayer is allowed the alternative of including in his income the entire profit from the contract instead of only the 10 percent permitted to be retained by him under the provisions of the Merchant Marine Act. Against the tax so computed, a credit is allowed of the amounts recaptured in respect of the taxable year by the Maritime Commission. This alternative tax applies if, and only if, it is less than the tax that would result from the inclusion in income of only 10 percent of the profits derived from such contracts.

Reorganizations and exchanges.—As we have seen from an analysis of the excess-profits credits provisions, the election to use the average-earnings method of computing such credit is dependent upon the taxpayer's having been in existence for the whole of the base period. Under supplements A and B of the bill, however, this privilege is extended to those corporations which, while themselves not actually in existence during this period, are, as a result of certain tax-free exchanges or reorganizations, the descendants of corporations which were in existence during the base period.

Supplement A—Average-earnings method.—This supplement extends the privilege of using the average-earnings method of computing the excess-profits credit to four classes of corporations, which, were this supplement not in the bill, would be forced to compute the excess-profits credit on the basis of invested capital. These four classes of corporations are as follows:

(1) Where corporation A, a New Jersey corporation, desires to move across the State line into Delaware: The usual method of accomplishing this result is for corporation A to create a new corporation T in Delaware and to transfer to such new corporation all of the assets of the old New Jersey corporation in exchange for the stock of the new corporation. In such cases the Delaware corporation is, for all practical purposes, identical with the old New Jersey corporation except in name and the State of its charter. It is felt desirable, in such a case, to allow the new corporation to use the experience of the old corporation and to elect the average-earnings credit; if the old corporation would have been entitled to such election had no such change occurred.

(2) If corporation T desires to absorb corporation B, a method frequently used is for T to acquire 80 percent or more of the stock of B and then liquidate B, taking over its assets in the process. This type of transaction is provided for in section 112 (b) (6) of the Internal Revenue Code and is generally described as a liquidation. In such a case, if T had not been in existence for the entire base period but B had, T would be allowed to elect the average earnings method and in computing its average income for the base period, could include the income of B. However, T could not use its own income for this purpose prior to the time the liquidation occurred. If T, itself, had also been in existence for the required period, it could, of course, use both its own experience plus that of its similarly qualified component.

(3) Another frequently used method of absorbing another corporation is by merger. In this case, corporation B is merged into corporation T. It is similar in result to the liquidation case but is covered by a statutory definition as to just what constitutes a merger. In cases of this type, supplement A makes the same provision as that applicable to the liquidation case.

(4) In both the merger and the liquidation case, one of the corporations involved continue in existence after having absorbed the other. In the case of a statutory consolidation, however, this is not true. Corporations X and Y consolidate and form corporation T, the taxpayer, and both corporations X and Y pass out of existence. In such a case, supplement A provides that corporation T, no matter when the consolidation took place, may elect the average earnings method if either of its components was in existence during the entire base period. It can use, however, only the experience of its components which were so in existence or had predecessors which were similarly qualified.

It will be noted that only mergers, consolidations, and other similar cases are covered in supplement A, and that cases of split-ups and corporate divisions are excluded.

This entire supplement, unlike supplement B, is composed of relief provisions, designed to extend the election privilege to corporations not otherwise entitled to elect. For this purpose, the resultant corporation is entitled to use the entire history of such of its components as are properly qualified. In the case of a split-up or a corporate division, a similar treatment would allow each resulting branch to use the entire history of the parent in its undivided form. This would, of course, produce a very inequitable result from the Government's point of view and would constitute a serious loophole. If, upon examination, the committee desires to broaden this supplement to cover the split-up cases, it would seem desirable to work out a method of prorating the experience of the parent corporation among the branches resulting from the split-up.

Supplement B—Credit based on invested capital.—Unlike supplement A, this supplement has for its chief objective the closing of certain very serious loopholes by which large corporations by splitting up into groups of small corporations might reap undue advantages. In addition, it prevents the additional invested capital which may be acquired in certain tax-free exchanges from receiving the beneficial treatment accorded to new capital generally.

On the other hand, it extends relief by allowing the base period experience of all corporations which flow together during the base period to be used by the resultant corporation in the computation of its base period experience.

As an encouragement to small corporations, the bill allows them a more favorable treatment generally than is accorded larger corporations. In this connection, there are four variable factors, each of extreme importance in arriving at the amount of excess profits tax which will be payable. The variations in these factors depend upon the size of the particular corporation involved. These variable factors are—

(1) The minimum tax-free return on invested capital of 7 percent on the first $500,000 of invested capital and 5 percent on the invested capital in excess of $500,000.

(2) The minimum tax-free return which is allowed on new capital of 10 percent on the amount of new capital which does not cause the invested capital to exceed $500,000, and 8 percent on new capital above that figure.

(3) The graduated allowance of that portion of the borrowed capital to be included in invested capital, ranging from 100 percent to 33⅓ percent, depending upon the size of the invested capital.

(4) The graduated tax rates themselves, reaching the limit of graduation at $500,000 of adjusted excess profits net income.

Each of the factors confers a particular advantage upon the smaller corporations as compared with the treatment accorded larger companies. Taken all together, the composite advantage of all of these factors is very substantial.

By breaking up into a number of small component parts, a large corporation could gain all of these favorable treatments accorded smaller companies, except for the provisions of supplement B.

This supplement, while extremely complicated in its language, has for its objective the readily understandable function of limiting the corporations which result from a split-up to the same comparable advantages of size which their predecessor had in its undivided form.

If the predecessor could include borrowed money only at the least-favored percentage of 33⅓, the corporations resulting from the split-up are also limited to this percentage even though their invested capital is less than $100,000, and a portion, at least, of the borrowed capital would otherwise be includible at 100 percent.

If the predecessor could not have added new capital entitled to the more favored 10-percent rate, neither can the resultant corporations, no matter how small their invested capital may be.

In cases where several corporations flow together to become one, these variable items become the sum of the comparable items of each of the constituent corporations. Thus, the lowest invested capital of the resultant corporation is the sum of the lowest invested capitals of the component corporations. The same is true with respect to the equity invested capitals and the borrowed capitals. The base period percentage of the resultant corporation is the weighted average of the base period percentages of the constituent corporations.

As a result of the application of these rules in cases where corporations flow together, the resultant corporation has a status equal to the combined factors of all of its component corporations except for the consequences which flow from increased size alone.

Thus in split-ups size advantage is frozen at the limits to which the predecessor corporation is bound, while in combinations the resulting corporation is subject to the limitations generally applicable to its increased size.

Corporations exempt.—If a corporation has an excess-profits tax net income of not more than $5,000 for its full taxable year, it will pay no excess-profits tax. This will exempt all but approximately 70,000 corporations. However, if a corporation has an excess-profits tax net income of more than $5,000, it may be subject to an excess-profits tax even though its net income is below $25,000.

(1) Corporations exempt from the income tax are exempt from the excess-profits tax. This includes relgious, charitable, educational, and other organizations exempt under section 101 of the income-tax law.

(2) Personal holding companies are exempt from the excess-profits tax. These corporations are already subject to surtax rates on their undistributed net income as high as 75 percent.

(3) Foreign personal holding companies are also exempt. The income of these corporations is required to be included in the income of their shareholders, whether distributed or not.

(4) Mutual investment companies are also exempt. These companies are required to distribute 90 percent of their income.

(5) Diversified investment companies: These companies are subject to registration by Securities and Exchange Commission. Since the other type of investment companies is exempt, it was thought advisable to also exempt these companies, since they distribute practically all of their income and are subject to regulation.

II. SUSPENSION OF THE VINSON-TRAMMELL ACT

Title III, 301, of the bill suspends provisions of existing legislation, known as the Vinson-Trammell Act, limiting profits on contracts or subcontracts for the construction of naval vessels and Army and Navy aircraft. The suspension operates on such contracts or subcontracts entered into or completed in any taxable year during which the excess-profits tax imposed by the bill is in effect.

As stated in the Ways and Means Committee report on the bill, it was felt that since the proposed excess-profits tax will apply to all corporations, including corporations now subject to the special profit-limiting provisions of the Vinson-Trammell Act, such special provisions should not apply while the excess-profits tax is in force. The result will be uniformity of tax treatment of all abnormal profits arising from the national defense program, a program which involves the production of a much larger category of munitions of war than is comprehended in the legislation proposed to be suspended. The chairman of the Committee on Naval Affairs, moreover, stated in the House during the debate on the bill that subcontractors were not anxious to get business falling under the profit-limiting provisions of the Vinson-Trammell Act, and he strongly urged the suspension of those provisions during the existing emergency.

The profit-limiting provisions of the act, as originally enacted, related only to contracts and subcontracts for naval vessels and aircraft. Section 14 of the act of April 3, 1939 (53 Stat. 555, 560), extended the application of those provisions to Army aircraft. Contracts and subcontracts made after June 28, 1940, where the award does not exceed $25,000, are exempt from the profit-limiting provisions of the Vinson-Trammell Act; contracts and subcontracts made prior to June 29, 1940, where the award does not exceed $10,000, are exempt. One of the prerequisites to the making of a contract by the Secretary of War or the Secretary of the Navy is that the contractor or subcontractor shall agree to make no subdivision for the purpose of tax evasion. Contracts and subcontracts for scientific equipment used for communication, target detection, navigation, and fire control, are also exempt.

The amount of the net profit required to be paid into the Treasury is that portion of such net profit in excess of 8 percent of the total contract price and the net profit so recoverable by the Treasury is the net profit from all contracts and subcontracts completed within the income-tax taxable year of the taxpayer.

III. AMORTIZATION OF EMERGENCY FACILITIES

The bill provides that the cost of certain facilities, certified by the Advisory Commission to the Council of National Defense and either the Secretary of War or the Secretary of the Navy as necessary in the interest of national defense during the present emergency, may be amortized over a period of 5 years. Such facilities must have been constructed, installed, or acquired after July 10, 1940. The write-off of the cost of these facilities is in lieu of the regular deduction for depreciation and obsolescence provided under existing law.

Taxpayers have the option of taking straight depreciation or the accelerated depreciation here called "amortization." Those having elected the amortization deduction may, at any time they desire before the expiration of the 5-year period, or before the end of the national emergency, return to the straight depreciation method. If, before the 5-year period is over, the President proclaims the ending of the emergency, or the Secretary of War or the Secretary of the Navy certifies that a particular facility has ceased to be necessary in the interest of national defense, the taxpayer may elect to recompute the amortization deduction on the basis of the shortened period as so terminated, in lieu of the 5-year period.

The CHAIRMAN. Mr. Harry C. Carr. Is Mr. Carr here?

Mr. CARR. Yes, sir.

The CHAIRMAN. Mr. Harry C. Carr, vice president and treasurer of The Bayuk Cigars, Inc., Philadelphia.

Have you a brief?

Mr. CARR. A short one that I would like to read.

The CHAIRMAN. All right.

Mr. CARR. I think it is short enough, Senator, so that it will not clutter up the record too much.

STATEMENT OF HARRY C. CARR, VICE PRESIDENT AND TREASURER, THE BAYUK CIGARS, INC., PHILADELPHIA, PA.

Mr. CARR. This brief is addressed to you with reference to the proposed excess-profits tax law. It presents very briefly the effect of this law on my company and I believe it can be said would reflect likewise the effect of this proposed law on many other companies in a similar position to ours.

We are manufacturers of cigars. On January 1, 1933, we reduced the price of our principal brand, "Phillies," from 10 cents at retail to 5 cents at retail, thus practically completely reconstructing our business. Since that time our business has shown a continuous and important increase each year in volume of sales, in purchases of tobaccos from American farmers, in continuous employment of labor, and has resulted in increased profits each year. The operations for 1940 are likewise showing an increase in all these respects over the operations for 1939.

A schedule is attached herewith showing the principal figures in connection with these questions for the years 1936 to 1939, inclusive.

With the theory of requiring businessmen to pay to the Government in taxes a goodly proportion of the profits derived from war or the defense program, we are entirely in accord. We, furthermore, recognize the difficulty if not impossibility of translating this theory into a statute which will not result in inequities in certain cases. We have recognized that under the plans which have been discussed, as presented through the press in the past 2 months, our company would suffer such inequity. But we were perfectly prepared to accept it without complaint, as we endorse completely the principle of an effective defense program for the country.

However, the bill as passed by the House has, in our judgment, gone beyond all reasonable bounds in proposing what we believe to be a gross inequity toward us and companies who have, like ourselves, grown in the past few years. During those years, while it is true our profits have increased, we have, we believe, done a constructive job in the national economy by more than doubling the number of our employees in the last 6 years and by providing for some 8,000 to 9,000 farmers in Pennsylvania and Connecticut a profitable return on what is for them their most important crop and in increasing quantities each year.

Senator DAVIS. You have had practically continuous employment during these years, haven't you?

Mr. CARR. We have had absolutely continuous employment, Senator. We haven't had a lay-off period of even 1 week, except vacations with pay, since January 1933, and the number of our employees has increased from something like 1,800 at that time to over 5,200 at the present time.

Senator GUFFEY. Where are your plants located?

Mr. CARR. Our main plants are in Philadelphia.

To consider, as we would have to under the bill as passed by the House, our average profits for the 4 years, 1936 to 1939, inclusive, as a measure of normal profits and to treat anything in excess of that average as excess profits due to the defense program, is simply not true. While the time has been too short to make accurate calculations, it is manifest that under the bill as proposed our total Federal taxes—normal plus excess profits taxes—would be considerably more than doubled. It is quite clear that up to the moment at least no part of our increased sales could be attributed to the defense program.

It is quite possible that a portion of our increased sales and resultant profits from now on, during the course of the defense program, might be attributed to that program, and we would be willing to concede, insofar as this tax is concerned, that all such increase might be so attributed.

To carry out the theory of the excess-profits tax, we respectfully suggest accordingly that we and companies in a similar position to ours be allowed to use as a base, at our option, either the 1936 to 1939 4-year average, or the last year immediately preceding the incidence of this tax—that is to say, if the tax is enacted for the year 1940, we be allowed to use 1939 as the base; if the tax be enacted effective for 1941, we would be allowed to use 1940 as the base.

We believe that such a proposal is realistic and equitable and would truly reflect the theory underlying this proposed legislation.

I would like to add there, if I may, Senator, that you notice I have suggested not the option of any 1 year out of 4, because I can see considerable possibility for inequity, both ways, in that kind of a proposition.

We are not alone, there are thousands of other companies like ours, who have gone up in these past few years through pretty hard work.

The CHAIRMAN. Yes; we have heard that.

Mr. CARR. And to say that we should be pushed down the ladder there and say, "This is your normal and above that is excess profits due to the war, or due to the defense program," just doesn't seem quite a realistic statement of fact.

Senator DAVIS. Would you like to have this statistical matter inserted in the record?

Mr. CARR. If you please, Senator.

The CHAIRMAN. Mr. Stam, mightn't this come under relief provisions for abnormal conditions?

Mr. STAM. I think it might well come under abnormal conditions.

The CHAIRMAN. Thank you very much, Mr. Carr.

(The statistical data referred to is as follows:)

	1936	1937	1938	1939
Annual net sales	$15,136,393.68	$16,231,497.00	$16,649,211.16	$18,950,853.50
Annual average number of employees	4,352	4,550	4,782	5,215
Annual taxes paid to Federal Government:				
Revenue stamps	$850,135.30	$966,583.68	$967,405.28	$1,111,412.58
Social security	40,858.33	136,425.01	175,748.90	202,720.87
Income	175,229.47	179,452.14	244,994.95	372,151.84
Surtax	68,311.64	81,905.14		
Import tariffs	1,365,276.75	1,453,044.98	1,344,588.66	1,577,476.70
Capital stock	15,000.00	15,352.00	18,000.00	22,000.00
Total	2,514,811.99	2,832,762.93	2,750,735.79	3,285,761.79
Annual net profits	966,053.05	1,004,482.50	1,257,785.53	1,744,963.68
Average net profits for the 4 years				1,243,321.69
Average percentage of net profit on invested capital				14.35

NOTE.—Average borrowed capital computed on basis of 12-monthly instead of daily totals.

The CHAIRMAN. Is Mr. Terry here?

Mr. TERRY. Yes.

STATEMENT OF WARD E. TERRY, PRESIDENT OF THE SLIDE MINES, INC., OF DENVER, COLO.

Mr. TERRY. I am not appearing in behalf of any company, but I am a small gold-mine operator from Colorado. Our problem is the same as that of a great many other small mines out there; in fact throughout the whole western area.

About 7 years ago we started an operation out there. We have, like most mines, continually ploughed our earnings back into our companies. It would be very hard to show just what our invested capital is, but according to the present system of measuring excess profits there will be very little invested capital to be shown for the work we have done out there; not more than $70,000 as an average over the base period.

We have contributed something like $750,000 in pay roll and another $750,000 in goods bought in that area. Those communities are very dependent upon us. We have shown a loss up until the last year, each year. They haven't been big losses, we have either broken even or have showed a loss of about $4,000. Last year we showed a profit of $12,000, and this year we will show a profit of $50,000. That is the result of all of the years that we have spent in developing these properties. Our present income has nothing to do with the defense measures that are up in front of us, we are absolutely independent of them as we produce gold as our principal product.

In the last excess-profits tax that was imposed on the country, gold mining was exempted, and I believe justifiably so. The Government fixes the price of our product, we cannot sell it in the open market, we cannot get a higher price for that product in markets outside of this country, although the product itself is selling at a higher price in markets outside of this country. We are caught in this situation of having to face rising prices although we cannot in any way, shape, or manner pass those prices on to the purchaser as, I say, our price is set.

We need to use the money that we have made this year, to pay off debts that we have, instead of paying that out as excess-profits tax.

As the previous gentleman stated, there are a lot of companies that have shown a gradual increase in earnings due to normal growth which are penalized under this tax, and we are doubly penalized because we have a ceiling as to the price at which we can sell our product, as determined by the Government; and are faced with increased costs as a result of the armament program.

I might say this, that gold mining is tied up with the production of platinum, which is very essential in the war-minerals industry. Platinum is a byproduct of the refining of gold, and is frequently produced along with the production of gold.

But that is our situation briefly, gentlemen, and it is not only the situation of this company, but it is the situation of a great many mining companies, for instance little tungsten companies that might start up in that area as a result of the demand for an increased supply of tungsten. But there again in the tungsten market, the market price controls, which is not the case with gold. However, venture capital will not be available for opening new mines if an excess-profits tax is imposed.

Have I made my situation clear, briefly?

The CHAIRMAN. Yes; and if you want you can elaborate on your statement and give it to the reporter.

Mr. TERRY. Thank you, sir.

The CHAIRMAN. That must be done, however, right away.

Mr. TERRY. Thank you.

(The supplemental statement by Mr. Terry is as follows:)

SUPPLEMENTAL STATEMENT OF WARD E. TERRY, BEFORE THE SENATE FINANCE COMMITTEE, SEPTEMBER 4, 1940

I addressed the above remarks to the Senate Finance Committee unexpectedly and with no prepared statement, and I would now like to elaborate on the above remarks. Nearly all the precious and rare metal mines of the West are comparatively small operations, the aggregate of which and the amount of employment of which are very considerable. In most instances the operations are carried on over a number of years without any expectation of profit at all, or with very small profit, in order to do the necessary development work. This is largely because the mines are all undercapitalized due to the hardship of getting venture capital into such a hazardous enterprise. If, after a period of development, the expected body of ore is reached, a very substantial profit may be made for 1, 2, or 3 years, sufficient to pay the cost of the development work and with an expectation of a profit commensurate with the great risk of failure.

In the particular case of the gold-mining industry, none of the profits are made as a result, either directly or indirectly, of preparation for the national defense. As stated above, the price of gold is fixed and there is but one customer, the United States Government. The price of the product cannot be raised corresponding to the increased cost of labor, supplies, and taxes. In fact, we are adversely affected by the defense program, due to our increased cost from which we have no relief. In short, in the particular case of precious-metal mines, there is no relation between Government expenditure for preparedness and the comparatively large profit which may possibly be made after the operator gets into pay ore, after years of exploration and development work. Furthermore, in the case of small operators, the amount of pay ore is usually very limited.

No one would engage in a mining operation with its infinite risk of failure unless he saw the chance of a very large profit. If the Government, through an excess-profits tax, may declare that any large profit in 1 year might be largely taken away, no one would engage in the venture of developing a precious metal mining property. Those small mines now in operation would probably be closed down and their employees would be obliged to go on relief. The districts in Colorado dependent upon mining, the stores and all other business, would suffer correspondingly.

We should do all in our power to encourage the development of new sources of metallurgical materials within the confines of the United States.

Congress recognized this concretely by the passage of the Strategic Minerals Act of 1939. The proposed excess-profits tax with the imposition of severe taxes on the rewards on venture capital will scare such capital away from the industry. In other words, this tax will completely nullify the Strategic Minerals Act of 1939 and cause a cessation of new mining activity at the very time when we need all the mineral resources of the country at our disposal for both the Government and industry itself. Nor should there be a differentiation between the various types of metal. The relationship of the base metals to the strategic metals and the precious metals with strategic minerals are all close, such, for instance, as platinum being a byproduct of gold. Instead of hampering the development of new mines, would it not be better to encourage in every way possible the exploitation of our natural resources with the thought in mind that if there are any large profits to be derived therefrom, that these profits can be recaptured for the Government through an income tax rather than through the imposition of a penalty tax such as this excess-profits tax would impose. Such a program would not only be for the distinct advantage of the armament program now being undertaken, and the safety of the sources of raw materials in time of war when our sea lanes might be shut off, but would also cause the employment of thousands of men in the areas of the West who are wholly or partially dependent on the mining industry for employment. On the other hand, the imposition of an excess-profits tax on the mining industry would cause the closing down of many mines and great hardship throughout those mountain regions of the West which are dependent upon the mining industry as their main or only source of revenue.

The excess-profits tax places a disproportionately heavy burden on all growing businesses especially those businesses such as the mining company referred to in my statement before the Senate Finance Committee which has charged off in current operations all normal development. As a result, there can be shown a very small invested capital in the business. Such a company would be terrifically penalized under the average base period earnings as there was only 1 year of profit in the base period, all the other years showing deficits, and also under the alternative method of figuring excess profit on income and invested capital as the allowed invested capital is very small. Under the first method, the total excess-profits tax, normal income tax and Federal stock tax would amount to 41.5 percent of our total income and with other Federal and local taxes would amount to 58 percent of our total income. Under the second method, the excess-profits tax, normal income tax and capital-stock tax would amount to 35 percent of our total income which, with the addition of other Federal and local taxes, would bring the total amount of taxes we pay up to 52.5 percent of our total income.

As I understand it, the purpose of the present excess-profits tax is to recapture for the Government a proportion of the earnings of those contractors and subcontractors who are directly benefiting from the defense program. If the Treasury feels that a sufficient amount of the profits which those contractors receive will not be recaptured through the normal functioning of the Bureau of Internal Revenue, I suppose some sort of excess-profits tax might with reason be levied against these contractors. However there is no justification for permitting the excess-profits tax to be a general levy against business as a whole, especially against that inarticulate group of small businesses such as ours which have no relationship to the armament program.

I suggest that some sort of an exemption be worked out for those businesses which do not benefit in a tangible way from the armament program. This could be achieved by setting up an independent board of tax appeals, separate from the Bureau of Internal Revenue which would be definitely instructed to exempt such businesses as are not direct beneficiaries of the defense program. It is necessary that they be instructed definitely to make such exemption, as past experience has proved that it is sometimes more expensive to fight the Internal Revenue Bureau than it is to pay the tax originally assessed. Another method of handling this would be a blanket exemption of $50,000 for all corporations which are not contractors or subcontractors under the defense program. The latter provision would ease the burden on the small growing businesses. The exemption would not be sufficient to allow any millionaires to be made out of any general prosperity due to the defense program. In fact, more revenue would probably accrue to the Treasury under such an exemption through the normal functioning of the corporation and personal income taxes than would accrue to it under the present proposed excess-profits tax.

The CHAIRMAN. Dr. Doran?

STATEMENT OF DR. JAMES M. DORAN, WASHINGTON, D. C., REPRESENTING THE AMERICAN SPIRITS MANUFACTURING CO., NEW YORK, N. Y.

Mr. DORAN. Mr. Chairman and gentlemen, I will be very brief. What few remarks I wish to make relate to section 719, page 30, with respect to borrowed and invested capital.

The position of the company I represent, and I believe it is likewise true of many of the—

The CHAIRMAN (interposing). What company do you represent?

Mr. DORAN. The American Spirits Manufacturing Co. of New York, which own the largest rum distillery in Puerto Rico, one of the biggest taxpayers in the island.

Ordinary borrowed capital in an ordinary commodity manufacturing business is quite different from borrowed capital in the distilled-spirits industry. The great bulk of borrowed capital, especially on behalf of the weaker financial units, is capital necessary to finance the high tax now levied.

As near as I can see, Congress has seen fit to collect, through this channel or vehicle, something around $1,000,000,000 a year, and I suppose my few remarks are apropos to the brewing industry as well.

The collector of internal revenue won't take a 90-day note, he has to have cash on the barrel head. Goods are taken out, sold, and anywhere from 10, 20, 30, or 90 days elapses before the money comes back.

That is usually supported by liquid bank loans. It is borrowed capital. We believe the committee should give some relief to the distilled-spirits industry in this particular section and permit the interest and charges on bank loans to be deducted from a taxable income, otherwise the smaller and weaker units will be tremendously handicapped as against the large corporations who have ample cash resources in their treasury.

We believe that while it would be difficult to write a specific section that would take care of this, that should the committee in its judgment see fit to insert the special-case provision such as obtained in the 1918 and 1921 acts——

The CHAIRMAN (interposing). You think that might help you?

Mr. DORAN. I think it might help, but at least, as Senator Vandenberg suggested this morning, there would be a forum before which equitable cases could be presented. At least we could get a hearing.

Senator GEORGE. You would have a talking point.

Mr. DORAN. We believe we have got a very equitable point, and one we feel that was not intended at all. Ordinary borrowed capital for the current conduct of business—and we have it—should be separated from this charge on financing the Government's own tax.

The CHAIRMAN. Is that the only fault you have to find with the bill right now?

Mr. DORAN. Yes, sir; and I would like permission to elaborate on this.

The CHAIRMAN. We will give careful consideration to the thought. Personally, I may say I am for the idea. You may file a statement within the near future.

Senator GUFFEY. Your product is a straight product, not a rectified or blended product?

Mr. DORAN. This is a straight distillation I am talking about, but the tax is the same.

Thank you, gentlemen.

(The following letter was submitted by Dr. Doran:)

WASHINGTON, D. C.,
September 9, 1940.

Hon. PAT HARRISON,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

MY DEAR CHAIRMAN: Supplementing my brief statements on behalf of the American Spirits Corporation of New York City before your committee, I desire to specifically place in the record our situation under H. R. 10413 now under consideration by the Finance Committee.

My remarks were particularly directed to section 719, page 30, line 8, of H. R. 10413 with respect to "borrowed capital." The distilling industry, which is the vehicle through which the Congress and various State legislatures have provided for the collection of taxes amounting in the last fiscal year to over $1,000,000,000, is confronted with a serious problem with respect to "borrowed capital." The taxes levied on the products of this indusry are over 10 times the commodity value and the industry is thus in a very different situation than any other industry. The collector of internal revenue must be paid cash when any spirits are removed from Government bonded warehouses. These goods have to be bottled, cased, sold, and collections made from 10 to 90 days after delivery to the vendee. In order to finance this it is necessary to make use of a great amount of money which under the terms of this bill would come within the words "borrowed capital." This money must necessarily be secured from banks or other loaners as there is practically no distilling corporation in the United States, certainly not in the smaller units, which has sufficient treasury cash to finance the collection of this Government tax.

This "borrowed capital" is clearly differentiated from ordinary borrowed capital incident to the continuance of a commodity manufacturing business. In our case the purchase of corn, rye, and barrels, the meeting of pay rolls and such like is carried on in part by ordinary "borrowed capital." It may be possible to secure some relief from what is obviously an inequitable situation if the Congress will see fit to enact a provision providing for "hardship cases." However, any such provision if adopted should be broad enough to permit a taxpayer to come before some tribunal and recive equitable treatment despite the general wording of the act.

We ask relief in two ways: Specific elimination with respect to "borrowed capital" as to expenses incurred in financing tax, Federal and State, or enactment of a "hardship" section which will enable us to present our equitable situation to the tax-collection authorities.

May I say in conclusion that the corporation and all individuals expect to pay more taxes and will gladly do so under present conditions. With respect to the bill generally I think it is unfortunate that it omits a so-called hardship section and that it does not confine itself particularly to corporations which will hold Government contracts and subcontracts relating to the defense program. If it is desired to raise more revenue from corporations generally the existing rates in the present act should be raised. In any event I hope it will be possible to draw a bill "in language so plain that a wayfaring man, even though he be a fool, may not err therein."

May I think you and the committee for the courtesy extended to me and the people whom I represent.

Very truly yours,

J. M. DORAN.

The CHAIRMAN. Is Mr. Harding in the room?

Mr. KNOWLES. I am representing Mr. Harding.

The CHAIRMAN. You represent the Associated General Contractors of America, Inc.?

Mr. KNOWLES. Yes.

The CHAIRMAN. All right, you may proceed.

STATEMENT OF BERT L. KNOWLES, REPRESENTING THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA, INC., WASHINGTON, D. C.

Mr. KNOWLES. I am presenting a statement of Mr. Edward J. Harding, managing director of the association.

The CHAIRMAN. Can you present to the committee just the high points of it, and put the statement in the record?

Mr. KNOWLES. The whole thing won't take me 5 minutes.

The CHAIRMAN. All right, maybe we will save time that way.

Mr. KNOWLES. This presentation is to propose, for the consideration of this committee, a very short amendment to the "Proposed Second Revenue Act of 1940." This is made in behalf of the Associated General Contractors of America, Inc., composed of 2,500 of the Nation's foremost construction firms, who regularly perform more than 60 percent of the value of all contract construction work in the United States.

The association is represented in every State of the Nation by contractors performing all types of construction work. From communications received, it is evident that the proposal to be here offered is of vital importance to contractors in every part of the Nation.

From an examination of the provisions of the proposed Second Revenue Act of 1940 (H. R. 10413), it would appear that an unnecessary hardship will be worked on many contractors reporting (in accordance with the law and regulations) on a completed contract basis, unless the bill is amended in the Senate.

Under the income tax laws and regulations for a good many years past, taxpayers who undertook contracts running over a period of more than 12 months (so-called long-term contracts) have been allowed the option of reporting the prospective profit on such contracts in one of two ways:

(*a*) On a percentage basis, that is reporting the profit each year based on a percentage of the contract completed during such year.

(*b*) On a completed contract basis, that is reporting the total profit on the entire contract in the year of completion.

Due to special hazards of the construction industry, many contractors handling construction contracts requiring more than a year for completion have found it absolutely essential to their continued existence to elect to report their profits on a completed contract basis, for the reason that it can never be established until a given construction contract has been entirely completed whether the venture will result in a profit or a loss. Construction operations are subjected to all of the hazards of nature, as well as those of economic import such as labor relations, availability and prices of material, and so forth.

Many construction contracts of the long-term variety give every indication in their earlier stages of being profitable but unforeseen happenings very frequently turn such anticipated profits into severe losses.

It follows, therefore, that a contractor who has been working for, say, 2, 3, or 4 years, on a contract, which was or will be completed in 1940 or a later year, will report in such year the entire profit for the past 2, 3, or 4 or more years, if he has elected to report the profit on such contract on a completed-contract basis. Such entire profit must be included in his tax return and become part of "the normal tax net income" for the year 1940 or later year. And it is this amount which is used as a basis for assessing the next excess-profits tax under section 711, paragraph (a) of the bill.

Obviously such contractor, when he made his election to report on a completed-contract basis, could not anticipate the likelihood or necessity of the present emergency excess-profits legislation, and unless relief is afforded in the bill he will be compelled to pay (in addition to his normal tax) a high additional tax on even that portion of his profit earned prior to January 1, 1940. No relief is asked for or expected from the imposition of such high additional tax on that portion of his profit earned after January 1, 1940.

It is suggested that, to relieve this apparent injustice, the following paragraph might be inserted in H. R. 10413 under section 711 in two places, viz:

As subparagraph (D) on page 6, under (a) (1).

As subparagraph (F) on page 7, under (a) (2).

Long-term contracts reported on completed contract basis.—There shall be excluded in the case of a taxpayer reporting on the completed contract basis (under sec. 42 and regulations 19.42–4) who started work on a long-term contract prior to September 1, 1939, that percentage of the final profit realized from such long-term contract, which the value of the work completed through December 31, 1939, bears to the total contract price.

This proposed amendment, if adopted, will not deprive the United States of any income which it might otherwise have obtained should the contractor have reported on an annual basis. As a matter of fact the United States will receive more revenue by reason of the fact that the normal taxes applicable under this bill and the prior Revenue Act of 1940 are substantially higher than for previous years. Neither does this proposal discriminate against other taxpayers as no request is made for exemption from the excess-profits tax for work performed and profits earned after January 1, 1940.

Attention is called to the fact that the amendment here proposed introduces no new principle as section 711 (a) (1) B and C, and section 711 (a) (2) D and E all deal with classes of income which are to be excluded from excess profits net income. The proposal here offered is recommended for insertion at points immediately following those other subsections dealing with exclusions, to which reference has just been made.

This short amendment is being proposed after the most careful study and consideration of evidence received from many contractors from various parts of the Nation, demonstrating that unless a modification to the proposed bill is made, a great hardship is certain to result.

We sincerely trust that the justice of this proposal will merit your favorable consideration.

The CHAIRMAN. In other words, you want to get the payment of this on the installment plan?

Mr. KNOWLES. We don't want to be placed in the high brackets simply because we report no profit for several years and have to report it all at once.

Senator RADCLIFFE. You don't see any difficulty in prorating your profits over a period of time?

Mr. KNOWLES. In prorating them?

Senator RADCLIFFE. You say in attempting to allocate to previous years the suitable or desirable percent of profit——

Mr. KNOWLES (interposing). I don't think I understand your question.

Senator RADCLIFFE. You don't want to be charged with all of the profits if the contract extends for more than 1 year, extends over a period of several years; you don't want to be charged with all of the profits in the last year because you have actually earned a part of the profits in the preceding years?

Mr. KNOWLES. That is right.

The CHAIRMAN. I wish you would talk to Mr. Blough of the Treasury Department, because we will give every consideration to that.

Mr. KNOWLES. Thank you.

The CHAIRMAN. Is Mr. Blazer in the room?

Mr. BLAZER. Yes.

The CHAIRMAN. Mr. Blazer is president of the Ashland Oil & Refining Co., Ashland, Ky.

STATEMENT OF PAUL G. BLAZER, PRESIDENT OF ASHLAND OIL & REFINING CO., ASHLAND, KY.

Mr. BLAZER. Mr. Chairman and gentlemen:

I call attention to the fact that the Excess Profits Tax Act as recently passed by the House of Representatives would inflict a most oppressive penalty on the company of which I am president, unless provision is made for exemption from the act of refunds of interest by the Federal Government in connection with overassessments of income taxes.

It appears that our company's earnings from normal operations will result in a liability for excess-profits taxes. We do not object to that. But in connection with a large overassessment of income taxes for the years 1926 to 1930, we should receive within the next few weeks a refund from the Federal Government of approximately $600,000 of which about $300,000 is interest that has accrued over all these years, but which, in accordance with applicable court decisions, would ordinarily be construed as income to us in 1940, the year finally awarded to us.

The principle involved here is just the same as the principle involved in the case of the gentleman just ahead of me. The Government will pay us roughly $600,000 which they took away from us, which the court says they owe us, but that will include interest which will come back to us now. That interest has been accruing for 14 years, but according to the courts, any interest awarded would be income in the year in which it is finally adjudicated, which would be this year.

The CHAIRMAN. You might have a chance if the Congress should pass one of these relief provisions. You still have the opportunity to present it.

Mr. BLAZER. This is very brief.

The CHAIRMAN. I understand, I am just telling you what we are liable to do so far as the Senate is concerned.

Mr. BLAZER. Although if you had been in the courts for 14 years and paid out a good many thousands which you didn't owe, and had been deprived of that——

The CHAIRMAN (interposing). Yes; but we have to pass the legislation to give you the opportunity to get relief. Then you may be in court 14 years after that. (Laughter).

Mr. Blazer (continuing). The act passed by the House would levy excess-profits taxes of approximately 45 percent on the $300,000 which together with normal income tax of 20.9 percent and State income tax of 4 percent, would leave us only about 30 percent of the amount awarded by the courts.

To especially point out the illogical and oppressive result, I call your attention to the fact that approximately $177,000 of the interest to be refunded to us represents a return of interest money actually paid by us to the Government in 1936 to avoid having to put up a bond for the tax deficiency and interest that had accrued to that date. Now that the highest courts have ordered the return of that $177,000 interest, together with other interest of $124,000 accrued to us since the time of the payment, it is manifestly unfair to levy an excess-profits tax on those refunds—yet that is exactly what will happen unless special handling is given to interest refunds by the Federal Government in connection with overpayments of incomes taxes.

It appears to me that the simplest way to avoid this obvious inequity would be to disregard entirely, for excess profits tax purposes, this abnormal type of income, such a precedent being established in the proposed law, when it provides for the elimination of capital gains. An amendment for that purpose might read as follows:

> Any interest received on overpayments of Federal taxes or any refund received of interest previously over paid in respect of Federal taxes is disregarded for the purposes of the excess profits tax.

However, if there should be objection to such complete elimination, I suggest an amendment reading as follows:

> Any interest received on overpayments of Federal taxes shall be treated for excess profits tax purposes as if it had been received ratably over the period during which the said interest accrued and any refund received by the taxpayer of interest previously overpaid in respect of Federal taxes shall be disregarded for the purposes of the excess profits tax.

You see there are two kinds of interest we are going to get back, $177,000 of interest which we paid out in cash in 1936 on the deficiency which the Government claimed in 1926, and then, rather than put up a bond we went ahead and paid them $177,000. But now we are going to get that money back, just an overpayment——

The Chairman (interposing). You think you are.

Mr. Blazer. They said we would get it in 2 or 3 weeks. It has been a good many years. It has been to the Supreme Court and the Supreme Court found in our favor. It has gone all the way through.

Senator Guffey. And what is the other interest charge?

Mr. Blazer. The other interest charge is the interest since 1936 when we paid in half a million dollars. They have had half a million dollars of our money for 4 years, and so the Government owes us interest on that at 6 percent.

The Chairman. Thank you very much. I am sorry you had so much trouble about getting your money back. [Laughter.]

Mr. Blanchard?

STATEMENT OF E. P. BLANCHARD, REPRESENTING THE BULLARD CO., BRIDGEPORT, CONN.

Mr. Blanchard. I represent Bullard Co., who are builders of machine tools. Inasmuch as that is an important factor in national defense, you can appreciate the predicament we are in. It is typical of the industry or I wouldn't impose an individual case, but I am speaking for my own company only.

The provision in this bill which calls for a retroactive feature back to the first of the year, is a particularly arduous thing for us in view of the fact of the business that we have had and of the expansion which we already have undertaken in anticipation of this business.

Actually at the present time we have probably invested as much, if not more, in buildings and equipment, on a gamble that it would be required as very essential to the defense act—more than the profits that we have gained over the first 6 months.

The CHAIRMAN. You want this date of June 10 moved back until about the 1st of January of last year?

Mr. BLANCHARD. I would prefer to have it January 1 of next year and I would want to make it applicable to national-defense contracts.

The CHAIRMAN. I understand.

Mr. BLANCHARD. We have no volume of national defense business up until about June 10 or about the 1st of July of this year.

The CHAIRMAN. Did anyone connected with the Government tell you that there might be an amortization plan adopted?

Mr. BLANCHARD. That is one thing that would help, but remember that in order to pay a sizable tax over the business we have had for the first half of this year, and assumed for the balance of the year, it would not permit us to go on and expand even under amortization conditions to support this movement, to carry on with machine tool manufacture that will make it very helpful to national defense—the bottleneck, as it has been called.

Therefore, the ex post facto feature is the part to which I want to call attention.

The CHAIRMAN. What is the specific suggestion you desire to make to the committee?

Mr. BLANCHARD. I have no specific suggestion; I am leaving it for the committee to frame its own bill, but there is the feature there which we consider extremely important, that it does require a payment of taxes that were not earned on national defense, profits not made on national-defense contracts. That is the part against which which we would like to have some relief and I offer that briefly.

The CHAIRMAN. If you have any further statement to make you may put it in the record, if you want to elaborate on your oral remarks.

Mr. BLANCHARD. Thank you.

The CHAIRMAN. The committee will recess until 10 o'clock tomorrow morning.

(Whereupon, at 5:15 the committee recessed until the following day, Thursday, September 5, 1940, at 10 a. m.)

SECOND REVENUE ACT OF 1940

THURSDAY, SEPTEMBER 5, 1940

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met, pursuant to adjournment, at 10 a. m. in room 312, Senate Office Building, Senator Pat Harrison (chairman) presiding.

The CHAIRMAN. The committee will be in order. There are on the calendar today nearly half a hundred persons to be heard. The committee must ask cooperation from those who want to be heard. We are going to finish these hearings sometime today and go into executive session on this piece of legislation tomorrow. It may appear in the course of these hearings that I have been a little hardboiled, but we have got to complete these hearings and expedite action on this bill. So the limit on speeches or arguments will be 10 minutes, at which time you will be called down and you will have to desist from further argument. Then you will have the opportunity of putting a memorandum in the record. We have with us gentlemen representing the Treasury Department, we have the chief of our Joint Committee staff with us, and they will consider these matters and in conference with us tomorrow we will consider all these recommendations. So I hope that the witnesses will confine themselves to pointing out the important points. I assure you we want to give just as much consideration to this bill and the suggestions which have been made and we will try to formulate something as it is possible to do so. We cannot please everyone but we hope to try to please some.

Dr. Hugh S. Magill, of the American Federation of Investors, Inc., in Chicago, wanted to appear, but instead he has written this letter which will be included in the record.

(The letter referred to is as follows:)

AMERICA FEDERATION OF INVESTORS, INC.,
Chicago, Ill., September 4, 1940.

Hon. PAT HARRISON,
Chairman and Members of the Finance Committee of the United States Senate.

GENTLEMEN: On behalf of many thousands of investors in the stocks of American corporations, may we urge that in your consideration of the excess-profits tax bill, the interests of the millions of stockholders in these corporations be not lost sight of.

Stockholders are the real owners of these corporations, and taxes paid by corporations come out of the pockets of stockholders in reduced dividends. Many thousands of stockholders, expecially women, depend wholly upon their dividends for support, and if these are wiped out or greatly reduced by taxation, such stockholders will be left destitute.

We recognize that heavy taxes must be levied, particularly in support of national defense, but we urge, as a matter of justice to that great body of thrifty citizens who have invested their savings in the stocks of American corporations, that their just rights shall be conserved.

As one example, we submit that it is unfair to those who would encourage American industry by investing their savings in the stocks of American corporations, and whose dividends have been greatly reduced by heavy Federal taxes, to further tax such investors on the income they receive in the form of dividends.

Respectfully submitted.

HUGH S. MAGILL, *President.*

The CHAIRMAN. Mr. George R. Blodgett, Boston, Mass.

STATEMENT OF GEORGE R. BLODGETT, BOSTON, MASS., REPRESENTING YANKEE NETWORK, INC.

The CHAIRMAN. All right, Mr. Blodgett. You represent the Yankee Network?

Mr. BLODGETT. I do.

The CHAIRMAN. Is that a baseball team?

Mr. BLODGETT. No, sir; a radio broadcasting network, a medium-sized one in New England, of which I am a director and one of the trustees, indirectly owning legal title to the stock.

The CHAIRMAN. Have you a brief that you want to put in?

Mr. BLODGETT. No, sir; not at this time.

The CHAIRMAN. All right, proceed.

Mr. BLODGETT. We recognize the need for more taxes and we recognize that they must come from the profits of the defense program. We admit the practical necessity of assuming that all increased profits come from the defense program, but we object to the technicality in the form of the House bill which would result in an excess-profits tax of $21,000 a year on us, when the earnings of our radio business, the only business we are now conducting, are shrinking steadily year by year. Each year beginning with 1936 and continuing through 1940, the radio earnings are smaller than the preceding year. That condition will probably continue in 1941.

The result of this excess-profits tax is brought about by the fact that for 2 years, in 1936 and 1937, we engaged in another activity in which we lost money, namely, a department store business which we bought very cheaply and finding we could not put on a profitable basis, we permanently discontinued in 1937.

The House bill requires combining, for the purpose of determining the exemption during the base period, the earnings of both businesses, and thereby it greatly cuts down our exemption, whether it is computed under the income credit or the income and invested capital credit.

We were organized in 1930 solely to conduct a radio business. That is all we have ever done or contemplate ever doing, except that during these 2 years of 1936 and 1937 we did engage in a department store business, which was permanently discontinued in 1937 when the store was closed. That business was entirely separate, carried on in a different location with different executives, different staffs, and different books. There would be no difficulty about separating it from the results of our radio business, which is the only business we are still carrying on.

I have said that the House bill requires the determination of our exemption, under either alternative, by combining the results of the department store business with the radio earnings. To use specific figures, the radio earnings would have averaged $200,000 in the 4 base years of 1936 to 1939, if there had been no store losses. They are estimated for 1940 at $143,000, and the same figure for 1941, but because of combining the store loss with our radio earnings in the base period our exemption would be reduced to $89,000, the result being a large excess-profits tax which has been estimated at $21,000.

The House bill, in section 711 (b), has provisions expressly designed to exempt special and nonrecurring items. It expressly provides that in determining the earnings for the base period you shall exempt such items as long term capital gains and losses, casualty losses, profits on retirement of bonds, certain processing tax matters, and so on.

We feel that our experience in the department store, lasting 2 years only in the 10 that we have been in existence and permanently wound up in 1937, is such a special, nonrecurring item which should receive similar treatment, for the reasons stated in the Ways and Means Committee report as follows:

The adjustment of income to take care of these unusual and nonrecurring items makes for equity and the removal of hardships which would otherwise occur.

I think the technical nature of the trouble we are confronted with is well illustrated by the fact that if we had gone into the department store business in a slightly different form, if we had bought the stock of the department store corporation instead of its assets at a corresponding price, then we would have no trouble of this kind even under the House bill, because then our loss in the department store would have been a loss on the capital stock which, under the provisions of the House bill I have just referred to, would not have operated to reduce our earnings for the base period. We feel that this peculiar situation in which we find ourselves is contrary to the general policy of the bill, to allow and exemption equivalent to the earnings in the base period, and I think it is very unfair to us from a competitive standpoint, because it seems very unlikely that any of our competitors will be in the same situation.

As to a remedy, we suggest that there should simply be added to these express provisions in the bill which provide for excluding, in determining the base-period earnings, the special and nonrecurring items which I mentioned, capital gains and losses, casualty losses, and so forth, further clauses having the same type of language and reading:

There shall be excluded the net loss of any business previously carried on by the taxpayer and permanently discontinued by the taxpayer before January 1, 1939.

As an alternative suggestion we suggest provisions for special assessment in cases of hardship, such as were found in sections 327 and 328 of the 1918 and 1921 excess-profits tax bill.

The CHAIRMAN. You think that might cure your troubles, at least give you a forum to present your case?

Mr. BLODGETT. It would give us a forum where a person could go years later, but it would not be very satisfactory in a business such as this where you need to know currently what your taxes are because of the tremendous need for capital in keeping up with progress in the act.

The CHAIRMAN. Thank you very much.

(Mr. Blodgett submitted the following brief:)

BRIEF REGARDING THE EXCESS-PROFITS TAX BILL OF 1940 (H. R. 10413), SUBMITTED BY THE YANKEE NETWORK, INC., BOSTON, MASS.

Advocating elimination of losses of separate businesses discontinued before January 1, 1939, in determining the average base period earnings

SEPTEMBER 5, 1940.

The broad purpose of the excess-profits tax provisions of the bill is to tax 1940 and subsequent year earnings of incorporated businesses insofar as they are higher than the average earnings of the base period 1936 to 1939. The Yankee Network, Inc., does not object to this purpose. We do object to the particular form of the bill which would have the effect of levying an excess-profits tax of about $21,000 on us in 1940, although the earnings of our only business activity in that year will be less than the earnings of that business in any of the years 1936 to 1939. To pay such an excess-profits tax on shrinking earnings is not only contrary to the broad intent of the bill but injures our competitive position because probably we alone among radio companies will be subject to the technicality of the law which imposes this added tax burden.

Our corporation was organized in 1930 solely to conduct a radio-broadcasting business. It has operated that business since 1930, and profitably since 1932, but because of wage increases and other expenditures the 1940 earnings of that business will be less than for any of the years 1936 to 1939, and the smaller earnings will probably continue in 1941. The corporation neither has at present nor contemplates having any activities other than the radio-broadcasting business, and it has had no other activities in the past with one exception—from December 1935 to December 1937 it owned and operated an entirely separate and distinct business, namely a department store. In December 1935 it purchased the assets and business of an established department store very cheaply. The store was conducted for 2 years as an entirely separate and independent enterprise from the radio—in different premises with entirely different executives, employees, and books. Finding that it could not turn this department-store business into a profitable venture, The Yankee Network, Inc., permanently closed the store in 1937, just 2 years after its acquisition. It sustained a loss in the operation of the store business which affected the composite earnings* of the corporation (the aggregate of both the radio business and the separate store business) as follows:

	Radio earnings [1]	Department store loss [1]	Composite earnings [1] for corporation
1936	$229,833.85	$69,315.16	$160,518.69
1937 (11 months)	20,893.43	214,914.17	5,979.26
1938	177,369.58	[2] 151,789.68	25,579.90
1939	156,643.40		156,643.40
Total	784,740.26		348,721.25
Average for 1936 to 1939 base period	200,359.21		83,035.21
Estimate for 1940 and 1941	142,380.00		142,380.00

[1] Figures for earnings are "excess profits net income" computed under sec. 711 of the bill.
[2] Store closed permanently in December 1937 but liquidation loss continued into 1938.

The excess-profits tax bill passed by the House makes this taxpayer's exemption from excess-profits tax depend upon its composite earnings for the 1936 to 1939 base period—the right hand column of figures above—which means that the exemption from excess-profits tax of the radio earnings in 1940 and subsequent years will be greatly reduced below the average radio earnings for the 1936 to 1939 base period solely because the corporation lost money in an entirely separate department store enterprise which was closed in 1937. The present wording of section 711 (*b*) requires the use of these composite base-period earnings, whether the exemption is computed under the income-credit option or under the income and invested capital credit alternative.

To illustrate with the figures given above, if the department store had not been operated in 1936 and 1937, the average earnings of the corporation in the base period, 1936 to 1939, would have been $200,359.21. This amount would then be exempt from the proposed excess-profits tax, and 1940 and 1941 earnings are estimated at only $142,380 per year. But under the proposed law and even though the only business in 1940 is the radio business, the amount of radio earnings exempt from the excess-profits tax will be greatly reduced solely because the same corporate taxpayer lost money in 1936-1937-1938 in a distinct department store business, carried on in only 2 out of its 10 years' existence. and then as an entirely separate enterprise in a separate location by separate executives and employees and with separate books. This technicality unless corrected by the Senate will cost this taxpayer a large excess-profits tax a year on shrinking earnings.

The House has recognized that special and nonrecurring items which have arisen in the past should not affect the excess-profits tax exemption and has made provision to that end even though such items arose in the normal course of the corporation's regular business. Section 711 (*b*) (2) A (ii), (iii), (iv), (v) and B (ii), (iii), (iv), (v) expressly provides that in determining the results of the 1936 to 1939 base period there shall be eliminated all long term capital gains and losses, income from retirement of bonds, casualty losses and processing tax matters, with the result that the taxpayer's exemption is to be determined without regard to such special and nonrecurring losses of former years. The department store business carried on only 2 years and closed in 1937 is a special, nonrecurring item which similarly should not affect the exemption of earnings of the separate radio business now in its eleventh year.

Nothing illustrates better both the sound basis of The Yankee Network, Inc.'s contentions and the extremely technical nature of the difficulty which faces it than the fact that if in 1935 the purchase of the department store business had been handled only slightly differently as to form, these remedial provisions of the House bill would expressly save The Yankee Network, Inc., from the excess-profits tax which now confronts it. When it took over the department store in 1935, The Yankee Network, Inc., bought the assets of that business. It could as well have acquired that business for a corresponding price by buying the capital stock of the corporation which previously owned the store business. If it had done so, the loss which it sustained on the store business would have been in the form of a loss on that capital stock, which would have been a long term capital loss under the tax law. The House bill, section 711 (*b*) (2) A (ii) and B (ii), expressly provides that long term capital losses during the 1936 to 1939 base period shall be entirely disregarded in determining the excess-profits tax exemption. With that slight change in the form of the purchase of the department store business in 1935, The Yankee Network, Inc., would have come squarely within these remedial provisions of the House bill which recognize that such past nonrecurring items should not reduce the excess-profits tax exemption for 1940 and subsequent years.

To remove this unintended tax burden we suggest the addition of the following remedial clause in the same part of the bill, namely at the end of section 711 (*b*) (2) A (v) and B (v) which relates to the computation of the excess-profits credits during the base years 1936-39 for the purpose of determining the amount exexempt from the tax in 1940 and subsequent years:

"(vi) There shall be excluded the net loss of any business previously carried on by the taxpayer and permanently discontinued by the taxpayer before January 1, 1939."

An alternative suggestion might be the inclusion in the law of provisions for special assessment in cases of hardship, such as were provided in sections 327 and 328 of the 1918 and 1921 excess-profits tax laws.

Respectfully submitted.

THE YANKEE NETWORK, INC.

The CHAIRMAN. Mr. Walter Mack.

STATEMENT OF WALTER S. MACK JR., REPRESENTING PEPSI COLA CO., LONG ISLAND CITY, N. Y.

Mr. MACK. Senator Harrison, I asked to come here today because I want to talk not on any particular question that affects any one business but because my experience in the last 8 or 10 years, in reorganizing a number of companies and working in a great many fields, has given me the opportunity to see the effect of this tax as it affects a great many different industries. For your information, I am chairman of the board of United Cigar Stores and Whelan Drug Co., which company I helped to take out of receivership in 1937 and start anew. I am also a member of the executive committee and director of the Celotex Co., which I helped to take out of bankruptcy in 1936. I am also on the board of the South Coast Corporation, which I helped take out of receivership when it went into bankruptcy in 1936.

Senator BARKLEY. Will you be available for consultation among some of us Senators?

Mr. MACK. Senator, I would love to. [Laughter.]

In addition to that, I am president of the Pepsi Cola Co., where I started to work 2 years ago.

With that background, I have been able to study what this bill will do to new companies, to companies that really, though being old, have had to start afresh and therefore probably a little worse off, a little more behind the eight ball than starting fresh; and also to the small businessman, because in these businesses we have to deal with and have to directly work with the small businessman. I am therefore talking about the bill in general.

I will say, Senator, I probably will be a little destructive in my criticism at first, but I want to offer some concrete suggestions afterward, because I just do not want to be destructive.

This bill is going to be pretty ruinous for the little fellow or for the new man. He has no established earnings because he is starting fresh. He has probably very little capital investment.

I would like to give you a typical example of what I mean. The Pepsi Cola Co. has 430 franchise bottlers throughout the United States. Out of the 430, about 300 of them have started business within the last 2 years, since I have been in the organization. They are typical of the small fellow. The parent company, the Pepsi Cola Co., has nothing to do with them, as far as financing or giving them working capital. They are completely independent. They get a franchise and they go into business. They are the typical American small businessman. A truck driver, a retail salesman, a retail store owner decides to go in the Pepsi Cola bottling business. He may have $2,000 or $3,000; he rents a store or rents a factory building. There is no capital investment there. He buys machinery on the installment plan from the Liquid Carbonic Co. or some other machinery company, pays for it over a period of 5 years, and then he goes out and hires a trucking concern to make his deliveries for him. It requires very little capital investment.

Senator BARKLEY. Does the Pepsi Cola Co. have an interest in this machinery that you say he buys?

Mr. MACK. None at all. That is his own. He works on his own capital.

Senator BARKLEY. I know, but does your Pepsi Cola Co. have any interest in the company that manufactures the machinery that the man buys?

Mr. MACK. No; he buys those from machinery companies like the Liquid Carbonic Co. The only thing we sell him is the concentrate, give him the franchise, and sell him the concentrate. He has to set up his own plant, his own delivery system, and his own business. He is in business for himself. After he does that, he usually puts his son, his brother, or perhaps his brother-in-law in the business to work for him, and he gets going. He has no capital investment, and having started new he has no earnings to fall back on to give him his 3-year average. You can see what that would do to him.

Senator BARKLEY. If he is an individual this bill does not touch him.

Mr. MACK. He is a corporation.

Senator BARKLEY. He is a corporation?

Mr. MACK. Yes. I say he is a corporation. Of the 430 that we have the large percentage of them are corporations. There are some partnerships, but I should say that a majority of them are corporations.

Senator BARKLEY. Does the Pepsi-Cola Co. have any stock in any of those corporations?

Mr. MACK. Not a share. We have nothing to do with them except selling them concentrate.

Senator BARKLEY. What connection does Loft & Co. have with them?

Mr. MACK. Loft & Co. has no connection with them except Loft is the owner of 80 percent of the Pepsi-Cola parent stock, but it has no interest in any of these franchise bottlers, as we call them. He starts to work and he has got to pay to build, he has got to have working capital.

Now, it is quite true that you have given an exemption to this little fellow of $5,000, but that is not much good, because he needs working capital to pay off his debts, to pay for what he is doing, and for making him able to expand. The usual performance is the first year he loses some money, the second and third year he starts to make some money.

You well may say the $5,000 exemption reduces the number of corporations to a very small amount, but you would not get people to go into business if you are going to say to them, "All you are going to be able to get exempted is $5,000, that is the limit you can make before you have to pay through the nose." That is very un-American. It is like the fellow, who believes in our American democracy and wants to believe his son has the opportunity perhaps to be Senator or to be President of the United States. He wants to think if his son goes into business that he has an opportunity some time to be head of a big corporation, not to be limited to $5,000 earnings. So although that may at the present moment only affect a few, it limits their opportunity and limits their incentive to go into business, and it would be very difficult for us to get franchise bottlers to go into business.

The CHAIRMAN. You have 2 minutes more.

Mr. MACK. I have 2 minutes left?

The CHAIRMAN. Yes. If you have got any suggestions to make, you had better make them.

Mr. MACK. I have got a number of suggestions.

The CHAIRMAN. I hope you will make them in 2 minutes.

Mr. MACK. There are two things in the bill that I particularly want to talk about. One is the question of depreciable assets. Under your bill the depreciable assets for excess-profits taxes are not deductible; under the regular normal income-tax provision, your depreciable assets are deductible before you figure the tax.

Now, my bottlers, at the end of 2 years, may want to sell their machinery. They amortize some of it, they sell it, and take a loss.

They ought to be allowed to take that loss in the year in which it occurs.

Senator GEORGE. You mean if a bottler buys a fleet of trucks and he has to sell those trucks, of course at a terrific discount, after they have been used a year or 18 months, or something of that kind, that he cannot take a depreciation as against the excess-profits tax?

Mr. MACK. That is right. Under the present normal tax law he can.

Senator GEORGE. Under this bill he cannot do that?

Mr. MACK. He cannot do that.

Senator GEORGE. Not for excess profits, but he can do it for normal?

Mr. MACK. He can do it for normal, but he cannot do it for excess profits. That is not fair, because he actually takes that loss.

The other point I want to make is something in connection with a lot of work that has to be done in reorganization work which is affected by this bill.

Senator BARKLEY. Let me ask you this: If he is not engaged in any defense activity so that he would not expand his business for the purpose of manufacturing defense materials, why should he be permitted to take the same sort of depreciation that would be allowed one who is engaged in manufacturing defense materials?

Mr. MACK. It has nothing to do with the question of the 5-year depreciation and defense amortization. He would have normal depreciation, which he is allowed under his normal taxes.

Senator GEORGE. You are not asking that he be given the special depreciation or amortization?

Mr. MACK. No.

Senator GEORGE. You are asking that he have the normal depreciation as against the excess profits?

Mr. MACK. The same as his normal tax, that is correct.

The other question is the question of mergers. I have had a lot to do with mergers and consolidations. If you keep the provision that you have in your present bill under consolidations, in which two companies if they are consolidated, the losses of one would have to be deducted from the profits of the other before you figure a base, you are not going to have consolidations. I have done quite a lot of that type of work. When you get a company that is losing money the only way you can save it and stop it from liquidation and throw all the people out of work is to try to get a company that has money, that is making money to consolidate with it. Under this bill the company that is taking it over will be penalized, because the losses of the company that is taken over will be taken from their base. You can say to these companies what you will, whether they be railroads or whether they are manufacturing plants, they will not consolidate because you create too big a penalty.

What I am suggesting is a simple little clause to be put in the bill to the effect that in consolidations or mergers the excess profits credit be not less than the credit that either of the two constituent companies would receive if taken alone. Now, that would allow what the administration is in favor of, the liquidation of holding companies and simplifying capital structures and be able to save quite a lot of these companies that are losing money by having companies that are making money take them over. If you do not do that they will never take them over, because there will be too much of a penalty.

Senator, I want to give you my general plan for this excess-profits tax if you give me 2 minutes more.

The CHAIRMAN. I cannot do it, Mr. Mack, with 50 witnesses here. We do not want to break the rule this early in the game.

Senator TOWNSEND. He can put it in the record.

Mr. MACK. Yes I know, but you will gain a lot, by having me tell it to you.

Senator CLARK. Mr. Chairman, if we are going to limit the witnesses to 10 minutes, I think they ought to be protected from questions. I do not think the Senators ought to argue with them if we limit them to 10 minutes.

The CHAIRMAN. I think that is true, and I think Mr. Mack is a very important character. I have been very glad to talk to him two or three times.

Mr. MACK. Thank you.

The CHAIRMAN. You may put into the record your constructive suggestions.

Mr. MACK. It would give you, I think, a solution of this problem, which we are all groping for as a practical matter.

The CHAIRMAN. I understand, but we just cannot do it today and treat these other witnesses fairly that have come here from everywhere.

Senator CONNALLY. Bring it in this afternoon and put it into the record.

Senator BARKLEY. In order to accommodate the witness, I will withdraw the questions that I asked a while ago.

The CHAIRMAN. Will you give us the benefit of those very constructive suggestions by putting them into the record?

Mr. MACK. Yes. Senator, may I ask the permission of the committee to consult with the technical experts of your staff?

The CHAIRMAN. You certainly may.

Mr. MACK. A consultation between my man and your men, to try and see if we cannot help a little bit and give you the benefit of our experience?

The CHAIRMAN. I would like for you to consult with the Treasury experts, and also Mr. Stam. You may all get together and see what you can work out. I hope you will get together. It will relieve us.

Mr. MACK. If later on, you would like me to appear again to explain this, I would be very glad to do so.

The CHAIRMAN. I hope we will not have to. Thank you very much, Mr. Mack. The Treasury experts and Mr. Stam will take care of your suggestions. See if you cannot get together on something.

(Brief submitted by Mr. Mack is as follows:)

BRIEF OF WALTER S. MACK, JR.

Mr. Chairman and members of the committee: I want to thank you for the opportunity of allowing me to address this important committee at this crucial time. I am chairman of the board of directors of United Cigar-Whelan Stores Corporation, and took active part in its reorganization in 1937 after receivership. I am a director of the Celotex Corporation and of the South Coast Corporation, and I took an active part in their reorganizations in 1936. I am a director of the Autocar Co., in whose recapitalization I participated in 1938. And I am president of the Pepsi-Cola Co., reorganized in 1932, and now a growing factor in the soft-drink industry. On the basis of this experience I feel qualified to point out some of the unfair burdens of the proposed excess-profits tax on new and reorganized companies still to be developed, as against their established competitors.

Before discussing the proposed bill, on behalf of the businesses which I represent, I wish to state that we are in accord with the national-defense program and recognize the need for an increase in the tax rate to help pay for it; and that we also agree with the declared policy of the bill that there should be no millionaires created by the profits of a rearmament program.

I firmly believe that business has been and must continue to be the backbone of our American economic and social system and that any excess-profits tax should, therefore, be fair, easily administered and one which will not stifle the growth of new American enterprise. Unfortunately, it is my considered opinion, after careful study of the bill, that the proposed excess-profits tax would be ruinous to growing business, whether new enterprises or reorganized companies.

I realize that a sincere effort is being made to equalize the burdens of the bill, particularly by allowing alternative methods of computing excess-profits credit. But this bill penalizes a corporation which is starting operations or starting afresh after a reorganization, because such a corporation will not as yet have established normal average earnings during the years of the base period. Nor will the invested capital alternative be of any relief in those cases where, in the nature of the business, capital plays a relatively small part in relation to volume of business of taxable earnings.

I can give you many examples of this, typical of small businessmen starting in business. We have over 430 of these small businessmen who are franchise bottlers for the Pepsi-Cola Co. They are independent enterprises, neither owned nor financed by our company but operating under free franchises from us. Such an independent bottler starts his business with a small amount of working capital, rents a building in his locality, purchases some bottling machinery on the installment plan, and purchases some trucks from a finance company. He puts his sons, his brother, and his brother-in-law to work in the plant, and by hard work and stint he starts to make a little money. The more he grows, the more money he needs for working capital to finance his purchase of bottles and trucks, to pay for laborers and for promotional expense.

The proposed excess-profits tax will be ruinous to such a bottler. Many of our franchise holders—about 300 of the 430 within the last 2 years—have started business in this manner. I suggest that our experience is typical of thousands of persons who embark upon new enterprises annually. It is easy to appreciate the risks which these small businessmen undergo, investing a few thousand dollars in materials or a plant, obligating themselves for machinery on installment, and expending money and effort selling merchandise on consignment. If they believed that they were limited to making $5,000 a year before heavy excess-profits taxes became operative, it is doubtful if many of them would undertake the hazardous business risks.

Of course, the large and well-established corporations who have, over the years, secured a higher earning base, or a large capital investment, will not be seriously affected. But there are in this country innumerable corporations which have neither sizable invested capital nor a record of large average earnings. The provisions of this bill discriminate against them ruinously because they fail to provide an equitable basis for determining what part of such profits are "excess." As to many such corporations the bill is in fact a profits tax with almost confiscatory rates, operating in many instances to the serious prejudice of a new competitor as against an established business.

There is a further point that the burden of this proposed tax inevitably falls on the common stockholders. If the common stockholder must bear all the risk of the enterprise and is to have no opportunity for an adequate return of profits, surely no one could be expected to invest in such securities. I believe that this committee should give serious consideration to the effect which this bill will have on the market for common stocks, and whether it is in the best interests of the country to encourage debt financing. Certainly the Securities and Exchange Commission has recently given definite indications that they encourage equity financing by common stock. In fact, the Public Utility Holding Company Act of 1935 expressly favors a capital structure with a large proportion of equity interest, and it is well known that a principal cause of the present financial plight of the railroads is the lack of adequate equity financing. If this bill passes, in all fairness I ask, How can you get new enterprises financed and what is going to happen to all the common-stock equities?

At the present time the Federal Government is virtually a partner in all American industry to the extent of 20 to 25 percent of the profits. It is a one-sided partnership because the Government bears no share of the losses. It is now proposed by this bill that the Government become a partner in many instances to the extent of 50 percent of the profits, even though those profits are in no way related to the Government's defense program.

I dislike exceedingly to be merely destructive in my criticism and would like to present to you what I consider to be a fair excess-profits tax. My suggestion has three points on its program:

1. That all industries deriving profits directly or indirectly from the defense program should be taxed as in the proposed schedule in the present bill. This would do exactly what I understand is intended for the excess-profits tax to do, prevent huge profits being made by business out of the rearmament program. I realize that it is not easy to determine what companies profit from the defense program or to what extent they so profit, but surely it is not an impossible task for this committee to resolve. If it is too difficult to establish a statutory standard applicable to all cases, provision might be made to require the taxpayer to secure an exemption on a proper showing to an appropriate Government agency. This suggestion is not too remote from the provisions presently found in title II of the bill, which requires the taxpayer to secure a certification from the Secretary of War or the Secretary of the Navy with respect to the amortization of certain emergency facilities. Where only a part of profits are traceable to the defense program, an allocation of profits may be made in the ratio of the volume of defense business to total volume. This type of allocation of profit is familiar to every businessman who must allocate his net income for tax purposes between the several States in which he does business.

2. On all corporations, a 3.1-percent national-defense tax should be added to their regular present taxes which would increase the taxes for all corporations from 20.9 as it is at present, to 24 percent.

3. In addition thereto, there should be levied on all other corporations, not subject to the excess-profits tax on defense business, a 4-percent excess-profits tax on any profits in 1940 in excess of those in 1939, and a similar tax on each successive year's increased profits, subject to a specific exemption of $5,000 a year.

These three proposals seem to me much preferable because—

(a) They are simpler to administer and can be easily understood by all corporations;

(b) they are fair and equitable to all corporations either large or small, new or old, and, therefore, do away with the inequities in the present bill which help the established corporations at the expense of the small growing ones; and

(c) they would raise much more revenue.

If you will bear with me just one more minute, I would like to point out two outstanding errors which I think have been made in the drafting of the bill and which are of vital importance to all businessmen. The first is the question of the handling of depreciable assets. In the present writing of the bill, losses from the sale of depreciable assets are not allowed to be deducted before figuring the excess-profits tax. This is neither fair nor proper accounting practice, and is entirely different from the handling of these depreciable items under the present existing income-tax laws where such losses are allowed to be deducted. These are actual and real losses—not theoretical ones.

Take again an independent bottler as an example of the small and medium-sized businessman. He buys trucks which he may depreciate over a period of 4 or 5 years and bottling machinery which he depreciates over a like period of time which is the life of the machine. Due to the growth of his business or the need for change of equipment he wants to sell that truck at the end of 2 years and buy a new one, or sell his machinery at the end of 3 years and buy a bigger one or one of more modern design. Heretofore he has been allowed to deduct for tax purposes his loss on the machine for the years on which his depreciation has not been written off. This is the usual way, and it is unfair to penalize him. The report of the Ways and Means Committee (p. 34) on the Revenue Act of 1938 specifically points out that this should be allowed to be treated differently than nondepreciable assets and should be considered losses to be allowed in the years in which such transactions occur. I don't think there can be any question in your minds about the fairness of having a similar provision for figuring an excess-profits tax.

The other item to which I want to call your attention is in regard to the question of reorganizations, consolidations, and mergers. As I pointed out before, I have been very active in such work during the last 8 years. I believe it is very constructive and important work to take a corporation which is in bankruptcy, or which has been losing money for a period of years, and consolidate it with a company which is showing some profits in a similar line of business. Thus the merged companies can carry on at reduced expenses and increased efficiency rather than be forced through liquidation as they quite often have been in the past, throwing many people out of work. This present proposed excess-profits tax, however, from a practical point of view, makes mergers and consolidations along these lines impracticable because if the losses of one company which is to be merged with another company are deducted from the profits of the well-run company before a tax base can be established, it stands to reason that the profitable company will not agree to any such merger as the penalty would be too great.

This could easily be corrected by a short provision to the effect that with respect to reorganization or mergers the excess-profits credit of the merged corporation should in no case be less than the credit to which either of the constituent companies alone would be entitled. The arguments for this policy are exceptionally strong at a time when the elimination of holding companies and useless corporate structures is being actively advocated by the administration.

In conclusion, I would respectfully request the committee to allow me or my representatives to consult with your technical experts to discuss in more specific detail the several suggestions I have briefly outlined here.

The CHAIRMAN. Mr. William G. Woolfolk, Detroit, Mich.

STATEMENT OF WILLIAM G. WOOLFOLK, REPRESENTING UNITED LIGHT & POWER CO., DETROIT, MICH.

Mr. WOOLFOLK. Mr. Chairman, I will try to comply with the 10-minute limitation. I have condensed my remarks on paper. If it is agreeable to you, and I have your permission, I am going to read from the manuscript.

The CHAIRMAN. If you desire to take that course, all right.

Mr. WOOLFOLK. Thank you, sir.

I am William G. Woolfolk, of Detroit, Mich. For the past 8½ years I have as president directed the operations of the Michigan Consolidated Gas Co., a retail utility serving two-thirds the gas consumers in the State of Michigan. This company is controlled by the United Light & Power Co., of which I have recently been elected president.

The United Light & Power system comprises operating gas and electric utilities in the States of Michigan, Ohio, West Virginia, Indiana, Illinois, Wisconsin, Iowa, Missouri, Kansas, Nebraska, Oklahoma, and Texas.

In availing of the privilege of appearing before you, I do not attempt to speak for the utility industry at large, but only for the companies in the United Light & Power system.

I disclaim any familiarity with tax law, and especially desire that my comments have not the slightest appearance of criticizing those who have prepared the present so-called excess-profits tax bill.

As you gentlemen know, public utilities have their rates fixed from time to time either by Federal, State, or municipal authority. We are allowed to earn no more than a reasonable return upon the fair value of the property. When our annual reports disclose that we do earn more, our rates are cut, when we earn less we have the right to apply for an increase, though during the past 15 years only one of our companies has had an increase in rates. Wherefore, as we already have a ceiling on our profits, there can be in fact or in law no excess profits in our business, and it may well be claimed that utilities should be entirely exempt from this act.

Let me assure you, however, that nothing is further from my mind than to suggest that my companies be relieved of their fair share of the cost of rearmament.

Now, "excess profits" as defined in the House bill does not mean excess profits but does mean those profits of a taxpaying corporation in excess of its 1936–39 taxable income even though such taxable income may not have been normal during those years. Also, in the case of some of our companies where the income has been normal for the period, the application of the formula does not correctly reflect the real profits.

When one comes to apply this "average earning tax formula" to the companies over which I preside, certain eccentricities, inequalities and discriminations become apparent. For example, using the estimated incomes for 1940 for our companies, which range from $31,300 to $5,322,000—the smallest company would pay a tax of 17 percent of its taxable net income, the largest 13 percent. One company with an income of $3,562,000 would pay a tax of 17 percent, another with an income of $2,800,000 a tax of 30 percent, still another with an income of $1,200,000 would pay a tax of 38 percent. Of two small companies who will have earnings of $77,000 each, one pays 6¼ percent and the other 25 percent. This refers to the excess-profits tax of 20.9 percent. There are numerous other inequalities of an equally disconcerting nature.

Accurate computations under the "invested capital method" have been impossible, because we do not know what is meant by "invested capital" and cannot know because the ultimate determination of "invested capital" as defined by the House bill will undoubtedly be a long, laborious, and costly procedure and even when determined by the taxpayer may be challenged by the Treasury Department and result in burdensome litigation. This proved to be the case with the 1917 bill, with which I had some familiarity.

However, using invested capital figures taken from our companies' books, computations disclose discrepancies and inequalities as great as those under the other method—the variations ranging between 31¼ percent and four-tenths of 1 percent of taxable net income.

In my opinion, these inequalities and discrepancies are due to several factors, principal among which is the artificiality and inaccuracy of the use of taxable net income as a basis for determining excess profits. I think that is a fundamental defect of this entire structure and this entire formula. For the purposes intended I deem this method fundamentally unsound. It produces inaccurate and misleading data with resultant erroneous conclusions. It is a departure from what I understand to be the taxation philosophy underlying this legislation.

Another factor of importance is the failure of the House bill to provide adequate adjustment for certain extraordinary or abnormal occurrences affecting income during the base period, with respect to which excess-profits taxes are to be calculated in later years. While the principle itself has been recognized in the bill by providing adjustments for a long term capital gains and losses, income from retirement or discharge of bonds, and casualty losses, it seems to me the application of this principle should be broadened. In the House bill adjustment is made only for income derived from the retirement or discharge of bonds, debentures, and so forth, outstanding for 18 months or more. In recent years many companies have refunded their indebtedness to avail of lower interest rates. Such refunding usually involves the payment of a redemption premium on the refunded issue of securities, as well as a write-off of the unamortized balance of discount and expense applicable to the refunded issue, all of which is deductible in determining the normal income tax. Where these deductions occurred during the base period, the average income of a corporation during such period is distorted downwards unless adjustment is permitted.

As an illustration, I mention the case of one of the subsidiaries of the United Light & Power Co. which in 1936 redeemed $15,500,000 of its outstanding bonds at a premium of $775,000 with unamortized debt discount and expense of $1,132,000.

The premium and unamortized debt discount and expense were allowable deductions for income-tax purposes and operated to reduce the taxable net income of the company for 1936 by approximately $1,900,000. For this reason the average taxable net income for this company is understated and is in no way commensurate with the average actual net income for the base period 1936-39.

Under the income-tax law this was all applied to the credit income. That company paid hardly no taxable income for that year. Another company who has taxable income which will be used in this excess net profits, the taxable income was $167,000 by reason of these credits, and it disbursed stockholders' profits of $1,600,000 a year. We are now facing the refunding of another company, some $26,000,000 of refunding bonds. This bill, as it stands, and using the taxable income as the earnings base, that company could refund and pay no excess profits at all, no excess-profits taxes at all this year, even though it is earning profits.

Nonrecurring and extraordinary deductions of this nature are entirely unrelated to the normal income of the company from its utility operations and unless excluded in computing excess-profits net income the actual income of the company is distorted downward and the company in such a case will be heavily penalized each year hereafter by the wrongful imposition of the excess-profits tax on approximately $475,000.

This also applies in substantial amount to three other of the largest operating companies in the system, which, in line with good business practice and prudent management, refunded issues during the period 1936-39. That applies to four of the largest companies in our system. I cannot give you the aggregate of their income, but it is in the neighborhood of $20,000,000 or thereabouts.

I would like to direct your attention to another matter of extreme importance, namely that of consolidated returns, because when I review the effect which the present tax bill has upon our various operating properties, I cannot but believe that it is sound to permit a system of affiliated corporations to file a consolidated return for excess-profits-tax purposes. Railroads are now given that right and such returns were permitted under the excess-profits law during our previous war.

I appreciate the opportunity of appearing before you. My time is practically up. I have tried to contribute something constructive here and not take your time in indulging in destructive criticism.

The United Light & Power Co., my company as I call it, the companies connected with it are of similar kinds. They all render public service in either gas or electricity. They have small communities of

25,000 up to 2,000,000. They are all regulated. The managements of course do not want to try to escape in any sense their share of this, but the use of the net income as the Treasury Department uses it does work grave inequalities.

Mr. Chairman, and gentlemen, I thank you very much.

Senator GUFFEY. Do you favor consolidated returns for utilities?

Mr. WOOLFOLK. Yes, sir. It is a fair leveling out, it seems to me, of those companies.

Senator GUFFEY. They took it out of the old returns?

Mr. WOOLFOLK. Yes.

Senator GUFFEY. How much would you say they would have to pay by making the consolidated balance sheet return?

Mr. WOOLFOLK. I haven't that figure, sir. I haven't had a computation made on that. I cannot give you a guess.

The CHAIRMAN. All right, Mr. Woolfolk, we thank you.

Mr. WOOLFOLK. We could put it into the record, Senator.

Senator CLARK. If there is any additional statement you wish to put in the record, I am certain the committee will be glad to have you put it in.

Mr. WOOLFOLK. May I have the same privilege as extended to the previous gentleman?

The CHAIRMAN. Yes. All right, Mr. Clark. Edward Clark, Austin, Tex., representing the Central Power & Light Co., Corpus Christi, Tex.

STATEMENT OF EDWARD CLARK, AUSTIN, TEX., REPRESENTING THE CENTRAL POWER & LIGHT CO., CORPUS CHRISTI, TEX.

Mr. CLARK. Senator Harrison, and gentlemen of the committee——

The CHAIRMAN. You have the same privilege to put your brief into the record.

Mr. CLARK. Yes, sir.

The CHAIRMAN. Just point out the high points.

Mr. CLARK. As I understand the bill under consideration, it provides exemptions for nonrecurring losses during the base period. We are simply here asking, and my remarks are only addressed to one point, and that is that the same exemption be extended to abnormal, unusual, nonrecurring expenses.

During the base period our company went through a refinancing arrangement and it permitted us to claim as a deduction in our income-tax return the remaining unamortized bond discount and expense as well as premium paid in calling the outstanding issues for redemption. These claims have produced substantial losses in our income-tax return, which, when taken into consideration with the earnings for the other years in the base period, produce a net taxable loss which would thereby eliminate any credit to which we might be entitled in this connection.

The CHAIRMAN. Does not that apply to some other companies throughout the country?

Mr. CLARK. Yes, sir.

The CHAIRMAN. In a similar situation?

Mr. CLARK. Yes, sir. In other words, unless that is given as a credit it will penalize any company who has refinanced during the base period; it will give a favored position to any company which hereafter refinances. In other words, we had an expense of something like $3,000,000, an unusual expense in connection with our refinancing arrangement. Unless we are given credit for it, our earnings are taken out of line with what they normally are.

Senator TOWNSEND. What is the capital of your company?

Mr. CLARK. $50,000,000.

Senator CONNALLY. Mr. Clark, may I ask you a question?

Mr. CLARK. Yes, Senator Connally.

Senator CONNALLY. In other words, unless you are allowed to deduct these extraordinary and unusual expenses of reorganization, just as the bill recognizes unusual losses, in that case your reorganization expenses were, in effect, a loss?

Mr. CLARK. Yes.

Senator CONNALLY. But they are not included within the language of the bill like other losses.

Mr. CLARK. I am afraid they are not, Senator, and I can see no substantial difference or distinction that should be made between a loss and an unusual and nonrecurring expense. In other words, for the year 1936, according to our income tax returns, we had a loss of $78,000; in 1937, we had a gain of $1,017,000; in 1938, we had a gain of $799,000, and in 1939, after making this deduction in our income-tax return, we showed a loss of $2,083,000.

Senator BARKLEY. In other words, you subtracted the $3,000,000 you spent for reorganization from your income and in that way it made a paper loss of $2,000,000 something?

Mr. CLARK. Yes, sir. Now, if we were given credit for that it would show—and this would be in line with the true facts—it would show in 1939 that we had a gain of $1,224,000, and if we are not given the credit over the base period we show a net loss of $345,000 plus. If we are given credit for this unusual expense we show an average for the 4-year period in net gains of $740,000, and that is just about in line with what our company actually makes.

Senator BARKLEY. Do you operate anywhere except in Corpus Christi?

Mr. CLARK. Yes; we operate in some 188 towns.

Senator BARKLEY. I could not see how a $50,000,000 corporation could be operating in only one town.

Senator TOWNSEND. That is in Texas?

Mr. CLARK. That is in Texas, yes. I have made some suggestions here on paper so that there would be no misunderstanding or confusion about the matter, and I would like to file it.

Senator CONNALLY. One question. Your contention is that this unusual expense of reorganization, which has occurred only once in the lifetime of the company, was substantially just as much as loss from its operating capital and income as if you lost in 1 year that amount by fire, flood, or something else?

Mr. CLARK. Yes; that is exactly as we understand it.

Senator CONNALLY. You can put your statement in the record.

Mr. CLARK. Thank you, Senator.

(The memorandum of Mr. Clark is as follows:)

To the Chairman and Members of the Senate Finance Committee:

My name is Edward Clark; attorney at law, Austin, Tex., and I represent Central Power & Light Co of Corpus Christi, Tex.

It is not my purpose to appear here in protest of any revenue act and my remarks are addressed solely to one point, for which we ask a clarification or addition.

As I understand the bill under consideration, it provides exemption for nonrecurring losses during the base period. It occurs to us and we respectfully suggest that the bill also affirmatively provide that this exemption include also exemptions for nonrecurring expenses.

During the base period our company as well as numerous other corporations in Texas completed refinancing programs, which refinancing programs permitted us to claim as a deduction in our income-tax return the remaining unamortized bond discount and expense, as well as premium paid in calling outstanding issues for redemption. These claims have produced substantial losses in our income-tax return, which, when taken into consideration with the earnings for the other years in the base period, produce a net taxable loss which would thereby eliminate any credit to which we might be entitled in this connection.

There is shown below the net income for income tax purposes for the 4-year base period 1936-39, inclusive, as filed in our income tax returns for those years and which would be used as a basis for computation of the new excess-profits tax:

Year:	
1936, loss	$78, 789. 42
1937, gain	1, 017, 316. 08
1938, gain	799, 365. 92
1939, loss	2, 083, 840. 30
Net loss	345, 947. 72

Section 713 (4) (B) of the proposed bill states: "The amount attributable to any taxable year in which there is such an excess (deductions over income) shall be the amount of such excess, except that such amount shall be zero if there is only one such year, or, if more than one, shall be zero for the year in which such excess is the greatest."

This would, therefore, eliminate the loss year of 1939 thereby producing a net income for the other 3 years of $1,737,892.58, or an average of $434,473.15 for the 4-year period.

On the other hand, should the law permit us to eliminate from the net income (loss) as shown for 1939 the amount of abnormal and nonrecurring expenses included therein represented by unamortized debt discount and expense and premium paid on retirement of our bonds in 1939, we would show a net taxable gain for 1939 of $1,224,591.70. Our earnings for the base period would then show as follows:

Year:	
1936, loss	$78, 789. 42
1937, gain	1, 017, 316. 08
1938, gain	799, 365. 92
1939, gain	1, 224, 591. 70
Total net gain	2, 962, 484. 28

Average over 4-year period, $740,621.07.

We claimed as a deduction in the 1939 return an abnormal and nonrecurring expense item of $3,308,432, representing unamortized discount and premium paid on retirement of our bonds, which accounts for the difference in earnings for 1939 as shown by the above two computations. And it is this type of abnormal and nonrecurring expenses that we would like to have included as exempt in the bill as finally enacted.

Section 711 (a) (1) (c) of the proposed bill reads as follows:

"(C) *Income from retirement or discharge of bonds, and so forth.*—There shall be excluded, in the case of any corporation, income derived from the retirement or discharge of any of its bonds, debentures, notes, or certificates or other evidences of indebtedness, which have been outstanding for more than 18 months."

A suggestion has been made that this secton be changed to read as follows:

"*Income from retirement or discharge of bonds, etc.*—There shall be excluded in the case of any corporation income derived from and deductions for retirement, premium paid and unamortized discount and expense allowed in connection with the retirement or discharge of any of its bonds, debentures, notes or certificates, or other evidence of indebtedness, which have been outstanding for more than 18 months."

With this change we feel that our earnings over the base period would be brought into line with normal earnings and would more nearly meet what we feel is the intent of the Congress in arriving at earnings for the base period to be used in the computation of the tax. This would also clarify the situation for the Commissioner of Internal Revenue in his administration of the internal revenue laws and leave no cause for technical misunderstanding in connection therewith.

If the bill would go to this extent, to allow as a credit nonrecurring expenses as well as nonrecurring losses, and on principal, we are unable to draw any distinction, it would not penalize any of the corporations in Texas that have refinanced their bonds and preferred stocks during the base period.

We certainly are not asking for any favored position but we do feel that Congress has no desire or intention to penalize a corporation that has completed a refunding operation during the base period. We feel that there is no real difference between nonrecurring expenses and nonrecurring losses and that they should receive the same exemption and, since it is apparently the desire of Congress to make net earnings over the base period, the basis for the computation of the tax, it should not be their intention to include therein any abnormal and nonrecurring expenses and/or losses.

Respectfully submitted.

EDWARD CLARK,
Attorney-at-law, Austin, Tex.

WASHINGTON, D. C., *September 5, 1940.*

The CHAIRMAN. Senator Lee wanted to appear before the committee with reference to an amendment with which I think the Senators are rather familiar. Senator, of course I told you we have a good deal before us, but you may proceed to present the matter as briefly as you can, please.

STATEMENT OF HON. JOSH LEE, UNITED STATES SENATOR FROM THE STATE OF OKLAHOMA

Senator LEE. Mr. Chairman, no matter what tax you pass the Government is confronted with borrowing several billions of dollars with which to finance the defense program. The first amount of that no doubt can be borrowed easily, but if the situation becomes more acute, and as the defense program swings into action and the opportunities of capital to earn more income become greater, it will be increasingly more difficult for the Government to sell Government bonds at low interest.. The result will be the Government will be required to continually raise the interest rate in order to make the incentive strong enough in order to sell Government bonds to finance this defense program.

If war should come the tendency of capital to hide out or seek higher investment will increase, and that will make it necessary for the Government to do the same thing it did during the World War, that is keep increasing the interest rate. We paid as high as 4¼ percent for the last Government bonds and guaranteed tax exemption.

Now, many of us would like to see the day come when we would stop exempting capital from taxation. Well, we cannot stop exempting capital if we borrow this money to finance the defense program by means of tax-exempt bonds. There will be several billions of dollars, how many I do not know, but the issuance of these bonds will start soon.

Now, I am offering here an amendment to this excess-profits tax bill which provides for a mandatory borrowing of money on the basis of ability to lend, just as we tax on the basis of ability to pay. This changes the present method of borrowing money in four major respects: First, the purchase of Government bonds for defense or war would be mandatory instead of voluntary; second, the amount purchased would be determined by a schedule based on ability to buy instead of being determined by patriotism, profit, or pressure; and, third, the interest rate would be low, as provided in this amendment, 1 percent, and the bonds would not be exempt from taxation, thus eliminating profits that would result from financing the defense program. And finally, the bonds would not be transferable. That is an important point. They would be in that respect like the soldier-bonus bonds.

Senator CONNALLY. Senator, may I interrupt you there?

Senator LEE. Yes.

Senator CONNALLY. You say the bonds would not be exempt from taxation. Would they be taxable not only by the Federal Government but the State governments as well?

Senator LEE. Yes; they would be Federal bonds, they would be taxable.

Senator CONNALLY. By the States as well as the Federal Government? I am just asking. I have not read the bill lately, I read it some time ago.

Senator LEE. They would be taxable; yes. The nontransferable feature would have this advantage: during the World War a small investor operating under patriotism or pressure bought a bond, but he was not able to keep that bond and he discounted and sold it, took a loss, and the bond wound up in the hands of a banker in the financial centers. When the pay-off of the bond came along it was after the war, in the period of depression. Instead of the money and the purchasing power going back to the original source, that is, to the man who originally purchased it, it went to the financial centers, thus augmenting the depression.

Under my amendment the bond would not be transferable, therefore when it was paid the money would go back to the forks of the creek and back to the grass roots and thereby hold up the purchasing power and, to a great extent, cushion the shock of an after-war depression.

Now, one of the important things of this plan is to utilize the nonliquid wealth of America as a backlog of credit for financing the defense program. Senator Ashurst used a very good illustration, which I will use now. He said, "Would the borrowing be based on net wealth, or on income?" "For example," he says, "a man with a cow cannot have beef and milk too."

Now, that is true, but he can place a mortgage on the cow and use her as security for financing his crop and sell milk from the cow to pay off the mortgage without destroying the stream of income or without destroying the cow.

And that is the same principle here.

Let me take this one example, which I think will suffice; here is a man worth $100,000; his money is tied up in a plant, it is nonliquid. Now, would anybody say that the man worth $100,000 should not purchase any bonds for defense or for war purposes? No; I think everyone would agree, comparing it with the days of the World War when we were selling bonds and asking every patriotic citizen to buy. I think everyone would agree that he should buy some bonds. Now, the, are we going to leave the amount he is to buy to his patriotism or to the pressure of the committee in the community, or to his desire for tax-exempt high-interest-bearing bonds, or should we leave it to some fair schedule that will put him on the same pro rata basis as some other fellow worth $100,000?

I think we will all agree that neither pressure, patriotism, nor profit are fair criteria for determining the amount of bonds he should buy. Therefore, by setting up a schedule we give him his fair quota. During the World War quotas were set by the arbitrary guess of the Liberty Loan committees. It would be much fairer to use a person's net wealth as a yardstick for determining his quota.

But you say his money is nonliquid. Many cases where people's capital was nonliquid during the World War were answered by the person going into the bank and borrowing the money and buying his share of the bonds. Many people who had no capital at all, like the soldiers in the service, bought bonds and paid for them out of their pay. Of course, they sold them as soon as they could at a discount, they took a loss, but somebody else made a profit.

In the first place, in the case of a man worth $100,000, it is inconceivable that he could not borrow enough money to buy his pro rata share of the bonds.

Senator BAILEY. He could mortgage his property, too.

Senator LEE. He could mortgage his property, just as I gave the example of the cow, he could attach that mortgage to his note and give that in exchange for the bond.

Senator BAILEY. You would not only have an expropriation of capital but also you would have a pressure mortgage.

Senator LEE. What would be the alternative if we did not have that?

Senator BAILEY. The alternative would be to do nothing of that sort, in my judgment.

Senator LEE. The Senator will remember that in the World War we had a number of cases that worked great injustices. Would the Senator say in that case a man worth $100,000 could not buy any war bonds?

Senator BAILEY. I think we have got the voluntary plan still working in America, and I am in favor of the voluntary principle of American life. However, if we are going into these things I am willing to hear about it. I think we are going very rapidly in that direction. I just want to know how far we are going. We have got now forced loans, expropriation of wealth, and forced mortgages. That is how far we have gotten down the road. Would you apply this to the farmers of Oklahoma, the fallow-land owner, the farmer in Oklahoma?

Senator LEE. I would apply it to everybody, sir. The truth is that the farmers would be forced to buy more bonds under the system of pressure and patriotism than under a system based on ability to lend because they have so little net wealth.

Senator BAILEY. You would make the farmers go out and borrow some money?

Senator LEE. Only in order to buy their share of bonds which would be based upon their net wealth. They borrowed money before far beyond their ability. Under this plan they would not buy nearly as many bonds as they bought before. A man who had a son in the service was much more subject to patriotic appeal, he bought far out of proportion to his ability to buy and the result was he borrowed money at 10-percent interest, and then discounted and sold the bonds some as low as 20 cents on the dollar, he sold the bonds at a loss. Under this plan he would not have to buy as much as he bought before. The present plan is based on patriotic appeal, which is a very poor criterion. A man's sales resistance usually increases in direct ratio to his bank account.

Senator BAILEY. You just said in the World War the farmers responded very patriotically and bought more bonds voluntarily than under this forced-loan proposition.

Senator LEE. I say that applies to the little investor. The small investor was at a great disadvantage, particularly the man with property that was visible was at a disadvantage, more so than the man who had intangible securities, whose property was not so visible. The high-pressure Liberty Loan committees would see this man's property and assign to him as mere guesswork, a larger quota than perhaps to his wealthier neighbor whose property was not so obvious.

Senator CLARK. Senator, as I understand it, you are making the same argument that was recently made for conscription of manpower as against the voluntary system. I don't know yet whether or not I agree with the details of this plan of yours, but I do agree with the principle that there is no justice or equity or Americanism in drafting manpower and not drafting everything else, which I understand is the principle to which you are driving.

Senator LEE. That is right.

Senator BARKLEY. Let us take the $100,000 man. Suppose he owns a plant worth $100,000, but he already has a mortgage on it, we will say, for $50,000, so his net worth is $50,000.

Senator LEE. Then he would be put in the $50,000 class, because this provides for net worth.

Senator BARKLEY. Suppose he hasn't got enough cash to buy his share of bonds under the bill; suppose he cannot get anybody to loan him any money on a second mortgage on that plant, what would you do in that case?

Senator LEE. Then the Government would take his note secured by a mortgage on the plant.

The CHAIRMAN. Senator, your suggestion to the committee was incorporated in the recent amendment offered on the floor, that we voted on, as to the point of order?

Senator LEE. That is correct.

Senator CLARK. We never had a chance to vote on the merits, we voted on the point of order.

Senator LEE. Mr. Chairman, I thank you very much. I have finished, unless someone wants to ask a question.

The CHAIRMAN. All right, Senator, thank you very much.

Senator BAILEY. I agree with everything, except I do not know how this man, the farmer, would pay off his mortgage.

Senator LEE. Remember, Senator, the bonds would not be transferable, so the farmer would have the Government bonds for the full amount of the principal of the mortgage. Therefore, when the Government paid off the bonds that would cancel out the principal of the mortgage. Thus, the Government would have borrowed the individual's credit to use as the backlog of financing the defense program. This would prevent much of the inflation that inevitably accompanies a great expansion of credit, which is not based upon specified earmarked property.

For example, during the World War, the banker loaned one of his good customers enough money on a personal unsecured note with which to buy a bond. Then the second Liberty Loan came along and the banker loaned this individual enough money to buy a second bond but took the first bond for security. Then later loaned on the second bond for the purchase of a third bond, and so forth, through the entire five bond campaigns. Thus, this pyramiding of unsecured bonds could not help but cause great inflation.

It is my opinion that the inflation would be much less if each loan is secured by earmarked property. But the Government would never be forced to take that property because for every mortgage there is a corresponding Government bond, the payment of which would cancel out the principal of the mortgage.

Mr. Chairman, I ask that the proposed amendment be printed in the record immediately following my remarks. I thank the committee.

(The amendment referred to is as follows:)

Amendment intended to be proposed by Mr. Lee to the bill (H. R. 10413) to provide revenue, and for other purposes, viz: At the end of the bill, insert the following new title:

TITLE V—DRAFT OF WEALTH

SEC. 501. Whenever Congress shall declare war, or shall declare that the imminence of war has created an emergency which in the judgment of the President is sufficiently serious to necessitate an increase in the Military Establishment by the drafting of manpower, the President is authorized and requested to cause to be taken a census of the net wealth of the Nation. Such census shall be taken in such manner as the President shall by regulations prescribe and by such agency or agencies of the Government as he may designate or establish for such purpose. Such regulations shall require every citizen of the United States, every resident alien, and every nonresident alien having any wealth in the United States to file with such person or agency as the President may designate a sworn declaration in such form as the President may prescribe with respect to his gross wealth and financial obligations: *Provided*, That such declaration in the case of a nonresident alien shall be only with respect to his gross wealth in the United States and financial obligations therein. For the purposes of this title, an individual shall be deemed to own any property held in trust for him or his benefit. Upon the completion of such census the President shall cause to be computed, and shall prepare a list setting forth, the net wealth of each person covered by such census which is subject to section 502 of this title and the portion of the net wealth of each such person which is subject to the borrowing power of the United States under this title.

SEC. 502. The following portions of the net wealth of every citizen of the United States and of every resident alien, and of that part of the net wealth of every nonresident alien which is located in the United States, shall be subject to the borrowing power of the United States under this title:

In the case of net wealth not in excess of $1,000, none.

In the case of net wealth in excess of $1,000 and not in excess of $10,000, 5 per centum of such excess.

$450 in the case of net wealth of $10,000; and in the case of net wealth in excess of $10,000 but not in excess of $100,000, 10 per centum in addition of such excess.

$9,450 in the case of net wealth of $100,000; and in the case of net wealth in excess of $100,000 and not in excess of $250,000, 15 per centum in addition of such excess.

$31,950 in the case of net wealth of $250,000; and in the case of net wealth in excess of $250,000 and not in excess of $500,000, 20 per centum in addition of such excess.

$81,950 in the case of net wealth of $500,000; and in the case of net wealth in excess of $500,000 and not in excess of $1,000,000, 25 per centum in addition of such excess.

$206,950 in the case of net wealth of $1,000,000; and in the case of net wealth in excess of $1,000,000 and not in excess of $2,000,000, 30 per centum in addition of such excess.

$506,950 in the case of net wealth of $2,000,000; and in the case of net wealth in excess of $2,000,000 and not in excess of $3,000,000, 35 per centum in addition of such excess.

$856,950 in the case of net wealth of $3,000,000; and in the case of net wealth in excess of $3,000,000 and not in excess of $4,000,000, 40 per centum in addition of such excess.

$1,256,950 in the case of net wealth of $4,000,000; and in the case of net wealth in excess of $4,000,000 and not in excess of $5,000,000, 45 per centum in addition of such excess.

$1,706,950 in the case of net wealth of $5,000,000; and in the case of net wealth in excess of $5,000,000 and not in excess of $7,500,000, 50 per centum in addition of such excess.

$2,956,950 in the case of net wealth of $7,500,000; and in the case of net wealth in excess of $7,500,000 and not in excess of $10,000,000, 55 per centum in addition of such excess.

$4,331,950 in the case of net wealth of $10,000,000, and in the case of net wealth in excess of $10,000,000 and not in excess of $25,000,000, 60 per centum in addition of such excess.

$12,331,950 in the case of net wealth of $25,000,000; and in the case of net wealth in excess of $25,000,000 and not in excess of $50,000,000, 65 per centum in addition of such excess.

$29,581,950 in the case of net wealth of $50,000,000; and in the case of net wealth in excess of $50,000,000 and not in excess of $100,000,000, 70 per centum in addition of such excess.

$64,581,950 in the case of net wealth of $100,000,000; and in the case of net wealth in excess of $100,000,000, 75 per centum in addition of such excess.

SEC. 503. (a) The Secretary of the Treasury shall from time to time determine the sums that will be necessary to prosecute to a successful conclusion any war declared by Congress or to provide for such expenditures for the national defense as may be necessary to meet any emergency declared by Congress which in the judgment of the President necessitates an increase in the Military Establishment by the drafting of manpower, and shall issue bonds for such sums. Such bonds shall be issued in convenient sizes and denominations, shall not be transferable, shall bear interest at a rate not in excess of 1 per centum per annum, and shall not be tax-exempt either as to principal or interest. The President shall prorate among the persons covered by any census taken pursuant to this title the sums which such persons are required to invest in each separate issue of such bonds so that so far as practicable the percentage of the net wealth subject to the borrowing power of the United States (computed on the basis of the graduated scale set forth in section 502 of this title) which any such person is required to invest will not be larger than the percentage which any other such person is required to invest, and the President shall proclaim the time limit within which such persons are required to purchase such bonds and shall notify each person the amount of such bonds he is required to purchase. Each person shall then purchase such bonds in the amounts so allotted and within the time so prescribed. If the aggregate amount which any such person shall have been required to invest in all the bonds so issued during any one such war or to meet any one such emergency shall have equaled that part of his net wealth which is subject to the borrowing power of the United States under section 502 of this title, such person shall remain subject to the borrowing power of the United States under this title but in computing that part of his net wealth which he may be required to invest there shall be deducted from his total wealth the amount of such bonds previously purchased by him.

(b) The borrowing power of the United States under this title shall not be exercised after the President proclaims the termination of the war or the emergency which has brought such power into existence.

(c) It is hereby declared to be the policy of Congress that, whenever bonds are issued pursuant to the provisions of this title, the proceeds resulting from the levy of any additional taxes or increased rates of taxation imposed by reason of the war or emergency as a result of which such bonds are issued shall, except insofar as they are needed in the immediate interests of national defense, be applied to the retirement of such bonds.

SEC. 504. (a) The President is authorized to establish, in the several States, Territories, and possessions, such number of local boards of wealth appraisers as may be necessary for the purpose of accurately determining the net wealth of the Nation. Each such local board shall be appointed by the President and shall consist of three or more members, none of whom shall be connected with the Military Establishment, to be chosen from citizens residing in the area within the jurisdiction of such board as determined in accordance with rules and regulations prescribed by the President. Such boards shall have power within their respective jurisdictions to hear and determine, subject to review as provided in subsection (b) of this section, all questions arising under this title with respect to the ownership and valuation of wealth.

(b) The President is further authorized to establish in each Federal judicial district of the United States such number of district boards of appraisers as he may find necessary, and each such district board shall consist of such number of citizens of the United States, none of whom shall be connected with the Military Establishment, as the President may determine. The respective jurisdictions of such district boards shall be determined in accordance with rules and regulations prescribed by the President, and each such district board shall have power, under rules and regulations prescribed by the President, to review on appeal, and to affirm, modify, or reverse, any decision of any local board of appraisers having jurisdiction in any area within the jurisdiction of such district board. The decisions of such district boards shall be final except that, in accordance with such rules and regulations as the President may prescribe, he may affirm, modify, or reverse any such decision.

(c) The district courts of the United States, the United States courts of any Territory, and the District Court of the United States for the District of Columbia shall have jurisdiction of offenses and violations under this title and the rules and regulations prescribed thereunder, and, concurrent with State and Territorial courts, of all suits in equity and actions at law to enforce any liability or duty created by this title; but no question within the jurisdiction of any local board of appraisers shall be litigated in any such court unless the person litigating such question has invested in bonds as provided for by section 503 of this title and until a final decision with respect to such question has been rendered pursuant to subsection (b) of this section. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. No judgment or decree rendered by any such court in any proceeding instituted by any such person shall require the United States or any of its agents to make reparation to the plaintiff, other than to repurchase from him such bonds as he was not rightfully compelled to purchase. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U. S. C., 1934 edition, title 28, secs. 225 and 347). No case arising under this title and brought in any State court of competent jurisdiction shall be removed to any court of the United States.

SEC. 505. (a) The President is authorized, in his discretion, to provide, under such rules and regulations as he may prescribe, for the acceptance by the United States of property or services which are valuable for the prosecution of war or the improvement of the national defense in payment for the bonds provided for by section 503 of this title. Such rules and regulations shall provide for the method of valuation of any such property or services.

(b) The President is further authorized to provide, under such rules and regulations as he may prescribe, for the acceptance from any person, in payment for the bonds authorized by section 503 of this title, of notes or other obligations of such person, bearing interest at the rate of 6 per centum per annum and adequately secured by liens upon specified property.

(c) The President is authorized to issue currency, notes, or other obligations of the United States upon the security of property, notes, or other obligations accepted under subsections (a) or (b) of this section; but the amount of the currency, notes, or other obligation so issued shall not exceed the value of the security held against them and the security so held shall be used or disposed of solely for the purpose of discharging or retiring such currency, notes, or other obligations.

(d) The President is authorized to take such action as may be necessary to enforce any lien accepted under this section and to sell or otherwise dispose of any property acquired under this section. In the event that any person fails to pay the amount of any note or other obligation made by him and accepted under subsection (b), and the property securing such note or obligation is insufficient to discharge the indebtedness in full, a sum sufficient to discharge the balance of such indebtedness shall be withheld in redeeming the bonds issued under this title to such person.

SEC. 506. The President is authorized to make such rules and regulations, in addition to those specifically provided for herein, as may be necessary to carry out the provisions of this title.

SEC. 507. (a) Whoever shall make any false statement in any sworn declaration required to be filed by the first section of this title, and whoever shall violate any provision of any rule or regulation made by the President under this title, shall upon conviction thereof be fined not more than $10,000 or imprisoned not more than two years, or both.

(b) Whoever shall fail to purchase the amount of bonds which he is required to purchase under the provisions of this title or shall fail to purchase such bonds within the time prescribed under the provisions of this title shall upon conviction thereof be fined not more than $100,000 or imprisoned not more than five years, or both: *Provided*, That the maximum penalties which may be imposed upon any person convicted of failing to purchase the required amount of such bonds shall be reduced in proportion to the extent of his compliance.

SEC. 508. The powers conferred upon the President and the duties and liabilities to which owners of wealth are subjected by this title are declared to be supplementary to and not in limitation of or in substitution for any powers, duties, and liabilities with respect to the national defense under any other title.

SEC. 509. There are hereby authorized to be appropriated such sums as may be necessary to carry out the provisions of this title.

The CHAIRMAN. Mr. W. B. Stokely, Jr., of Indianapolis, Ind., representing Stokely Bros. & Co., Inc.

STATEMENT OF W. B. STOKELY, JR., REPRESENTING STOKELY BROS. & CO., INDIANAPOLIS, IND.

Mr. STOKELY. Mr. Chairman and gentlemen: I am W. B. Stokely, Jr., Indianapolis, Ind., president of Stokely Bros, Inc., manufacturers of canned fruits and vegetables. We operate pretty well over the country, starting from a small beginning, and my particular purpose in asking to come before this committee was to put before you the plight of a company that will be very seriously affected by this bill if it goes through as drafted.

Senator BAILEY. Let me ask you a question. Have you read this bill?

Mr. STOKELY. Yes, sir.

Senator BAILEY. Do you understand it?

Mr. STOKELY. No, sir.

Senator BAILEY. Are you going to explain it to us?

Mr. STOKELY. No, sir. In fact, I have been trying to get somebody to explain it to me.

Senator BAILEY. That is what I want. I want somebody to come here and tell me the practical effect of this bill. Nobody yet has been able to tell me that.

Mr. STOKELY. As nearly as I can interpret the effect as applied to our particular business, it has this effect on our business: We did last year something over $20,000,000 of business and we made on that $330,000, or a little over 1½ percent on sales, which is abnormally low for any manufacturing business.

Senator CONNALLY. What is your capital?

Mr. STOKELY. Our capital is $5,800,000. The year before we lost $713,000, the year before that we lost $353,000. Our average, going back for 18 years—I have to relate earnings to sales—in the past 18 years we have had 14 profitable years and 4 unprofitable years. They vary all over the map in relationship of return on sales, they vary from a low of minus 3.7 percent to a high of 17.4 percent. These variations are largely out of our control. We contract with the farmer for a certain amount of acreage and we agree to take all the acreage he has at a fixed price.

Senator BAILEY. How far would you go to contract with a farmer that was forced to mortgage his property to buy a Government bond? Could you contract with him?

Mr. STOKELY. I could not answer that one, sir. We contract with this farmer to take his acreage, and we have a wide variation in yield. If it so happens that the other canners at the same time get a large yield, at the same time we do, then the canning industry, being notoriously under-financed, we haven't got the financial strength to carry our merchandise through until some time when we could secure our cost, so as a consequence we made large profits at times and large losses at other times, but averaged over this period we made an average of 6.8 percent on sales over a period of 18 years, and going back to the beginning of our company, which is 42 years old, we have averaged a little over 10 percent on sales.

Senator CONNALLY. How does that compare with the income on your capital? Of course, so much on sales does not represent necessarily your earnings. How high do your profits run on your capital?

Mr. STOKELY. Well, they have run as high as making 30 percent on our capital and as low as losing 25 percent on our capital. In other words, it is a very speculative business. It is a whole lot like farming and it is closely related to the farmer. There are over 3,000 different companies in the industry and most of them are in the same fix that we are in.

As to this particular base period, going back over our entire history we could not pick out a worse period of 4 years.

Senator BAILEY. Tell us how this affects you.

Mr. STOKELY. It affects us in this particular way, it affects us in two ways: First, we figure that we should have a normal income or a normal percentage of sales, either way you want to figure it.

Now, normal income in this business I figure, based on our own experience, should be not less than 6.8 percent on sales, and based on capital, if you are going to start taking off the top with no guarantee of the bottom when it comes back, which it always does, you should have 20 percent on your capital in the good years to take care of the bad ones, or else you will end up by earning practically nothing.

Senator BAILEY. Could you tell me how much your business would pay under this section 710?

Mr. STOKELY. Yes, sir. If we made that required amount, that suggested amount, figured on 7.5 percent before taxes——

Senator BAILEY (interposing). What would be the percentage of income?

Mr. STOKELY. 46.8 percent.

Senator BAILEY. On an income of how much?

Mr. STOKELY. On an income of $1,500,000, before any income taxes at all.

Senator BAILEY. If you took the other alternative, section 714, what would you have?

Mr. STOKELY. The only alternative that we can take in this period is the invested capital alternative. None of the others does us any good.

Senator BAILEY. You mean to say under the average earnings or normal earnings principle in subdivision (2) of section 714 it would be more than 46 percent, is that right? You said you could not take it. I suppose it would be because it would be more?

Mr. STOKELY. Yes; that is right, sir.

Senator BAILEY. Is that normal for corporations of your type all the way through?

Mr. STOKELY. I do not quite understand the question.

Senator BAILEY. Would that affect all other corporations in your group?

Mr. STOKELY. Yes; I think there are a great many of them that it would affect even more seriously than it does us, because we have built a business, we have built out our own brands, and we do not have quite as much fluctuation as some of the smaller units in the industry do.

Senator BARKLEY. You made $300,000 profit in 1939?

Mr. STOKELY. Yes.

Senator BARKLEY. And you had a loss in 1938 and in 1937?

Mr. STOKELY. Yes.

Senator BARKLEY. What about 1936?

Mr. STOKELY. In 1936 we had a profit of $1,657,000, before taxes.

Senator BARKLEY. Taking the base period of 4 years, you would take your combined profits for the 2 years and subtract from them your losses for the other 2 years and then divide it by 4 in order to get your average profit for the 4 years, would you?

Mr. STOKELY. No; I figure taking the 2 good years and subtracting the bad years, which is the way I understand the bill to be.

Senator BARKLEY. The bad years of the base period, that would be 1937 and 1938.

Mr. STOKELY. Yes.

Senator BARKLEY. You would get a net of what you made over the base period by taking all the years combined.

Mr. STOKELY. Yes.

Senator BARKLEY. Your point is that for 1940, no matter what you made, everything above the average for the 4 years would be excess profits?

Mr. STOKELY. That is right.

Senator BARKLEY. And you would have to pay a tax on it?

Mr. STOKELY. That is right. That average, as compared with our 18-year average, is just one-third as much on sales, and as compared with our 42-year average it is one-fourth as much on sales.

Senator BARKLEY. Do you think it is possible to write into the bill a provision to take care of a situation like that, or to provide for some tribunal to take into consideration hard cases like that and adjust them?

Mr. STOKELY. I think there should necessarily be a tribunal. I think this bill is supposed to tax excess profits, and I do not see how excess profits could possibly accrue to any manufacturing business which did not make at least 5 percent on their sales. That, incidentally, is my suggestion, that the bill be not make applicable to any manufacturing business that does not make at least 5 percent on their sales.

Senator BAILEY. You would lose a good deal of money, say, in 1 year.

Mr. STOKELY. Yes.

Senator BAILEY. If you were small you would not have any opportunity to pay off that debt in subsequent years.

Mr. STOKELY. As a matter of fact, that is the crux of my problem right now, because I am seriously concerned with this bill putting us out of business. Now, you wonder how that could happen, and I will tell you how. During these tough years we had to borrow a lot of money from the banks; we borrowed $4,750,000. They carried us along because they knew we had a good, sound business in an industry that goes up and down. If it happens that we come back we cannot take our money and apply it to the debts, and then the banks, if they are smart—and they are smart—they will pick a time when we are on the peak and if they cannot get the money they close us out, because they will know there is another decline coming.

Senator BAILEY. You would not, in the prosperous years, declare dividends, because you wish to retain a reserve so as to take care of the deficiency when it comes?

Mr. STOKELY. We have not declared dividends on common stock in the last 3 years, and on preferred stock in the last 2 years. I see no nearby prospect even without this.

Senator BAILEY. If you made a good deal of money this year, with this tax bill before you, you feel you should keep your money rather than declare it out in dividends?

Mr. STOKELY. I think we should be allowed to pay off our obligations so our company will be sound when the next decline comes along.

Senator BAILEY. Would not you have to keep your profits in any year with a view to a bad year coming, because you know you could not borrow when that bad year comes?

Mr. STOKELY. It would be very hard to get any outside capital in this business. We are talking abour raising capital on a business making 7 percent or 5 percent. If somebody can tell me where we can get any equity capital in the canning business for twice that, I would like to see it.

Senator BARKLEY. To what exent is your turn-over seasonal?

Mr. STOKELY. It is about 80 percent.

Senator BARKLEY. There is a difference between profits on sales and profit on your capital?

Mr. STOKELY. Yes.

Senator BARKLEY. The smaller your capital the greater the percentage of profit on it, based on a certain percentage of sales.

Mr. STOKELY. That is right. We happen to be undercapitalized. We would like to have more capital and make a smaller percentage on our capital, but we do not know where to get it.

Senator BAILEY. I will be glad to give you an opportunity to discuss it with our experts.

Mr. STOKELY. I would be glad to discuss it with him. I may have made an error.

Senator CONNALLY. You say you could not have picked out 4 worse years than these 4, 1936, 1937, 1938, and 1939?

Mr. STOKELY. As a group. I had one what I would call average year in there, one subnormal year, and two terribly bad ones.

Senator CONNALLY. How would it work out instead of balancing this over 4 years, we will say, put it over 10 years?

Mr. STOKELY. That would be much better.

Senator CONNALLY. Ten prior years.

Mr. STOKELY. Any additional years you could add to it would help us.

Senator CONNALLY. You would get a more even spread?

Mr. STOKELY. That is right.

Senator CONNALLY. The longer the period the more even the average.

Mr. STOKELY. That is right.

(The brief submitted by Mr. Stokely is as follows:)

BRIEF OF W. B. STOKELY, JR., INDIANAPOLIS, IND., PRESENTED TO THE SENATE FINANCE COMMITTEE AT HEARINGS ON THE EXCESS-PROFITS BILL

SEPTEMBER 5, 1940.

Mr. Chairman and gentlemen, I am William B. Stokely, Jr., of Indianapolis, Ind., appearing as president of Stokely Bros. & Co., Inc., an Indiana corporation engaged in the canning of vegetables, fruits, and other food products.

I have asked an opportunity to testify because the excess-profits tax bill, in its present form, threatens the future of our company. In the last fiscal year we sold over $20,000,000 worth of food products and the first time in 3 years showed a profit, but even that profit was only $330,000 or a little over 1½ percent on sales. In the previous year the company had a loss of $713,000, and the year before that a loss of $353,000. In only one year of the base period, the fiscal year ended in 1937, did we show a normal profit. In that year earnings were $1,382,000 or 7½ percent on gross sales of $18,000,000.

The losses suffered in 1938 and 1939 and the smallness of the profit in 1940 were due to causes beyond the control of the management. In the fiscal years ended May 31, 1938 and 1939, unusually large crops coincided with a general business decline. In spite of such recurring conditions the business for a period of 42 years has shown average earnings of over 10 percent on sales. It so happens that the base period provided in the bill is the worse 4-year period in the history of the company.

Normal earnings adequate to pay off bank loans of $4,750,000 incurred during recent bad years and to make it possible for the company to obtain equity financing which it needs for working capital in the conduct of a $20,000,000 business, would mean net profits for several years averaging over a million dollars. Before any thought of war or profits due to defense expenditures, the management of the company confidently looked forward to duplicating or bettering its 1937 earnings. If it does that now $1,000,000 will be called excess profits. The excess-profits tax will apply to everything over 1.5 percent on sales. The present bill would divert almost half of our normal profits and, in my opinion, is calculated to throw us and many others like us into receiverships if the industry should again face conditions like those of 1938.

As applied to 3,000 companies in the canning industry, the tax is a discriminatory income tax, not an excess-profits tax. It discriminates against the very companies least able to pay. Incidentally, when the canners fail it is the growers of the crops who are hardest hit, having usually been forced to deliver their farm produce to the smaller companies on credit.

My understanding is that this situation is receiving consideration and that a number of suggestions have been made for relief. Of these the proposal of the National Canners Association, permitting a carry-over of unused credits in any of 3 prior years, would be helpful.

An alternative suggestion offered, for what it may be worth, is that companies engaged in manufacturing should be allowed a minimum credit of 5 percent on sales. In a manufacturing operation profits limited to 5 percent on gross sales cannot be reasonably classified as excess profits.

The CHAIRMAN. We have a communication from Mr. L. H. Parker and I will ask the clerk to read this for the record. He was going to appear today but decided to submit a brief.

The CLERK (reading):

SEPTEMBER 4, 1940.

Hon. PAT HARRISON,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

MY DEAR CHAIRMAN: With the intention of appearing at the hearings being held by your committee, I asked and was accorded time for such appearance.

It was my purpose to present a memorandum in behalf of the Republic Steel Corporation showing that this corporation as well as the industry as a whole should be entitled to a credit of at least 6 percent upon invested capital before the imposition of any excess-profits tax.

It is noted that you have approximately 37 witnesses scheduled for appearance on Thursday of this week. Therefore, I am submitting, instead of appearing personally, the memorandum on this subject herewith, with the request that it be made a part of the record. This will conserve the time of the committee while at the same time putting before them in concise form the substantial reasons why a credit of at least 6 percent on invested capital is imperative to my client and to the steel industry as a whole. I trust this memorandum will be given the serious consideration which it deserves.

Very respectfully,

LOVELL H. PARKER, *Tax Associate*,
GUY & BROOKES,
Edmonds Building, Washington, D. C.

The CHAIRMAN. The memorandum referred to by Mr. Parker will be put into the record.

(The memorandum referred to is as follows:)

MEMORANDUM OF REPUBLIC STEEL CORPORATION ADVOCATING A MINIMUM CREDIT OF SIX PERCENT ON INVESTED CAPITAL BEFORE THE IMPOSITION OF THE PROPOSED EXCESS-PROFITS TAX

Submitted by: Lovell H. Parker, Tax Associate; Guy & Brookes, Edmonds Building, Washington, D. C., August 26, 1940

(This memorandum was prepared for printing prior to the action of the Ways and Means Committee of the House, changing in certain important respects the proposals contained in the published report of its subcommittee.

Insofar as concerns the argument herein presented the only change in point is the increase of the credit on invested capital from 4 to 5 percent. While this increase is important and helpful it does not meet the absolute minimum requirement in such regard of Republic Steel Corporation and of the steel industry.

It is therefore felt that the position hereinafter stated is still fundamental and appropriate.)

1. GENERAL PRINCIPLES

The most important requisite of any excess-profits tax in a country which desires to promote rather than to discourage private industry is that a certain fair percentage of profit be allowed upon capital invested before such a tax will apply. Only as a result of such encouragement can the Government, over a period, obtain maximum revenue through taxation. Thus, it has a purely selfish reason for encouraging industrial earnings.

In determining a fair percentage of profit, the following points should be considered:

(*a*) Capital will not be invested freely in business ventures where less than a 6 percent return is indicated. In fact, in businesses which are hazardous to any considerable degree or which are likely to have substantial fluctuation in profits, capital will demand a higher prospective rate of return. The published report of the subcommittee of the Committee on Ways and Means recognizes this by allowing a credit of not less than 8 percent of the invested capital in the case of new businesses incorporated after 1939. In such cases, it even allows a credit of 10 percent of the first $500,000 of invested capital. Why corporations formed before 1940 are not entitled to equally fair rates on money already invested is not explained in the report of the House Ways and Means subcommittee. New capital is just as necessary for established corporations as it is for new corporations. In one case it is needed for expansion and rehabilitation; in the other for installing equipment and starting operations. The investor in either case is influenced by prospects of return on his investment. The effect of severe limitation of earnings on existing capital must, of necessity, influence his disposition to supply new capital, even though such new capital is accorded special treatment. For purposes of future earnings the new capital is merged into the old.

(*b*) A fair rate of return on capital has long been considered as 6 percent. This is shown by the legal interest rate generally provided for in State laws, by the fair return rate allowed in the case of public utilities, by the income tax act itself in specifying the rate of interest to be paid on overpayment or underpayments of tax, and by the average experience of business in obtaining money.

(c) The return yielded by the average long-term corporate bond or preferred stock over any normal cyclical period also establishes the reasonableness of a 6 percent rate.

The subcommittee report, in case the taxpayer elects to be taxed on the so-called "invested capital method," provides for a credit against excess-profits tax net income of only 4 percent of the invested capital. It is true the report allows a minimum credit of 6 percent on the first $500,000 of invested capital, but this is not of substantial help to corporations, of which there are many, whose capital runs into millions. It should be remembered that the corporation with a large capital may have hundreds of thousands of individual stockholders who will have their dividend income reduced by higher taxes, while the corporation with small capital may all be owned by one stockholder whose surtax rates are far above the proposed combined corporate tax rate. In other words, if the proposal is aimed at the objective of preventing the creation of millionaires through the operation of the national defense program, the amount of a corporation's invested capital has little relation to the objective.

2. CONTENTION

It is submitted that the proposal should provide for a credit of not less than 6 percent of the invested capital. This would be fair to all industries, would reduce the inequities inevitable in an excess-profits tax law, and in the long run result in more revenue for the Government.

3. APPLICATION TO STEEL INDUSTRY

The steel industry must be permitted to earn in excess of 4 percent (the credit provided for in the subcommittee report) on its investment before being subject to an excess-profits tax for a number of substantial reasons. First, in the interest of its employees, it must have sufficient earnings after taxes to maintain, over the long pull, wage standards, group insurance, vacations with pay, and other employee benefits; second, it must have sufficient earnings after taxes to recoup the losses of certain years and to attract capital for additions to plant and to leave available funds for research and development; and third, in the interest of stockholders, the earnings after taxes must also be sufficient to pay reasonable dividends.

The great majority of the corporations comprising the steel industry will undoubtedly be compelled to elect the invested capital method of computing excess-profits tax. This is because their invested capital is relatively large and their earnings abnormally low during the base period years 1936 to 1939, inclusive. The minimum rate of return to be allowed before the excess-profits tax is applied is therefore extremely important to the industry which, with the exception of one or two units, will secure practically no relief from the use of the average earnings method.

The relation of the earnings of the steel industry to invested capital in the period 1923 to 1939, inclusive, will first be considered. This data is shown in the following table:

TABLE I.—*Ratio of net earnings to invested capital in the steel industry (from Records of American Iron and Steel Institute)*

Year:	*Percent earned on investment* [1]	Year:	*Percent earned on investment* [1]
1923	6.15	1932	—2.83
1924	4.73	1933	—.50
1925	5.34	1934	.50
1926	6.49	1935	2.19
1927	5.10	1936	4.54
1928	6.15	1937	6.18
1929	9.08	1938	.47
1930	4.35	1939	4.24
1931	.29		

[1] Present approximate invested capital in steel industry is $4,200,000,000. Investment includes funded debt and percentages, therefore, are obtained from the ratio of net earnings plus interest to such investment.

Earnings in the steel industry have been subject to wide fluctuation in the last 17 years and, as the above table shows, the percentage of earnings to invested capital has, of course, proportionately varied. In 5 of the last 9 years (1931 to 1939) the industry has actually shown no net earnings after interest charges. This means that the industry has been able to survive and expand to meet expanding demands of the country only through the occurrence of compensatory periods of high earnings operating to offset periods of deficit and of grossly inadequate earnings.

Unless the industry is permitted the utilization, free of onerous taxes, of a substantial portion of its peak earnings, it will not be able to maintain itself over the periods, sometimes prolonged, of minor earnings or substantial deficits.

The average earnings over a period of years, are ridiculously small considering the enormous invested capital.

The subcommittee report proposes to fix the credit allowed on invested capital by reference to a base period. The base period specified is the 4 years, 1936, 1937, 1938 and 1939. It is submitted that this is not a representative period of normal profits. In these 4 years the ratio of net earnings to invested capital averages 3.85 percent. If we selected the 4 years 1923 to 1926, inclusive, as the base period the average ratio of net earnings to invested capital would be 5.67 percent. This would be a much fairer base period than that proposed. It should be noted that the period 1923 to 1926 does not include 1929, when earnings were 9.08 percent of invested capital. If we go further back in the history of the steel industry we will find that for the 10-year period 1909 to 1918, net earnings averaged 8.2 percent of invested capital.

Too much stress cannot be laid on the fact that if the actual earnings of the period from 1923 to 1930 had been depleted by an excess-profits tax, then the steel industry would have been seriously handicapped in meeting obligations and recovering from the depression years 1931 to 1935, when the average earnings of the steel industry on its invested capital was less than nothing (—0.07 percent).

For the current and subsequent years, the subcommittee report proposes to apply the excess-profits tax to earnings in excess of 4 percent of invested capital when a corporation averaged not more than such a percentage during the base period. It gives no relief for the future for years which fall below 4 percent For example, if a corporation makes a profit of 1 percent on invested capital in 1940, 1 percent in 1941, 1 percent in 1942 and 5 percent in 1943, it will be required to pay as excess-profits tax in 9943, although its average earnings for the 4-year period 1940 to 1943 were only 2 percent. That such a case would not be unusual can be seen by examining the ratios of earnings to invested capital given in table I.

It is also to be noted that the period immediatey ahead, starting with 1940, promises to be one of the peak periods, without which, history has shown, the steel industry cannot survive.

Certain important conclusions can be drawn from the figures in the following table covering the proposed base period years, 1936 to 1939, inclusive:

TABLE II.—*Base period statistics*

[From the records of the American Iron and Steel Institute]

Year	Percent earned on investment [1]	All Federal taxes	Wages and salaries
1936	4.54	$40,685,000	$889,634,000
1937	6.18	80,812,000	1,124,445,000
1938	.47	22,602,000	730,367,000
1939	4.24	52,140,000	970,760,000
4-year average	3.85	49,061,000	928,801,000

[1] Present approximate invested capital of the Steel Industry is $4,200,000,000. Investment inludes funded debt and percentages, therefore, are obtained from the ratio of net earnings plus interest to such investment.

It has already been shown that this 4-year period covered by the above table is not a normal period for the steel industry. It should be observed that in only 1 year did the percentage of earnings exceed 6 percent, and it is evident that the fluctuation in net earnings was considerable. In 1938, the steel industry had no earnings, and this, of course, makes the period still more abnormal.

The table shows how seriously the revenues of the Government are affected whenever the earnings of the steel industry are poor. Total Federal taxes dropped from over 80 million dollars in 1937, when earnings were fair, to less than 23 million in 1938, when most companies lost money. Thus the Government suffered a 57-million-dollar revenue loss. The effect of these fluctuations in earnings on the Federal income tax alone is even more pronounced. The receipts in the case of this tax fell from $62,000,000 in 1937 to $8,000,000 in 1938. It seems clear that an unfair tax on the steel industry will eventually decrease the revenue of the Government instead of increasing it. This is because, over a period of years, expansion will cease and net income diminish. Receipts from an income tax depend even more on volume of net income than on high rates of tax.

In a similar way the wages and salaries paid out by the industry decline with the net earnings. The table shows wages and salaries to be over 1,124 million dollars in the year 1937, and only 730 million in the bad year 1938, or a decrease in wages and salaries paid of nearly 400 million dollars. Any tax which cuts into the earnings which are necessary to the continued expansion of the business will eventually increase unemployment.

The steel industry now represents an investment of about $4,200,000,000 and it is paying wages in excess of $1,200,000,000 to about 650,000 employees. The improvement of its plants has required large expenditures and during the period 1935 to 1939 there was expended $942,000,000 on new construction and equipment.

The steel industry is unique in that the cost of installation of a new integrated unit is so great and the history of earnings of established units so spotty that, practically speaking, there is no prospect of any new unit being established. Therefore, the country must depend upon the expansion of existing units from time to time to meet the growing requirements for this important product. If new money cannot be attracted on reasonable terms the industry and the country as a whole must suffer. New money will scarcely be attracted on favorable, if any, terms to an industry which cannot return in excess of 4 percent on its invested capital without the payment of a substantial portion of such excess in Federal taxes. The fact that the law may allow new capital a higher rate of return is a negligible factor in the case of established businesses with large capital. The new capital will be merged with the old and the rate of return permitted before the imposition of an excess-profits tax will not be substantially increased.

It seems obvious that unless the steel industry prospers the country as a whole will not prosper. In our opinion an excess-profits tax on earnings of less than 6 percent of invested capital will seriously hamper efforts to obtain the necessary capital required by the industry, and will eventually result in increased unemployment, little if any dividends, and less revenue to the Government.

4. APPLICATION TO REPUBLIC STEEL CORPORATION

The history of Republic Steel Corporation parallels the history of the steel industry as a whole as far as earnings, ratio of earnings to invested capital, employment, and Federal taxes are concerned. It seems sufficient to show this by a table giving statistics from the records of Republic Steel Corporation for the proposed base period years, 1936 to 1939, inclusive.

TABLE III.—*Base period statistics of Republic Steel Corporation and subsidiaries*

Year	Percent earned on investment	All Federal taxes	Wages and salaries
1936	4.98	$3,327,000	$74,616,000
1937	4.35	4,540,000	91,353,000
1938	−1.08	794,000	58,505,000
1939	4.57	3,593,000	83,350,000

NOTE.—Present approximate invested capital, including funded debt, of Republic Steel Corporation and subsidiaries is $327,000,000.

During the entire period from 1931 to 1940, the company has been able to pay no common dividends and is presently in arrears to the extent of $1,435,000 on its 6 percent preferred stock now outstanding. During the same period the company paid substantially more than 4 percent, on the average, on its funded debt, and is presently paying more.

It will be observed, in general, from the above table that practically everything that has been stated about the Steel Industry as a whole also applies to Republic Steel Corporation. It will also be observed, in particular, that Republic Steel

Corporation earned over 4 percent in every one of the base-period years, except 1938, and yet the subcommittee report proposes an excess-profits tax on this corporation whenever it earns over 4 percent.

The subcommittee report points out a number of provisions designed to give relief to the taxpayer. (See page 8 of the report.) Practically none of these provisions is of any advantage to Republic Steel Corporation. For example:

(*a*) The alternate method of computing the tax on the basis of average earnings gives no relief since earnings were low during the base period.

(*b*) The inclusion in invested capital of borrowed capital gives no relief since the corporation pays more than 4 percent on its funded debt. In fact this provision is a penalty since the adding of one-third of Republic Steel Corporation's funded debt to capital and reduction of one-third in the allowable interest deduction will have the effect of increasing its excess-profits tax

5. CONCLUSION

We submit that, if Republic Steel Corporation is not permitted to earn at least 6 percent on its invested capital before the imposition of any excess-profits tax, the expansion of its business will be retarded, the number and welfare of its 50,000 employees adversely affected, and, in the long run, the amount of taxes paid the Government diminished rather than increased.

The same considerations are present in the case of most of the other units in the steel industry, as has been shown by industry figures heretofore appearing in this memorandum. Undoubtedly, they also obtain in other important industries.

Therefore, we respectfully urge that the Congress of the United States make appropriate provision in the proposed tax bill for the allowance of a credit of 6 percent at least upon invested capital before the imposition of an excess-profits tax.

Submitted in behalf of Republic Steel Corporation by

LOVELL H. PARKER,
Tax Associate,
GUY & BROOKES,
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AUGUST 26, 1940.

The CHAIRMAN. All right, Mr. Alvord. Mr. Ellsworth C. Alvord, representing the United States Chamber of Commerce. We will be glad to hear you, Mr. Alvord, but we will have to limit you.

Senator BAILEY. Mr. Chairman, would you give Mr. Alvord more than 10 minutes? He is quite a man on taxes.

The CHAIRMAN. I know he is quite a man on taxes, but we cannot deviate from the program. So I hope you will be right to the point.

Senator BAILEY. I really want to learn something about this bill.

STATEMENT OF ELLSWORTH C. ALVORD, REPRESENTING THE UNITED STATES CHAMBER OF COMMERCE

Mr. ALVORD. In order to meet the convenience of the committee, I have prepared a fairly long statement which I ask to be filed.

First, however, I ask that you permit me to express my highest admiration of the ability of your legislative draftsmen. Messrs. Beaman, O'Brien, Tarleau, and their associates, under most trying circumstances and with woefully inadequate time available, have succeeded in putting on paper policies which I had feared would prove impossible to draft. They are to be praised and not criticized for the product of their efforts. Complicated, conflicting policies cannot be expressed in understandable language.

I am in a rather unusual position today in that I do not guarantee any of the conclusions which I set forth in my statement. They merely represent my best opinion in the time available as to the effect of the bill. I shall discuss only a few of the provisions.

I congratulate your committee. You are confronted with a very extraordinary opportunity. You can, I think, formulate and assist in enacting a true excess-profits tax.

The CHAIRMAN. Well, give us those ideas.

Mr. ALVORD. I will do that, Senator. I think you can make almost any change in the bill as it now stands without any Member of the House appreciating that a change has been made. [Laughter.]

I also sympathize with the committee because you are confronted with what I fear is an impossible task.

Considering the time available to me, I shall confine myself to a very few of what I consider the essentials of a true excess-profits tax. It will not be a sound tax even with the adoption of all the suggestions I make. The formulation of a sound excess-profits tax, gentlemen, will take you months—and months, I understand, are not available.

I would substitute for the complete lack of basic policy in the bill and the maze of its entangling, conflicting, detailed policies, one fundamental policy. If you adopt one fundamental policy, you can eliminate four-fifths of this utterly incomprehensible document you have before you.

Before discussing policy, however, I want to summarize my two conclusions with respect to the bill:

First, this bill, in my opinion, cannot be administered. I have listened to all the hearings and I have yet to hear it said that the bill can be administered. You will recall that one of the fundamental and sound objections to the old excess-profits tax laws was that they could not be administered. Second, it is equally my sincere opinion that this bill cannot be applied by taxpayers. Utterly impossible computations are required. I would like to go through the bill with you in detail in order to show you the required determinations and computations. But obviously that cannot be done.

So I would suggest one fundamental policy: Tax true excess profits only. If you do that, then you must realize that under normal times, or under what I might call ideal conditions, your true excess-profits tax will necessarily yield no revenue—because there will be no excess profits.

Your biggest difficulty in taxing true excess profits is deciding upon the proper measures or yardsticks for normal profits. Past experience is obviously one appropriate yardstick. If we could select a normal period in the past, a period unaffected by defense expenditures, a period unaffected by depression, a period unaffected by unreal prosperity, a period unaffected by price inflation, all would agree that that period would reflect normal profits.

The 4-year period in the bill, gentlemen, does not reflect normal profits. One of those years, 1938, was admittedly an extraordinary loss year. Practically every corporation in the country suffered a loss in 1938. Your combined corporate net incomes of all the corporations in the country was slightly in excess of $4,000,000,000, about half of their normal. So that if you took 3 out of the 4 years you would then recognize that 1938 was a loss year. But even then, it must be recognized that 3 out of the last 4 years are not an adequate measure of normal activities.

An average-earnings basis will not apply soundly and fairly in innumerable situations. It should apply in many more cases than the bill now permits. I find, as I study the bill, a determined effort to make the average earnings basis unattractive and perhaps impossible to most taxpayers. If past experience is a true measure of excess profits, then certainly there are no excess profits until the normal profits of past experience have been exceeded. Both simplicity and fairness combine to encourage and not penalize its use.

There are several types of corporations to which the average-earnings basis clearly is inapplicable. Obviously, those corporations which have had no normal past experience in any period which you can select, corporations not in existence, corporations with an increasing trend of perfectly normal, reasonable profits based upon just the progressive enterprise of the individual which we are trying to encourage, must have some other basis.

A second basis is the invested-capital basis. That was the basis used under the old laws—enacted, bear in mind, after excess profits were already realized and after World War speculation and inflation had taken full effect. That is not the situation today.

Senator BAILEY. And the standard would be the net return to the corporation and stockholders in relation to the capital invested?

Mr. ALVORD. That is the normal basis.

Senator BAILEY. The normal standard would be a sufficient return to justify the investor to further invest capital?

Mr. ALVORD. That is a very appropriate standard, one suggested as early as 1917.

Senator BAILEY. If you have any other standard do not you paralyze the whole structure?

Mr. ALVORD. You certainly do, sir.

Senator BAILEY. All right.

Mr. ALVORD. For those corporations which have a substantial invested capital—and they are not the majority of the corporations by any means—and which likewise have a poor earning record in the past, then I suggest that you select that rate which, in your judgment, represents, under all the circumstances, a fair return on that invested capital and say there shall be no excess profits until that amount has been earned.

One of the best measures that I can give you is the standard suggested by Senator Bailey: What return is necessary to attract outside capital? There is adequate experience, there are adequate statistics available by which you can decide that rate. If you are to base your tax solely on the experience of 1 year, then, as the witness who just preceded me pointed out to you, a 20-percent rate would be necessary. But that rate would be clearly excessive for a large number of other corporations.

The rate which I would suggest to you is 10 percent—but even then you should avoid many of its unfairnesses by the simple device, applicable to both the average-earnings basis and the invested-capital basis, of attempting to determine excess profits over a period of years, precisely as you attempt to determine your normal profits. You cannot measure excess profits by the result of 1 year's experience.

Unfortunately, and very unfortunately, business is both a loss proposition as well as a gain proposition. I think the rough average for corporations throughout the country is 3 good years out of 5.

Many of them rely on 2 good years out of 5. I think Senator Bailey will agree that in the textile industry, for example, they are happy if they get 1 good year out of 5.

Senator BAILEY. They have been doing much better in the last several years.

Mr. ALVORD. In 1939 and 1940. In good years enterprises must be able to make and withhold adequate earnings to maintain them in the loss years, to carry on their business, to pay their debts, to pay their labor, and to keep their plant in proper maintenance and repair.

Now with the average-earnings basis and the invested-capital basis, there is still a substantial group of corporations not cared for. I have previously suggested a series of yardsticks. Many have never been tried before. I would not like to see you try them now, in a short period of time. I think some of them would have merit. But some provision is essential to take care of that large group of corporations which have no normal earnings in past experience, no adequate invested capital, those corporations which, for example, by reason of new products, inventions, new territory, greater efficiency, more ability and perhaps some luck, have just begun to make profits commensurate with the effort which has been put into the enterprise. That type of corporation, gentlemen, will be crucified under the provisions of this bill. The only remedy I can suggest, in the time that is available to you, is a provision similar to the special-assessment provision of the old law. But I would use those provisions not solely for the purpose of determining the rate of tax. I would include the purpose of determining what should the normal profits be of this corporation under all the circumstances under which it is doing business. That is a much more simple determination. It could be made more intelligently by a nonpartisan independent board than the determination which was required under the special-assessment provisions of the prior law.

The CHAIRMAN. You have 2 minutes more.

Mr. ALVORD. Yes, sir. Now, in determining the excess profits, in addition to these three basic provisions, I would make every effort to eliminate extraordinary gains and extraordinary losses in the base period as well as in the taxable period. Your bill does not do it. Statements have been made that it does.

The statement made by Mr. Clark, who preceded me, with respect to unamortized bond discount and expense upon the retirement of bonds before maturity, illustrates but one of the innumerable situations not covered by the bill—the effect being that you will impose an excess-profits tax on an expense, on a loss, on a deduction. That, I am confident, you do not want to do. I would much prefer to err on the side of liberality than err on the side of the arbitrary imposition of a tremendous tax. Under present law, all unamortized bond discount and expense is deductible in the year the bonds are retired. If net income for excess profits taxes is not restored, this deduction will grossly and unfairly distort income—normal income—and result in unintended tax liabilities.

Preferred-stock dividends are in exactly the same class. So far as the excess-profits tax is concerned, a preferred stock dividend much more closely resembles interest upon bonded indebtedness than it does a share of earnings going to stockholders.

With respect to consolidated returns, I am glad to report that argument is no longer necessary with respect to both the necessity and advisability of computing excess-profits-tax liabilities upon the basis of consolidated returns. I am equally confident that if the policies I am outlining to you are adopted, the difficulties of drafting will disappear. They should be permitted for all purposes.

I can close by merely mentioning part II of the bill. I think it is hopelessly involved and complicated. I have yet to find anyone who claims to know what it says. I should think that the policy could be stated rather simply and then drafted on a general basis rather than upon the basis of attempting to give statutory and specific computation for every conceivable situation. As I pointed out in my statement, there are also several defects in the provisions as I interpret them.

On amortization, I still feel, as I stated at the joint hearings, that the present law is adequate for all except two cases. But it has not been construed as applicable. The present law and regulations fit the situation like a glove, in my opinion, but the Treasury says "No." Therefore you must have legislation. I discussed before the House, quite at length, the basic principles of amortization, which I shall not repeat. My testimony is printed and is available.

I agree, unqualifiedly, with the testimony of Mr. Knudsen and the other officials of the Defense Council, that subsections (i), (j), and (k) must be eliminated.

Thank you very much.

Senator BAILEY. Mr. Alvord, the standard that you propose would bring out a tax bill which would look forward to a heavy increase in revenue, would it not?

Mr. ALVORD. Yes, sir.

Senator BAILEY. And this bill here looks forward to the freezing of income, and probably the destruction of the income and consequently less revenue in taxes?

Mr. ALVORD. That is very true, sir. Regardless of how the bill defines normal profits, you will find very large normal, reasonable profits in the future, within your definition.

Senator BAILEY. Do you expect we have reached the point here where we have got to decide whether the Government will have to finance all industry or take it over, or whether we will have a policy that will encourage the American people to invest their money, and to increase their investments?

Mr. ALVORD. I honestly believe that policy should be decided before this bill is enacted.

Senator BAILEY. Have not we reached the point where the decision should be made?

Mr. ALVORD. I think you have passed that point, sir, as I testified before.

Senator BAILEY. Do you think we can now retrieve our losses?

Mr. ALVORD. Yes; I think it is not too late. I think the decision should have been made some time ago. It is not too late, but having once embarked upon what I consider the basic policies of this bill it may then be too late. The time will come when you cannot retrieve, in other words.

Senator BARKLEY. May I ask you this: If I understand your theory on the basis upon which excess profits can be calculated, it is that we ought to write into this bill some provision recognizing or taking note of what corporations ought to have made, if they made anything, over the base period?

Mr. ALVORD. Yes.

Senator BARKLEY. And deduct that from the base and then levy excess-profits taxes on all above that. Is that in substance your position about the base period?

Mr. ALVORD. It is a little more detailed than that, but that is what the present bill does. I would be a little more accurate than the present bill.

Senator BARKLEY. The bill does not do that, it does not calculate altogether what the company ought to have made in terms of percentages when it did not make it at all.

Mr. ALVORD. Yes it does, Senator. That is my objection to the bill. It says if you made less than 5 percent, or 7 percent on $500,000, then they will let you earn that much, but if you get more than 10 percent, they will cut down to 10.

Senator BARKLEY. Would your suggestion raise as much money as the bill under consideration?

Mr. ALVORD. During periods of excess profits my suggestion would raise tremendous revenues. During a normal period of time, Senator, my suggestion to you is that you openly and avowedly collect your revenues from normal profits, not under the guise of excess-profits taxes.

Senator GEORGE. May I ask you one question?

Mr. ALVORD. Yes.

Senator GEORGE. You heard Mr. Mack's testimony here?

Mr. ALVORD. Yes.

Senator GEORGE. Do you believe it to be sound that we should eliminate loss from sales of depreciable assets held over 18 months? I think that is what he was talking about.

Mr. ALVORD. Certainly it is sound, yes, sir; in the base period to eliminate all extraordinary or nonrecurring losses.

Senator GEORGE. Yes.

Mr. ALVORD. If you do not eliminate them, you will so depress your normal earning power that you will then be subjected to a tremendous excess-profits tax.

Senator GEORGE. This bill does undertake to eliminate capital losses in the base period.

Mr. ALVORD. Yes.

Senator GEORGE. He wants the elimination of those depreciable assets losses in the taxpaying year.

Mr. ALVORD. In the taxable year, a loss upon the sale of an asset, whether or not depreciable, used in the trade or business should be allowed. All ambiguity on this point was removed in 1938, I think. I see no reason to change the policy. It is a real loss.

Senator CONNALLY. Mr. Alvord, do you regard it as necessary that we have both standards, the invested capital theory and average earnings?

Mr. ALVORD. Certainly, sir.

Senator CONNALLY. We have got to have both?

Mr. ALVORD. Yes; we have got to have both.

Senator CONNALLY. All right.

Mr. ALVORD. Plus the third I suggested.

Senator LODGE. Mr. Alvord, I would like to ask you some questions. As I understand your proposal on excess profits, it is devoted solely and singly to the taxation of excess profits?

Mr. ALVORD. Yes.

Senator LODGE. It has no other objective?

Mr. ALVORD. No, sir.

Senator LODGE. Is it fair to say that the excess-profits provision of this bill has got that objective, and then several other objectives?

Mr. ALVORD. I do not find that objective in it, Senator.

Senator LODGE. The excess-profits provision in this bill does not even have the objective of taxing excess profits?

Mr. ALVORD. It has nothing to do with excess profits, as I read it.

Senator LODGE. What would you say are some of its objectives?

Mr. ALVORD. The basic, declared objective is the raising of revenue.

Senator LODGE. That is an entirely distinct matter from taxing excess profits?

Mr. ALVORD. Yes, sir.

Senator LODGE. Would not it be an excellent thing, and without any sacrifice of revenue to the Government, if this matter were studied further and action on it was postponed to a later date?

Mr. ALVORD. I certainly think so, sir.

Senator LODGE. And the Government would lose no revenue at all?

Mr. ALVORD. The Government would lose no revenue at all. You may recall that that is precisely the recommendation I made at the time you passed the first revenue act of 1940. I told you then that that plan was not adequate.

Senator LODGE. Is it not also true that other parts of this bill could be reported out at once and this other matter could be held up for further study?

Mr. ALVORD. If legislation is necessary on amortization, I think that could be enacted without delay.

Senator LODGE. Thank you very much.

Senator BARKLEY. Let me ask you this: Perfectly sincere and able people disagree, always have disagreed on tax legislation, and probably always will.

Mr. ALVORD. Certainly.

Senator BARKLEY. What improvement do you guarantee in view of these differences, that might be written into the bill if it were put over until January or some other time in the future? What improvement do you guarantee over what the committees are giving to the consideration of the whole subject now while it is hot, and not let it get cold and come back here next year and try to put it over again? Is there enough consensus of opinion among companies, experts and nonexperts, one of whom I am, to feel that next year or any future time we can write a better bill than we can write now?

Mr. ALVORD. There is, Senator; yes. I think you yourself were much sounder 2 months ago than you are now.

Senator BARKLEY. According to that, we will be less sound next January.

Mr. ALVORD. Time was the reason, Senator, that 12 months ago you gentlemen said, "we want the experts to study excess taxes and report back to us on the 1st of October, so we can then devote the balance of the year to the enactment of an excess-profits tax some time in the next session of Congress applicable to 1940." I think you would have gained a great deal had you adhered to that procedure.

The CHAIRMAN. Well, we change our opinions a good deal. [Laughter.]

Mr. ALVORD. I appreciate that.

(The brief submitted by Mr. Alvord is as follows:)

BRIEF OF ELLSWORTH C. ALVORD

(Presented to the Committee on Finance of the United States Senate at the Hearings on the Second Revenue Bill of 1940, September 5, 1940)

Mr. Chairman, gentlemen; my name is Ellsworth C. Alvord, an attorney, of Washington, D. C., chairman of the committee on Federal finance of the Chamber of Commerce of the United States.

INTRODUCTION

The general problems with respect to financing the national-defense program were discussed by me before your committee during its consideration of the first revenue bill of 1940, and before the Committee on Ways and Means during its consideration of the subcommittee report which preceded the pending bill. This discussion is available in the printed hearings and, therefore, will not be repeated here.

OUTLINE OF GENERAL PROBLEMS

Upon the basis of messages of the President of the United States, statements and testimony of high Government officials, and reports of committees of the Congress, the Congress and this committee are confronted with the following general problems:

(1) The national-defense program must be speeded up.

(2) The cooperation of private enterprise in the defense program must be stimulated.

(3) The creation of war millionaires, and unjust enrichment as a result of the national-defense program, must be prevented.

(4) Inflationary price increases must be avoided.

(5) Additional revenues to help defray the cost of the national-defense program, and additional borrowing power to finance the balance, must be provided.

SUMMARY OF THE GENERAL POSITION OF BUSINESS

Businessmen unquestionably are in full accord with the foregoing objectives. In addition, their position with respect to the national-defense program, the enactment of an excess-profits tax, and additional revenues for the national-defense program, may be summarized as follows:

(1) Business always has been, is now, and will continue to be, willing to cooperate fully with the Government in the development of an adequate national-defense program.

(2) Business has urged the enactment of a true excess-profits tax, in order that there shall be no "war millionaires" and no "unjust enrichment" as a consequence of the national-defense program.

(3) Business expects to assume any justifiable taxes imposed for defense purposes and urges that the national-defense program be placed on a sound basis.

BASIC POLICIES AND GENERAL EFFECT OF THE BILL

There is no basic policy or philosophy upon which the pending bill has been formulated. The effect of its entangled conflicting principles is diametrically opposed to the policies which this committee, the Defense Commission, and the Congress are seeking to carry out. In its present form, it will—

(1) Jeopardize the national defense program.

(2) Accelerate and encourage unjustified price increases, and disturb the commodity and security markets.

(3) Discourage private financing and the repayment of debt.

(4) Impose tremendous tax burdens upon normal profits, and rely mainly upon them for its estimated increased revenues.

(5) Depress normal peacetime activities, discourage and, in many cases, prevent normal healthy growth and expansion.

(6) Greatly accentuate the domestic problems of idle men and idle money.

(7) Hold out to the youth of the country no hope for better opportunities than those afforded them during the last 10 years of depression.

(8) Abandon all existing precedents under our old excess-profits taxes and disregard the experience and lessons of the past.

THE EXCESS-PROFITS TAX

The following principles are fundamental in the formulation of a true excess-profits tax:

(1) An excess-profits tax should be designed primarily to prevent or limit excess profits, not to produce revenue from normal profits.

(2) If additional revenues, rather than control of excess profits, are the objective, they should be sought directly and openly through taxes on increased incomes and other available sources.

(3) An excess-profits tax should protect and permit the realization of normal profits; there is no warrant, in a purported excess-profits tax, for defining reasonable and normal profits as excessive.

(4) An excess-profits tax is a most complicated and dangerous instrument of taxation, which may profoundly affect both our peacetime economy and our defense program; it requires, therefore, the most careful deliberation and debate, preceded by thorough analysis of the problems and followed by painstaking drafting.

MAJOR OBJECTIONS TO THE PENDING BILL

The bill which passed the House is not a true excess-profits tax. It does not meet the fundamental standards of such a tax.

Our principal objections to the measure, apart from its many technical defects, are as follows:

(1) *Uncertainty.*—In its present form, the bill is virtually incomprehensible. The report of the Committee on Ways and Means declares that its purpose is to make tax liabilities definite and certain. The bill achieves precisely the opposite result. These provisions will stand as conclusive proof that, at least so long as your present legislative experts remain in office, anything can be drafted. But the ordinary taxpayer, if he has seen the bill, must be completely bewildered, and totally unable to apply the provisions to his own circumstances; and neither his lawyers nor accountants will offer much enlightenment. Unquestionably, it would take years of dispute and litigation before tax liabilities could be determined under the bill. Even the relatively simple problems arising in the base-period years (which include the years subject to the undistributed-profits tax) haven't yet been settled.

(2) *Tax on normal profits.*—Under the guise of taxing "excess" profits, the bill is designed to raise revenue from reasonable, essential profits which are not in any sense excessive nor related in any way to the defense program. It proposes to collect an additional normal tax of more than 4 percent on all profits for use of the "income" or "average earnings" method. It provides a minimum return on invested capital lower than interest and preferred stock dividend requirements prevailing in many cases. Its drastic structure of rates is applied without regard to the relation of income to actual invested capital or the relation of excess profits to real normal profits. The bill makes no effort to measure normal profits or to ascertain or prevent true excess profits.

(3) *Penalties.*—The bill proposes to inflict penalties on the use of the average earnings method of determining normal profits, which are so severe as to emasculate the method. It is generally conceded that average earnings over a representative prior period is a fair method of ascertaining true normal profits. Nevertheless and apparently with the sole object of discouraging the use of the average earnings basis, the bill provides for an additional 4.1 percent normal tax, and a 5 percent rate differential on excess profits, determined by this method.

In addition to these two penalties, the following discriminations against the average earnings basis are imposed:

(*a*) No deduction is computing excess-profits net income is allowed for the 4.1 percent normal tax imposed for use of the income method.

(*b*) There is no 10 percent preferential rate amount for capital additions, under the income method.

(*c*) The income method is available only to corporations in existence for the entire 4-year base period. For corporations in existence only part of the base period, the bill constructs an assumed invested capital, but will not permit the construction of assumed base period earnings for the income method.

(*d*) Although the bill purports to give corporations in existence for the full base period an adequate base period income credit, it fails to do so where the taxpayer has acquired another corporation in the base period or thereafter, owing to the restrictions imposed in part II, supplement A (hereinafter discussed).

(4) *Invested capital.*—As an alternative to the use of "average earnings," the bill prescribes an invested capital base which is arbitrary and illogical, bearing little relation to realities. Moreover, to determine the invested capital credit, an impossible series of computations is required.

A mere enumeration of the computations in the ordinary case is appalling. The taxpayer must determine:

(*a*) Equity invested capital for each day of the 4 years in the base period.

(*b*) Borrowed invested capital for each day of the 4 years of the base period.

(*c*) The sum of (1) and (2) for each day of the base period, in order to determine whether 100 percent, two-thirds or one-third of borrowed capital may be included in invested capital.

(*d*) The aggregate of invested capital, equity and borrowed, for each year of the base period.

(*e*) The amount of admissible and inadmissible assets for each day of the base period, determined by ascertaining the adjusted basis of each asset of the corporation for each such day.

(*f*) The aggregate amount of admissible and inadmissible assets for each year of the base period.

(*g*) Reduction of invested capital for each year of the base period by the percentage of inadmissible assets to total assets.

(*h*) The aggregate invested capital, after reduction for inadmissibles, for all 4 years of the base period.

(*i*) The aggregate excess-profits net income for the 4-year base period, after numerous adjustments to normal tax net income to place it on the same statutory basis as will be used in 1940 (and perhaps in subsequent years), with further adjustments for deficit years.

(*j*) The percentage which aggregate earnings bear to aggregate invested capital for the base period.

(*k*) The invested capital for the taxable year, applying steps (*a*) to (*g*), inclusive, for such period.

(*l*) The "lowest invested capital," necessary to determine new capital acquired after the base period.

(*m*) The "excess-profits credit," consisting of varying percentages of 5, 7, 8, and 10 applied to invested capital, depending on various combinations of the base period percentage, the lowest invested capital and the sum of $500,000.

These intricate and probably impossible calculations cover only the normal case. Special additional computations are necessary if there were reorganizations, mergers or liquidations in the base period or the taxable year (requiring computations of "preferential rate amounts," "borrowed capital bases," etc.) or if the corporation was not in existence for the full base period; or if there were any short-term gains and losses involving inadmissible assets. Literally, hundreds and thousands of separate computations may be required, all of which may have to be recomputed if any change in any item is required in the course of the final determination for any one of the 5 years involved.

(5) *Discriminations.*—The bill is discriminatory and imposes tremendous tax liabilities beyond the control of the taxpayer. No adequate provision has been made for any of the following situations:

(*a*) Past losses and future losses.

(*b*) Normal profits presently earned as a result of years devoted to exploration, development or research.

(*c*) Profits which will not be increased and which may be decreased by the defense emergency.

(*d*) Normally increasing and expanding business volume and profits, unrelated to defense expenditures, resulting, for example, from increased demand, new products, new territory, new undertakings, or greater efficiency.

(*e*) Fluctuating incomes.

(*f*) Enterprises conducted through affiliated corporations.

(*g*) Borrowed capital, particularly in the case of the corporation which, by reason of its prior earning record and the risk involved, is compelled to pay high interest rates.

(*h*) Extraordinary or not regularly recurring expenses during the base period.

(6) *Relief provisions.*—Despite the involved and technical terms of the bill, and the certainty that it will produce severe discriminations and tremendous hardships, there is no adequate provision for relief against unintended and unanticipated consequences.

GENERAL RECOMMENDATIONS

We continue to urge the adoption of the following program:

(1) The amortization provisions should be separated from the excess-profits-tax provisions, and passed without further delay.

(2) Adequate time should be allowed for the development of the basic principles and provisions of a true excess-profits tax.

A TRUE EXCESS-PROFITS TAX

A properly devised excess-profits tax should be inapplicable to normal profits. It should be directed solely to improper or excess profits.

Such a tax should contain the following essential provisions:

(1) Bases for measuring normal profits—Three alternate bases for determining normal profits should be provided:

(*a*) *Average earnings basis.*—Unquestionably, earnings over a fair and representative normal period is one useful measure of normal profits. This method is simple; it does not discriminate on the basis of size, capitalization, or risk; and it confines the excess-profits tax to profits which have increased after the defense emergency arose. No penalties, limitations, or restrictions on its use can be justified.

An average of any 3 of the last 4 years should be permitted as a base period. This will give appropriate recognition to the fact that the last 4 years, taken as a whole, were not years of normal profit for industry, and that 1938 was a severe loss year for many corporations. It will recognize that a deficit year is not a factor in computing true excess profits; but, on the contrary, must be repaired out of profits before a normal profit can be realized.

An average-earnings basis, however, fails as a measure of normal profits, and other yardsticks must be provided, in the following cases:

(i) Newly created corporations;

(ii) Enterprises which have encountered abnormally low profits during the base period—and there are far too many of them;

(iii) Peacetime enterprises which have recently become successful.

(*b*) *Invested-capital basis.*—A fair return on invested capital is an appropriate alternative to average earnings as a measure of normal profits. In the time now available, it is probably necessary to adopt such a basis for corporations formed after the base period; and for many businesses, such as the heavy-goods industry, railroads and railroad suppliers, and the construction industry, in which average earnings have been abnormally low during the last 4 years.

In order to avoid the impossible calculations of base-period percentages of earnings to invested capital, and to avoid duplication of the average-earnings method, a flat rate of return should be specified. Illogical and impracticable distinctions between "new" capital and "old" capital, and capital "under $500,000" and "over $500,000" should be avoided. If excess profits are to be measured on an annual basis, a rate of 10 percent should be allowed. If excess profits are averaged over a period of years, a rate of 8 percent might properly be recognized. Fully three-fourths of the complicated provisions of the present bill could be eliminated by the substitution of a simple flat rate of return on invested capital for the elaborate invested capital computations required by the bill.

(*c*) *Special-relief basis.*—But neither an average-earnings basis nor an invested-capital basis will provide a satisfactory measure of normal profits in certain exceptional cases. This is particularly true of the following types of corporations:

(i) Those which have had both abnormally low earnings over the past 4 years, and low invested capital;

(ii) Those which, during the base period, had an increasing trend of profits not arising from the national-defense program;

(iii) Those which, as a result of years of research, development, and exploration, finally realize profits in a year subject to the excess-profits tax.

Various other "yardsticks," heretofore untried, could be attempted. But for present purposes, the only practical possible relief for those types of corporations seems to be an appropriate provision for "special assessment." But contrary to the provisions of the prior law, at least one of the purposes and objectives should be a determination of normal profits. As a practical matter, normal profits could be constructed on the basis of all relevant factors, such as the nature of the industry, the degree of risk involved, prior-year losses, debts, market values of and the average yield upon outstanding securities, gross profit per dollar of sales or per unit of production, the "normal" earnings of representative corporations, etc. The determination of normal profits should be entrusted to an independent board of experienced, practical men.

(2) *Rates of tax.*—Severe rates of tax on excess profits are justified if normal profits are appropriately defined and protected. The principle of graduated rates is sound, particularly if the tax is computed on an annual basis, for cumulative or nonrecurring income will frequently fall in a single year and should not be taxed at a high flat rate. But if a graduated rate scale is used, it should be based, at least in the upper brackets, upon the percentage which excess profits bear to normal profits, and not solely upon the dollar amount of excess profits. A rate structure based on dollar volume discriminates between corporations with the same ratio of profits to invested capital or prior earnings, but with different dollar amounts of excess profits.

(3) *Consolidated returns.*—It is essential that consolidated returns should be permitted for both normal and excess-profits tax purposes. The principle of taxing as a business unit affiliated enterprises which are, in fact, operated as a business unit, has not been opposed. Treasury officials and members of the Ways and Means Committee apparently agree that consolidated returns are necessary and appropriate. The sole objection is that such a provision cannot be drafted in the time available. This emphasizes, again, the fact that a sound excess-profits tax should not be written without adequate preparation and study. But if a flat return on invested capital is substituted for the present invested capital basis, the excessive complications, upon which the statement rests that a consolidated return provision cannot be drafted within the available time, disappear.

(4) *Period of measuring excess profits.*—Neither excess profits nor ability to pay taxes can appropriately be measured by income realized in 1 year. The profit system is in fact a profit-and-loss system. Business income is highly fluctuating and, unfortunately, frequent losses cannot be avoided. Relatively few corporations experience more than 3 good years out of 5. Many rely upon 1 or 2 good years out of 5. This fact is of the highest importance in determining what rate of return upon invested capital should be specified as a measure of normal profits. For example, if a 10-percent return is specified, then a corporation having 3 good years out of 5 will realize over the 5-year period a total return in the profit years of 30 percent upon its invested capital, which is in fact an average return of only 6 percent, with no allowance made for recouping the losses. To meet this situation the following provisions are recommended:

(*a*) An adequate net loss carry-over;

(*b*) A carry-over of "deficiency income," namely, the amount by which income for any year is less than the excess-profits credit;

(*c*) An adjustment of "excess profits" if "deficiency income" exists in subsequent year: and

(*d*) Permission to apply losses in the first year or two of the "post-emergency" period against profits realized during the years when the tax was in force, as in the 1918 act.

(5) *Borrowed capital.*—The taxpayer should be allowed the option of including all borrowed capital in invested capital while excluding all deduction for interest; or of excluding all borrowed capital from invested capital and taking the full interest deduction. This method of treatment is infinitely simpler than the involved scheme of borrowed capital bases proposed in the pending bill. The option is necessary, because many corporations, particularly small corporations (those having poor credit standing) are required to pay high rates of interest on borrowed money. Also, in many instances, the amount of borrowed capital involved is not sufficient to warrant its inclusion, with attending complications, in the invested capital base.

(6) *Preferred stock dividends.*—It should be recognized that no corporation realizes excess profits until it has earned its dividend requirements upon its outstanding preferred stock—at least if issued prior to the enactment of the new tax. From an excess profits point of view, preferred stock dividends are closely related to interest payments upon bonded indebtedness.

(7) *Newly organized corporations.*—Corporations formed after the base period must, of course, compute excess profits either by the invested capital method, or in accordance with appropriate special relief provisions. Corporations which were actually in existence for at least a full year during the base period should be given the option of electing the average earning basis, with the base period earnings averaged over the period of actual existence—or prior years' earnings supplied, as under the invested capital basis, by a specified percentage of its invested capital. The pending bill arbitrarily denies this option, requiring corporations not in existence for the full 4 years of the base period to use the invested capital method, and constructing an artificial invested capital for the period when it was not in existence.

ADMINISTRATIVE AND TECHNICAL RECOMMENDATIONS

(1) *Treatment of unamortized bond discount and expense.*—The bill defines "excess-profits net income" to exclude income arising from the retirement or discharge of certain indebtedness. An adjustment to eliminate such income is prescribed both for the taxable year and the base period, and for both the "income" and "invested capital" methods. (Secs. 711 (a) (1) (C); 711 (a) (2) (E); 711 (b) (2) (A) (iii); and 711 (b) (2) (B) (iii).) This was done on the theory that nonrecurring items of income should be excluded. On the other hand, no adjustment has been provided where the retirement of indebtedness results in loss or expense in the base period or the taxable year—as, for example, where bond premium is paid or bond discount or expense is still unamortized when the bonds are called or reacquired prior to maturity. Obviously, this is also a nonrecurring item which, in fairness and equity, should be excluded from the computation of "excess-profits net income."

(2) *Property paid in for stock.*—In the determination of equity invested capital, section 718 (a) (2) provides that property paid in for stock shall be included at its "basis (unadjusted) for determining loss upon sale or exchange." The old law provided that property should be included at its value when paid in. This substitution of the arbitrary tax concept of "basis" for actual cost is undesirable for the purpose of determining actual capital investment in a corporation. It will work a severe and unnecessary hardship where property with a low basis has been acquired at fair market value by the issuance of stock, but the provisions of the revenue law require that the transferor's basis be carried over to the transferee. An unsound result is also produced in the converse situation, where property with a high basis has depreciated in value and is transferred for stock at market value, with a "carry-over" basis required.

Even if the use of basis instead of cost is accepted, the provision is still objectionable in that it requires use of the basis for determining loss. This prevents the use of March 1, 1913, value where such value is higher than cost. When the March 1, 1913, value of property has been determined and accepted for tax purposes, it will nevertheless be necessary, for invested capital purposes, to discard this value and ascertain the cost of the property, possibly in the hands of prior owners, and in transactions occurring many years ago.

(3) *Election of method.*—Section 712 permits the taxpayer to elect either the average earnings basis or the invested capital basis for any taxable year. But the election must be made in its return for the taxable year. Undoubtedly, the taxpayer will elect the method which at the time appears to produce, on the basis of its computations, the lesser tax. It will, however, not be in a position even to estimate with reasonable accuracy the consequences of its election. For example, after the return has been filed, changes will frequently be made by the Commissioner, or the Board of Tax Appeals, or the courts, either in base period or taxable year income or invested capital or both, which will make the basis selected by the taxpayer less favorable than the alternative method. The tax should be imposed in the alternative, and the taxpayer should be required to pay only the lesser amount, without regard to election.

(4) *Statute of limitations.*—Another question which arises in connection with redeterminations of base period income is whether the Commissioner can make such redeterminations, for excess-profits tax purposes, after the period of limitations has run on years in the base period. For example, the taxpayer's return for 1940 may be audited after the period has run on the years 1936–39, in which the taxpayer showed a base period income of $1,000,000. The Commissioner may decide, however, that the base period income should be reduced to $500,000 and require an excess-profits tax computation on that basis, although it is too late for the taxpayer to claim a refund. This question should be clarified. No such power to affect closed years should be permitted.

(5) *Completed contracts.*—The bill takes no account of hardships which may be worked on taxpayers reporting income on a completed contract basis. Many taxpayers engaged in the performance of long-term contracts (as, for example, bridges, dams, buildings, etc.) are unable to report income in the ordinary manner. The regulations have, for a long time, permitted such taxpayers to report income from such contracts either on a percentage basis, according to the percentage of work completed in each taxable year, or on the completed contract basis, under which all income is reported at the completion of the contract. Taxpayers on the latter basis are severely penalized by the bill, since all the income on contracts

entered into but not completed prior to this year will be thrown into a year subject to the excess-profits tax and base period income will not reflect any portion of such income. Such taxpayers should be allowed to reallocate the income over the life of contracts entered into prior to enactment both for the purposes of the current taxable year and the base period, or should be given the benefits of a special relief provision.

(6) *Taxable stock dividends.*—Section 713 (c) (3) provides that, under the "income" method, stock dividends shall not be treated as property paid in, and hence shall not be considered capital additions to the average earnings base. This treatment is proper for nontaxable stock dividends, but should not be applied to taxable stock dividends. A taxable stock dividend is, in effect, the same thing as a distribution of cash which is reinvested in the corporation by the stockholders. In the latter case, of course, the corporation receives a capital addition; and no difference in treatment for taxable stock dividends is justified.

(7) *Distributions in first 60 days of taxable year.*—Section 718 (c) (2) repeats a provision used in the World War excess-profits tax, that distributions during the first 60 days of the taxable year are considered to have been made on the last day of the preceding taxable year, and reduce accumulated earnings and profits to the extent thereof. This is contrary to the provisions in present law that distributions during the taxable year are deemed to be out of the most recently accumulated earnings and profits, regardless of the amount earned on the date of distribution. (Sec. 115 (a) and (b).) It is also contrary to the rule prescribed in section 718 (c) (3) for distributions after the first 60 days of the year. If the new rule is considered essential to prevent tax evasion, considerable care will be required to avoid discriminations and conflicts.

(8) *Capital additions during base period.*—Section 713 (c) provides for capital additions and reductions to base-period income occurring after the base period. There is no provision, however, for increases or reductions of capital during the base period, which obviously affect the average earnings over the period. If a large increase in capital occurred in 1939, the taxpayer will have the benefit of only 1 year's earnings, or less, upon this capital in figuring base-period earnings. The increased capital, however, will presumably continue to produce income in 1940 and thereafter, in years subject to the excess-profits tax. In the converse situation, where a capital reduction occurred late in the base period, the taxpayer will be unduly favored in computing excess-profits taxes. This situation should be corrected.

(9) *Deduction of taxes in computing excess profits net income.*—It should be noted that the 4.1-percent tax for use of the income method, although it is designed and described as an addition to the normal tax, has been drafted as an additional excess-profits tax, in an amount equal to 4.1 percent of normal-tax net income. The result of this phrasing is to prevent the deduction of this tax, along with the 20.9-percent normal tax, in computing income subject to the excess-profits tax. If this penalty is not removed (as it should be), it should certainly at least be deductible as a part of the corporate normal tax.

(10) *Personal service corporations.*—The definition of personal service corporations in section 723 is too limited in its scope. The definition requires that the owners of at least 80 percent of the stock be regularly engaged in the active conduct of the affairs of the corporation. This limitation operates to exclude a large number of personal service corporations in which the persons performing the active services obtained capital to run the business from outsiders, in return for a substantial portion of the stock (usually a majority). These corporations are substantially similar to limited partnerships. They have the following characteristics: (*a*) The capital is relatively small, (*b*) it is not a material income-producing factor, and (*c*) the number of stockholders is small. These tests should be applied in determining the scope of the personal service corporation provisions, rather than the arbitrary and unrealistic standard of the present bill.

In fact, much could be said for affording to every corporation an exemption from the excess-profits tax if its stockholders returned and paid tax upon all its income, whether or not distributed.

(11) *Refunds of A. A. A. taxes.*—Sections 711 (b) (2) (A) (5) and (B) (5) add back to base period income amounts taken as a deduction by vendor corporations for repayments or credits to their vendees of taxes paid under the Agricultural Adjustment Act. On similar grounds, an adjustment should be made for refunds of processing taxes under title VII of the 1936 act, most of which have

not been adjudicated by the courts and will be received in years subject to the excess-profits tax. These refunds are nonrecurring items of income, constituting the return of money paid under an unconstitutional tax. They are not "windfalls," subject to the unjust enrichment tax, since it must be shown in order to obtain the refund that the tax was not passed on by the processor. They are not profits attributable to the defense program. They should not be subjected to an excess-profits tax.

A. Supplement A—credit based on income

(*12*) *Exchange provisions.*—These provisions are intended to make appropriate adjustments for reorganizations, mergers, liquidations, etc., in the base period or the taxable year where the excess-profits credit is based on income.

In the following situations, however, the taxpayer will be denied a fair base period credit:

(*a*) In any case in which the taxpayer acquires the assets of another corporation, in the base period or thereafter, unless such acquisition was effected by a statutory merger or consolidation, in a 112 (b) (6) liquidation, or by exchange of all the stock of the taxpayer for all the assets of the other corporation. This excludes many tax-free reorganizations, compelling many corporations, parties to such reorganizations, to compute their excess-profits credit on the invested capital method. It is particularly harmful in the case of practical mergers and consolidations as distinguished from statutory mergers and consolidations, which are not specifically provided for under the laws of many States.

(*b*) Even in the limited group of situations recognized by the bill, the taxpayer is denied the base period earnings of a corporation which it has acquired unless such corporation was in existence for the full base period.

(*c*) Although the bill purports to make the income method available to corporations not in existence for the full base period where they have acquired in reorganization the assets of another corporation which was in existence at the beginning of the base period, this right is also limited to the specific types of reorganizations referred to above, and further limited by the exclusion of the earnings of the acquiring corporation for any period prior to the acquisition.

(*d*) Where a corporation has been organized to succeed the business of an individual or partnership, the base period earnings of the individual or partnership base period are not available to the successor corporation. This is a common type of reorganization, and was provided for under the 1918 and 1921 acts.

B. Supplement B—credit based on invested capital

These provisions are intended to make adjustments for certain exchanges, where the excess profits credit is computed on the invested capital basis.

Unquestionably, these sections, covering over 30 pages, are the most complicated in the bill. In neither the House committee report nor in the Treasury statements before the Senate committee has there been any attempt to explain the purpose and effect of this part of the bill in other than the most general terms. I seriously question whether anyone has been able to analyze the provisions and their ramifications satisfactorily in the time available. Testing the effect of the provisions, however, upon certain specific cases, the provisions seem to contain discriminations both against the taxpayer and the Government, which may be illustrated by the following cases:

(*a*) Prior to the base period, a parent corporation creates a subsidiary and transfers to it $10,000 in cash in exchange for all the subsidiary's stock. Under section 752, which contains no date limitation, it would appear that the parent's invested capital would be reduced by $10,000. Thereafter, during the base period, the subsidiary is liquidated under section 112 (b) (6), and all its assets (representing the original investment and the results of years of operation) are acquired by the parent corporation. There appears to be no provision in part B, or any other part of the bill, which would have the effect of reinstating the parent's original invested capital, or otherwise increasing the parent's invested capital, as the result of the reacquisition of the assets of the subsidiary. If this is correct, a serious discrimination against the taxpayer exists.

(*b*) A parent corporation creates a subsidiary and transfers $10,000 thereto in exchange for all the subsidiary's stock. Under the provisions referred to above, the subsidiary would be entitled to an invested capital of $10,000, and the parent's invested capital would be reduced accordingly. However, if the parent corporation uses the income method of computing its excess-profits credit, there appears to be no provision in the bill which would require an adjustment in the parent's credit with respect to income attributable to the assets transferred to the subsidiary. If this is correct, a serious loophole exists in the bill, operating against the Treasury.

Possible errors of this magnitude should demonstrate that provisions as complicated as those contained in supplement B of part II cannot be satisfactorily drafted in the time that has been available. Before the bill is enacted into law, taxpayers affected by these provisions should have an adequate opportunity to study them, and to determine the application of the provisions to their particular situations.

Although it is nowhere expressed, I assume the policy of part II could be expressed somewhat as follows:

"In the case of tax-free transfers and exchanges in connection with reorganizations, liquidations, and the creation of new corporations, proper adjustment shall be made in invested capital and excess profits net income, so that the effect of such transfers and exchanges will be properly reflected in the computation of the taxpayer's excess-profits credit."

If this is a reasonably correct statement of the underlying policy, it would seem that it could be stated in legislative language more advantageously, from the point of view of both the Treasury and the taxpayer, than the present effort to reduce all possible contingencies to a stated computation.

AMORTIZATION

It is essential that there be recognition that the economic life of facilities devoted to the national-defense program will be limited to the defense emergency. In our opinion, this fact could have been promptly recognized and applied by the Treasury Department under present law, without recourse to special legislation. Ample authority for such administrative action is contained in the depreciation allowance under section 23 (l) of the existing revenue law.

In view of the present position of the Treasury Department, however, the enactment of an adequate provision for accelerated depreciation and obsolescence (usually referred to as amortization) is necessary. Passage of this provision should be expedited by separation from the excess-profits tax-provisions.

The amortization provisions of the bill appear to us to be unduly complicated and detailed. In our opinion, the purpose of the bill would have been accomplished satisfactorily by a simple provision directing the Treasury Department to take into consideration the period of the defense emergency in determining a reasonable allowance for the exhaustion, wear and tear of property, and fixing the emergency period at not more than 5 years.

The bill also contains some unnecessary restrictions which impair the usefulness of the provision. These may be summarized as follows:

(1) The provisions of subsections (i), (j), and (k) should be eliminated. We endorse unqualifiedly the statement of Mr. Knudsen yesterday before the Finance Committee, and of the other members of the Advisory Commission, in this respect.

(2) Subsection (e) (1) limits the benefits of the deduction to facilities completed after July 10, 1940. This limitation is unfair to taxpayers who have gone ahead with construction of defense facilities at the request of the Government prior to July 10. In view of the certificate required to show that the facilities were necessary to national defense, the prescription of any basic date seems unnecessary. In any event, the basic date should be moved back to January 1, 1940, which corresponds more closely to the beginning of the defense emergency.

(3) It is apparently required, under subsection (a), that the deduction shall be taken ratably over 60 months. It has been the practice of the Bureau, in many cases, to allow depreciation to be added to the cost of goods in closing inventory, and thus recovered directly against the income from the sale of such goods in a subsequent period. The requirement of the bill would apparently prevent this sound method of depreciation, as well as other appropriate methods for recovering cost against proceeds of sale, such as the job or contract method of depreciation.

(4) Subsection (f) (3) provides that a certificate of necessity for national defense shall have no effect unless made before the beginning of construction, or 60 days after enactment of the bill. This would put the risk of delay on the taxpayer, although the Government might be responsible. If a certificate is actually issued, it should be sufficient that it was applied for within the prescribed time.

The CHAIRMAN. Mr. Fernald of Montclair, N. J. Mr. Fernald represents the American Mining Congress. All right, Mr. Fernald.

STATEMENT OF H. B. FERNALD, REPRESENTING THE AMERICAN MINING CONGRESS, MONTCLAIR, N. J.

Mr. FERNALD. Mr. Chairman, and members of the committee——

The CHAIRMAN. We have your testimony before the Joint Committee. You are going to discuss some new questions by virtue of this new bill?

Mr. FERNALD. Yes, sir. Primarily, I would like to speak first on the bill itself which we did not have before us at that time.

The now pending tax bill is the most difficult, involved, complicated, and incomprehensible tax legislation which has ever been presented. It is a maze of abstruse, interlocking, mathematical formulae, the practical applications of which seem impossible adequately to envision.

It seems inconceivable that this bill should be seriously proposed as a law to go out to taxpayers in order to give them certainty as to their tax liabilities.

Neither business corporations, public accountants, practicing attorneys, nor the Government's own force of examiners will be able to apply such a law as this to the practical business problems which must be met.

The proposal is arbitrary and unreasonable, and in many cases confiscatory. It will class as excess profits what are simply the reasonable, normal profits of industry. Certain examples of this are submitted in the appendix which I have here. In each case it is assumed that the earnings for the first 4 excess-profits years will be just the same as the earnings for corresponding years in the base period.

I took certain figures to see what this would do under certain circumstances. One was an example, in the committee report, of an instance of base period earnings. I wanted to see what would happen if those same earnings came in the first 4 years of the excess-profits tax. I took three examples, which I have worked out roughly in this appendix to the paper I present herewith.

Here are the results: Example A is an example of one corporation which showed for the first year $100,000 deficit, for the second year $40,000 earnings, fo the third year no earnings or deficit; for the fourth year $200,000 earnings, or an average of $140,000 earnings for the 4-year period. Of those earnings, $135,000 would be considered as excess profits subject to a $55,000 excess-profits tax, even though the earnings were exactly the same as in the base period

Example B, that is the one found in the committee report, with years of $300,000 and $200,000 earnings and $150,000 and $100,000 deficits. Out of $250,000 net earnings for the 4-year period, $190,000 would be considered as excess profits and subject to $80,000 excess-profits tax. I changed that example just by one year, putting $60,000 in the first year instead of $300,000, and then out of $10,000 net earnings for the 4-year period, $115,000 would be considered as excess profits, with a tax of $45,000.

They seem preposterous, yet they are just the kind of examples you will get in ordinary business. They are relatively simple cases. They have been made simple by following the income method without getting into questions of invested capital.

As to invested capital, the mere volume of mathematical computations required with daily computations made mandatory by the bill, with differential rates continually affecting the computations, both on invested capital more or less than $500,000, borrowed money, giving invested capital more or less than $100,000, more or less than $1,000,000, are simply tremendous.

Now, not merely are we going to have the taxpayer troubled when first he must make daily computations of equity invested capital and daily computations of borrowed money, with differential computations of whether two-thirds or one-third of the borrowed money will be allowable any day for invested capital; if there are any inadmissible assets, daily computation must be made of those; and he may put that figure on his tax return; and then when the Treasury field examiners come in, if there is any change in all those figures—and remember this applies not merely to the current taxable year but to 4 years of the base period—if they make any change as to bases of assets, even a change in depreciation, or any classification of expenditures, it will mean a revision of all these computations. For example, a change in the depreciation rate will change the ratio for each day in the year between admissible and inadmissible assets.

Then we have another step. If the department changes the field agent's report in any way, again all these computations must be revised. I am not going to speak at length on that, although I would like to portray that in greater detail.

I would like to ask, better than anything I can say, if you would simply request the Treasury Department to present to you the detailed computations required for a corporation with invested capital running from $700,000 to $900,000, borrowing generally daily, borrowing from $600,000 to $1,000,000, investment in stock of other corporations varying from $100,000 to $300,000, plant investment varying from $800,000 to $1,000,000, with depreciation previously allowed at the 5-percent rate and then changed by the Commissioner to a 4-percent rate, assuming any scale of fluctuating earnings they wish, and that for each year, 1938 to 1940, the Commissioner, after the return is filed, determines that just a small amount should be treated not as an expense but as a cost of depreciable assets. If you will have before you the thousands of computations required in the first computation and in a revision, you will have some idea of what this presents.

Then I wish you would do another thing. I wish you would ask your staff, or the general counsel, to give you a statement of all the points involved there as to which there is doubt and uncertainty. I think you will then see just what it is I am talking about here.

Now, part of this is due, part of the complications in the bill are directly due to these particular things that I am going to mention:

First, the use of differential rates. This sliding scale less than $500,000, more than $500,000; $100,000, and $1,000,000 on borrowed money, if those are cut out you can immensely simplify your law and immensely simplify your computations.

Second, the attempt to write into the law the requirement for daily averages. That should not be in the law, that should be left to the Commissioner, as it was before. In many cases, daily averages are entirely unnecessary. A fair average can be obtained on a monthly or even on an annual basis. Let the Commissioner determine that by regulations, because if you write it into the law, the Commissioner cannot waive it.

Third, the desire for revenue. I am not going to go into any length on that. I think you have heard from Mr. Alvord on that subject.

Fourth, consolidated returns are not provided for. If consolidated returns were permitted you may simplify or eliminate or make much less important some of the complicated provisions which are now in this bill. Those I am speaking of from the standpoint of complications and difficulties in framing the law, and I most earnestly urge that these things be done:

Cut out the differentials on borrowed money and on invested capital; cut out the requirement for daily computations; include provision for consolidated returns; make definite endeavor in every way to simplify the basic policies of the bill; and to make clear and intelligible to the ordinary taxpayer the essential provisions of this law.

Now, as to the substantive provisions, I will cover those very rapidly, Mr. Chairman. We have these suggestions to make, wholly independent of any question of simplifying and clarifying that law:

Base period earnings should be those of not more than 3 out of the 4 years based period. Mining is essentially a business of fluctuating incomes. 1938 generally was a very poor year in the mining industry, and at least 1 of the others was a poor year, perhaps a year of loss. We have the difficulties of mines under course of development, and we have urged that 2 years should be allowed out of the 4.

If the other provisions we are urging here are made we can concur with others as to the 3-year period.

All years of loss should be eliminated or should be considered as zero.

There should be no penalty placed on the use of the income method.

The 4.1 percent tax on the entire net income, the 5 percent higher rate required on that than in case the invested capital method is used, should be eliminated.

The right to use the income method should be allowed to corporations which were in existence for 1 full year or more of the base period. We see no reason why that should be confined to those corporations which were in existence for the entire 4-year period.

The taxpayer should be permitted to make his election of method at any time. If you will get before you figures such as I have mentioned, showing the volume of computations required having in mind lack of definite settlements for years so that when the taxpayer is faced with this the election which the bill requires should be made you will see that when the return is filed he is in no position then to make an intelligent election. He ought to be able to do that at any time, whichever method he may wish.

As to the property basis to be included in equity invested capital, this should be modified. The present bill says the basis for determining loss. What we are determining here is determining profits, we are using invested capital to determine profits. We ought to have the basis for property for determining gain. It is not a proposition of trying to determine loss. I would like to speak more on that, but I will pass that.

As to borrowed invested capital, the taxpayer should have an option to include the entire amount of borrowed money in invested capital or to exclude it.

Senator GEORGE. Eliminating it, including the interest?

Mr. FERNALD. Naturally. Mr. Chairman, I have in mind the case of a large corporation that happens to have just a small obligation outstanding which would rank as borrowed money. It is entirely negligible. The matter of daily computations here would make it better to waive the thing completely in every way, rather than to have to go through and make that for a wholly immaterial amount.

Now, speaking for mining, our mining industry is largely in States where interest rates are high. They may have to pay high rates on their money. If that is true they certainly ought to be allowed to deduct the interest they have to pay on that money if they wish to do so. For that reason we think there should be the option as well as the right to include 100 percent of it.

The CHAIRMAN. All right, Mr. Fernald, your time has expired.

Senator LODGE. May I ask a question? You made a suggestion there that interested me very much, on the number of computations.

Mr. FERNALD. Yes, sir.

Senator LODGE. That would have to be made.

Mr. FERNALD. Yes.

Senator LODGE. You suggested that the committee get that information officially. Can you make that suggestion a little more definite? I think it would be well worthwhile to get that data. Would you want the information on a corporation having an income of a certain amount, and so on?

Mr. FERNALD. So far as the amount of income is concerned, I would be entirely ready to take one of my examples that I give here, or let the Treasury Department itself give examples of fluctuating income. I am speaking here of the result, you see. That was not my primary purpose in asking that, but merely to get before you a visioning of the volume of computations involved.

Senator LODGE. That is what I would like to have for the record, a definite number of computations, because that is something the average man can understand.

Mr. FERNALD. All I can say, there are going to be thousands of them. I made a tentative estimate of what might be required and I got about 180,000 computations that were required.

Senator LODGE. For one return?

Mr. FERNALD. For 1 year, including the 4 years of the base period.

Senator LODGE. And how many of those involved questions that were in doubt and were subject to debate and interpretation, and so on?

Mr. FERNALD. I should say about 100,000 of them.

Senator LODGE. Mr. Chairman, can we have that information developed officially for the record?

The CHAIRMAN. We will ask Mr. Sullivan if it is possible to get that information for us.

Senator LODGE. The number of computations and the number that are doubtful.

Mr. SULLIVAN. That is right.

Senator LODGE. Thank you very much.

Mr. FERNALD. Mr. Chairman, might I just say one word? I call attention to the statement we made urging the average basis for excess-profits tax determination either by carrying forward the deficit or deficiencies or by actually taking an average for the years. I give two further examples.

The CHAIRMAN. All that is in your brief?

Mr. FERNALD. Yes; and I also wish to urge most strongly the absolute need of special assessment provisions such as we recommend here.

The CHAIRMAN. We will give that careful consideration.

(The brief of Mr. Fernald and the appendix are as follows:)

BRIEF OF HENRY B. FERNALD, CHAIRMAN, EXECUTIVE TAX COMMITTEE, AMERICAN MINING CONGRESS, BEFORE THE SENATE COMMITTEE ON FINANCE

THE AMERICAN MINING CONGRESS,
Munsey Building, Washington, D. C., September 5, 1940.

In re proposed excess-profits tax.

To the Honorable Chairman and Members of the Committee on Finance:

The now pending tax bill is the most difficult, involved, complicated, and incomprehensible tax legislation which has ever been presented. It is a maze of abstruse, interlocking, mathematical formulas, the practical applications of which seem impossible adequately to envision.

It seems inconceivable that this bill should be seriously proposed as a law to go out to taxpayers in order to give them certainty as to their tax liabilities. Neither business corporations, public accountants, practicing attorneys, nor the Government's own force of examiners will be able to apply such a law as this to the practical business problems which must be met.

The proposal is arbitrary and unreasonable and in many cases confiscatory. It will class as excess profits what are simply the reasonable, normal profits of industry. Certain examples of this are submitted in the appendix herewith. In each case it is assumed that the earnings for the first 4 excess-profits years will be just the same as the earnings for corresponding years in the base period. Making some simple computations under this bill as I understand it, but without full detailed computations of every kind, the results (computed on the "income" method) seem as follows:

In example A, with years of $100,000 deficit, $40,000 earnings, no earnings, and $200,000 earnings; out of $140,000 net earnings for the 4-year period $135,000 would be considered as excess profits subject to $55,867 excess-profits tax.

In example B (based on an example in the committee report) with years of $300,000 and $200,000 earnings and $150,000 and $100,000 deficits; out of $250,000 net earnings for the 4-year period, $190,000 would be considered as excess profits subject to $80,234 excess-profits tax.

In example C, the same as example B, except $60,000 for the first year; out of $10,000 net earnings for the 4-year period, $115,000 would be considered as excess profits, subject to $45,793 excess-profits tax.

These are not unusual examples of results. Each will be found in actual business. They are relatively simple cases without attempting to bring in all the complications and difficulties which will be necessary in actual practice. They have been made simple by following the income method instead of getting into the involvements of invested capital.

As to invested capital, the mere volume of mathematical computations required for the daily calculations made mandatory by the bill, with the differential rates continually affecting the computations, is appalling. Take the case of a corporation with something less than $1,000,000 of equity invested capital but with borrowed money such that the aggregate invested capital may swing more or less across that dividing line. Let it be a corporation which has frequent changes in its borrowed money, as one which was borrowing against accounts receivable. Assume also inadmissible as well as admissible assets. We then have the following steps:

First.—The taxpayer must make its daily computations of equity invested capital and its daily computations of borrowed money with the differential computations of whether two-thirds or one-third of the borrowed money will be allowable any day for invested capital. Then it must make its daily computations as to admissible and inadmissible assets and the adjusted basis of each asset to be used. After its has made these thousands of detailed computations for the current taxable year and for each of the 4 years in the base period, it will obtain a figure which it may use on its tax returns.

Second.—When the Treasury field examiners make their audits, every change which they propose—such as a change in basis for any asset, a change in depreciation, reclassification of expenditures, etc.—will mean revision and restatement of all these computations. For example, a change in depreciation rate will change the ratio for each day in the year between admissible and inadmissible assets.

Third.—If in departmental conferences changes are made in the field examiner's results, again all these daily computations must be revised.

All of this is with respect to the comparatively simple situation of a single corporation, and without considering possible appeals, refund claims, etc.

It is impossible to picture the volume of work to be done and redone, the points to be canvassed and recanvassed in any such situation as that portrayed on pages 30 and 31 of the committee's report, where there have been reorganizations, mergers, or consolidations.

Many of the difficulties and complications in the bill are the inevitable consequences of certain features of the present proposals; particularly the following:

(a) *The use of differential rates.*—The allowances to be made if invested capital is more or less than $500,000, the differential treatment to be accorded borrowed money depending on whether aggregate invested capital is more than $100,000 or is more than $1,000,000, are the occasion for many of the most involved and difficult provisions of the bill.

Before the House committee we urged that a flat rate should be allowed on invested capital, regardless of whether it was more or less than $500,000. We also urged that the taxpayer should have the option of including or not including the entire amount of borrowed money as invested capital. These recommendations were made from the standpoint of what we believe fair and reasonable.

The need for simplifying the law and making its administration practicable, adds a most weighty argument to what we have urged from the standpoint of equity. We are confident your experts will concur in our statement that many of the provisions of the bill could be eliminated or simplified if these differentials were abandoned.

(b) *The attempt to write into the law the requirement for daily averages.*—The method of determining averages should be left to be covered by the Commissioner's regulations as was done under our prior excess-profits acts. Under such acts, the Commissioner could insist on daily averages but generally he did not do so because fair and reasonable averages could be obtained either on a monthly or an annual basis. If the law requires daily averages, the Commissioner will not have authority to waive them even in the many cases where manifestly a monthly or annual average would be wholly adequate.

(c) *The desire for revenue.*—An excess-profits tax should not be looked on primarily as a revenue producer. Our Revenue Acts of 1917 and 1918 yielded tremendous revenues because they were enacted when business was booming after inflationary price increases had occurred, and when true excess profits had been realized. Under the price-fixing policies of the War Industries Board, high prices were fixed, intended to bring out the maximum amount of marginal production. Production was of greater importance than price. Such prices, while they did not yield large profits to the marginal producers, did yield large profits to those not in the marginal class. If a similar policy were now adopted, any excess-profits bill would yield immense revenues. However, if we do not have such great increases in prices, we should not expect to have large excess profits.

If taxpayers are actually making abnormal, excessive profits, the excess-profits tax may rightly apply to them. It is, however, a perversion of the excess-profits tax principle to try to make the tax yield great revenue by applying it to what are in fact the normal and usual profits of business.

We believe the bill sets up a false and misleading standard of what should be considered as excess profits, and then wanders into its great complications to enforce such standards arbitrarily and unreasonably.

(d) *Consolidated returns are not provided for.*—If consolidated returns were permitted, this would largely eliminate need for many of the special provisions regarding reorganizations and consolidations, and for the difficult provisions with respect to corporate split-ups; or at least it would greatly minimize their importance.

Accordingly we urge that the differentials as to borrowed money and as to allowable return on invested capital should be abandoned; that the law should not require daily computations; that provision should be made for consolidated returns; and that definite endeavor should be made in every way possible to simplify the basic policies of the bill, and to make clear and intelligible to the ordinary taxpayer the essential provisions of this law.

As to substantive provisions of the proposal, we urge the following:

I. BASE-PERIOD EARNINGS

(a) *Base period earnings should be those of not more than 3 out of the 4 years base period.*—This was the proposal of the Connally amendment. It was announced that the Ways and Means Committee at one time approved it as a fair method; then reverted to the 4-year basis solely because that would yield more revenue.

We had urged before the House committee that the taxpayer should be permitted to select any 2 of the 4 years. This is particularly important to the mining industry.

In mining there are great fluctuations in income from year to year. During periods of depressed prices and lack of demand it is often necessary to stop or greatly curtail production. However, when a mine is once opened, it is generally impractical to shut it down completely unless it is to be abandoned. If shut down, it may fill with water and its entries and working places cave, making it costly and difficult, if not impossible, to reopen.

Even if production is entirely stopped, pumping, timbering, and other protective operations are still necessary and many other expenses such as local taxes, organization, insurance, welfare, etc., must be continued. Curtailed production with attendant losses may be carried on to give employment and keep alive the communities in which the mines are located.

Generally 1938 was a bad year for mines, and at least one of the other base-period years was poor.

We cannot stress too strongly our opinion that to use this entire 4-year period is unfair and inequitable.

For these reasons we urged that only 2 years out of the 4 should be required. If, however, other measures we here recommend are adopted, we can concur in the proposal which others have made that 3 out of 4 years in the base period should be used.

(b) *All years of loss should be eliminated or should be considered as "zero."*—This will not be so important if the foreoing recommendation is adopted, yet it seems the fair thing to do

II. PENALTIES ON USE OF THE INCOME METHOD

The use of the income method should be permitted without penalties.—To determine the normal profits which should be exempt from the excess-profits tax the taxpayer is to be given a choice of two methods, the first being the average profits of the base period and the second being an allowance on invested capital.

However, the bill puts burdensome penalties on corporations which use the income method—

> First: By adding a separate and additional excess-profits tax of 4.1 percent on its total normal-tax net income.
>
> Second: By increasing by 5 percent the rate of the excess-profits tax in the several brackets.

The 4.1 percent tax is imposed on the total normal-tax net income, not merely on the excess-profits portion thereof. Furthermore this 4.1 percent tax on the normal-tax net income is not deductible in determining the excess profits.

The declared purpose of the act is to tax excess profits, that is profits of abnormal size resulting from the defense activities of the Government. It is a distortion of this purpose to impose penalties for using the average earnings method.

III. RIGHT TO USE THE INCOME METHOD

(a) *The income method should be allowed to corporations which were in existence for 1 full year or more of the base period.*—This method is only available, under the bill, to those corporations which were in existence for the entire 4 years of the base period. We believe that any corporation which was in existence for 1 full year or more of the base period should be permitted to use this method.

(b) *The taxpayer should be permitted to make his election as to method at any time.*—The bill requires that the taxpayer who elects to use the income method must so indicate on his tax return. When the tax return is filed, he may have little assurance as to what will finally be determined as his invested capital and his net income, either for the base period or for the taxable year. Few taxpayers are in a position to make an intelligent election at the time the return is filed.

There is no good reason why the taxpayer should not be permitted to make this important election when his taxable status is finally determined.

IV. PROPERTY BASIS FOR INVESTED CAPITAL

The basis for property to be included in equity invested capital should be modified.—(1) The bill provides that the basis to be used for property in computing invested capital should be the basis for determining loss. Since the purpose of this bill is to use invested capital for determining taxable gains or profits, we urge that the property basis to be used should be the basis for determining gain.

(2) Furthermore, the purpose of this bill is to apply the property basis in a test of whether excessive profits are being made in any case. The closer in point of time we can bring our asset bases to the period of measurement of reasonable profits, the better will be our standard. There seems no occasion to go back, as in some cases might be required under this bill for one or two generations, with all the research and evidence required to establish a cost of properties to some predecessor in the distant past. One generation should be long enough to go back. No one should be required to go back before a March 1, 1913, value.

(3) Also, we believe that in any case where an existing corporation has acquired assets for more than their cost to a predecessor, it should have the right to include such assets for purpose of invested capital at their cost or fair value when thus acquired.

V. BORROWED INVESTED CAPITAL

The taxpayer should have an option to include the entire amount of borrowed money in invested capital.—We commend the recognition given to the principle of including borrowed money in invested capital. However, we believe full recognition should be given to this principle without the reductions proposed to be made on a sliding scale.

We make this recommendation from the standpoint of equity to taxpayers and also from the standpoint of simplification of the computations. For a company which has frequent changes in the amount of its borrowed capital and must compute its average invested capital on a daily-average basis, the introduction of a sliding scale of differential allowances for borrowed money requires exceedingly involved computations. As we have already noted herein, if the full 100-percent allowance for borrowed money is made, it will greatly simplify the wording of the law and the average computations to be made.

We further urge that it should be made optional with the taxpayer whether he includes borrowed money as invested capital (with the exclusion of interest paid thereon in computing net income) or does not include borrowed money in invested capital and has full deduction for interest paid. It is quite possible that some corporations would rather avoid the extended computations which will be necessary to compute average invested capital based on borrowed money than to get some small advantage from including borrowed money in invested capital. Furthermore, if the inclusion of borrowed capital is required, it may discriminate unfairly against many corporations which have to pay comparatively high rates of interest.

VI. RATE OF RETURN ON INVESTED CAPITAL

An adequate flat rate of return on invested capital should be allowed—For the mining industry this rate should be not less than 10 percent.—The difficulties and complications in the bill which result from using differential rates of allowance on invested capital, have already been referred to. Moreover, if a flat rate is used, invested capital need only be computed for the current taxable year. Four years of base-period computations will be eliminated. These alone are persuasive arguments for using a flat rate.

Furthermore, an adequate flat rate should be adopted as a matter of equity.

No intelligent businessman would risk his capital in equity investments, except in nonhazardous situations, for an expected average return as low as 5 percent or even of 7 percent. The rates proposed as allowable on invested capital are certainly inadequate, and have no reference to the realities. Unsecured business loans to the ordinary corporation carry rates of 6 to 8 percent or more depending on circumstances and locality.

We accordingly urge that credit on invested capital should be allowed at a flat rate of not less than 10 percent. Even this is far from adequate to cover the normal capital risks of the mining industry.

VII. AVERAGE BASIS FOR EXCESS-PROFITS DETERMINATIONS

Excess profits should be determined on an average basis and not on the basis of results for a single year.—The bill recognizes the principle so far as the base period is concerned, that normal profits should be determined on a basis of averages over a period of years. Yet it abandons that principle completely in determining excess profits for the taxable period. Certain examples of rather extreme results of fluctuating earnings where there are some years of loss are presented in the examples A, B, and C in the appendix herewith. Even in simpler cases where there are no loss years, great injustice may be done unless some plan of average for taxable years is adopted.

Example D

Assume a corporation with $500,000 of invested capital entitled to an average income credit of 10 percent on $500,000 of invested capital, viz: $50,000 a year.

If it has for 4 excess-profits-tax years net incomes of $10,000, of $25,000, or $75,000 and of $90,000, it will have had an average net income of $50,000 a year for the period, viz: 10 percent of its invested capital. However, in the computation required by the bill, with a total credit and exemption of $55,000 a year, it will be determined to have had $20,000 excess profits in 1 year and $35,000 excess profits in another. Accordingly, while it has only made a fair average return, $55,000 of that amount will be treated as excess profits.

Example E

Another corporation engaged in developing a mine has no profits in the first 2 years under this act, has only $30,000 profits in the third year, and thereafter realizes $60,000 profits a year for the next 3 years, after which the mine is exhausted. It has thus realized $210,000 total earnings over 6 years—an average of $35,000 a year. Assume it had a credit and exemption of $35,000 a year. This is all the average return it has realized, yet for its 3 years of substantial production it will be considered in each year to have had $25,000—or a total of $75,000—of excess profits.

Grievous injustice will be done by thus taxing as excess profits what are in fact only the normal profits of the business. Some provision should be made for averaging the returns over a period of years.

This could be done by adopting a cumulative annual average provision. Under such a provision no excess-profits tax would be imposed unless the income for the taxable year and prior years had yielded an amount in excess of the average credit; with provision that at any time when such cumulative average return was lowered, appropriate refund or credit would be given for any excess-profits tax previously paid.

Another method of meeting the situation would be to provide for deficiency credits. Under this plan any amount of a deficiency (i. e., the difference between the allowable credit and exemption and the net income) of 1 year would be applied to a subsequent or a prior year when the income had been in excess of the allowable credits. In cases where the earlier years showed such deficiencies they would be carried forward against any subsequent year which might show excess profits. However, if full equity is done, there should also be provision for allowing the taxpayer to have a deficiency of a subsequent year credited back against any prior year in which there had been excess profits.

VIII. CONSOLIDATED RETURNS

Consolidated returns should be permitted.—We have consistently taken the position that consolidated returns are essential to the determination of the true taxable net income of an enterprise composed of two or more corporations. Most certainly excess profits are not realized unless the group as a whole has aggregate earnings above normal.

The principle of consolidated returns was first brought into our income tax law in connection with the 1917 excess-profits tax, when the Commissioner prescribed consolidated returns for excess-profits tax (even though at that time separate returns were required for income tax). To avoid any question of the authority of the Commissioner so to do, a provision was written into the 1921 Revenue Act specifically authorizing consolidated returns for the 1917 excess-profits tax. Under the 1918 and 1921 acts, consolidated returns were required or permitted by law for both excess-profits tax and income-tax purposes. We believe the validity of the principle thus recognized still holds and that consolidated returns must be recognized.

IX. SPECIAL RELIEF

Broad provisions should be made for special relief to be administered by an independent board.—The bill makes no adequate provision for relief or special assessment for the many unusual situations which will arise where gross inequity or exceptional hardship will result from its provisions. Many corporations operated at depressed levels during the base period, some were in the red for 2 or more years, others were only in course of development. There are therefore many corporations that will have real occasion for special relief if they are not to be dealt with harshly or unfairly.

We therefore recommend that the special relief provision be considerably broadened, with provisions similar to those that were necessary and were included in prior Excess Profits Tax Acts. We believe, however, that the special relief provisions should be administered, as a matter of equity, by a special board, independent of the Bureau of Internal Revenue. We do not believe that the application of special relief should rest in the same Bureau that has to deal with the application of the technical provisions of the law.

So there shall be no question that mines that have been under development, shut down, or with reduced production would be cared for under the special relief provisions, we urge that the provisions in the law authorizing such a board and providing for special assessment should include among its specifications: (*a*) "in the case of mines which were shut down or in process of development during the base period", and (*b*) "in the case of mines where the volume of production in the taxable year has been substantially increased over that of the base period."

X. BRACKETS FOR COMPUTING THE TAX

Broad tax brackets based on invested capital or on exemption should be allowed.—The present bill adopts a series of tax brackets expressed in dollar amounts which are to be the basis for the graduated tax rate, regardless of the amount of the earnings, or the credit or the invested capital.

The subcommittee report had proposed brackets of 10 percent of the amount of the credit. Criticism was made that such brackets were entirely too narrow. It was pointed out that in our 1918 and 1921 acts, for example, an excess profits tax exemption of 8 percent of the invested capital had been allowed. The first bracket was then from 8 to 20 percent of invested capital. This first bracket was equal to 12 percent of invested capital, which was equivalent to 150 percent of the amount of the 8 percent credit (without taking into account the specific $3,000 exemption).

The bill recognizes that for small corporations the proposed brackets of 10 percent of the credit were entirely inadequate and so fixes brackets in dollar amounts for the benefit of the smaller corporations.

Without taking exception to this as a measure of proper relief for smaller corporations, we urge, however, that reasonable provision should be made as to the brackets of the larger corporations, for which the money brackets allowed are wholly inadequate.

Net income determination is not a matter of exactness but rather of estimate and of a series of arbitrary rules. It has been repeatedly recognized by the Bureau and by the courts that annual income determinations are at best very faulty. Minor variations in annual income determinations under arbitrary rules are inevitable, but these should not be magnified and heavily penalized by imposing a high excess profits tax on slight variations.

While we recognize the appropriateness of the dollar figures to be applied to small corporations, we urge as a matter of fairness that the general basis should be relatively broad brackets. We suggest these brackets should be not less than 10 percent on invested capital or, if based on the credits, the brackets should each be 100 percent of the credits. For example, if the credit were 10 percent of the invested capital then the first bracket should be from 10 to 20 percent of invested capital, the second bracket from 20 to 30 percent of invested capital, etc.

XI. THE 60-DAY PROVISION REGARDING DIVIDENDS PAID

The provision of the bill for reduction of invested capital on account of distributions made during the first 60 days of the taxable year, which are to be considered as if made from the surplus of the preceding year, should be eliminated.—This was a provision of our prior excess profits tax laws. Under those laws it was not an unreasonable assumption. That situation is, however, altered by the change which has now been made in section 115 (a), which provides that all distributions during any year shall be considered as out of the profits of that year to the extent of such profits. So long as this stands as a binding assumption under section 115, we should not have an assumption of a different status for such a dividend written into the excess profits tax law. The proposed 60-day provision with respect to dividends should therefore be omitted and the present provisions of section 115 (a) continued.

XII. EFFECTIVE DATE OF THE LAW

The law should only apply to taxable years beginnnig after December 31, 1940.—The bill provides that this tax shall apply to each taxable year beginning after December 31, 1939.

We have already had one heavy increase in taxation enacted in June of this year, with retroactive effect to the beginning of the year. We believe we should not have another heavy tax now imposed with retroactive effect when the year has largely expired. There seems no probability that the Treasury Department will be able to issue its appropriate regulations under this law before the end of the present year; in fact it seems doubtful if the Treasury will be able to issue adequate regulations by the time the tax returns are due to be filed on March 15. We do not feel it is desirable that the Department should issue quickly some regulations which will be inadequate or faulty so that for a long period thereafter there will be a continuing series of Treasury decisions amending and supplementing such regulations.

We believe it will be hopeless for taxpayers to take such a bill as this and try to make themselves acquainted with it and its requirements so as to be in a position properly to file their tax returns next March, with due consideration to the volume of Treasury regulations which will be required.

Furthermore, we believe it is recognized that a fair excess-profits tax will yield no material amount of revenue on 1940 incomes. Certainly there will be no material amount of incomes resulting in this year from the Government's defense program.

We therefore urge that the law should not be effective until after December 31, 1940.

If this is done, there will be needed time for proper consideration of the many difficult questions involved in such taxation, for the proper framing of the law and for the formulation and issuing of proper Treasury regulations.

The provision for amortization, as to which there seems need for prompt action, in order to give contractors and subcontractors some certainty as to their status in that regard, can be promptly passed as a separate measure. Certainly no taxpayer is going to get any certainty as to his tax liabilities from the passage of a bill such as this.

Appendix to Statement of Henry B. Fernald

EXAMPLES OF THE APPLICATION OF THE PROPOSED TAX TO A CORPORATION WITH FLUCTUATING EARNINGS

If we assume the years 1936 to 1939 were a normal period, we must also assume that the variations in annual earnings during that period are normal. We must expect that such fluctuations of earnings for good years and bad are rightly to be taken into account in arriving at a normal average.

Unless we take into account for the excess-profits period the average of good years and bad, we shall have some preposterous results. This is shown if we take certain examples and assume that the results for the first 4 years of the excess-profits period will be the same as the 4 years of the base period.

Three examples are submitted on the attached sheets. In all of these the tax is computed on the "income" method. In stating them the word "earnings" is used (as it is used in the committee report) to mean "excess profits net income." Where "net loss carry-over" is involved, it is, for the purpose of these examples, shown as applied in total to "earnings" without making the detailed computations for the "normal tax" adjustment thereto. The results of these computations, as they are hereinafter set forth, may be briefly summarized as follows:

Example "A."—This is a comparatively simple example for a corporation which showed for the first year $100,000 deficit; for the second year $40,000 earnings; for the third year no earnings or deficit; for the fourth year $200,000 earnings; resulting in net earnings for the 4 years of $140,000. With these same earnings for 4 excess profits tax year, the following results are shown:

(*a*) Out of $140,000 net earnings for the period $135,000 would be considered as "excess profits."

(*b*) The "excess profits" tax would be $55,867.

(*c*) The corporation would then have left only $84,133 net for the 4 years' excess-profits period, as compared with $140,000 net for the base period.

Example B.—This is an example in which earnings were $300,000 and $200,000 for the first 2 years, with deficits of $150,000 and $100,000 for the next 2 years (as stated on p. 5 of the report of the Committee on Ways and Means). This results in net earnings of $250,000 for the 4-year period. With these same earnings for excess-profits-tax years, the following results are shown:

(*a*) Out of $250,000 net earnings for the period $190,000 would be considered as "excess profits."

(*b*) The "excess profits" tax would be $80,234.

(*c*) The corporation would then have left only $169,766 net for the 4 years excess-profits period, as compared with $250,000 net for the base period.

Example C.—In this example, only a single change for one year is made from the stated earnings of example B, viz., to show the first year's earnings as $60,000, instead of $300,000. The following results are then shown:

(*a*) With only $10,000 net earnings for the period, $115,000 would be considered as "excess profits."

(*b*) The "excess profits" tax would be $45,793.

(*c*) The corporation would then have, after taxes, a net deficit of $35,793 for the 4 years excess-profits period, as compared with the net surplus of $10,000 for the base period.

These are not at all unusual examples. Results such as these will often be found in actual business. They show how a business which had exactly the same earnings in the excess-profits years as in the base period might have all, or substantially all, of such earnings taken in so-called excess profits taxes, or might even be left with a net deficit.

If, in these examples, we could assume large invested capital, the situation might be mitigated, but not all corporations have large capital. Even to make the computations of "daily average invested capital" is itself a heavy penalty. To master, and to make, such computations is probably beyond the ability of such an accounting staff as would be found in corporations with normal earnings which averaged $100,000 or less, as in these examples.

Perhaps there may be errors in the computations as here made, because it has been impossible to master the bill's provisions in the few days it has been available. As previously noted, the examples are not worked out in full detail. However, they are believed fairly to present results such as are likely to be found under the plan proposed in the bill, as we understand it.

Example A

Earnings of corporation A	Actual	Computed
1936 deficit	−$100,000	0
1937 earnings	+40,000	+$40,000
1938 earnings	0	0
1939 earnings	+200,000	+200,000
Total	+140,000	+240,000
Base-period average		+60,000

If for the first 4 excess-profits tax years Corporation A has similar earnings and deficit, the net result, with tax computed on the income method, will be as follows:

	Earnings	Credits	Excess profits	Tax	Net earnings after tax
1940	−100,000				−100,000
1941	{ +40,000 / [1] −100,000 }				40,000
1942	0				0
1943	+200,000	65,000	135,000	[2] 55,867	144,133
Total	+140,000		135,000	55,867	84,133

[1] Assumed net loss carry-over, 1940 to 1941.
[2] Tax computation:

Earnings (excess profits net income)	$200,000
Credits	65,000
Excess profits	135,000
Excess-profits tax:	
25 percent of $20,000	5,000
30 percent of $30,000	9,000
35 percent of $50,000	17,500
40 percent of $35,000	14,000
	45,500
4.1 percent of normal net income ($252,844.50)	10,367
Total tax	55,867

In this case, out of its net earnings (net income less normal tax) for the first 4 excess-profits-tax years, totaling $140,000—the same as in its base period—it will be considered to have $135,000 excess profits and will pay $55,867 "excess-profits" tax.

Example B

This example of corporate "earnings" in the base period is given on page 5 of the committee report.

Earnings of corporation X

	Actual	Computed
1936 earnings	+$300,000	+$300,000
1937 earnings	+200,000	200,000
1938 deficit	−150,000	0
1939 deficit	−100,000	−100,000
Net total	+250,000	+400,000
Base-period average		+100,000

If for the first 4 excess-profits years it had similar earnings and deficits—viz, 1940 earnings, $300,000; 1941 earnings, $200,000; 1942 deficit, $150,000; 1943 deficit, $100,000—the results will be:

(1) In such case its $100,000 loss of 1939 (but not its $150,000 loss of 1938) would be carried forward against 1940, so that 1940 earnings of $300,000 would be taxable only to the extent of $200,000.

NOTE.—For simplicity we are not attempting to bring in detailed income-tax differences, but deal only with "earnings," using that word as it is used in the committee's example, to mean "excess-profits net income."

(2) On this basis, its net results for the first 4 excess-profits years would be as follows:

	Earnings	Credit	Excess profits	Tax	Net earnings less tax
1940	+$300,000 [1] −100,000	$105,000	$95,000	[2] $40,117	[1] +$259,883
1941	+200,000	105,000	95,000	[2] 40,117	+159,883
1942	−150,000				−150,000
1943	−100,000				−100,000
Net total	[1] +250,000		190,000	80,234	169,766

[1] It is here assumed (to avoid extended computations) that the entire $100,000 loss of 1939 would serve to reduce by that amount the $300,000 "earnings" of 1940. The 1939 loss is not taken into account in stating the "net total" earnings for the period.

[2] Tax computation:

Earnings (excess-profits net income)	$200,000
Credits	105,000
Excess profits	95,000
Excess-profits tax:	
25 percent of $20,000	5,000
30 percent of $30,000	9,000
35 percent of $45,000	15,750
Total	29,750
4.1 percent of normal tax net income ($252,844.50)	10,367
Total excess-profits tax	40,117

Accordingly, if its earnings (net income less normal tax) for the first 4 years of the excess-profits tax period were the same as its earnings for the base period, then (even after deducting a "net loss carry-over" from 1939), out of net earnings of $250,000 for the 4 years, $190,000 would be considered as "excess profits" and "excess-profits taxes" of $80,234 would have to be paid thereon. The net result would be to leave it, for the 4-year excess-profits period, with about two-thirds of the net amount of its normal net earnings for the base period.

Example C

Changing the preceding figures for only 1 year, we have such an example as the following:

Earnings of corporation Y

	Actual	Computed
1936 earnings	+60,000	+60,000
1937 earnings	+200,000	+200,000
1938 deficit	−150,000	
1939 deficit	−100,000	−100,000
Net total	+10,000	+160,000
Base-period average		+40,000

On similar earnings for the first 4 excess-profit tax years, the result would be as follows:

	Earnings	Credits	Excess profits	Tax	Net earnings less tax
1940	+$60,000 [1] −60,000				+$60,000
1941	+200,000 [1] −40,000	$45,000	$115,000	[2] $45,793	+154,207
1942	−150,000				−150,000
1943	−100,000				−100,000
Net total	+10,000		115,000	45,793	−35,793

[1] Net loss of $100,000 for 1939 is here applied to 1940 and 1941 "earnings," but not in stating "net total."

[2] Tax computation:

Earnings (excess-profits net income)	$160,000
Credits	45,000
Excess profits	115,000
Excess-profits tax:	
25 percent of $20,000	5,000
30 percent of $30,000	9,000
35 percent of $50,000	17,500
40 percent of $15,000	6,000
Total	37,500
4.1 percent of normal tax net income ($202,275)	8,293
Total excess-profits tax	45,793

In this case, with a net $10,000 of earnings for the first 4 excess-profits tax years, $115,000 would be considered as excess profits, and an excess-profits tax of $45,793 would have to be paid. Thus the net result would be a deficit of $35,793 for the 4-year excess-profits period, instead of the $10,000 net profit for the base period.

The CHAIRMAN. Mr. Tyrrell.

STATEMENT OF RICHARD H. TYRRELL, REPRESENTING CHAIN BELT CO., MILWAUKEE, WIS.

Mr. TYRRELL. Mr. Chairman and gentlemen of the committee. I am Richard H. Tyrrell of the law firm of Wood, Warner & Tyrrell of Milwaukee, Wis., the general counsel for the Chain Belt Co., of Milwaukee, a corporation that has business enterprises, that has plants in Milwaukee, Wis., and in Massachusetts. I appear here on behalf of that company.

I am not here to raise any question with respect to the rates of this bill, nor to any tax levy that may seem proper to finance the defense program. I do, however, wish to point out one single inequality that affects seriously not only Chain Belt Co. but all taxpayers similarly situated in at least 13 States. It may be of interest to the members of the committee that 6 of these States are represented by members of this committee.

Senator LODGE. Will you read the names of those States?

Mr. TYRRELL. The States affected are Iowa, Massachusetts, Mississippi, Montana, Nebraska, Oklahoma, Oregon, Rhode Island, South Dakota, Texas, Vermont, Wisconsin, and Wyoming.

This inequality is illustrated by the situation of Chain Belt. Chain Belt Co. in 1939 acquired a business located in Massachusetts, a noncompeting business.

The CHAIRMAN. What kind of business?

Mr. TYRRELL. The Chain Belt Co. is engaged in the manufacture of chain for transmitting power, and it is also engaged in the manufacture of construction machinery and malleable and grey iron castings to some extent.

Now, it so happens that Chain Belt Co., assuming a law of this kind is passed, would find it desirable to employ the basis of earnings and using, as the law now permits, the earning record of both constituents. However, the law is so drafted at the present time that mergers entitle the surviving corporation to use the earning record of the old corporation only in the event the merger has been consummated pursuant to a statutory merger.

It so happens that in Wisconsin, and according to our investigation in the other 12 States, there are no statutes that permit mergers. Mergers in such States are accomplished, as they are in Wisconsin and as this one was accomplished, by the general common-law power of a corporation to merge. Thus simply because of the accident of this corporation being a Wisconsin corporation, without the benefit of a particular statute permitting mergers, it is denied the right to use in the computation of its earnings credit, the earning record of the constituent companies. As the result, the difference in this tax over the situation that would have resulted had this been organized under the laws of another State, say either Connecticut or Illinois, would have been $273,000 as compared with $156,000.

Now, that is an equality which is, I think, just an oversight, and it is important to all corporations similarly situated in any of these States.

Now, this problem is not entirely new to this committee. This committee, in its report on the 1934 act, when an attempt was made, and was carried out, to revise the definition of reorganizations that are entitled to certain tax-free exchanges, commented upon the fact, and it appears in its written report to the Senate, that not all States have adopted statutes providing for mergers or consolidations, and the committee at that time recommended to the Senate a provision to be inserted in the definition of a corporate reorganization covering the practical or common-law kind of merger or consolidation that is undertaken in these States that do not have statutes.

Now, we believe that this inequality can be easily remedied by enlarging the definition of what constitutes an acquiring corporation within the definition of the act, and we have undertaken to draft a provision for that purpose. Our view of it is that the Treasury Department is concerned solely with the proposition that both the old corporation and the new corporation shall not claim the benefit of the earning record, and our amendment proposes, in accordance with what these mergers are, that one of the essential factors is that the transferor corporation, the old corporation, shall have promptly undertaken a policy of complete liquidation, and thereby it assures the fact that only the new or the successor corporation, in this case called the acquiring corporation, shall claim the benefit of the earning record, and I therefore think that it meets any objection that the Treasury Department might have.

I therefore invite the attention of the committee to this problem and ask permission to put it in the record.

The CHAIRMAN. You may put it in the record. You have in your brief, I imagine, the suggested provision that you want to incorporate?

Mr. TYRRELL. That is correct.

Senator LODGE. You drafted an amendment?

Mr. TYRRELL. It is incorporated in this proposed statement. I should like to submit that. I made additional copies for the members of the committee.

Senator LODGE. This is a technical injustice which should be corrected in the interest of fairness to people in all States?

Mr. TYRRELL. I think that is true. It simply results from the fact that 13 States, as we have examined the list, do not have provisions for statutory mergers.

(The brief of Mr. Tyrrell is as follows:)

BRIEF OF RICHARD H. TYRRELL, REPRESENTING CHAIN BELT CO.

I am Richard H. Tyrrell, of the law firm of Wood, Warner & Tyrrell, of Milwaukee, Wis., general counsel for Chain Belt Co., of Milwaukee, a Wisconsin corporation having plants in Wisconsin and Massachusetts. I appear here on behalf of that company. I am not here to oppose the tax rates of this bill nor any other tax levy that may be required to finance the defense program, but wish to point out an inequality that exists in the present bill that will work a severe hardship not only upon Chain Belt Co. but upon all similar taxpayers in 13 States of the Union.

This inequality is illustrated by the situation of Chain Belt Co. That company in 1930 acquired the business of a noncompeting company located in Massachusetts. The Massachusetts company was in existence during the 4-year base period, and Chain Belt Co. would like to use the earning basis for computing its excess-profits tax. However, on the earning basis its tax for 1940 under this bill will be approximately $273,000, whereas if it were organized under the laws of certain other States, say, Illinois or Connecticut, such tax would be only approximately $156,000.

This inequality arises from the following provisions in the present bill:

This bill permits certain corporations to adopt the average-earnings method of computing the tax. In the case of corporate reorganizations during the base period the bill in certain cases extends to the surviving corporation the privilege to include in its base-period earnings the earnings of the cosntituent or old corporation. This is obviously done to recognize as normal, the earnings that will normally accrue to the surviving corporation from the business and assets of the old corporation. However, in cases of mergers and consolidations the bill (sec. 740, p. 41) extends the election only to statutory mergers or consolidations. In Wisconsin we have no statutes providing for mergers or consolidations. We accomplish the same thing under the common-law powers of a corporation. The United States Treasury Department, we believe, has always placed a very strict construction upon the term statutory merger, and under that definition recognizes mergers only when expressly covered by statutory law. Thus, simply because Chain Belt Co. was organized under the laws of Wisconsin, rather than a State having statutes dealing with mergers, it is denied the right to use the earning history of the acquired company and is penalized some $117,000.

This situation is not peculiar to Wisconsin. Our investigation discloses that there are 13 States so situated. They are: Iowa, Massachusetts, Mississippi, Montana, Nebraska, Oklahoma, Oregon, Rhode Island, South Dakota, Texas, Vermont, Wisconsin, and Wyoming. Thus corporations of any of these States which have had transactions similar to that of the Chain Belt Co., are unjustly discriminated against by the present bill.

This problem is not entirely new to this committee. In connection with the Revenue Act of 1934, this committee considered proposed revisions in the reorganization provisions of the income tax law, and in its report upon that proposed act (p. 16 of committee report dated March 28, 1934, upon the revenue bill of 1934) expressly commented upon the fact that "not all of the States have adopted statutes providing for mergers or consolidations," and the committee recommended a provision to include within the definition of reorganization mergers other than statutory mergers and the recommendation was incorporated in the law.

We believe that this inequality can easily be remedied by an amendment to section 740 (p. 41) of the bill, and have drafted and will submit herewith, or as a supplement hereto, our porposed amendment for the consideration of the committee.

We invite the attention of the committee to this problem.

RICHARD H. TYRRELL.

SEPTEMBER 5, 1940.

PROPOSED AMENDMENT TO PLACE NONSTATUTORY MERGERS ON THE SAME BASIS AS STATUTORY MERGERS

Add the following new paragraph at the end of subsection (a) of section 740 (p. 40):

"(5) A corporation which has acquired, in exchange solely for all or a part of its voting stock, substantially all the properties of another corporation, if—

"(A) such exchange was a transaction with respect to which gain or loss was not recognized under section 112 (b) (4) of chapter 1 or a corresponding provision of a prior revenue law, and

"(B) such other corporation, immediately subsequent to or in connection with such exchange, and in pursuance of the plan of reorganization, proceeded in good faith and without delay to effect a complete liquidation."

and the following new paragraph at the end of subsection (b) of section 740 (p. 41):

"(5) In the case of a transaction described in subsection (a) (5), the corporation the properties of which were acquired."

STATEMENT OF KURT F. PANTZER, REPRESENTING TECUMSEH COAL CORPORATION, INDIANAPOLIS, IND.

The CHAIRMAN. Mr. Pantzer.

Mr. PANTZER. Mr. Chairman and members of the committee:

The Tecumseh Coal Corporation is an Indiana corporation. It was organized pursuant to contracts entered into August 21 of last year. That was just a week or so before the European war began. It is a coal-mining corporation, mining by the strip method.

The corporation presents the problem of the way in which this proposed Excess Profits Tax Act affects a corporation which has, sometime during the last 4 years, followed the injunctions of both Republican and Democratic Members of Congress in starting the wheels turning. The total amount of equipment which this corporation committed itself to purchase approximates $1,900,000. It has an invested capital of only $1,000.

It is impossible, in the light of the experience of coal-mining companies in the Middle West, to obtain financing from banks or from investment security houses. The method of financing this corporation is orthodox and not shoestring or haphazard. The basis of contracting the $1,900,000 credit was, first, the character and reputation of the managing officials of the corporation, and, secondly, the fact that those managing officials had under option coal lands in southern Indiana which had an appraised value of $4,000,000 in coal in the ground which, through the royalty lease method they would attract as another item of what you might call capital investment in the corporation.

Now, the corporation attracted this capital on the basis of a budget. It went to the Marion Steam Shovel Co., of Ohio, for $600,000 of that credit on an installment time basis; it went to the McNally-Pittsburgh Manufacturing Corporation, a tipple and washer company, for another $500,000 of that credit, and the balance of the credit is represented by trucks and items of that sort.

It will require to pay the $1,900,000 of indebtedness 5 years of $400,000 earnings per year in order to meet our indebtedness, to pay our creditors. The budget whereby we had figured that out was not passed by men who are inexperienced in the coal business but by hard operators or representatives of Marion Steam Shovel Co. and the other men who have financed similar enterprises before. In other words, it was a sound budget and not a dream budget.

Now, this bill affords two alternative methods of relief: First, it directs our attention to the base period for average earnings, which we have not, we did not get into operation until May 17 of this year, and, secondly, it directs attention to invested capital.

Now, our equity invested capital was 60 days after we started business in May, $1,000. It has increased a bit since then because we have been paying off monthly these equipment obligations. Our borrowed invested capital is actually $1,900,000, but according to the percentage provisions of this bill, only $1,000,000 is allowed. Nine hundred thousand dollars of brand new equipment therefore is given no credit whatever by the provisions of this bill. We think that that places this corporation, a new enterprise employing capital goods, the kind of industry that the Government has been trying to get started, at a great disadvantage with other industries.

We counted upon an income tax of $83,000, a normal corporation income tax. Pursuant to the provisions of this tax, as I understand it, the additional tax will be $81,500. That is practically a 100 percent step-up.

According to another calculation it is $115,000. It represents one-fourth, approximately, of the indebtedness we have contracted to pay off in each calendar year.

If this industry, this enterprise, financed according to the normal method of the industry, has this sort of an experience with the act, you cannot attract capital according to the normal means of financing that kind of an industry while this act is in effect.

Coal will become, I believe, one of the important industries of the war, and we may require every ton of coal we can get to further our defense program.

I want to leave with the committee a memorandum and ask that it be made a part of the record. That sets forth some of the basic figures which I have discussed.

I wish to state the relief which I have considered, and which I think is the least relief to which we are entitled, a special relief provision affecting not merely equity invested capital, as the act is now drawn, but also borrowed invested capital, and a relief in that regard is what we desire. I find no provision for special relief to corporations that have a large borrowed invested capital.

Now, if a special relief provision is inserted in the act, I think it should be special relief according to the rules and regulations of some tribunal like the Board of Tax Appeals. With that suggestion, I am in hearty accord, but I also venture to suggest that the act provides that an industry may apply upon 60 days' notice, for a determination of the kind of relief to which it is entitled. Businessmen need definiteness in order to work out their programs, and to have hanging over the head of any industry a possible period of 5 years before whichever particular kind of relief to which the industry will be entitled can be determined, is asking too much.

The CHAIRMAN. Your suggestions will be incorporated into the record, and I suggest also that you see Mr. Stam, our expert, and talk with him about the matter while we are at lunch.

(The brief submitted by Mr. Pantzer is as follows:)

SENATE OF THE UNITED STATES OF AMERICA COMMITTEE ON FINANCE

In the matter of the hardship of the proposed excess-profits tax upon Tecumseh Coal Corporation

STATEMENT OF FACTS

Tecumseh Coal Corporation is an Indiana corporation, organized August 15, 1939, with a paid-in capital stock of $1,000, for the purpose of mining coal by the stripping method upon mining properties at Dickeyville, Warrick County, Ind.

On August 21, 1939, Tecumseh entered into commitments to acquire the plant, stripping machinery, and trucks necessary to mine the coal area, which provided for acquisition of such property upon a time-payment, title-retention basis. The chief contracts so entered into by Tecumseh were with the following creditors, for the items and amounts indicated:

Creditors	Items	Principal amount
McNally Pittsburg Manufacturing Corporation.	Tipple and washer	$565,000
Marion Steam Shovel Co	Stripping and loading shovels	681,000
New York Central R. R. Co	Spur and tipple trucks	209,000
Mack International Truck Co	Trucks	111,000
Fruehauf Trailer Co	Trucks and trailers	37,000
International Steel Co	Garage, shop, and storeroom building	17,000
Westinghouse Electric Co	Power lines and transformers	24,000
Miscellaneous supply houses	Pumps, pipe line, track scales, tractors, etc	31,000
Continental Illinois National Bank	Advances to purchase miscellaneous equipment and working capital.	195,000
Total		1,870,000

No capital outlay or credit for coal land was required because this is mined upon a lease-royalty basis.

The entire credit of $1,870,000 was, as already stated, extended upon time-purchase, title-retention commitments excepting moneys advanced by the Continental Illinois National Bank, which moneys were loaned upon the basis of a pledge of part of the gross earnings of Tecumseh.

This credit of $1,870,000 has been funded by payments payable over a 5-year period beginning approximately 60 days after the Tecumseh mine was in operation, or July 15, 1940. Pursuant to figures submitted to the creditors of Tecumseh prior to extension of credit by them, it was estimated its earnings, after payment of the then-existing Federal income tax on corporations, would be sufficient over the first 6 operating years to pay off the creditors. A chart showing the amount of payments due upon a calendar-year basis and the amount of net earnings available to pay the same upon an operating-year basis for the first 6 years of operations (the only form in which figures are available) follows:

	Payments due calendar year Jan. 1–Dec. 31	Earnings available operating year July 16–July 15
First year, 1940	$245,000	$307,000
Second year, 1941	427,000	328,000
Third year, 1942	419,000	344,000
Fourth year, 1943	619,000	358,000
Fifth year, 1944	113,000	369,000
Sixth year, 1945	47,000	382,000
Total	1,870,000	2,098,000

It will be seen that the total indebtedness, consisting of $1,870,000, can just be paid, with $228,000 left to cover deficits in earnings below the estimated amounts during the first 5 years, or upon which an excess-profits tax can be paid in the sixth year.

THE PROBLEM PRESENTED

The average annual net income of Tecumseh, after payment of the normal Federal income tax upon corporations for the period in question, is $347,000. Under the proposed excess-profits tax, as outlined by the subcommittee of the House Ways and Means Committee in its report of August 8, 1940, crediting the indebtedness as borrowed invested capital taken in the proper amounts in the 66⅔-percent bracket and the 33⅓-percent bracket, an excess-profits tax of approximately $81,500 will be payable by Tecumseh. It will be seen, by comparing this unanticipated charge against the average annual earnings of Tecumseh, that it cannot carry out its schedule of obligations with its creditors.

SUGGESTED SOLUTIONS

Various solutions have been discussed to solve the hardship of the proposed excess-profits tax upon Tecumseh.

A. A general solution, perhaps covering too much ground, is the following:

"In case a corporation which had no earning record for the base period, or any part thereof, did, within a year before July 10, 1940, incur indebtedness for the construction, reconstruction, erection, installation, or acquisition of capital equipment pursuant to a plan of financing which, but for the incidence of the tax imposed by this act, could be met out of the net income of such corporation remaining after normal Federal income tax, then to the extent that such indebtedness can be met out of net income remaining after normal Federal income tax, the same may be deducted from such net income before calculating the excess profits of the corporation subject to the excess-profits tax. The foregoing deductions may be taken at the option of the corporation, but not for a period exceeding 5 years from July 10, 1940."

B. Another solution would be to extend the amortization period to construction work initiated after September 1, 1939, and define coal production as a basic war industry. This solution is perhaps also too broad.

C. A third solution would be to expand the provision for giving special relief so as to cover the situation. Section 721 in House bill 10413 gives no special relief whatever to corporations having a borrowed invested capital. A section should be added expressing the spirit of Mr. Kenneth Carroad's suggestion to the committee broadening the provisions for special relief. If such a provision is added it should be worded so as to provide for a determination of the facts and a final decision as to whether the provision applies to a given industry or not within 60 days of application for determination by the taxpayer so the taxpayer does not have to file his tax return and wait for 5 years before knowing what the final decision as to exemption is.

D. The suggested solution made by certain witnesses before the subcommittee of the House that total taxes paid by corporations, including the excess-profits tax, be limited to 30 percent to 31 percent of net income would be a substantial partial solution.

ARGUMENT

The following arguments are advanced, in outline, in favor of the suggested solutions:

1. Coal production is a basic industry, with respect to which consideration should be shown during emergencies calling for industrial production upon a large scale. With respect to the 5 year amortization provision in House bill 10413, it may be noted that there were provisions in the Revenue Acts of 1918 and 1921 which resulted in tax relief for the coal industry. Section 214 (a) (9) of such acts provided for a reasonable deduction for amortization of buildings, machinery, and equipment installed after April 6, 1917, "for the production of articles contributing to the prosecution of the war." In *U. S.* v. ——— ——— (2d) 489, aff'd in 23 F. (2d) 673 (C. C. A. 5th 1928) it was held that coal was an article contributing to the prosecution of the war and that the cost of opening and developing a mine was amortizable.

2. The original financing of Tecumseh was done in good faith after calculation and presentation to all creditors of Tecumseh of estimates of its earnings (as listed in the chart above). The incidence of the proposed excess-profits tax upon the net income of Tecumseh was unforeseeable on August 21, 1939.

3. Tecumseh is not financed in an unusual or shoestring manner. New strip mining ventures in the Middle West are generally financed in a similar way. Obtaining new capital through regular sources by way of sale of securities to the public or through banking channels is practically impossible because of the past

experience of investors with coal securities. Furthermore, credit like that extended to Tecumseh will only be extended to operators having thorough experience over a long period of years. Similar financing for similarly large amounts has been effected for the following corporations in recent years:

1936 Northern Illinois Coal Corporation	$1,500,000
1936 Southwestern Illinois Coal Corporation	1,300,000
1936 Little John Coal Co	1,300,000
1937 Sunlight Coal Co	400,000

4. The mere fact that Tecumseh is given relief does not mean the Federal Government will not receive an excess-profits tax upon the mine. Each of the supplying creditors of Tecumseh will have to pay such a tax upon the profits made from its sale of the equipment to Tecumseh, and most of these corporations, it is believed, will be in the higher tax brackets. If the mine is closed down the supplying creditors will take losses on their regular corporation income tax instead of having excess profits to report.

5. Each of the equipment notes executed by Tecumseh to its various creditors has been discounted by such equipment creditors to banks. These banks are members of the Federal Reserve System. They will expect payment of such notes punctually.

6. The only honest step open to the management of Tecumseh, in the event an excess-profits tax is adopted as proposed, will be to stop operations. Operations which will not pay the creditors as anticipated will waste the equity upon which the creditors rely for payment of their debts. Cessation of operations may deprive the Nation of a million tons of coal a year during the emergency. Cessation of operations will also deprive the Government of the normal Federal income tax ranging from $67,000 for the first year to $84,000 for the last of the 6-year operation in question. That enactment of the tax will result in cessation of operations is self-evident, because the creditors supplying trucks and other movable equipment (as opposed to the fixed equipment) will immediately, as a matter of self-interest and protection, repossess the same, thereby making further operation impossible.

RECOMMENDATIONS FOR CONSIDERATION BY COLIN STAMM, PURSUANT TO INSTRUCTIONS BY SENATOR HARRISON, CHAIRMAN OF THE COMMITTEE

1. Statement of the hardship imposed upon Tecumseh Coal Corporation. As pointed out at the hearing by Mr. Kurt F. Pantzer, Tecumseh Coal Corporation is deprived of slightly less than 75 percent of the advantages of the possibilities of deduction permitted other corporations under the proposed Second Revenue Act of 1940.

> 1. The average earning method of calculating credits is denied Tecumseh because it was not in operation at any time during the base period.
>
> 2. The borrowed invested capital method of calculating credits, because of the percentages written into the House bill, permits Tecumseh only to claim credits upon $1,000,000 of its physical assets rather than upon $1,900,000 of its physical assets. It will be recalled that the entire $1,900,000 of assets have just been purchased and are brand new. There is no question of their value. It will also be noted that the House bill does not have a provision for special relief in the case of corporations depending upon borrowed invested capital for their deductions. Section 721 relates only to equity invested capital in special cases.

It will thus be seen that Tecumseh will actually be entitled to approximately 25 percent of the relief from possible hardship of the excess-profits tax to which the normal corporation will be entitled.

II. RELIEF SUGGESTED TO ELIMINATE HARDSHIP UPON TECUMSEH COAL CORPORATION AND OTHER CORPORATIONS

1. *Special relief administered by independent tribunal.*—It is recommended that an independent tribunal such as the Board of Tax Appeals have delegated to it the duty of providing relief for corporations encountering hardship under the act because of any one of the four following factors:

(*a*) Failure to operate during all or any portion of the base period,

(*b*) A poor showing as to earnings during the base period as compared to 10-year period preceding the base period,

(c) Failure of equity invested capital (calculated according to the House bill) to reflect actual physical values of the corporation and the properties from which it derives its profits,

(d) Failure of borrowed invested capital (calculated according to the House bill) to reflect 100 percent of the actual physical value of the plant and equipment with which the corporation conducts its business.

2. *Right of taxpayer to prompt determination of basis for relief.*—One of the chief difficulties of the House bill as drafted is its complicated provisions which will encourage delay and litigation. The average businessman must have definiteness if he is to conduct his business. As a result, it is recommended that a taxpayer be permitted, upon 60 days' notice, to have a determination made by the independent tribunal of the amount of relief from hardship to which the taxpayer is to be entitled during the term of the act. If the determination so made by the independent tribunal does not suit the Commissioner of Internal Revenue, he may appeal within 60 days; and if the determination does not suit the taxpayer, it may appeal within 60 days. At all events, the taxpayer will be entitled to know the amount of relief which, initially, the independent tribunal is willing to accord it.

3. *The act should specify certain broad principles to be considered by the independent tribunal, in granting relief.*—One of the complaints of the special relief section under the 1918 and 1921 Excess Profits Tax Acts was that no one knew the principles which were being applied by the Commissioner of Internal Revenue in according special relief from hardship under the provisions of those two acts. It is therefore recommended that the Second Revenue Act of 1940 incorporate certain principles which, among others, to be left to the discretion of the independent tribunal, shall be considered and weighed by the independent tribunal in granting special relief. To attempt to work out rules for special relief will be impossible because of the short space of time permitted a committee in drafting the act. That is the reason that it is suggested certain broad principles be incorporated in the act for the guidance of the independent tribunal. Such principles will, it is believed, govern the elimination of hardship in most cases submitted to the Senate Finance Committee.

The independent tribunal should be obliged to consider the following factors, even if they are not made a final determination by the act:

(a) The normal net income per $1,000 of equity invested capital of other corporations in the same industry and throughout the base period.

(b) If the taxpayer obtained credit from suppliers of its plant and machinery or raw materials upon the basis of a bona fide estimated budget of receipts, expenditures, and net income, then the average earnings disclosed by such bona fide budget.

(c) The nature of the industry in which the taxpayer is engaged, from the viewpoint of its hazardous or nonhazardous nature and the low or high earnings generally made in that industry.

(d) The amount of the actual net income of the corporation for each taxable year which is (1) directly attributable to war activities, (2) indirectly attributable to war activities.

(e) Any other factors having a bearing upon the question of hardship or the amount by which the taxpayer in question pays a tax greater than what actually attributable to war profits.

Respectfully submitted.

TECUMSEH COAL CORPORATION,
Indianapolis, Ind.
T. C. MULLINS, *President.*
KURT F. PANTZER, *Director.*

The CHAIRMAN. Mr. C. N. Osborne of the National Association of Manufacturers.

STATEMENT OF NOEL SARGENT, SECRETARY, NATIONAL ASSOCIATION OF MANUFACTURERS, NEW YORK, N. Y.

Mr. SARGENT. Mr. Chairman, Mr. Osborne, who appeared before your joint committee hearing, was unable to come here, and with your permission—I am secretary of the National Association of Manufacturers—I would like to appear in his stead.

The CHAIRMAN. Have you got a brief?

Mr. SARGENT. I have a statement. I would like to talk informally and leave the statement, with an appendix, with the clerk.

The CHAIRMAN. All right, proceed.

Mr. SARGENT. Mr. Chairman, as you and other gentlemen will recall, we appeared before the joint hearings.

Senator LODGE. What is your name, please?

Mr. SARGENT. Noel Sargent, secretary of the National Association of Manufacturers, Senator, appearing in place of Mr. Osborne.

Representatives of our association, Mr. Osborne and others, appeared before the joint hearings recently and approved the enactment of a soundly drawn excess-profits tax, beginning with 1940 incomes, as an emergency measure, although we stated that we were opposed to and we would oppose the enactment of such a measure as a permanent part of the tax system, because we believe an excess-profits tax is basically unsound.

In addition to the points that we have listed in the memorandum that I am leaving with the clerk, I wish to observe that we think much of the complexity that has been referred to in this bill arises from the desire to get a large amount of immediate revenue from the measure, and to devise it, therefore, in such a manner that the revenue will come regardless of whether the business income to be taxed actually results from the armament program. An equitable tax to recapture excessive defense profits can only produce large revenues when substantially higher levels of defense spending are reached than are in contemplation at the present time or in the near future. We believe it is highly desirable that the country should be advised by your committee whether the primary motive of the bill is to tax revenue from any source, whether it is to tax additional profits due primarily to the armament program or whether it is to establish certain economic objectives. The primary purpose should obviously substantially affect the character of the bill to be finally enacted.

I may observe, in this connection, with reference to the complexities of the bill, that the Canadian bill on excess profits, which received royal assent about a month ago, consists of some 13 pages, with the official explanation.

Senator LODGE. Mr. Sargent?

Mr. SARGENT. Yes.

Senator LODGE. Do you think if we had a straight excess-profits tax simply to prevent excess profits, having that as a primary objective, do you think we would raise more or less revenue in the next 2 years than we would presumably raise under the terms of the bill as now drafted?

Mr. SARGENT. If you refer solely to the ability to raise revenue from additional income derived from armament production you would probably derive less, because this bill does not go to that class of income, it goes to all kinds of income.

Senator LODGE. I am not talking about that, I am talking about a bill such as you described, such as Mr. Alvord described, which is aimed solely to prevent and to tax these excess profits, that is the sole objective. Would a bill like that raise more or less revenue in the next 2 years than the pending bill would raise?

Mr. SARGENT. I should say if it were a true excess-profits tax based upon any normal calculation of income it would probably raise less, because the period under contemplation was not the normal period of income for most corporations.

Senator LODGE. It would raise less money probably?

Mr. SARGENT. Yes; than the present bill. It does not rest upon the normal basis of income.

Senator LODGE. Can you give us an idea of how much less?

Mr. SARGENT. Well, no, sir. That would require considerable calculation, because no one knows what the general improvement in business will be. The balance of this year I think it will be somewhat substantial, and the balance of next year I think rests upon the production in 1941.

Senator LODGE. Is it not true if you do not have that kind of bill the reduced revenue that might come to you will be more than compensated for by the increased productivity in industry?

Mr. SARGENT. I think so. I think the normal income tax would raise far more revenue than it does at the present time.

Senator LODGE. That is my point.

Mr. SARGENT. In fact, that should probably be our primary reliance for increased revenue.

Senator LODGE. So the net revenue might not be lower at all?

Mr. SARGENT. That is correct.

Now, there are three primary points in this bill that we wish to call attention to—its amortization features, its discriminatory tax features, and the failure to provide for consolidated returns.

We are in favor of enactment at this time of a carefully drawn emergency excess-profits tax, but we emphatically oppose the form of the present bill, since it revives in tax theory the principle adopted in 1935, and subsequently repealed, that size or success should be taxed as such. It thus restores doubts as to governmental attitude; doubts as to desire to create and maintain the united effort of us all that the President referred to on September 2.

We particularly direct your attention to the fact that the tax method in the pending bill is not that which was proposed in the report of the subcommittee of the Ways and Means Committee and that there was thus no opportunity during previous hearings to discuss this method. This is not the method which was in the previous excess profits tax, it is not the method which any foreign country has used or uses at the present time in connection with the taxation of excess-profits income. Not only is this true, but it also represents punitive discrimination and violates sound tax principles.

The pending bill, under either tax schedule proposed, would definitely tend to tax a larger volume of earnings at higher rates, with inadequate consideration of the relationship between so-called excess profits and real normal profits, and in complete disregard of whether the higher monetary earnings represented any higher rate of earnings, either over previous earnings or upon capital investment, than earnings which might be taxed at a lower rate.

Such a proposal is unsound for a variety of reasons. It represents an effort to tax size as such, and to the extent that size is the result of ability such taxation is entirely unsound in principle. It is contrary to the American philosophy that the able and successful should not be penalized.

As a matter of fact, moreover, it is the large corporations upon which the Government must, in many instances, rely for large-scale production of preparedness materials, and to discriminate against them may severely handicap the defense program.

The pending bill, moreover, would discriminate against the small investor as compared with the large investor, and against the small investor in large corporations as compared with both large and small investors in small corporations.

The pending bill would discriminate between investors with the same ability to pay. To give you an illustration, and I have other illustrations in this statement which I am leaving with you, for example, one man with an income of $5,000 a year has an investment of $1,000 in a company having taxable excess-profits income of $1,000,000, his share of such additional income being taxed at an effective rate of 45.4 percent. His wealthy neighbor, on the other hand, with a $50,000 yearly income, has an investment of $25,000 in a much smaller company, but one proportionately just as successful, which has taxable excess-profits income of $100,000. His share of such additional income will be taxed, under the pending bill, at an effective rate of 31.5 percent, as compared with about 50 percent more in the case of the man with a smaller investment that had the misfortune to invest in a larger company.

The point is this: Because business earnings are the earnings of individual investors, you cannot devise a tax imposing higher rates upon greater business earnings which does not permit and result in rank differentiation as between investors with differing abilities to pay, thus violating every principle of equitable taxation.

We respectively urge you to reject the punitive basis of the pending bill, and to provide schedules which will not produce gross discrimination and arbitrary penalization of business success and of the very type of concerns whose abilities will be most needed in the preparedness program of the Nation.

There is, moreover, in this bill an undoubted penalty against companies which elect to use the previous income basis.

You have had referred to you the 4.1 percent penalty for those electing one alternative, thus indicating an effort to discourage election of the particular alternative. The pending proposal seeks, furthermore, to induce use of the alternative which is most difficult to administer, even though it is desirable of inclusion as a matter of fairness. The proposed penalty tax of 4.1 percent is, moreover, not even deductible as a credit in determining the amount of income subject to the excess profits tax rates, thus constituting a deplorable form of double taxation. If it is desired to increase the normal corporate tax this should be attempted in the normal way, and not through side-window insertion in an excess-profits-tax act.

There appears to be no sound justification for the higher graduation of the rate of tax for companies electing the income credit option.

Now, a specific illustration of the discrimination against companies using the income credit basis is the fact that their net additions to capital are allowed 8 percent earnings, while corporations using the invested capital base are in certain instances allowed a return of as much as 10 percent.

The CHAIRMAN. Would it be more profitable to put a 3-percent tax on all corporations, without respect to whether the average income basis or the invested capital basis were used, eliminating the 4.1 percent?

Mr. SARGENT. My personal opinion is as between the two, it would be better, Senator.

The CHAIRMAN. There would not be any lost revenue there, would there?

Mr. SARGENT. I should not think so. We find that companies electing the income credit basis pay the excess-profits tax on intercorporate dividends subject to normal tax, while companies using the invested capital basis would not. This would establish triple taxation of corporate earnings in some cases, as well as discriminating against shareholders in companies electing the income credit basis.

The pending measure needs great clarification and simplification. A reestablishment of the right to file consolidated returns would make unnecessary many of the complex provisions which it contains. We call this committee's attention to the fact that consolidated returns were permitted under Federal law and its administration over the entire period from 1917 to 1934, and we are of the opinion that the provisions existing in prior law should and could be immediately reenacted.

In this connection, I direct your attention to the fact the report of this committee submitted to the Senate December 6, 1918, by Senator Simmons declared:

> So far as its immediate effect is concerned, consolidation increases the tax in some cases and reduces it in others, but its general and permanent effect is to prevent evasion which cannot be successfully blocked in any other way. * * * The committee is convinced that the consolidated return tends to conserve, not to reduce the revenue. The committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but because the principle of taxing as a business unit what in reality is a business unit, is sound and equitable and convenient both to the taxpayer and to the Government.

It is doubtful if any excess-profits tax can work fairly if it does not provide for consolidated returns.

The President, in his September 2 address at Chickamauga declared:

> New defense industries are more safe from attack * * * behind the mountains than if they were located on our more exposed borders.

As we understand it, the national-defense program contemplates the establishment of productive facilities between the Allegheny and Rocky Mountains. Separate corporate entities will undoubtedly be required in most cases to provide this necessary expansion even though they may represent only an extension of the efforts of present operating companies. The ban against consolidated returns may in some of these cases represent a handicap to the extension of industrial facilities away from the coastal areas where 80 percent of crucial war industries are now located.

The CHAIRMAN. You can put that elaboration there in your brief in the record as representing Mr. Osborne and yourself.

Mr. SARGENT. I may say, in connection with the statements made on the amortization proposal, that we agree with that statement by Mr. Henderson to this committee yesterday, to the effect that the money to be used is the taxpayers' money. There is no justice requiring a taxpayer to agree to the Government taking over the property following the end of the period involved. We believe if the provision is included, however, there should be eliminated the reference to impairment or substantial alteration because of the difficulties of interpretation that are involved.

Senator LODGE. Mr. Chairman, may I just ask to have this done by the Treasury, on this point that more revenue will accrue to the Government if we had a straight excess-profits tax than there would out of the tax in this bill, taking into account the increased receipts from the income tax. That is the point you made?

Mr. SARGENT. Yes.

Senator LODGE. Can we get some figures on that from the Treasury? I would like to get an estimate on that.

The CHAIRMAN. Will you make a note of it, Mr. Sheer?

Senator LODGE. We will get it later on. I would like to get it for the record.

Mr. SHEER. Would you make that statement again, please?

Mr. SARGENT. I made the statement if business production expanded substantially during the next year or perhaps even remained at the same level that would probably exist as at the last quarter of this year, that an excess-profits tax based in the way or manner in which Senator Lodge is discussing, coupled with the operation of the normal corporation tax, would probably tend to produce a larger amount of additional revenue than the provisions of the pending measure.

Senator LODGE. That is a straight excess-profits tax, and with that alone and not have revenue-producing features in mind. Would taking into consideration the corporation tax, would a straight excess-profits tax produce a greater amount of revenue than these provisions would produce?

Mr. SHEER. We would need some more specifications on just what your excess profits would be.

Senator LODGE. I think it is an important point, if you can get it definitely for us.

The CHAIRMAN. You can talk to Mr. Sullivan, explain to him anything you want about it.

Mr. SARGENT. Yes.

(The brief submitted by Mr. Sargent is as follows:)

BRIEF BY NOEL SARGEANT, SECRETARY, NATIONAL ASSOCIATION OF MANUFACTURERS BEFORE SENATE FINANCE COMMITTEE, ON THE 1940 EXCESS PROFITS TAX BILL

WASHINGTON, D. C.,
September 5, 1940.

The pending tax bill originated in the expressed desire that armament production should furnish no opportunity for the creation of new war millionaires or the further substantial enrichment of already wealthy persons. Industry is sincerely in accord with this aim and has repeatedly insisted that in production for national defense there shall be no profiteering.

Representatives of the National Association of Manufacturers appeared at the recent joint hearings on the pending tax bill and approved enactment of a carefully drawn excess-profits tax, beginning on 1940 incomes, as an emergency measure, although opposing such a tax as a permanent part of the tax structure because of its basically unsound nature. We now reiterate our position on these points.

We likewise submit, with the request that it be incorporated in the printed record, a list of specific points in the pending bill which we believe require careful consideration. It is unfortunate that so drastic a measure as is now under consideration has been rushed through one branch of the Congress without adequate consideration of, and debate upon, its very complex provisions.

Much of the complexity and unsoundness in the present bill apparently arises from the desire to get a large amount of immediate revenue from this particular measure, and to devise it therefore in such a manner that the revenue will flow regardless of whether the business income to be taxed actually results from the armament program. An equitable tax to recapture excessive defense profits can only produce large revenues when substantially higher levels of defense spending are reached. It is highly desirable that the country should be advised by your committee whether the primary motive of the new bill is to tax revenue from any source, whether it is to tax additional profits due primarily to the armament program, or whether it is to establish certain economic objectives. The primary purpose should obviously, substantially affect the character of the bill to be enacted.

We now present for your consideration our observations upon three major aspects of the pending legislation—its amortization features, its discriminatory tax features, and the failure to provide for consolidated returns.

ARBITRARY TAX DISCRIMINATION

We are in favor of enactment at this time of a carefully drawn emergency excess-profits tax, but we emphatically oppose the form of the present bill, since it revives in tax theory the principle adpoted in 1935, and subsequently repealed, that size or success should be taxed as such. It thus restores doubts as to governmental attitude; doubts as to desire to create and maintain the "united effort of us all" that the President referred to September 2.

We particularly direct your attention to the fact that the tax method in the pending bill is not that which was proposed in the report of the subcommittee of the Ways and Means Committee and that there was thus no opportunity during previous hearings of discussing this method. The pending method is entirely different from that used in the old excess-profits tax. The pending method is utterly different from that contained in the excess-profits tax laws of foreign countries. Not only is the tax method in the pending bill utterly different from methods previously and elsewhere used in connection with excess-profits taxes, but it also represents punitive discrimination and violates sound tax principles.

The pending bill, under either tax schedule proposed, would definitely tend to tax a larger volume of earnings at higher rates, with inadequate consideration of the relationship between so-called excess profits and real normal profits, and in complete disregard of whether the higher monetary earnings represented any higher rate of earnings, either over previous earnings or upon capital investment, than earnings which might be taxed at a lower rate.

Such a proposal is unsound for these reasons:

1. It represents an effort to tax size as such, and to the extent that size is the result of ability such taxation is entirely unsound in principle. It is contrary to the American philosophy that the able and successful should not be penalized.

2. As a matter of fact, moreover, it is the large corporations upon which the Government must, in many instances, rely for large-scale production of preparedness materials, and to discriminate against them may severely handicap the defense program.

3. The pending bill would discriminate against the small investor as compared with the large investor, and against the small investor in large corporations as compared with both large and small investors in small corporations. Thus, Secretary of the Treasury McAdoo well said in 1918: "Any graduated tax upon corporations is indefensible in theory, for corporations are only aggregations of individuals, and by such a tax the numerous small stockholders of a great corporation may be taxed at a higher rate than the very wealthy large stockholders of a relatively small corporation."

4. The pending bill would discriminate between investors with the same ability to pay. Let us consider an example, assuming that the income base method is used by the taxpayers.

(*a*) Thomas Brown is an investor of $1,000 in a small corporation which has taxable excess-profits earnings of $50,000. His share of those earnings would be taxed at an effective rate of 28 percent—in addition, of course, to the 25-percent tax upon normal net income.

(*b*) Henry Jones, neighbor of Brown, has the same annual income and is also an investor of $1,000, but in a much larger, although proportionately no more successful corporation, one with taxable excess-profits earnings of $500,000. His share of these earnings would be taxed, in addition to the same 25-percent tax upon normal net income, at an effective rate of 40.8 percent—almost 50 percent greater—before he would be entitled to receive any dividend.

Here are two men with equal income, equal investments and equal earnings upon their investments, yet under the pending bill the man would be arbitrarily penalized who has invested in the larger company.

Not only would the pending bill permit discrimination as between individuals with the same ability to pay, but it permits unfair discrimination against individuals with less ability to pay. For instance—

(A) John Little, with an income of $5,000 a year has an investment of $1,000 in a company having taxable excess-profits income of $1,000,000, his share of such additional income being taxed at an effective rate of 45.4 percent.

(B) William Magnus, his wealthy neighbor, with a $50,000 yearly income, has an investment of $25,000 in a much smaller company, but one proportionately just as successful, which has taxable excess-profits income of $100,000. His share of such additional income will be taxed, under the pending bill, at an effective rate of 31.5 percent.

The point is this, Senators—because business earnings are the earnings of individual investors, you cannot devise a tax imposing higher rates upon greater business earnings which does not permit and result in rank differentiation as between investors with differing abilities to pay, thus violating every principle of equitable taxation.

We respectfully urge you to reject the punitive tax basis of the pending bill, and to provide schedules which will not produce gross discrimination and arbitrary penalization of business success and of the very type of concerns whose abilities will be most needed in the preparedness program of the Nation.

We further submit that the method set up in the pending bill for the taxation of corporations which elect the "income credit" basis is both unsound and unjust.

(*a*) It discriminates severely against companies which have successfully conducted business in the past on a modest capitalization.

(b) The bill should offer two fair alternatives, but this is not done when there is a penalty tax of 4.1 percent for those electing one alternative, thus indicating an effort to discourage election of the particular alternative. The pending proposal seeks, furthermore, to induce use of the alternative which is most difficult to administer, even though it is desirable of inclusion as a matter of fairness. The proposed penalty tax of 4.1 percent is, moreover, not even deductible as a credit in determining the amount of income subject to the excess-profits tax rates, thus constituting a deplorable form of double taxation. If it is desired to increase the normal corporate tax this should be attempted in the normal way, and not through side-window insertion in an excess-profits tax act.

(*c*) There appears to be no sound justification for the higher graduation of the rates of tax for companies electing the "income credit" option.

(d) Specific illustration of the discrimination against companies using the "income credit" basis is the fact that their net additions to capital are allowed 8 percent earnings, while corporations using the invested capital base are in certain instances allowed a return of as much as 10 percent.

(*e*) Again, we find that companies electing the "income credit" basis pay the excess-profits tax on intercorporate dividends subject to normal tax, while companies using the invested-capital basis would not. This would establish triple taxation of corporate earnings in some cases, as well as discriminating against shareholders in companies electing the "income credit" basis.

CONSOLIDATED RETURNS

The pending measure needs great clarification and simplification. A reestablishment of the right to file consolidated returns would make unnecessary many of the complex provisions which it contains. We call this committee's attention to the fact that consolidated returns were permitted under Federal law and its administration over the entire period from 1917 to 1934, and we are of the opinion that the provisions existing in prior law should and could be immediately reenacted.

In this connection I direct your attention to the fact the report of this committee submitted to the Senate December 6, 1918, by Senator Simmons declared—"So far as its immediate effect is concerned consolidation increases the tax in some cases and reduces it in others, but its general and permanent effect is to prevent evasion which cannot be successfully blocked in any other way. * * * The committee is convinced that the consolidated return tends to conserve, not to reduce the revenue. The committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the Government."

It is doubtful if any excess-profits tax can work fairly if it does not provide for consolidated returns.

The President in his September 2 address at Chickamauga declared, "New defense industries are more safe from attack * * * behind the mountains than if they were located on our more exposed borders."

As we understand it, the national-defense program contemplates the establishment of productive facilities between the Alleghany and Rocky Mountains. Separate corporate entities will undoubtedly be required in most cases to provide this necessary expansion even though they may represent only an extension of the efforts of present operating companies. The ban against consolidated returns may in some of these cases represent a handicap to the extension of industrial facilities away from the coastal areas where 80 percent of crucial war industries are now located.

We do not agree with the statement by the Ways and Means Committee that it would require extreme delay to "prepare a consolidated return provision." It would be very easy to establish the principle, with the Commissioner of Internal Revenue given authority to prescribe administrative regulations. We have, moreover, the precedents of the World War excess-profits tax provision requiring consolidated returns and the proposal by Senator La Follette requiring such returns.

AMORTIZATION PROVISIONS

There is urgent need for rapid enactment of an amortization provision to allow recovery of the cost of special investment in defense facilities. Representatives of the Treasury, the War Department, the Navy Department, and the National Defense Advisory Commission have testified as to the need for immediate enactment of this amortization provision.

The amortization features included in the pending tax bill contain sections which were not covered by the report of the Ways and Means Subcommittee which formed the basis for the recent joint hearings. In particular, there was no disclosure of an intent to include the present section providing for the acquisition in certain cases by the Government of private facilities entitled to amortization allowances.

If the pending amortization principles are sound and proper from the standpoint of the taxpayer and the Government then there should be no penalty provided for their use. As Mr. Leon Henderson, Chairman of the Securities and Exchange Commission, has soundly observed before this committee, since the money to be spent on new facilities will largely be that of private business the Government should not assume the right to dictate the post-preparedness use to which the new facilities should be put. The present proposal would add to doubts already created by other provisions of the pending measure as to basic governmental attitude toward business and stockholders.

But if the principle of the provision in question is retained, then certainly the present language should be modified. Because of interpretative difficulties the words "impair or substantially alter" should be eliminated.

The original amortization proposal submitted by the House Ways and Means Committee was generally sound and we believe should be immediately enacted with the addition of the following clarifying provisions:

1. Facilities specially acquired for national-defense needs should be permitted 5-year amortization even though not directly utilized in filling Government contracts.

2. If a contract between taxpayer and Government specifically covers amortization in a manner not inconsistent with law, the contract should supersede general amortization provisions.

3. The restrictive character of the certificate given emergency facilities should be modified. No consideration is made for special amortization of facilities previously acquired for other purposes and subsequently used for defense purposes. Furthermore, in order to prevent delays in necessary construction and erection of facilities it should be provided that the certificate be granted at any time not later than 60 days following the beginning of such period of construction or erection. This would tend to avoid delays in obtaining necessary Government certificates.

CONCLUSION

The pending tax bill is extremely complicated. Because of this fact there is grave danger that there will be in it provisions whose effects would hamper the national preparedness program. The principles, methods, and discriminations in the pending bill would be economically harmful at a time when help instead of hindrance should be the national goal. Unjust taxation produces inequity for individuals and may damage the country as a whole.

In seeking to frame an excess-profits tax which will be as equitable as any such tax can be, we believe Congress should particularly consider seven major problems—

1. No discouragement of young and growing companies. They are builders of America and should be encouraged.

2. Inclusion of fair optional methods of computing the tax, without arbitrary penalties for option of either method.

3. Tax rates which are related either to previous earnings, capital investment, or excess-earnings credits, but without primary reference simply to mere size of earnings.

4. Provision for the filing of consolidated returns, in the interests of both the Government and taxpayers.

5. Limiting the proposed law to a period of 2 years—1940 and 1941—in order to determine whether it is actually workable, and represents no handicap to the building of our national defense.

6. Provision for a special review board to make adjustments in cases where the operation of necessarily inflexible statutory provisions would create hardship.

7. Immediate enactment of a sound amortization or cost-recovery provision to stimulate necessary acquirement of defense facilities. Even if present difficulties require greater consideration of the excess-profits-tax provisions there is neither need nor justification for delaying enactment of the amortization provisions.

Providing maximum defense with a minimum of delay is a major national task. Industry has one major job—producing the needed ships, guns, tanks, and planes.

Industry wants to do this—and it is willing to accept its full share of sacrifice and to pay its full share of taxes in the national preparedness effort. It is anxious to produce for national defense without profiteering.

A sound tax bill can remove present obstacles to the investment of the savings of millions of individuals in defense facilities which may be entirely worthless at the end of the emergency, and will stimulate business expansion, provide jobs, and hasten our program for national defense.

Finally, Mr. Chairman, we recommend that when the new tax bill is enacted it should provide for the creation of a special commission, including representatives of Federal and State Governments, business, labor, agriculture, and of professional economic societies, to immediately undertake a study of the fiscal and related problems unsolved in our national-defense program.

Specific Suggestions and Constructive Criticisms Applying to the Second Revenue Act of 1940 as Passed by the House of Representatives

[Submitted to Senate Finance Committee September 5, 1940, by Noel Sargent, National Association of Manufacturers]

1. The normal profits of numerous companies, having no relation to the rearmament activity of the country, can only be determined by prior earnings. An option to compute excess-profits on the basis of normal earnings in the 1936–39 period should be granted without penalty to these companies who depend largely upon skill and enterprise for the successful operation of their businesses.

2. In determining the normal earnings during the base period a company should have the option of selecting 3 out of 4 income years. Loss years during the base period should be eliminated and the average earnings computed by dividing only by the number of earnings years. The present bill unfairly penalizes those companies who have suffered losses from 1936 through 1939.

3. Other companies which have had little or no earnings in the base period because of depressed or abnormal conditions of business should be allowed a fair fixed return on capital actually invested in the business as a measure of normal earning power. Under prior law an 8-percent return was so allowed. The rate of 5 percent on invested capital above $500,000 proposed to be allowed before the excess-profits tax would apply would not represent a fair rate of return to companies in general who have passed through past periods of subnormal earnings.

4. The 10 percent limitation of a return on invested capital set as a maximum may easily work injustice in the case of companies with a conservatively low amount of invested capital.

5. A special relief provision comparable to sections 327 and 328 in the Revenue Act of 1918 should be provided to avoid undue hardship to companies not protected by the preceding options. In our modern, complex, economic structure it is particularly necessary to provide for such special relief in order not to unjustly burden those companies who cannot be covered by a general rule.

6. All earnings to be taxed under an excess-profits levy should be taxed on the same basis. The present discrimination against companies who must necessarily measure normal profits on the basis of prior earnings should be eliminated; that is, the penalty tax of 4.1 percent added to the normal tax should be removed and the proposed tax upon excess profits so determined should be reduced to conform with the tax upon similar profits computed under the invested capital option.

7. In establishing the invested capital base all capital actually used in the business, including borrowed capital, should be included without discrimination. The last decade of depressed economic conditions accompanied by difficulties in securing equity capital has forced many companies to depend upon borrowing for necessary operating capital. All such borrowings should accordingly be fully included in the invested capital base.

8. The proposed graduated rates on the amount of excess earnings violates the sound tax principle of ability to pay. It fails to recognize that the earnings of larger concerns usually belong to a great many stockholders whose small earnings may then be taxed at a higher rate than the comparatively larger earnings of the stockholder in a smaller company.

9. Consolidated returns should be provided both for excess-profits and normal tax purposes. This privilege would make unnecessary a substantial portion of the complex and unintelligible language of the pending bill. Such consolidated returns were filed under the Federal law and its administration from 1917 through 1934 and could be reestablished without difficulty or delay.

10. If consolidated returns are reestablished, the present double taxation of intercorporate dividends should naturally be eliminated for the same basic reason of recognizing a business entity as such.

11. Companies should be protected against future losses arising either out of the cancelation of Government contracts or the termination of defense activities.

12. Provision should be made for the protection of those companies which now must meet preferred-dividend requirements out of net income. In some cases under the pending bill companies may not even earn such preferred dividends and accumulations thereof before the heavy excess-profits taxes will apply.

13. It is difficult to determine with certainty whether the earnings and invested capital of dissolved and absorbed subsidiaries are given equitable treatment in establishing the earnings and invested capital during the base period. The provisions dealing with such predecessor companies should be clarified.

14. Protection should be afforded to those companies which will realize sharp increases in inventory values and accordingly earn bookkeeping profits subject to heavy excess-profits tax if after the emergency ceases these inventory values return to former lower levels and create offsetting bookkeeping losses.

15. The existing excess-profits tax and related capital-stock tax should be repealed because of their unsound rate and since under the proposed bill they represent a further complicating tax factor.

16. Because of the national economic importance of increasing exports from the United States and in order not to discourage companies organized under the Webb-Pomerene Act to engage in such foreign trade, these companies should be exempt, as are other special classes of corporations, from the operation of the excess-profits tax law.

17. If consolidated returns are not permitted, companies electing the invested capital basis should be allowed to include in their admissible assets investments in capital stock of nonprofitable domestic subsidiary companies; otherwise companies with profitable subsidiaries will have an advantage over an integrated unit including subsidiaries operating at a loss.

18. In making necessary adjustments to establish the excess-profits credit, deductions in the form of an amortized premium, discount and expense from the retirement or discharge of bonds as well as income arising from the retirement or discharge of bonds should be given effect.

The CHAIRMAN. Mr. William J. Kelly, Chicago, Ill., representing the Machinery and Allied Products Institute.

STATEMENT OF WILLIAM J. KELLY, REPRESENTING THE MACHINERY AND ALLIED PRODUCTS INSTITUTE, CHICAGO, ILL.

Mr. KELLY. Mr. Chairman, may I comment briefly and supplement this statement with a more comprehensive statement later?

The CHAIRMAN. Yes.

Mr. KELLY. My name is William J. Kelly, of Chicago. I am president of Arthur J. O'Leary & Son Co., and I appear today as president of Machinery and Allied Products Institute. This institute is a federation of trade associations, the members of which produce capital goods. Capital goods are the facilities of production, distribution, transportation, and commerce—that is to say, broadly, business plant and equipment. These are the companies to which the depression of the 1930's gave the hardest licking.

When the House Ways and Means subcommittee's report on this legislation was discussed in public hearing, the Machinery Institute commented that we were in substantial agreement as to that part of the bill which provided for special amortization or depreciation-tax deductions for national-defense facilities. We do however, object to the use of July 10, 1940, as the earliest effective or installation date because we believe the manufacturers who engaged in plant expansions for national-defense purposes prior to July 10, 1940, should not be penalized for being the first to assist in expansion of production for the national-defense program. The limited emergency was declared to exist September 8, 1939; we can see no reason against, and a distinct gain in equity in favor of, dating back to September 8 this provision to include additional national-defense facilities, when certified as such by Government representatives in the manner now provided in H. R. 10413.

Now, another and even more serious objection has arisen since our statement to the House Ways and Means Committee. This objection arises from the recent insertion of subsections (i), (j), and (k) on pages 91 and 92 of the bill, imposing conditions of transfer of title to Government, and so forth. Representatives of the Defense Commission spoke frankly and accurately yesterday on this proposition. We endorse their views. We hope your committee will use its influence to have these subsections stricken from the bill. Furthermore, the Machinery Institute continues to believe, as we have said to you before, and as we said to the Treasury Department as far back as last May, amortization legislation can be and should be passed separately and promptly. Excess profits legislation should be analyzed carefully, over whatever period of time is required to develop an understandable and equitable bill. The bill before you certainly is not an excess-profits-tax measure.

As I have said, capital-goods companies generally suffered tremendously during the depression of the 1930's for the reason that they produce a class of goods the purchase of which may be postponed for long periods. You cannot for long put off buying a loaf of bread or a pair of shoes or a suit of clothes, but you can defer almost indefinitely by extended maintenance either constructing a factory or furnishing it with new facilities for the production of durable goods. Member companies of this institute experienced the consequences of such postponement for most of the last 10 years; because of the extended losses in the 1930's, capital-goods companies view with dismay the alternatives on which the proposed excess-profits tax would be levied. Therefore we recommend greater latitude in the choice of base years by permitting the taxpayer to average earnings over the best 3 years in the decade 1930–39.

In a report of original research recently completed and entitled "Capital Goods Industries and Federal Income Taxation," the Machinery Institute identified and particularized an inequality which is at the heart of the basic inequities of the taxation proposal embodied in the bill before you. This report, a copy of which I am submitting as a part of this testimony with the request that it be incorporated in the record of these hearings, identifies a marked difference in the operating characteristics as between capital-goods companies as a group on the one hand, and the consumption-goods companies as a group on the other hand.

The CHAIRMAN. It may be inserted in the record.

Mr. KELLY. It measures this marked difference in terms not only of production, but specifically as to number of net-loss years, average profits, and return on invested capital. The story is there, clearly and in detail, and it proves beyond question that the 10-year period 1930–39 witnessed (1) substantial, and in many cases almost constant, losses for practically every concern engaged in the capital-goods industries, and (2) extremely severe Federal tax discrimination against these companies. To premise a definition of normal earnings on the years 1936–39 is rankly unjust to the capital-goods industries. To temper such a definition by providing that 1 loss year may be counted as zero though retained in the basic calculation, is a departure from principle and fact, and of slight assistance in achieving equity. In our judgment substantially greater latitude is needed in the choice of base years, and we recommend to your committee consideration of permitting the taxpayers, capitl goods companies and consumption goods companies alike, to average earnings over the best 3 years of the 10 years 1930–39. Next:

We recommend extension of the period over which excess profits are to be measured by provision permitting a 6-year carry-over of net losses as an offset to taxable profits.

Reference to the report attached, "Capital Goods Industries and Federal Income Taxation," will demonstrate that application of Federal taxation can be equitable to the capital-goods industries only if a 6-year period is adopted as the measure of normal or average profits. It is necessary for the future that provision be made for losses which capital-goods companies are likely to incur in this cycle of operation. Such provision is necessary in the interest of equity before application of normal tax rates, but it is doubly necessary in contemplation of steeply graduated excess-profits-tax rates.

This necessary provision may be accomplished in substance, or in principal part, in a variety of ways:

(a) By a 6-year net loss carry-over, as aforesaid.

(b) By provision permitting carry-over of unused exemptions, or the amount by which income for any year is less than the excess-profits credit.

(c) By permissive application of losses incurred in the first several years following termination of the limited emergency against profits realized during the preceding years.

Further:

We recommend amendment of the bill to assure against taxation of profits which are less than a 10-percent return on capital.

The bill before you places the excess profits tax-free return on invested capital at a minimum of 5 percent, excepting return on capital of $500,000 or less which is allowed 7 percent before excess-profits tax. It is important to note that few machinery manufacturers or other capital goods companies were successful during any substantial period of time within the decade 1930–39 in earning as much as these minima, and that to stay in business in these industries it is an absolute necessity that earnings during active years be substantially in excess of any such minima. Yet the proposal, after making such allowance, would subject earnings to excess-profits rates. We submit that this is nothing less than a discriminatory tax on normal, necessary profits. If the Federal Government requires additional revenue from taxation of normal profits, we believe that the burden must be spread evenly on sound premises, and not discriminatorily under the guise of taxing excessive profits. If on the other hand the Federal Government truly desires to tax excessive profits, or to impose a war-profits tax, we submit that the measure of excessiveness must be found through scientific, realistic analysis of normal profit cycles, and that to avoid gross inequity to the capital goods industries the solution cannot be found short of amendment of the bill to assure against taxation of profits which are less than a 10-percent return on invested capital.

There are other jokers in the bill which we hope your committee will eliminate and which we will call to your attention in a more comprehensive statement to be filed later. For example, the case of the capital goods manufacturer who because of the fact that he is incorporated in Wisconsin which does not happen to have statutory consolidation provisions, must pay a tax vastly greater, double in one case you heard of today, than he would be assessed were he incorporated in Illinois or any one of a number of States which has statutory provisions for consolidations or mergers. Surely such gross inequities like this one cannot be included in fairness in the revenue laws of the country.

We conclude this brief testimony in behalf of the Machinery and Allied Products Institute by asking again that your committee—

First, revise the present special amortization or depreciation tax deduction provision along the lines of the Defense Commission request, and pass it separately and promptly.

Second, if we are to have excess-profits legislation that the Congress insist upon taking enough time to achieve an equitable and understandable statute.

The CHAIRMAN. You referred to an amendment. Have you that prepared?

Mr. KELLY. We would like to file it later.

The CHAIRMAN. You better file it pretty soon, then.

Mr. KELLY. We will do it very promptly, Mr. Chairman. It is now in course of preparation.

The CHAIRMAN. You said that the Congress should insist upon taking enough time to achieve an equitable and understandable statute. Can you give us any idea how long that would take?

Mr. KELLY. Mr. Chairman, I have considerable confidence in your committee. I do not believe it would take as long as sometimes we may think it might.

The CHAIRMAN. Thank you very much.

(The matter submitted by Mr. Kelly is as follows:)

CAPITAL GOODS INDUSTRIES AND FEDERAL INCOME TAXATION

A report of original research disclosing discriminatory effects of Federal tax laws with recommendation for correction

JULY 1940

[Foreword and appendix charts omitted]

FOREWORD

Large expenditures of the Federal Government are now required for national defense preparedness. They too will cause income taxation of the country's business enterprises to be heavy. These are facts generally recognized and accepted.

In these circumstances still other facts stand out with equal force. The American enterprise system is a system of capitalism, individualism—a system of profits and losses under which the history of our industrial progress has been written through the trial and error of men who sought profit against odds.

If industrial production is to be sharply increased, these odds may not be made so great as virtually to confiscate the prospect or opportunity for a fair return upon capital subjected to risk. Nor can the country approve discriminatory effects of Federal tax laws, which naturally increase in severity of discrimination with every increase in tax rates.

This study identifies and particularizes the extent of a gross inequity in the present distribution of the Federal tax burden which is unnecessarily penalizing the capital goods industries. Its existence, heretofore undocumented, is directly due to lack of understanding of the vastly different characteristics which influence the operating cycles of two major groups of production industries—(1) durable goods, including capital goods industries, and (2) consumption goods industries.

Economic writings for only a relatively short time have perceived the large economic significance of these vastly different characteristics. It has been only as a result of discussions starting in business circles in 1932 that statistical information has become available on the differences in economic behavior between them. And it has been even more recently, as late as 1939 in fact, that rather general agreement has been obtained on the fundamental fact that the United States depends for full business activity and employment upon investment in capital goods and other durable goods through which national wealth, income and purchasing power are sustained and increased. On this there is now widespread, almost unanimous, agreement on the part of students of the economic condition of the Nation.[1]

The differences in economic behavior between these two major groups are seen to be due largely to the fact that while the demand for consumption goods, that is to say such essentials to current living as food, clothing, and gasoline, is relatively well maintained from year to year, the public can defer the purchase of durable goods, or dispense with them entirely. A substantial portion of the public does so in periods of uncertainty and depression. Not only can initial purchases of new durable goods be deferred, but the replacement of old with new, such as machinery and mechanical facilities used in the production of other goods, often can be indefinitely postponed while the old durable goods are continued in use by extended maintenance and by reduction in the standard of efficiency expected of them.

This ability to postpone the purchase of durable goods results in a great variation in the volume and in the constancy of their demand. In consequence, there are marked contrasts in the levels of production and employment experienced within

[1] See Saving and Investment in the American Enterprise System, an analysis of Temporary National Economic Committee testimony, pamphlet, 1939, Machinery and Allied Products Institute, Chicago.

the two groups of industries. The extent of these swings is graphically related in the now familiar charts which face this page.

These trends in volumes of production and employment do not in themselves, however, reveal the full economic significance of the characteristic differences to which we have referred. Further exploration is required, one step in which is the tabulation and analysis of the profit and loss data of individual companies and the determination of the distribution of the burden of Federal income taxation as between each of these two major groups of producing industries.

This is the purpose of the present study. It has provided material of a type not previously available in the light of which it is now possible to offer appropriate recommendations for future Federal income tax policy.

Manufacturers of machinery and allied products have long been concerned with the provisions of Federal revenue laws regulating the offsetting of business losses against the profits of succeeding years. This pamphlet undertakes to analyze the reasons for such concern, and to present the results of a statistical investigation of the adequacy of present Federal revenue act provisions especially as they affect the capital goods industries.

Capital Goods Industries and Federal Income Taxation

I. THE RELATION BETWEEN INCOME TAX LIABILITY AND THE TIME UNIT USED FOR ASSESSMENT

It is generally recognized by students of taxation, though not, unfortunately, by laymen, that the burden of Federal income taxes, especially the distribution of the burden among individual taxpayers, is profoundly affected by the length of the time unit chosen as the basis of assessment.

We are so accustomed in the United States to assessment on a yearly basis that it has come to be accepted by most taxpayers as a part of the order of nature. Actually the use of this time unit for income tax purposes, whatever its practical advantages, is essentially an arbitrary arrangement. The period of assessment could conceivably be a month, a quarter, a half-year, or several years.[2]

To illustrate the relation between the time unit and the distribution of tax burdens, let us take three hypothetical corporations whose monthly incomes during a certain year are shown following.

Net income

	A	B	C
January	$10,000	$2,000	[1] $20,000
February	8,000	8,000	[1] 10,000
March	11,000	20,000	30,000
April	5,000	20,000	40,000
May	6,000	10,000	30,000
June	12,000	[1] 10,000	[1] 20,000
July	8,000	[1] 15,000	[1] 30,000
August	10,000	5,000	[1] 30,000
September	10,000	10,000	40,000
October	5,000	25,000	60,000
November	7,000	20,000	20,000
December	8,000	5,000	[1] 10,000
Total for year	100,000	100,000	100,000

[1] Deficit.

While these companies have identical incomes for the year as a whole, and of course would pay the same taxes if assessed on an annual basis, their tax liability on a monthly basis is very different. The annual reckoning offsets deficits incurred during the poor months against the income earned in the good ones. The monthly reckoning makes no such offset; taxes are assessed against the total net income of the good months regardless of losses during other portions of the year. Corporation A, having no deficit months, shows the same taxable income by both methods of reckoning, namely $100,000. Corporation B shows $100,000 on an annual basis and $125,000 on a monthly basis. The corresponding figures for C are $100,000 and $220,000.

It is obvious that the shortening of the time unit from a year to a month gives a relative advantage to corporations that show income consistently throughout the year and is prejudicial to those earning intermittently. Companies whose

[2] In Great Britian corporate income taxes were assessed, prior to 1926, on a 3-year-average basis.

business has a high degree of seasonality, and which normally run deficits during slack periods, as a rule would pay in taxes a higher proportion of their annual income under this arrangement than would companies enjoying the advantage of a stable demand. This would be true also of corporations whose business during the year is erratic or "lumpy" for other than seasonal reasons.

By computing income for tax purposes annually instead of monthly we eliminate the effect of differences in the stability of earnings within the year. We put corporations that earn during part of the year and lose the rest of the time on a basis of equality with those that earn more consistently. The fairness of this arrangement commands universal recognition. What is less universally recognized, however, is the incompleteness and inadequacy of the equalization attainable within the limits of a single year. The same considerations that support the use of annual rather than monthly income periods argue with equal force for arrangements that effect an equalization over a longer period.

Differences in the regularity and consistency of corporate earning power are not due solely to differences in seasonal variations, or in other fluctuations of business short enough to be completed within the limits of a year; they are attributable in part to differences in cyclical and other movements extending over several years. Because such movements result in wide fluctuations in annual earnings for one corporation and only slight fluctuations for another, they give rise, over a period of years, to inequalities in tax burdens very similar to those that would prevail, within the limits of a single year, if incomes were computed on a monthly basis.

The principle involved in the two cases is the same, and it may be superfluous, therefore, to offer another example. We do so simply to illustrate the problem in the form in which it will be further discussed. Again we have three hypothetical corporations, this time with annual earnings as follows:

Net income

	A	B	C
1931	$130,000	[1] $100,000	[1] $300,000
1932	80,000	[1] 300,000	[1] 500,000
1933	90,000	[1] 200,000	[1] 400,000
1934	110,000	[1] 100,000	[1] 200,000
1935	120,000	100,000	100,000
1936	130,000	250,000	300,000
1937	180,000	500,000	800,000
1938	160,000	350,000	300,000
Total for period	1,000,000	500,000	100,000

[1] Deficit.

For the 8-year period covered by this illustration, the three companies have net incomes of $1,000,000, $500,000, and $100,000. On the basis of annual assessments, however, the incomes subject to taxes during the same interval aggregate $1,000,000, $1,200,000 and $1,500,000, respectively.[3] Consider what this means in terms of the relation between tax payments and net income for the period as a whole. Assuming a tax rate of 20 percent, A pays exactly this percentage, B pays 48 percent, and C pays 300 percent.

Extreme as these differences are, they are less so than many to be fonud in the actual records of these years. There were thousands of corporations with sizable net deficits (before income taxes) for the period as a whole, but which nevertheless paid substantial levies against income. There were other thousands, resembling corporation C in our illustration, which had a small net balance of income for the period, but which paid income taxes in excess of this balance. There were a great many like A, on the other hand, that weathered the deperssion with no annual deficits, and which paid on the net income for the entire period only at the rate applicable to the income of a single year.

We submit that this situation represents a gross discrimination in favor of corporations which are able to show an annual net income consistently over a period of years and against those which have earnings in some years and run deficits in others. We hold also that there is as much reason for removing this discrimination, which results primarily from differences in the cyclical stability of earning power, as there is for our present practice of eliminating discrimination attributable to differences in seasonal stability.

[3] Assuming no provision for the carry-over of losses.

II. DISCRIMINATION AGAINST THE DURABLE-GOODS INDUSTRIES

This discrimination just referred to would be serious enough if it merely applied in random fashion to individual corporations. The fact is, however, that its effect is not random. While there may be found in nearly all lines of industry a scattering of companies which for one reason or another display an erratic alternation of annual profits and losses unrelated to the movements of business in general, it is evident that the discrimination in question weighs most heavily against corporations in industries which respond with more-than-average sensitivity to the cyclical fluctuations in economic activity as a whole.

The most significant classification of industries with respect to the amplitude of their cyclical movements distinguishes those producing durable goods from those producing nondurable goods and services. It is quite unnecessary, in view of recent researches,[4] to dwell at length on the basic differences in the economic behavior of these two groups of industries. The durable-goods industries as a whole are subject to cyclical swings in activity several times as wide as those of the nondurable group.[5]

While extreme cyclical instability is characteristic of the production of nearly all types of durable goods,[6] and while, therefore, it is the durable-goods industries as a class that are the chief victims of the discrimination in taxation which we have been discussing, we wish to devote our attention primarily to a single subdivision of this class, namely the industries producing capital goods, the facilities for production, distribution, transportation, communication, and commerce—that is to say, business plant and equipment. This happens to be the field in which the Machinery and Allied Products Institute is most directly interested. It should be understood, however, that conclusions reached as to the requirements for equitable taxation of corporations in this field are generally applicable to companies producing durable goods for personal use such as houses, passenger automobiles, refrigerators.

III. PROFITS AND LOSSES IN THE CAPITAL GOODS AND CONSUMPTION GOODS INDUSTRIES

The extreme cyclical variability of profits in the capital goods industries as compared with those in industries producing consumption goods such as food, clothing, drugs, etc., is too well known to require demonstration. It is confirmed by every compilation of corporate earnings which permits a comparison of the two categories. By way of illustration, chart 1 shows the results for 400 companies (219 capital goods, 181 consumption goods) covering the 10-year period 1929–38. The upper portion of the chart gives indexes of combined net profits (less deficits) for the two groups of corporations, with the year 1929 as 100. The lower portion shows for each year the percentage of the companies in each group reporting a profit.

The picture is a striking one. Only in the worst year of the depression (1932) did the combined net profit of the consumption goods companies fall below 55 percent of 1929. Only in that year did fewer than 70 percent of these concerns make a profit. For the capital goods companies, on the other hand, 3 consecutive years showed a combined net deficit, while in the worst year fewer than 15 percent of the reports showed profits.

It is not likely that these samples present exactly the picture that would be derived from a tabulation of all corporations in the capital goods and consumption goods fields, were such a tabulation available. Previous experience with sample tabulations of profits drawn, as these mainly are, from published statements[7] hence for the most part from larger-than-average corporations, indicates a tendency toward a relative overstatement of earnings during the depression. It is probable, therefore, that a compelte tabulation of corporations in these two fields would show for both categories a greater relative decline in combined net

[4] See, for example, Simon Kuznets, Commodity Flow and Capital Formation, and Commodity Flow and Capital Formation in the Recent Recovery and Decline, 1932–38 (National Bureau of Economic Research, Bulletin 74).

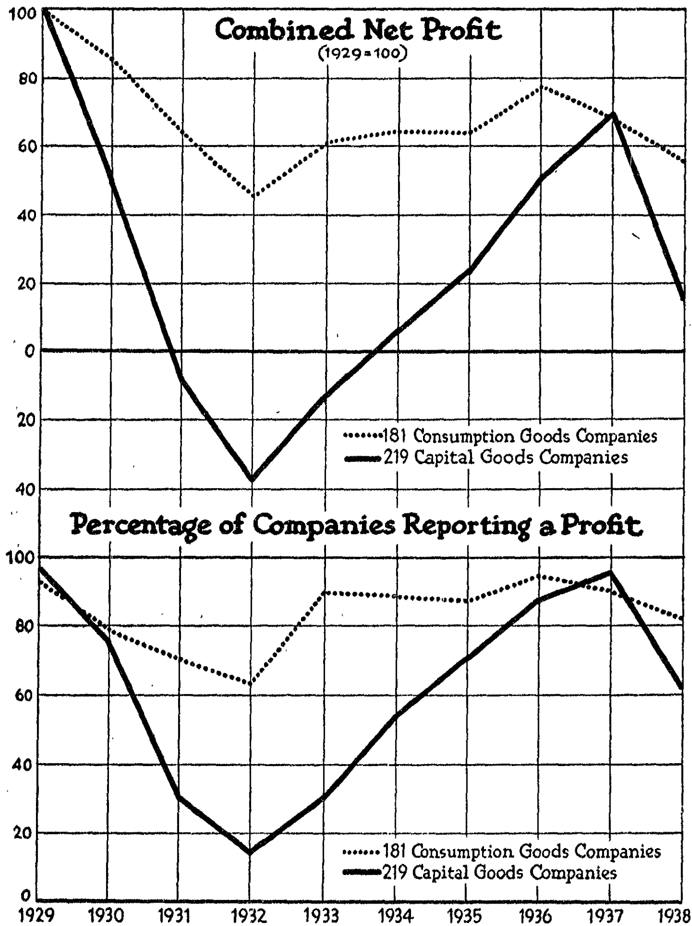
[5] This is due primarily to the postponability of demand for new durable goods. In the case of nondurable goods and services consumption can be sustained over any considerable period of time only by a concurrent and approximately equivalent production. The consumption of durable goods, on the other hand, is within limits relatively independent of current production. The country's existing stock of these goods constitutes a huge reservoir of unconsumed services, from which extensive withdrawals can be made in excess of replacements. Because these withdrawals (current consumption) can be sustained for some time at a rate only slightly diminished even in the absence of replacements, the addition of new durable goods to the stock in use can be readily deferred during periods of economic adversity.

[6] Most exceptions are to be found among goods sold largely or exclusively to governments.

[7] Figures for 312 of the 400 companies are from published statements; for the remainder they are from confidential responses to a special questionnaire.

CHART 1

Combined net profit, and percentage of corporations reporting a profit, 1929–38 [1]



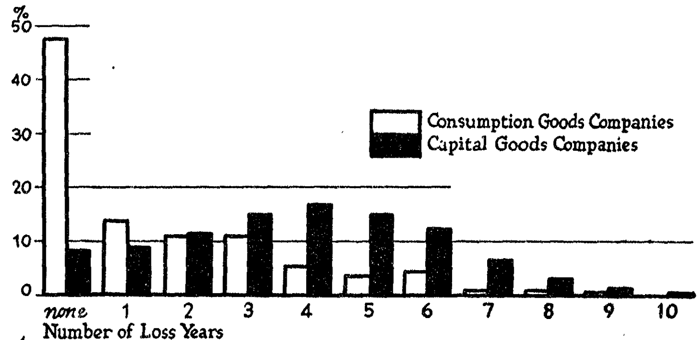
[1] Profits are after Federal taxes.

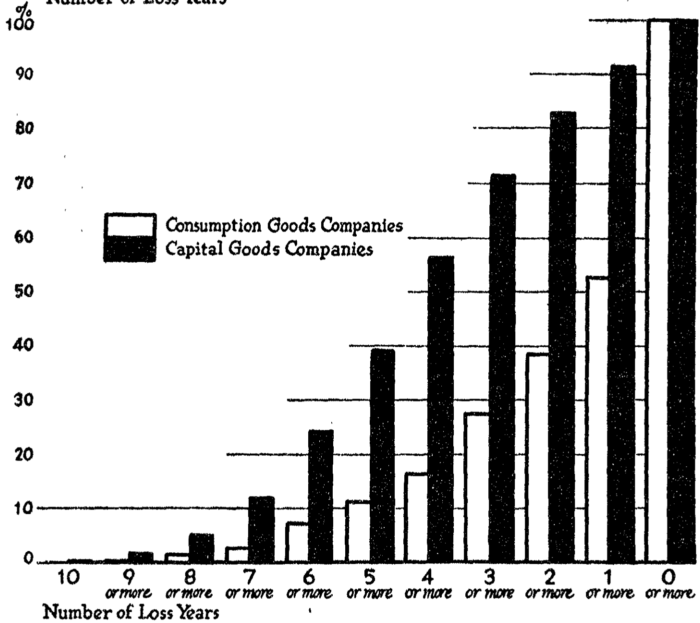
profits following 1929 than indicated by the sample, with of course higher percentages of losing corporations, at least in the poor years. It is certain, however, that a comprehensive tabulation would show a broadly similar picture as to the relative amplitude of movement for profits in the two areas. It is with this that the present comparison is primarily concerned.

Using the same sample of 400 corporations, let us classify the concerns in each group as to the number of deficit years incurred during the 10-year period 1929–38.

CHART 2

Capital goods and consumption goods companies classified by the number of loss years during the decade 1929–38 [1]





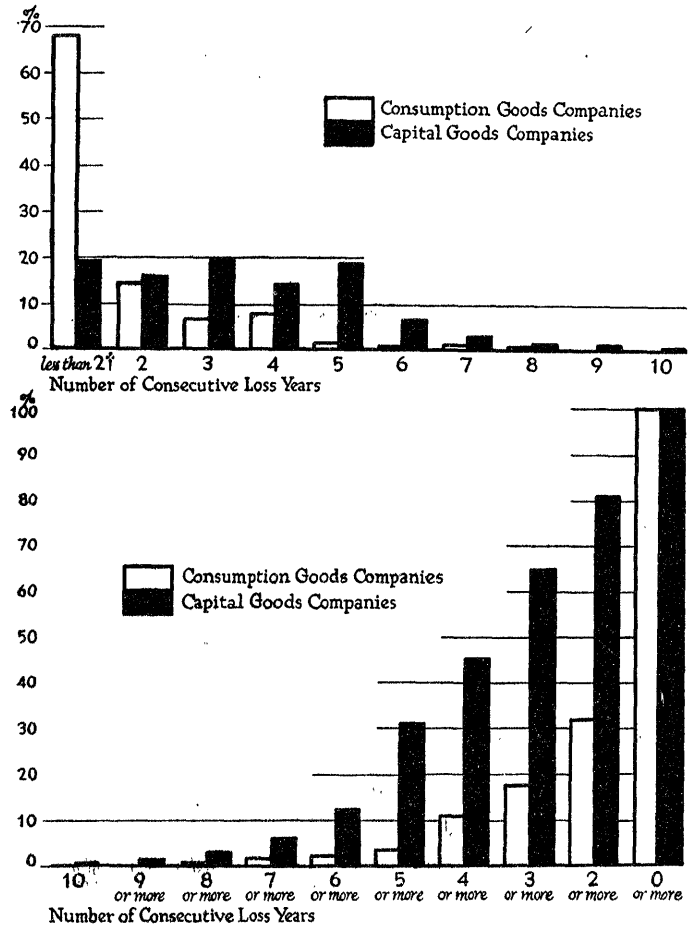
[1] Losses are after Federal taxes, if any.

The results appear in the upper part of chart 2 the lower section of the chart showing the same data in cumulative form.

Of the consumption-goods companies, 47.5 percent had no net losses during the decade, the corresponding figure for capital goods companies being 8 percent. Of concerns in the former category only 11 percent had losses for 5 or more years, against 39 percent for the latter class. The average number of loss years for the two categories as a whole was 1.4 and 3.8 years respectively. These are truly striking contrasts.

CHART 3

Capital goods and consumption goods companies classified as to the greatest number of consecutive loss years experienced during the decade 1929–38 [1]



[1] Losses are after Federal income taxes, if any.
†No net loss year, or a single net loss year followed by a profit.

Let us proceed a step further to classify these corporations according to the greatest number of consecutive years of net loss experienced during the decade. The results are given in chart 3, again with cumulated data in the lower section.

Here again the contrast between the two classes of corporations may be described as striking. More than two-thirds of the consumption-goods companies (68 percent) had no consecutive years of loss. This can be said of only 19 percent of the capital-goods enterprises. The proportion with 3 or more consecutive loss years was 18 and 65 percent, respectively; with 5 or more years, 3 and 31 percent. Nothing could show more clearly the fundamental disparity in the stability and continuity of earnings in these two areas of production.

IV. TAX DISCRIMINATION IN PRACTICE

It is obvious that this marked contrast in the gravity and duration of the deficits experienced by the two groups of corporations must have been reflected in extreme differences in their relative tax burdens. In the absence of provision for the carry-over of losses, taxes must be paid on all the net income of all the profitable years in any period. They must be paid, in other words, both on income that is offset by deficits within the period and on income that is not offset. Since the proportion of income that is offset is greater for capital-goods companies than for consumption-goods companies, the former pay in taxes a larger proportion of their incomes in excess of deficits. It is the levying of taxes against profits which are canceled out by losses that is the source of the discrimination of which we have been speaking.

If we compute taxes paid as a percentage of the excess of income over deficits we obtain what may be called the "effective" tax rate applicable to capital-goods and consumption-goods companies. While the effective rate for the former is the higher of the two, it is evident that the degree of difference will vary widely, depending on the character of the period chosen as the unit of computation. For a period of sustained prosperity such as 1923–29, during which losses were small relative to earnings for both classes of corporations, the difference in effective tax rates as between the two groups would probably have been slight even in the absence of the 2-year carry-over of losses then permitted. For the decade 1929–38, which contained both good and bad years, the capital-goods enterprises had an effective rate one-third higher than the other group.[8] For a period of depression such as 1931–35, the difference would be enormous.

By what margin the effective tax rate of capital-goods companies would exceed that of consumption-goods companies "over the long run," it is impossible to say. The calculation must be made for a definite period of years, and no such period can be considered satisfactorily representative of the "long-run." That the margin was enormously wide during the period of depression covered by our data is demonstrable. There is no reason to doubt that it would be wide in any depression in the future, and substantial in any period including a depression along with a more prosperous interval. The impracticability of measuring the discrimination against the capital-goods companies over a fully representative "long run" period in no way diminishes the desirability of removing the discrimination.

It is of interest to observe the distribution of effective tax rates for a particular period among individual corporations in the two groups. For this purpose we use the 8 years of depression and partial recovery of 1931–38. During this period the consumption goods companies as a whole paid 15.5 percent of their net profit [9] in Federal income taxes. The capital goods companies paid 28.6 percent. This proportion of net profit paid in Federal income taxes is 185 percent (not far less than double) the proportion paid by the group of consumption goods companies.

For this period 41.2 percent of the capital goods companies had a net deficit,[10] yet paid taxes on one or more years of income. Of the consumption goods companies, only 15.4 percent fell into this category. Moreover, 11 percent of all

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[8] The rates were 19.4 and 14.7 percent, respectively. Net profit is before Federal taxes.

Net profit as shown in published returns is not necessarily identical with net income for tax purposes, since certain items of nontaxable income may be included in computing net profit, while certain deductions from gross income may be taken that are not allowable for income-tax purposes. However, the difference between published net profit and "statutory net income" for the two groups of corporations covered by this study is too slight to affect materially either the above comparison of effective tax rates or the analysis of the effect of various loss carry-over provisions to be presented shortly. A test tabulation which we have made covering a group of 23 capital-goods companies for each of the 10 years 1929–38 shows a difference of only 4.6 percent between published net income before income taxes, and net income reported for tax purposes.

[9] Net profit is before Federal taxes.

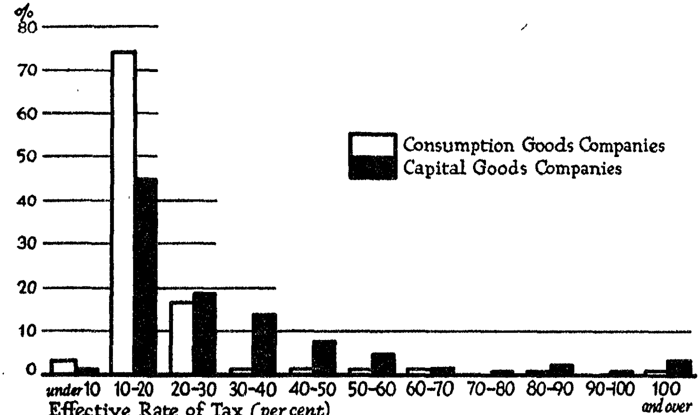
[10] Before Federal taxes, if any.

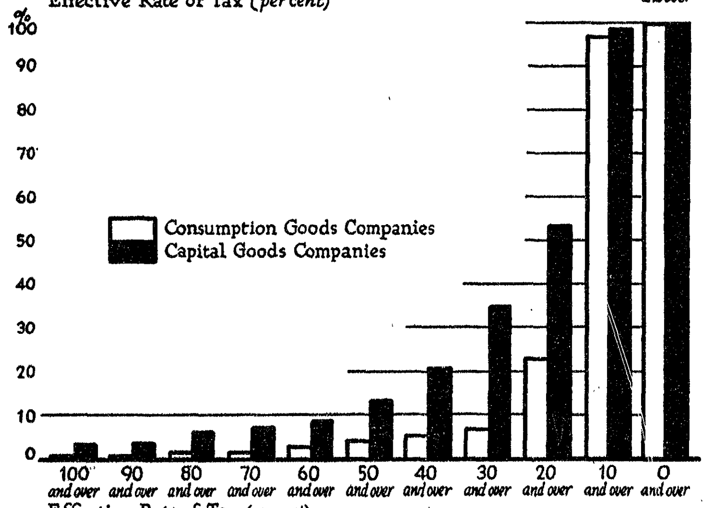
Federal income taxes paid by the capital goods corporations were paid by the deficit concerns, while the corresponding figure for consumption goods companies is only one-half of 1 percent.

Even if we exclude from both groups of corporations those having a net deficit for the 8-year period, we still find a marked discrimination in relative tax burdens. Capital goods companies showing a net profit for the period paid income taxes equal to 19.4 percent of this profit, as against 15.4 percent for profitable consump-

CHART 4

Capital goods and consumption goods companies showing a net profit for the period 1931–38. Classified as to the percentage of such net profit absorbed by Federal income taxes [1]





[1] Profits are before Federal taxes. Based on data covering 129 capital goods and 153 consumption goods concerns.

tion goods companies.[11] The proportion of these concerns with a tax liability extremely heavy in relation to profits was of course higher in the former group. This is shown by chart 4, which classifies concerns in both groups in accordance with the effective tax rates applicable to their net profit for the period. The lower section is in cumulative form.

The chart requires little comment. While 77.1 percent of the consumption goods corporations had less than a fifth of their 8-year net profit absorbed in taxes, only 46.5 percent of the capital goods companies were so fortunate. On the other hand, 21 percent of the latter paid out more than two-fifths of their profit, against 5.3 percent of the former. There were even a few capital goods concerns that paid in taxes more than their entire profit.

It is appropriate at this point to answer an argument sometimes advanced to minimize and disparage the extent of the discrimination of Federal income-tax law against capital goods companies. These companies, it is said, make much larger profits in good times than consumption goods enterprises, and hence can stand heavier taxes.

Whether capital goods concerns as a class average a substantially higher rate of return during periods of prosperity than do consumption goods companies is open to question. This is indicated by the lower section of chart 5, below, which gives the rate of return on net worth for the capital goods companies and consumption goods companies for which we are able to obtain a continuous record for the period 1923–38. These two groups show an almost identical return during the prosperous years of the twenties.[12] The upper portion of the chart presents indexes of net profit with the year 1929 as 100.

This question of whether capital goods companies are much more profitable in good times than are consumption goods companies need not be further pursued for the present purpose, however, for even were such the fact this would not support the argument sometimes advanced in justification of heavier taxes upon capital goods companies. If capital goods companies make larger profits in prosperous periods than consumption goods companies this is not evidence of special privilege or good fortune that can compensate for discriminatory taxation; the making of such profits is a necessity if the two classes of corporations are to realize the same average rate of profit in the long run. To attain this parity, capital goods companies must earn more during their profitable years to offset their larger losses in poor years. It is what they net over the long pull that counts.

V. CARRY-OVER PERIODS REQUIRED TO OFFSET LOSSES OF CAPITAL GOODS AND CONSUMPTION GOODS COMPANIES, 1929–38

The tax discrimination described in the preceding section illustrates what may happen in the absence of any provision for the offsetting of losses against the income of later years.[13] Such an offset is a prime requisite if this discrimination is to be eliminated, or even substantially reduced.

Alternative methods of equalizing the tax burden of the intermittently profitable corporations with that of the more consistently profitable concerns may be dismissed as relatively impractical. An assessment period several years in length might effect a substantial equalization, but even if it had no other drawbacks it would entail so great a lapse of time between the accrual of taxable income and the due date of the tax as to occasion excessive difficulties in collection. There would be too many improvident concerns unable to pay, in a period of adversity, on incomes made and spent years earlier. The same objection applies, though in lesser degree, to the system of yearly assessments on a moving average of annual incomes and deficits for a period of years.[14] Other possible alternatives to the loss carry-over arrangement are subject to other objections.

Assuming that the tax discrimination which we have been discussing is to be dealt with by offsetting losses against the incomes of later years, let us examine the record of our 400 corporations for the light it may shed on the question of the carry-over period.

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[11] Profits are before Federal taxes.

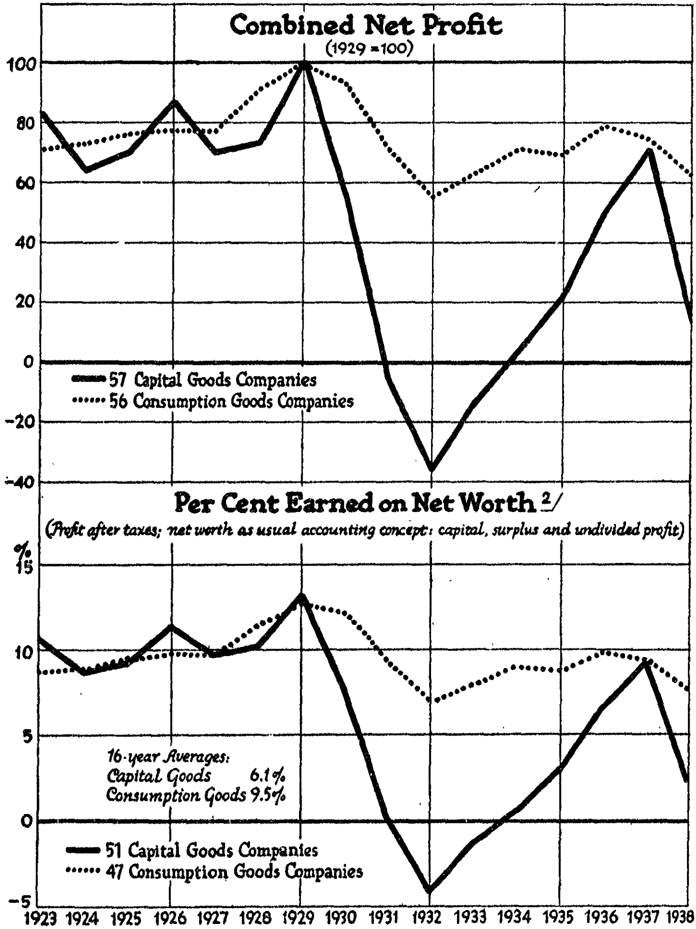
[12] These indexes correspond very closely during the period 1929–38 with those shown previously for these years for 219 capital goods and 181 consumption goods companies (chart 1). All the companies in the smaller samples are included in the larger.

[13] Although Federal revenue laws provided for a 2-year carry-over of prior losses against incomes of 1929–31 and for a 1-year carry-over against the income of 1932, these were years of rapidly declining earnings, and comparatively little offsetting of losses was possible. During the recovery period of the decade covered by this study, when the offsetting might have been substantial, none was permitted. Thus it is safe to say that for the decade as a whole the record as given is approximately what it would have been had no carry-over been allowed at any time.

[14] A 3-year moving average was in use in Great Britain prior to 1926, but was abandoned in that year in favor of single-year assessments with a 6-year carry-over of losses. The Royal Commission on Income Tax (1920) which recommended this shift, reported that "hardly anyone has a good word for the average." The chief benefit the commission anticipated from the change was that "it will make the amount of profits assessed correspond more closely in point of time with the amount of profits actually being made."

CHART 5

Combined net profit[1] and percent earned on net worth,[2] 1923–38



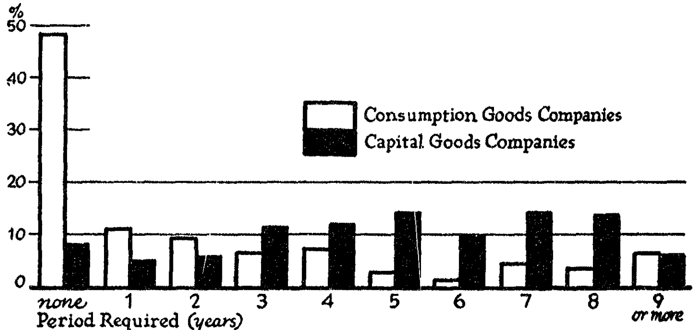
[1] After taxes.

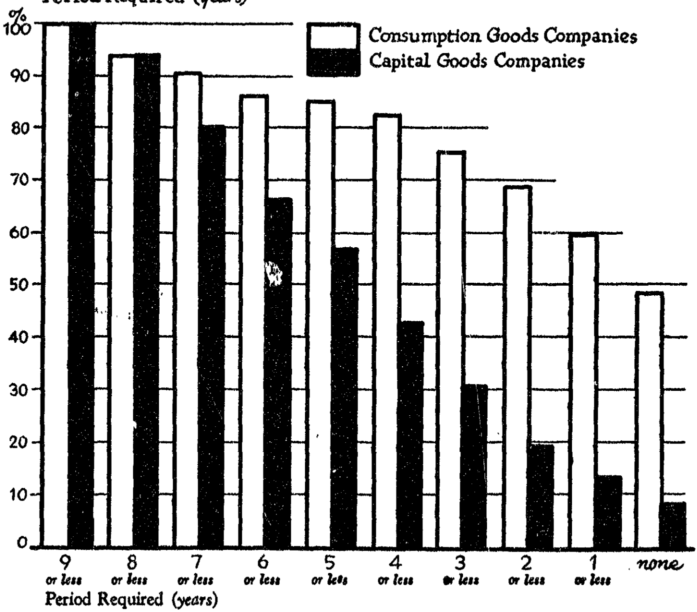
[2] The percent earned on net worth is overstated to the extent that heavy and extended losses resulted in some years in reduction of surplus and write-down of capital. Calculated against predepression net worth aggregates, the percent earned on net worth would be lower for each group of companies, but more than proportionately lower for the capital goods companies. Expressed in percent earned on 1929 net worth the averages are 5.2 percent instead of 6.1 percent for capital goods and 8.8 percent instead of 9.5 percent for consumption goods.

A word of explanation is first in order. Since the tabulation for these companies covers only the 10 years 1929–38, there are many cases in which losses for certain years have not been completely offset by subsequent income received prior to the close of the period. How many more years would be required to complete the offset it is impossible to say. In tabulating these companies for inclusion in chart 6, below, we have taken the longest carry-over period known to be required.

CHART 6

Capital goods and consumption goods companies classified as to the carry-over periods required for a complete offset of losses incurred, 1929–38 [1]





[1] Both profits and losses are computed before Federal taxes. Data for the chart include a break-down between corporations completing their offset during the period 1929–38 and corporations not completing it.

It is quite possible, of course, that the carry-over period needed in the case of losses offset after 1938 may be longer than the one entering into the tabulation, hence the result is an understatement of the length of the carry-over period which may be required.

Chart 6 classifies 219 capital goods and 181 consumption goods companies as to the carry-over periods required to offset losses incurred in the decade 1929–38. The lower portion of the chart gives cumulative figures.

The chart reveals again the contrast which we have repeatedly noted as between the consumption goods and the capital goods companies. Nearly half (48 percent) of the former needed no offset whatever, for the reason that they had no losses during the period, whereas only 8 percent of the latter fell in this category. Of the consumption goods companies 68 percent were protected by an offset period of 2 years, but only 19 percent of the capital goods concerns. The latter, on the other hand, required 5 or more years in 57.5 percent of the cases, a requirement applicable to less than 18 percent of the consumption goods enterprises.

VI. HOW LONG SHOULD THE CARRY-OVER PERIOD BE?

It is quite obvious from the foregoing comparison that a loss carry-over period sufficient for corporations in the consumption-goods industries may be wholly inadequate for concerns producing capital goods. It is the requirements of the latter that must govern the carry-over provisions of the revenue laws if a substantial equalization of tax burdens is to be achieved.

It is not here proposed that the allowable carry-over period should be unlimited, or that it should secure a complete offsetting of losses in every case. What is now suggested is a practical compromise that will make possible a complete offset for the great majority of capital-goods companies, and other companies with similar income characteristics. For this purpose the present provision for a 2-year carry-over is clearly inadequate.[15]

If this provision had been in effect during the decade 1929–38 [16] it would have permitted only 19.2 percent of the capital-goods companies in our sample to make a complete offset of losses. The percentages covered by longer carry-over periods would have been as follows:[17]

Carry-over period in years:	*Percent of companies offsetting losses*
3	30.6
4	42.5
5	56.6
6	66.2
7	80.3
8	94.0
9	99.5

If the experience of these corporations during the decade 1929–38 is a valid criterion of the length of the carry-over period required—and we believe it is—the conclusion follows that nothing less than 6 years will suffice to meet the test of a complete offset of losses for the large majority of capital-goods companies.

It may be noted in this connection that in Great Britain the Royal Commission on Income Tax (1920) after a careful study of the whole question, recommended a 6-year carry-over, a recommendation that was adopted in 1926.[18] The provision has since remained in effect, and has even been liberalized by later legislation.[19]

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[15] A 2-year carry-over was provided for in the Revenue Acts of 1921, 1924, 1926, and 1928. The act of 1932 reduced this to 1 year, and the act of 1933 abolished the carry-over entirely. The 2-year provision was revived in the act of 1939, and is now in effect.

[16] It was effective during the early years of the period, but was of little practical consequence. See footnote 13, p. 321.

[17] It will be recalled that this tabulation tends to overstate the coverage of the shorter carry-over periods because of the treatment of corporations with losses offset after 1938 (pp. 321–324, and because the companies in the sample probably had smaller losses during the depression relative to their subsequent incomes, than the run-of-mine capital-goods concerns (p. 315).

[18] See the Report of the Royal Commission on Income Tax, 1920; also House of Commons Parliamentary Debates, 1926, vol. 198, July 12–August 4.

[19] The act of 1932 permitted the carrying forward beyond 6 years, and without limit as to time, of either the balance of the loss at the end of 6 years, or the total of depreciation set off within the 6 years in priority to such loss, whichever is less. See Income Tax, Surtax, and National Defense Contribution, by E. M. Taylor and V. H. M. Bradley.

We submit that a carry-over period of at least 6 years is necessary to secure even an approximate equalization of tax burdens between consistently earning corporations and those with intermittent earnings. The desirability of amending our present law to this effect is increased with every increase in tax rates. The excess-profits taxes scheduled to be imposed in connection with the present national-defense program will make this reform more pressing than ever. We therefore urge immediate consideration of this important problem by Congress.

Senator CONNALLY. For the information of the committee I desire to have printed in the record a letter from Vinson, Elkins, Weems & Francis, of Houston, Tex., commenting on the proposed excess profits taxation; also, letters addressed to the committee by George C. Beaury of San Antonio, and J. W. Colvin, of Houston, Tex.

(The letters referred to are as follows:)

VINSON, ELKINS, WEEMS & FRANCIS,
Houston, Tex., August 24, 1940.

Senator TOM CONNALLY,
United States Senate, Washington, D. C.

DEAR SENATOR CONNALLY: In the proposed new excess-profits-tax bill, as explained in report of a subcommittee of the Committee on Ways and Means, corporations which were in existence during the whole of the base period (years 1936 to 1939, inclusive) are allowed an optional method of computing their excess-profits-tax credit, as follows:

(1) They may take as a credit against net income for the taxable year the average earnings for the base period, said credit increased by 8 percent of the additions to capital after the beginning of the taxpayer's first taxable year under the excess-profits tax and decreased by 6 percent of the reductions in capital during the same period; or

(2) They may take as a credit an amount equal to the percentage of the invested capital for the year involved which the earnings during the base period bears to the invested capital for the base period, such percentage not to exceed 10 percent, nor to be less than 6 percent with respect to the first $500,000 of invested capital, nor less than 4 percent with respect to the balance of the invested capital.

On the other hand, a corporation which has been in existence for only a portion of the base period has no option but must use only the invested-capital method for determining its excess-profits-tax credit, with certain arbitrary allowances for invested capital and earnings for the portion of the base period during which it was not in existence.

The following example will serve to demonstrate how a decided disadvantage will arise to a corporation in existence for only a part of the base period, as compared with a corporation having similar earnings and invested capital and in existence for the entire base period:

SITUATION 1.—*Corporation in existence for only a portion of the base period*

Year	Invested capital	Excess-profits tax income	Base period percentage
1936 (allowance based on 1940 invested capital)	$150,000	$15,000	
1937 (allowance based on 1940 invested capital)	150,000	15,000	
1938 (actual invested capital and earnings)	10,000	150,000	
1939 (actual invested capital and earnings)	100,000	100,000	
	410,000	280,000	68.29
1940 (actual invested capital)	150,000		

As I understand the subcommittee recommendations, the above corporation would receive a credit for excess profits tax for 1940 of only 10 percent of $150,000, or $15,000, despite the fact that its earnings for the base period as shown above were 68.29 percent of its invested capital for the same period (the maximum credit under the invested capital method is 10 percent of the invested capital for the taxable year).

SITUATION 2.—*Corporation in existence for entire base period*

Year	Invested capital	Excess-profits tax income	Base period percentage
1936 (actual invested capital and earnings)	$150,000	$15,000	
1937 (actual invested capital and earnings)	125,000	75,000	
1938 (actual invested capital and earnings)	150,000	100,000	
1939 (actual invested capital and earnings)	125,000	90,000	
	410,000	280,000	68.29
1940 (actual invested capital)	150,000		

This corporation would have the option, for 1940, of taking as its credit for excess-profits tax $15,000 (10 percent of $150,000), or $70,000 (its average earnings for the base period—one-fourth of $280,000); and would, of course, take the larger figure.

Thus, under situation 1 above, the corporation's maximum excess-profits tax credit would be $15,000, whereas, under situation 2 the corporation's credit would be $70,000. If the corporation under situation 1 were permitted an election to use either the average earnings method or the invested capital method of determining its excess-profits tax credit, of course it would receive the same $70,000 credit as the corporation under situation 2.

I think this inequity would exist in any case where a corporation in existence only a portion of the base period had earnings in excess of 10 percent of its invested capital, as would often happen in the case of those corporations which have their ups and downs in the business world.

It is recommended that the present law under consideration by the House Ways and Means Committee be amended so as to give a taxpayer corporation, which has not been in existence during the whole of the 4-year base period, the option to use its average earnings during such part of the base period as it has been in existence rather than force the corporation to be restricted to the invested capital base. It is our understanding that the present Canadian Excess Profits Tax Act permits a corporation which has not been in existence during the entire base period to use such a part of the base period as it has been in existence as a basis for this credit.

It appears that it is the intent of Congress to tax excess profits beyond the normal amount and not to penalize American industry. The average of the 4-year base is fair, but not to give other corporations who have been in existence only a part of this base period an equally advantageous option is unjustly discriminatory. As a matter of fact it would appear that corporations, which have been in existence for a shorter period than the base period, are entitled to a more liberal treatment than those who have been in existence for the whole period. The latter corporations have a more accurate yardstick for the determination of a normal income than the corporations which have been in existence for a shorter period. If the above recommendation is not to be accepted, there should be some liberal provision inserted in the new excess-profit tax act such as a comparison with similar corporations as was involved in the special assessment provisions of the earlier revenue acts.

With kind personal regards, we are

Yours very truly,

VINSON, ELKINS, WEEMS & FRANCIS,
By WRIGHT MATTHEWS.

BLANCO OIL CO.,
San Antonio, Tex., September 3, 1940.

To the Honorable Chairman and Members of the Finance Committee of the United States Senate:

GENTLEMEN: With relation to H. R. 10413 covering proposed excess-profits taxation and special amortization, we would like to offer the following suggestions or recommendations:

EXCESS-PROFITS CREDIT

(1) From the reading of the bill on proposed excess-profits taxation, it is clear of course that the basic concept of the tax is to place an extra tax on profits made in excess of normal profits. In other words, if a corporation has during the basic

period (1936 to 1939) made profits which are considered to be normal profits, then it may use such average profits during that period as a basis for credit toward the excess-profits tax; however, it seems to us that corporations that have been in existence for only a short period of time may be severely penalized by using such a basis of computation without giving proper consideration to earnings of corporations in similar or related businesses, or taking into consideration abnormal expenditures made during such period in connection with the promotion and development of such business in its early stages. Such corporations may have had a satisfactory amount of sales in each of the years of the base period, but because of the high cost of operation caused by the fact that in a new business the promotion and development cost is high, they may actually show losses or very little profits, and yet, other corporations with the same volume of sales may show a very satisfactory earning record. For this reason, to use the earnings of such new corporations as a basis for excess-profits tax credit without any other consideration would be in effect penalizing them for not having made a normal return of profits from its sales. It is suggested, to remedy the situation, that some provision be made for either placing such corporations on the same basis as other corporations in a similar or related line of business, using their average return as a basis for excess-profits tax credit, or eliminating from their expenses for the basic period the extraordinary expenses for promotion and development, which caused the abnormally low earnings.

Under the subcommittee report, corporations such as described above would receive no excess-profits tax credit based on earnings because, as outlined above, the expenses in the early stages of the corporation would in all probability exceed the income, and such corporations would actually show losses during such period and, therefore, they would not only be allowed no excess profits credit based on earnings, but their invested capital would be reduced by the losses and they would receive a lesser credit because of the reduced invested capital.

For the above reasons and in order to alleviate the situation, we recommend that the following provision be added to the bill:

If a corporation can show that its profits compared with its sales during the base period were abnormally low because of extraordinary or nonrecurring expenses necessary to bring the business to a productive stage and losses, or that other corporations in a similar or related line of business made, during the base period, at least double the amount of profit in proportion to their sales, then the profits used in determining the excess-profits tax credit should be computed either by eliminating such extraordinary or nonrecurring expenses and losses as the taxpayer can reasonably show as having been deducted in arriving at the profits; or allow as the profits factor for its excess profits credit, the same percentage of sales that the profits of similar or related businesses bear to their sales.

(2) Under the bill it is proposed for a corporation that had been in existence during the base period, that it may use as a minimum excess-profits credit 7 percent of the first $500,000 of invested capital and 5 percent of the balance of the invested capital in excess of $500,000. It appears to us that 7 and 5 percent are rather low rates of return to be expected from a corporation on its invested capital and that percentages more in line with the risks involved in any general business undertaking, as distinguished from the much lesser risks involved in secured investments, would be from 6 to 8 percent, at least. In further support of this recommendation, we again submit that due consideration should be given to corporations such as described in paragraph 1; those that have had practically no profits throughout their existence and, therefore, have had no real return on their capital; the owners of the business having risked the capital; knowing at the outset they would have no profits, but expecting a higher return in the later years after the business was developed.

INVESTED CAPITAL

(1) The bill includes the use of borrowed capital as invested capital, limited to certain varying percentages from 100 to 33⅓ percent. The cost of securing borrowed capital is practically the same whether the amount is small or large, assuming that the other factors, such as security for the loan, are equal and we, therefore, see no reason why the full 100 percent of the borrowed capital should not be allowed as invested capital. It seems to us that allowing only a proportionate part of invested capital will place a corporation which operates mostly on borrowed capital at a disadvantage with respect to corporations with large equity invested capital. The channels by which a corporation in most cases borrows capital are not the same ones used in selling equity capital, and if a corporation needs money for the operation and development of its business it may be able to secure borrowed capital when it may not be possible to secure equity capital, because in cases where a corporation secured borrowed capital instead of equity

capital, it usually has been by reason of the fact that the potential investor has insisted upon good security and a certainty of payment, and did not want to leave the money with the corporation indefinitely. If a corporation has been in existence during the base period and is using its invested capital as the basis for its excess-profits credit for the first $500,000 it would, according to the present proposed bill, be allowed only 7 percent, and only 5 percent on the balance of its invested capital. This is very little above the rate of interest on loans. On the other hand, if a corporation is perchance paying a higher rate of interest than 7 and 5 percent, then its borrowed invested capital will be of no benefit to the corporation and would actually be a detriment, because of the fact that, while it would get 7 and 5 percent of its borrowed invested capital, it would have to increase its excess profits net income by a rate of interest higher than the rate of excess-profits credit. In view of the above, it is our recommendation that corporations be allowed to use all of their borrowed capital as invested capital, at their option, and that in the event they use all their borrowed capital as invested capital that no deduction be allowed for the interest on such borrowed capital so used, and that if they elect to use no part of the borrowed capital as invested capital, then the interest deduction shall be fully allowable for the purpose of the excess-profits tax.

COMPUTATION OF EXCESS-PROFITS TAX

(1) Under the proposed excess-profits tax, the rates applicable if the income credit is used are 5 percent greater in each bracket than if the income and invested capital credit is used. This seems to be a sufficient equalization between the two methods without adding 4.1 percent to the normal income tax as well if the income credit is used, and we would recommend that the 4.1 percent not be added to the normal income tax. An additional reason for not adding this 4.1 percent is that the proposed tax, in our opinion, should be limited to excess profits without disturbing the normal income tax.

Respectfully submitted.

BLANCO OIL CO.,
GEORGE C. BEAURY, *Secretary.*

MEMORANDUM

Re proposed excess-profits tax law (as reported).

The importance of proper oil reserves in the national economy is beyond argument. The Oil and Gas Journal, semiannual number, issue of July 25, 1940, page 55, states:

Crude-oil reserves discovered first half 1940—Production for same period:

	Barrels
New discoveries	94, 627, 000
Extensions—Old fields	181, 061, 000
Total new oil discovered	275, 688, 000
Production	684, 733, 094
Loss in total reserves	409, 045, 094

The facts are that, despite major oil company talent, a surprisingly large proportion of present-day oil reserves in sight—such as East Texas field—has been discovered by independent wildcatters. If such independently found oil reserves did not exist today the oil situation would be very alarming. Accordingly, it is reasonable to look at this proposed tax from the standpoint of its effect on the wildcatter and small oil company.

As you know, many wildcatters have solicited—and must continue to solicit—outside aid for their initial wildcat test in any given area, and for the protection of those who so speculated, small corporations were frequently formed with nominal capital to do the job. As and when discoveries resulted, such small corporations frequently initially elected—hence were subsequently required—to charge off intangible well costs as development progressed. Accordingly, during such period, from an income-tax-accounting standpoint, they sustained losses.

Due to the necessity of pursuing offset well development and the low allowables prevailing in recent years, especially in Texas, funds for completion of such oil wells were necessarily borrowed, with the result that banks, and others, throughout the Southwest have sizeable sums now invested in such oil payments which require the operator (small companies) to pay not less than one-half of the net working interest oil runs toward liquidation of such debts.

If the excess-profits tax, as passed by the House, is subsequently approved by the Senate in its present form, it is obvious that such small companies, with nominal invested capital and no record of earnings, would be in position of having practically all subsequent earnings—assuming their development program is now reasonably completed—treated as excess profits. The result is they will not have sufficient funds remaining out of their retained one-half, after payment of operating expenses, to pay their ad valorem taxes, their normal income taxes, and the proposed excess-profits tax.

As no company, whether large or small, can indefinitely pay out more than it takes in, the effect of the above law would be to destroy the wildcatter. In any event, it would certainly result in the banks and others being required to take over, for their own protection, large numbers of such properties where discoveries resulted, and where the small company operator, lacking working capital, had been required to borrow for its offset well costs.

In the 1936 undistributed-profits-tax law, proper provision was made so that, in effect, funds which were assigned under agreements executed on or before May 1, 1936, were exempt from the penalty tax. A somewhat similar exemption provision in the presently considered excess-profits-tax law would safeguard the interest of numerous companies with small capital which, it is obvious, otherwise will be forced to lose their properties, in due course.

If the taxpayer company is not to be allowed the option to use its declared value in arriving at what constitutes excess profits, then some proper provision for small oil companies, such as the above, is necessary for their continued existence.

J. W. COLVIN,
Houston, Tex.

The CHAIRMAN. The committee will reconvene at half past one.

(Whereupon, at 12:35 p. m. a recess was taken until 1:30 p. m. of the same day.)

AFTERNOON SESSION

(The hearing was resumed at 1:30 o'clock.)

The CHAIRMAN. The committee will come to order.

Mr. Jay Iglauer, of Cleveland, representing the National Retail Dry Goods Association.

All right, Mr. Iglauer.

STATEMENT OF JAY IGLAUER, VICE PRESIDENT, THE HALLE BROTHERS CO., CLEVELAND, OHIO, CHAIRMAN, TAXATION COMMITTEE, NATIONAL RETAIL DRY GOODS ASSOCIATION

Mr. IGLAUER. Mr. Chairman and members of the committee:

I am the chairman of the taxation committee of the National Retail Dry Goods Association, having in its membership some 5,700 retail drygoods and department stores, located in every State in the Union.

Except for the fact that no time for a meeting was afforded, the taxation committee would have had a meeting, would have prepared a report, and this report for presentation to your committee would have been approved by the board of directors of the National Retail Dry Goods Association.

Because of lack of time and the many changes which have been made in the present bill, as compared with the report of the subcommittee of the Ways and Means Committee, no opportunity has been afforded to follow our usual procedure.

It is, therefore, rather as a private citizen that I come before you, having canvassed by mail and long-distance telephone as many members of my committee as were available, as well as other important members of the National Retail Dry Goods Association.

Mr. Chairman, after reading and listening to the presentations for the last 2 days before your committee, I confess to considerable confusion of mind concerning the practical workability of the proposed statute, and the effect that so complicated a measure will have upon the average corporate taxpayer. I entertain the earnest hope that the Senate Finance Committee and the Senate will recast the bill more nearly in the form indicated in the report of the subcommittee of the House Ways and Means Committee to the full committee of that body.

May I presume, also, that, in your consideration of the bill, you will study the suggestions that have occurred to me, as the result of listening to you question some of the witnesses who have appeared before you in the last 2 days.

The suggestions follow:

1. I take it that this second tax bill of 1940, as distinguished from the first Revenue Act of 1940, was intended specifically to tax abnormal profits. If this premise is justified, the penalty tax of 4.1 percent upon the normal profits of corporations which has been inserted into the so-called earnings basis of the proposed measure, is an invasion of the normal-income-tax bracket, and constitutes double taxation in its present form. Remember, please, that the high-income-producing corporations in the 1936-39 years were sources of substantial revenue to the Government. I suggest the elimination of the penalty tax. Mr. Stam indicated yesterday that there is not the great advantage in the earnings basis that has been attributed to it. It is like the choice between being chewed up by a lion and nibbled by a bear. It is truly a penalty upon energy and high efficiency in the use of relatively small capital. It will force many corporations inequitably to use the invested capital basis with its disputes and uncertainties.

2. If any equalization is, in the wisdom of the committee, found necessary, let it be done by raising the rate of the exemption on the invested capital basis to a "floor of 8 percent" for all corporations. The floor at present is too low. It works a hardship on many corporations and is the cause of the many requests for special relief. I think it is fair to say that this section of the law is so difficult to understand and to interpret that it will doubtless lead to innumerable tax disputes with the Bureau of Internal Revenue

This brings me to my third point, namely:

3. That corporations be required to compute their taxes each year upon both the basis of average earnings in the base period, and the basis of invested capital; and that the tax payable shall be whichever is lower. This has the effect of establishing a ceiling for each year's excess-profits tax. As an example, assume that a corporation would pay, under the earnings basis, a tax of $100,000, and under the invested capital basis, $30,000. The return is made on both bases with first payment on the basis of $80,000. If later, by reason of review by the examiners of the Bureau of Internal Revenue, disallowance occurs in the amount of invested capital and the resultant tax on that basis should be $110,000, the amount of the tax would then be $100,000. If, on the other hand, the finding should turn out in favor of the taxpayer with a resultant tax of $75,000, then that would be the actual tax paid.

The CHAIRMAN. You wouldn't want to put the burden on the Treasury Department, would you, to figure out these two bases, and the tax, and then let the taxpayer elect as to which one of the two he should use, instead of having the taxpayer go and put up a good deal of money to get a tax lawyer——

Mr. IGLAUER. He will need one anyway, but under the present law, because of his election, he will have to figure the tax both ways in order to know which of the two methods he will select from year to year.

4. It has been suggested by witnesses who have appeared before you, and indicated by questions from the committee, that the taxpayer be allowed to select any 3 of the 4 years 1936 to 1939, inclusive, as his base period. I urge upon the committee the acceptance of that suggestion upon the ground that it will grant relief to corporations having abnormally low years in that period. In 1938 there was an unprecedented drop in industrial production beginning in August and accelerating in October. That year—in manufacturing and retailing—was a poor year for most corporations.

5. In view of the testimony before your committee it is, in my opinion, necessary to include in the act some general relief provision such as sections 327 and 328 of the 1921 law. I urge that this be done. It is possible that with the reenactment of this provision some of the special relief requested will be adequately met. In this connection, some requests have come to us for a special relief provision incident to low earnings due to a general strike situation, such as that confronting all corporations operating in San Francisco, during the general strike there in 1937. This was a situation analogous to that created by fire, flood, acts of God, or to that created by the processing taxes. I hope——

Senator KING. Pardon me, have you submitted a proposed amendment to deal with the matters which you discuss in paragraph 5?

Mr. IGLAUER. It would be presumptious for me to attempt to do a piece of drafting, although I would like nothing better than to sit in with the drafting committee.

Senator KING. That may not be done, but haven't you such concrete ideas that you could submit a proposed amendment?

Mr. IGLAUER. Well, it could be done in comparatively simple language, that the tax shall be computed upon both bases and that the tax shall be, whichever is the lesser of the two.

I think it is a suggestion well worth consideration.

6. Consolidated returns on a permissive basis would be a most helpful change.

7. Preferred stock in most corporations is another form of borrowed capital. When issued prior to the enactment of this act with cumulative dividends and penalties for nonpayment of those dividends, those dividends, in equity, should come before the imposition of excess-profits taxes.

In conclusion, may I impress upon you the fact that retailers in general have already expressed their willingness to bear their fair share of the burden of increased taxation for defense purposes; all we ask is that the imposition be equitable and not discriminatory as between taxpayers, and that it be clearly understandable.

The CHAIRMAN. Thank you very much, Mr. Iglauer.

Is Mr. Savoy here?

Mr. SAVOY. Yes.

STATEMENT OF PREW SAVOY, COUNSEL, AUTO-ORDNANCE CORPORATION, OF NEW YORK, N. Y.

Mr. SAVOY. Mr. Chairman and members of the committee:

I represent, as one of its attorneys, Auto-Ordnance Corporation of New York City.

This company, since 1919, has manufactured one sole product, a submachine gun. From 1919 until the present date it has had recurrent annual deficits, it has made no money in any year; it has written off its patent costs and development costs during those years without writing them off against income except in 3 years, when the operating expenses did not eat up all of the income.

So that there was a slight tax benefit in only 3 years.

This corporation is going to cooperate entirely with the defense program to the extent that its product is needed. If its product is needed in great quantities, it will expand its facilities, regardless of what the provisions of the excess-profits tax may be. It will cooperate 100 percent. That question is not involved here at all. It has not delayed because of not benefiting from amortization provisions; it has gone ahead without them.

It has, however, two very peculiar problems. Having no earnings it has no earnings base. It has a very small invested capital base. Most of it is borrowed capital.

It has two requests to make of the committee:

The bill has provided that where, after July 10, 1940, new facilities are developed, those new facilities may be amortized over a period of 60 months, or 5 years. This company feels that it should not be treated any differently. It prepared for 20 years to meet this very emergency. It knew that that gun would be of very little, if any, use until the next war or emergency—so it prepared over a 20-year period and developed a very efficient gun which the armed forces now need. It is going to supply that.

Now, unless special provision is made, it will never get back its patent and development costs.

The first relief provision, you may call it, that it asks, is this: It asks that it be permitted to capitalize its patent and development costs and to depreciate or amortize them over 60 months in the same manner as a corporation now acquiring new facilities for the purpose of this emergency.

It suggests to the committee that there is no reason for not treating it on an equal basis with such a corporation merely because it started 20 years ago to prepare for this emergency.

The CHAIRMAN. Do you think we could go back 20 years, under the circumstances?

Mr. SAVOY. I think this: That where a company is manufacturing something exclusively for the armed forces, where that company has taken such amortization or depreciation as it has against no income, and expected to make up those deficits out of income in the war period, before you attach excess profits to them you ought to let them get back their costs. I can't see how you can talk about excess profits until you at least get back the costs of your patents and developments. And also, unless you do put in a provision of that sort, you are going to tax them, not impose just normal taxes, but put on an excess-profits tax before they get back their costs. And I don't think that is an excess-profits tax.

The simple provision which would do that would be to provide, on page 87, after line 26, this sentence:

Provided, That patent and development costs (to the extent to which a corporation has enjoyed no prior tax benefit) of standard equipment of the United States armed forces incurred prior to July 10, 1940, may, in the discretion of the Advisory Commission to the Council of National Defense and under the applicable provisions of subsection (f), be certified as an "emergency facility" under the terms of this title.

The CHAIRMAN. Have you discussed this with the Treasury people at all?

Mr. SAVOY. I have discussed it only with the experts of the joint committee.

Senator KING. Did you discuss it with Mr. Stam?

Mr. SAVOY. Yes, sir.

The CHAIRMAN. Did you discuss it with the Advisory Commission——

Mr. SAVOY. I would like to discuss it with the experts of the Treasury and go over the language, particularly in the event the committee should decide it is willing to do something to take care of this peculiar situation.

The CHAIRMAN. I am very sympathetic to moving that date back, but I never thought that there were any contracts made between the Council of National Defense under this program that we have mapped out, that would date back further than the 1st of January of this year.

Mr. SAVOY. It isn't a question of contracts, Senator Harrison. Supposing you prepared in 1939—any time—foreseeing that we might get involved in conflict, or that we would enlarge our armed forces, and began to expand then, and build up. Should you not be permitted to amortize your costs over a reasonable period, such as 5 years, and get back at least your costs before you pay an excess-profits tax? That is the question, and I think no date should be put in, and that it should be left to the Advisory Commission to determine whether this company developed something for the emergency. If it did, then I think this corporation should be given equivalent consideration with new facilities—Under that arrangement I think an excess-profits tax would be satisfactory, if there are profits.

The CHAIRMAN. You don't think that such provision as we had in the old acts, 1918 and 1921, on relief cases, would cover you?

Mr. SAVOY. No, sir; for this reason: Every other manufacturer of which I have been informed or know, manufacturing armament, has, during the peace period of 20 years, manufactured other articles. This is the only company of which I have any knowledge which didn't manufacture during that period any other type of article except a submachine gun.

Senator KING. If there had been no war, then your company would have had all these expenses for nothing, and probably would have been in the hands of a receiver?

Mr. SAVOY. Eventually, yes; that is correct.

The CHAIRMAN. I hope that you will talk to the Treasury experts about this.

Mr. SAVOY. I would like to, if I may do so.

Senator KING. There is a good deal of merit in your suggestion, but it seems to me that there is going to be some difficulty in determining where to draw the line.

It will be contended by those who may not have had the prescience that you did, or those who did, such as people who were making blankets in anticipation of the war, and stored up a vast quantity of woolen goods that are needed in the time of war, going back 10, 15, 20, or even 6 or 8 years.

Mr. SAVOY. That is why I suggested that it be left to the discretion of the Advisory Council to certify or not certify this as an emergency facility.

The CHAIRMAN. Have you a copy of the amendment you suggested?

Mr. SAVOY. Yes, sir.

The CHAIRMAN. All right; put it in the record.

Mr. SAVOY. The second problem is this: The company is very havily indebted to its principal stockholder. The stockholder, if the law is clarified, would forgive that indebtedness, so as to put the corporation on a better financial basis, improve its financial structure, to permit it to expand and to go into new facilities.

But before doing that, it would like to know whether the amount forgiven would be considered part of invested capital of the corporation. Now under present law and regulations, only the principal amount of the debt canceled is so considered, and there is nothing in the statute that suggests that even the principal amount would be included in invested capital.

It seems to us that the bill ought also to cover accumulated interest, not paid, and forgiven. If the corporation owes $100,000 principal and $100,000 in interest that has accumulated, and the stockholder forgives all, it is our suggestion that the statute should specifically state that the $200,000 would be included in determining invested capital as paid-in capital or paid-in surplus; and for that purpose, at page 26, line 13, after the word capital, could be added the following language:

(including the amount of any obligation of a corporation whether principal or interest forgiven by a shareholder).

Senator TOWNSEND. I think on that question, that the gentleman (Mr. Sullivan) who was before us yesterday from the Treasury practically agreed to that language.

Mr. SAVOY. I looked at his testimony. He endorsed the principle but he wasn't sure the language would do it, he didn't want to commit himself.

The CHAIRMAN. I hope you will have a talk with him so that we may be eliminated from that, at least.

Mr. SAVOY. I shall gladly do so. May I file this statement with the committee?

The CHAIRMAN. Yes.

(The matter referred to is as follows:)

Mr. Chairman and Members of the Committee:

The Auto-Ordnance Corporation of New York, in 1919, began the production of a submachine gun for war and emergency purposes. It expected, during the period of development, that is, from the last war to the next war or national emergency, to have annual operating deficits and to make up its patent costs and development costs, in other words, its deficits, out of the profits that might be realized when the submachine gun was needed and put in use.

From 1919 through its taxable year 1939, the corporation had an annual deficit in every single year. While writing off its patents, it has had no tax benefit, except a small amount in 3 years, for the reason that operating deficits, without regard to patent write-offs, existed in all but 3 years.

During that period, this corporation developed a very efficient submachine gun which is essential to the arming of our forces.

Its expectations and plans have materialized in every respect, except that, unless due consideration is given to the facts peculiar to this company, it will never get back its patent and development costs, because the excess-profits tax as proposed will make this impossible. Certainly, until there has been a recovery of those costs, it is anomalous to talk of excess profits.

As the company has had a deficit in every single year since 1919, it cannot use average profits in the base period to determine excess profits. There were no profits.

Its equity invested capital, being the patents acquired, will be the cost of those patents, if there is no change in the proposed bill—that is, if the accumulated deficit is not used to wipe out the patent costs. However, no provision is made in the bill whereby it may recover its patent costs and development costs before the excess-profits tax applies.

This company cannot benefit from any special assessment, because other companies developing and producing implements of war during the 20 years peace manufactured other articles from which profits were derived as well, whereas this company manufactured only the sub machine gun.

The only treatment which will give this company an opportunity to recover its patent and development costs will be to allow it to capitalize its patent costs and development expenses and to allow the deduction thereof to the extent that no tax benefit was previously derived from the write-offs over a 60-month period, in substantially the same manner as is proposed for new equipment and facilities.

In view of the fact that this company was organized to produce a sub machine gun for war, or for a national emergency short of war, expressly for the armed forces of the United States, there is no real difference between this corporation, which voluntarily over a period of 20 years developed a gun to meet the emergency, and a corporation which voluntarily after July 10, 1940, enlarges its plant for the same purposes. If there is equity which prompts Congress to permit special amortization of new plant facilities, because they are primarily for this emergency, and it can be proved that the company of which I speak did the same thing over a period of 20 years, there are certainly equivalent equities in its favor.

There are two possible methods of making provision for this situation.

This bill provides special amortization provisions only for new facilities commenced after July 10, 1940.

This date, July 10, 1940, will cover only corporations which would otherwise refuse to cooperate in this emergency and which are virtually being bought to take part in the national-defense program. This date leaves out every corporation which has gone ahead voluntarily to take part in our national defense. The use of any date will leave out some corporation. To meet every situation, I would suggest that the National Defense Council, or a board, be given authority to certify all corporations that have established plants and developed patents specifically to meet war or emergency conditions, irrespective of the date thereof. It could then be provided that such corporations be allowed to capitalize plant, patent costs, development expenses, and to amortize or depreciate them, to the extent to which they have previously derived no tax benefit, over a period of 60 months.

This could be accomplished by the following provisions:

On page 12, after line 8, insert the following subsection:

"(VI) *Patent and development costs.*—Patent and development costs of standard equipment for the United States armed forces may be restored to invested capital by any corporation to the extent to which such corporation has enjoyed no prior tax benefit therefrom."

On page 87, after line 26, insert the following proviso:

"*Provided*, That patent and development costs (to the extent to which a corporation has enjoyed no prior tax benefit) of standard equipment of the United States armed forces incurred prior to July 10, 1940, may, in the discretion of the Advisory Commission to the Council of National Defense and under the applicable provisions of subsection (f), be certified as an 'emergency facility' under the terms of this title."

May I respectfully request that Treasury and joint committee experts examine this amendment and confer with me concerning it.

Another method of meeting the problem I have raised would be by a specific provision along somewhat the following lines:

"In the case of a corporation engaged continuously since 1918 in the development, manufacture, or sale of implements of war solely, which implements are standard equipment for the armed forces of the United States, patent and development costs previously written off may be restored as an asset to the extent that the corporation was not benefited thereby in computing its taxable income for all tax purposes, and the sum so determined shall be depreciated over a period of 60 months."

This matter has been discussed with the experts of the Joint Committee on Taxation, who understand the problem thoroughly.

Another problem is presented by reason of the fact that this corporation is heavily indebted to its principal stockholder. It is considered desirable by the company and this stockholder, in view of the needs of the emergency program, to place the company, from a financial standpoint, upon a sounder basis. It would be desirable from every standpoint for the principal shareholder to forgive both the principal amount of the debt and accumulated interest thereon, making this an additional contribution to capital. This would strengthen the financial structure of the company materially, and would have an effect upon the development of additional plant facilities. Whether or not this will be done, however, depends in large part on whether the amount of the obligation, both the principal and interest to be forgiven, will be considered a capital contribution.

This could be accomplished by adding the following language:

Page 26, line 13, after the word "capital" a parenthesis and the words "including the amount of any obligation of a corporation whether principal or interest forgiven by a shareholder."

It is essential that this language be included, because the regulations now in effect provide that only, in general, is this to be the rule, and provide also that only the principal of the debt shall be so considered.

The company is going on to cooperate in every way with the defense program, whatever may be its base for determining excess profits. It is going to expand, because its product is greatly needed. In view of this fact, it asks this committee to give its problems consideration in imposing the excess-profits tax.

The CHAIRMAN. Is Mr. McCracken here?

This is Mr. Robert T. McCracken, of the Philadelphia Chamber of Commerce, Philadelphia.

STATEMENT OF ROBERT T. McCRACKEN, PHILADELPHIA CHAMBER OF COMMERCE, PHILADELPHIA, PA.

Mr. McCRACKEN. I want to say first, for the benefit of the committee, that I represent here not any one particular business, but the Chamber of Commerce of Philadelphia, which comprises the vast majority of the industries in and around the Philadelphia area.

The Philadelphia area, under the present defense program, will have the largest allocation of work of any area in the United States. I am told that in the ultimate, there will be an allocation which will total $1,600,000,000.

The Philadelphia area also has the largest diversification of industry in any part of the United States. I am told that out of the 336, I think it is, classified industries, classified by the Department of Commerce, some 281 are functioning in Philadelphia. And yet, despite that fact, the industries for which I speak here are not what are known as nationally known, big-business industries. I don't know that my clients would particularly appreciate it, but I think it is only fair to say to the committee that you have probably never heard of most of the industries for which I speak. Senator Guffey has heard of them, I know, but most of the committee have not. They are not on the "big board" as it were. They are old, well-established industries, some of them over 100 years old.

Now I am going to surprise the committee by this statement. Representatives of most of these industries met for some 2 or 3 hours the day before yesterday and went over the matter in every phase of it, in an effort to educate me.

The general consensus, indeed the unanimous opinion expressed by these gentlemen, was that the philosophy behind this tax bill, this act, is basically sound. They believe that there should be a tax upon excess profits, they expect to do the work, they hope to make profits, and they believe that they should pay a tax and thus reduce the amount of money that the Government should be required to borrow.

There are only three or four things which I am asked to call to the attention of the committee which in their judgment, render this act, as presently drawn, an impracticable and too cumbersome and unfair a measure.

To start with, something which Senator Lodge brought out this morning, the complexity of the measure.

When you consider the amount of money that is going to be passed through the treasuries of these many industries in Philadelphia on this very large allocation of work in the next 2, 3, 4, or 5 years, I think one might almost fear that if this act becomes a law, as presently drawn, and calculations have to be made on a daily basis, that the lunatic asylums in the neighborhood of Philadelphia will become filled with certified public accountants in a very short time.

Senator HERRING. Perhaps we can help that by distributing some of these contracts to some of the rest of the States of the Union.

Mr. McCRACKEN. I don't speak for the certified public accountants, I speak for the industries.

Aside from the complexity of the measure, the suggestions which I have to make were largely made by Mr. Fernald this morning, and I don't want to tire the committee by repeating them.

The first and most important, in our judgment, is the opportunity to select 3 out of the past 4 years as the base. We have had a pretty hard time in Philadelphia the past 10 years, industries which earned a nice income for 50 or 60 or 70 years, haven't had a good time. But these men are prepared and think it would be fair if they are permitted to select 3 out of the 4 years as the base.

Now the next thing which I want to call to the committee's attention is the amortization provisions, and particularly sections (i), (j), and (k), which have been mentioned several times this morning.

I suppose this has come to your minds; it certainly didn't come to mine until after I had read this a number of times. But the way this thing works is this, on the recapture clause. An industry is permitted to charge off a new investment in the plant over the 5-year period, 60 months. Then the Government is permitted to purchase that plant at the adjusted value, not less than $1. Let's take the dollar as the test, if it be all charged off over the 5 years. It has not been charged off in its full investment because each year, as one-fifth of that was charged off, the charge-off was applicable to normal income tax to the extent of 20.9 percent. So that what would really happen, if the Government purchased one of these additional investments at the end of 5 years for a dollar, would be that the Government would get 79.1 percent of the investment for a dollar, the industry having only had the advantage of 20.9 percent of the charge-off each year.

I don't see how you are ever going to get private capital to make large investments in additions to plant; in other words, I think the Government is going to have to provide the money for the additions, if that is the case. That is not the way we did it in 1917 and 1918. It was done by private capital at that time.

Senator KING. This plan which you have just discussed, you are assuming would lead to a discouraging of investors and compel, in the end, the Government to take over the plants?

Mr. McCRACKEN. Yes, sir; there is no question about it.

The moment that was pointed out to an investor, he simply wouldn't put his money into it, because we found before, after the last war, that there was huge expansion of plant, and, therefore, we had a tremendous effort to fill it with new kinds of materials and products, and all that sort of thing, and a great deal of it didn't work, as the Senators know.

Senator KING. Have your investigations, or the investigations of your organization, demonstrated that there are many investments which are called for, for preparedness, in which, without some very great inducement, private capital would not be invested; or is it your view that none of these investments that are necessary for preparedness will be required to be made by the Government because private capital, with a reasonably safe and sound and fair tax bill, would make the necessary investments?

Mr. McCRACKEN. I think it will, sir; I can speak from the record of the past, and I know there is an awful lot of money that wants that kind of investment, if they have any kind of a sound basis, in and around Philadelphia. I know that. I happen to represent one or two banks, and I do know the attitude of the banks in that respect.

May I also say to the committee that we don't quite understand either, why, on the amortization program, a businessman who had the foresight to start erection of a plant, and has perhaps already completed the same prior to July 10 of this year, should not have that taken into account in the program. The proposed act puts a pin in July 10 and dates all investments subsequent to that date, and there are a good many men who have had the foresight to go forward with preparation for some of this work, and we feel that the year 1940, if the tax is to apply to that entire year, should incorporate any such investment when you come to that calculation.

The CHAIRMAN. Do you think it would be fair to take in all of 1940 and go back to January 1?

Mr. McCRACKEN. Yes, sir; that is about the time when they began to get active about it, and it seems to me that the calculation would be infinitely easier, for one thing, and it seems to me it would be infinitely fairer, and my clients so believe.

We also don't see why you can't go ahead and pass the amortization program, if some delay is required for consideration of the excess-profits tax. We all feel that the amortization program is a vital one for national defense, and with those two amendments that I suggest, we see no reason why that shouldn't go forward as is, with those two suggestions, the suggestion as to July 10, and the suggestion as to cutting out paragraphs (i), (j), and (k).

Senator KING. In view of your statement as to the very extensive activities of manufacturing establishments in the vicinity of Philadelphia, is there any complaint that the bill, as suggested, or the proposal which has been suggested, is discriminatory against the small businessman, small operator?

Mr. McCRACKEN. Yes, sir; that complaint has been made, and I speak in large measure for the small businessman, not a shoestring businessman—to use the "Street" term—but the vast majority of these industries that are doing the work in Philadelphia are what would be called small business in the general view of the situation. I think Senator Guffey will bear me out in that respect.

I must admit that they do view it from their own standpoint as a small businessman would. They are concerns largely held by Philadelphia capital, as I said, long-established concerns which have been content for many years to make a fair profit and let it go at that, many of them in the same plant they were in at the time of the Civil War—it is an old-established community.

Senator KING. Many of those industries, I assume, existed before any war talk, and have been, as you stated, in existence for years, and they are not connected with what might be called military preparations or munitions plants?

Mr. MCCRACKEN Not at all. One of my clients is the Edward G. Budd Manufacturing Co. Mr. Budd makes the streamlined trains that some of the Senators have ridden on, that go out to Denver and Santa Fe, and he also makes bodies for automobiles. I don't know what Mr. Budd will be in this matter, but it is an old, well-established industry, and in no sense connected with the war program.

Then we have the Disston Saw, the Baldwin Locomotive Works—one after another—are all included in this program, but they are not war babies in any sense, they are far past the baby stage.

We also suggest—which I don't think I need to elaborate, so much has been said about it—the necessity of consolidated returns, or at least the option to make consolidated returns. It has been so well said this morning that I don't want to waste any further time.

We don't understand why there should be a 4.1 percent penalty on those who choose to report on the average earnings rather than on the invested capital basis. No one has been able to make sense to me with that suggestion, or to any of my clients. Those two parallel columns, showing the amount of tax to be paid on $500,000 business done, either dependent on whether you calculate on average earnings or invested capital, just doesn't seem to make sense. They drive one definitely into the invested capital bracket, and it doesn't seem to us that that is a sane piece of legislation.

We also don't understand why there should be a minimum earnings of 8 percent permitted upon newly invested capital, and that the minimum should be lower on capital which has been there before. Now I just ask that question, I can't see why they did it. You have 7 percent minimum on present capital, and on new capital 8 percent, and it doesn't seem to make sense, either.

I am in the vocative case as to both of those questions.

Aside from those objections, which we believe would be simplified, could be infinitely simplified by some of the suggestions made this morning, and nine-tenths of the difficulty would disappear if the 3 out of 4 choice were given, we believe that the philosophy behind this bill is a sound one, and we are prepared to go along and pay the tax if it is an excess-profits tax.

Senator KING. I attended some of the hearings in the House, and I heard nothing about this 4.1 penalty. Is that something that has been cooked up since?

The CHAIRMAN. That is a new baby that has been born.

Senator KING. Quite different from the discussions that preceded it. It seems absurd to me. I suppose that is one of the babies of the Treasury Department.

The CHAIRMAN. Thank you, Mr. McCracken.

Paul Shorb. Paul E. Shorb, an attorney of Washington, D. C., who seems to be here in behalf of the National Canners Association.

STATEMENT OF PAUL E. SHORB, REPRESENTING THE NATIONAL CANNERS ASSOCIATION, WASHINGTON, D. C.

Mr. SHORB. Mr. Chairman and members of the committee: I appear for the National Canners Association, which has about 800 canning companies as members of the group, and represents about 80 percent of the pack in the total canning industry.

Now it is limited, my appearance is limited to companies who are canning fruits, vegetables, and fish. There are about 3,000 companies throughout 40 States of the Union, and some of the Territories, that are engaged in this business. The members of the association, as I said, represent about 80 percent of the pack, and the business is closely allied, as the Senators and members of the committee will understand, with the agricultural industry in that it is the processing of fruits and vegetables and fish.

Senator KING. And most of the companies are local in character?

Mr. SHORB. Yes; and they can right near the source of production. Of course, the profits and losses in the annual operations in the industry are influenced, if not wholly governed, by factors over which the canner, as an individual, has no control, in that he is subject to the hazards of drought, excessive heat, rainfall, or frost, insect infestation, and other hazards of nature; or, as to the fish canner, he may not get a run of fish.

The Federal Government also, as you know, has conservation laws, and they may sharply curtail operations on account of those situations. I mention these factors because I think they are factors, like fires and storms, that are not subject to the control of the individual canning company.

When this happens, of course, production for the year may be small or there may be a complete failure resulting in a large annual loss to the companies. Or you may have a very large crop, as happens now and then in the cycle of the business, or a large run of fish, which results in a tremendously large pack for the industry as a whole, which means, of course, a surplus, and, as you would expect, low prices and quite often large losses in the industry.

Only the fortuitous combination of a pack balanced to demand enables the canner in 1 out of 3 to 5 years to obtain earnings sufficient to offset the years of unavoidable large losses, and possibly to permit a return over the entire period.

It seems to be unique, or at least it certainly is true of the canning industry, that these losses recur in a great many years, and then you will have a year of a very large profit. That was illustrated by one witness, you may remember, who testified here this morning.

Now the fruit, vegetable, or fish canner, of course, only gets one annual crop, and he can only plan his operations for a year in advance, and at the time his crop is planted, or at the time he gets ready to take the run of fish—as in the case of salmon, as you all know on the west coast and in the Alaska waters.

After he makes those plans he can't make any adjustments. Vagaries of nature absolutely take control. The past 10 years, that is, 1930 to 1939, include, of course, the 4 years in the base period for computing your excess-profits tax credit, whether you do it on the income or invested capital basis.

Now during that period, we have made a study—as complete as possible—of a group of companies, 97 representative companies. We took a certain group of small companies, a certain group of medium-sized companies—and by "small" I shoul say that they would be companies with capital under $100,000; medium companies would be with capital in excess of $250,000; and the larger group would be larger than that with capital in excess of $2,000,000.,

Analysis of the earnings of those 97 representative canners of fruits, vegetables, and fish, is shown on exhibit A attached to this statement, and your honors will see, if you examine it, if you take the chart there, the heavy black line covering the base period years 1936 to 1939, inclusive, showing the companies with capitalization of under $100,000.

You will see that in 1936 they were up in substantial earnings, but they dropped down in 1937 and 1938 into large losses, and in 1939 they come practically up to the 10-year average earnings point, which runs right through the middle of the chart.

Now you can see the other lines, the quarter-inch dashed line, which shows the capitalization of companies from $250,000 to $500,000. Their pattern, you will notice, runs very much the same as that of the small company, except the peaks and the valleys are not so severe; in other words, they never hit quite the high earnings on the percentage of thousands of dollars, nor do they drop down in quite such severe losses.

And the same is true of the third group with a capitalization over $2,000,000.

That is based on a study, as I said, of 97 companies who are members of the industry, and I think it shows that there is this pattern in the industry—widely fluctuating losses and profits.

For instance, for the 10 years, 1930 to 1939, the 17 small companies with a capitalization of under $100,000, their average was a loss of $688 a year. In other words, no gain over the 10-year period. They just kept going and consuming a certain amount of the agricultural products, and employing a certain amount of labor locally.

The earnings of that same small group of 17 companies during the base period fluctuated very, very substantially. In 1936, for example, these companies earned, on the average, 1,363 percent above the 10-year average, a very high peak, as the graph shows. But in 1936 the earnings were 512 percent below the 10-year average, and in 1938, when most companies in the canning industry suffered losses, the earnings of this group were 1,614 percent below the 10-year average, which illustrates what I said, that on the small company the peaks or the graph, rather, shows greater depressions, or greater earnings when they hit an earnings year.

Now the medium-sized group shows practically the same result. The companies in that group, with capital from $250,000 to $500,000, had an average annual earning of $5,379 for the 10-year period. In 1936, however, the average earnings of this group were 518 percent above the 10-year average; and in 1938, the average earnings in this group were 1,077 percent below the 10-year average, showing again wide fluctuation, but not quite as heavy as in the small group of companies.

Senator KING. What was the average earnings on all those large and small groups?

Mr. SHORB. Well, the average earnings in the middle group—first, in the smaller group, for the 10-year period they had no average earnings, it was a loss. The same would be true, probably, in the base period, although some of them might have earnings and some not.

Now the medium-sized group had an average annual earnings of $5,379 in the 10 years, the companies in that group out of the 97 selected companies that the graph is based upon.

Senator KING. $5,000?

Mr. SHORB. On capital of $250,000 to $500,000, which is, over an average period of 10 years, a very low return. If you take $250,000, an average of $5,000 a year is only 2 percent, nothing like 5 or 7, even, as proposed in the bill, or 10 as some of the men who have appeared here this morning have suggested.

Now of course it is also true that when the canning industry, these smaller companies, have these loss years, then they come along and have a good year, as other witnesses for other industries have told you, and they figure on using the gains of that good year to recoup their misfortunes of the earlier years; and in a sense they need it, and if this excess-profits bill doesn't make some further provision over that passed by the House, for such situations, I think a great many of the smaller companies, which, after all, are in local communities where the farmer produces his vegetables and fruits, will necessarily have to go out of business.

That is probably true also with the medium sized and some of the larger ones.

Now, based on the experience in the industry, and on the fact that 2 years out of the 4-year base period, 1936 to 1939, in a good many cases were loss years, and in some cases 3 for the canning industry, in that base period, we have suggested an amendment which is attached, right after the graph, to our statement.

Now that amendment is based on the principle of an unused excess-profits credit carry-over, which recognizes the seasonal fluctuation in this industry.

On page 5 of my statement, we set out an example of a canner who has a statutory invested capital of $100,000, and who made, after normal Federal income taxes, or lost, according to the figures set out there.

He has a loss of $20,000 in 1936; a profit of $4,000 in 1937; in 1938 a loss of $45,000; and in 1939, a loss of $30,000.

Now assuming he used the income and invested capital method of computing his excess-profits credit, that is, of 7 percent, he being under $100,000, you see there he would have a certain amount of unused credit which is set out in the last column.

Our suggestion is that he be permitted to take the unused credit and carry it forward in the next year. So that you, in a sense, make up for the difficulty with the present bill, which I think the committee here recognizes, and the testimony shows, is its concept as to some industries, at least you don't reach true excess profits as yet, you are just taking income, whatever the income is.

The House bill stops at a certain point, but it doesn't go far enough to measure true excess-profits taxes.

Now this draft, suggested draft, fits in with the present scheme of the House bill. The only thing is that it gives partial relief, it probably wouldn't be as good for the canning industry as a whole, as a

3-year net loss carry-over provision, which I heard suggested by other persons who appeared here.

But it does, we think, recognize the pattern variation of steep earnings, and then very severe losses in the canning industry, and if the committee is going to adhere to the 4-year base period years of 1936 to 1939, the suggested draft provision would relieve the canning industry, as such, or any taxpayer engaged in seasonal agricultural or fishery operations, 50 percent or more of whose gross income is derived from growing, harvesting, processing, or otherwise preparing for market any seasonal fruit or vegetable, or from catching, processing, or otherwise preparing for market any fish or other marine life.

That definition is broad enough to limit it generally to the particular members of the association which we describe, and you already have in the bill your excess-profits credit, just how you figure it, either on your average net income—I mean, treating it as zero the loss year, as the House passed it—so that whatever that excess-profits credit is, if the taxpayer doesn't use it fully, he is permitted to carry it over against his second year or his third year.

That is very simple and requires very little change—I think it fits in with the bill as now drafted.

The CHAIRMAN. Have you talked to the Treasury about this?

Mr. SHORB. I have not, Senator; I would like to. I talked to Mr. Stam this morning generally on the suggestion.

The CHAIRMAN. Well, I would like you to talk to them if you get the time.

Mr. SHORB. I would like to do that.

The only other thing that I would like to say, in conclusion, is, if the committee can't do something that will carve out and recognize the difficult situation of the canning industry, then the net loss carry-over would help, or if you would permit what the House committee once voted to do, the average of 3 years out of 4 would be much better for the industry.

And then finally, we do need a special relief provision, your honor, that would take care of a great many of these situations, although not so satisfactorily, in that it doesn't permit a taxpayer to know immediately what his tax is; whereas, the amendment we suggest would permit him to compute it and know when they filed their return.

The CHAIRMAN. You are filing that statement?

Mr. SHORB. Yes.

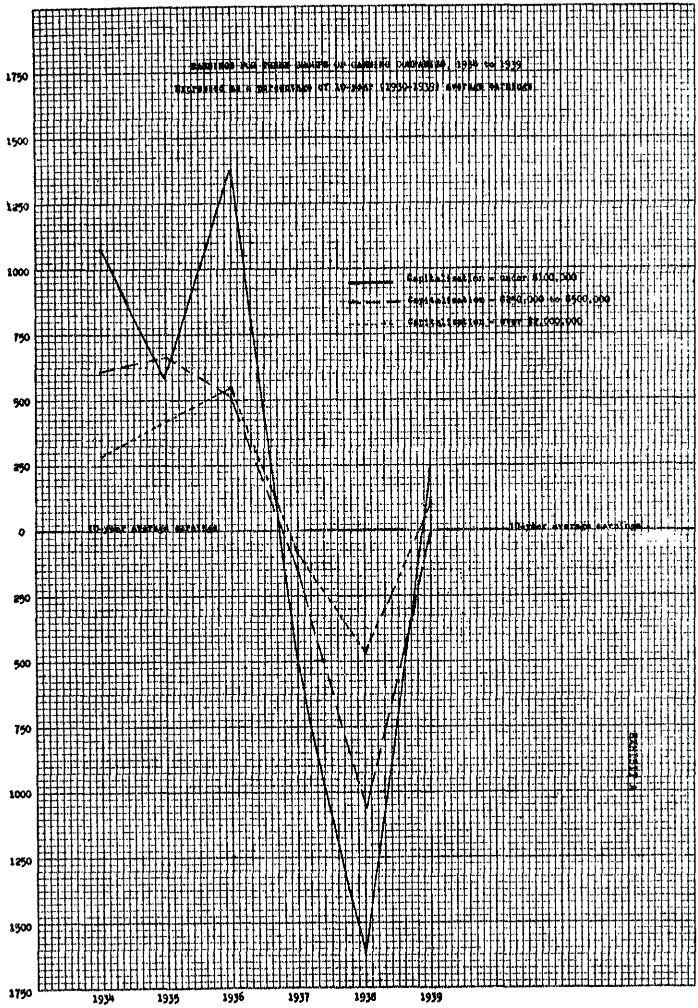
The CHAIRMAN. All right, thank you.

(The statement of Mr. Shorb is as follows:)

STATEMENT ON BEHALF OF THE NATIONAL CANNERS ASSOCIATION

The canning of seasonal fruits and vegetables and of fish is carried on in over 3,000 small and large plants, located, near where the crops are grown or the fish are caught, in 40 States and the Territories. Profits or losses in annual operations are influenced, if not wholly governed, by factors over which the canner has no control: Localized crop failure may result from drought, excessive heat or rainfall, frost, insect infestation, and other uncontrollable causes. Or a run of fish may not materialize, or Federal or State conservation rules may be seasonally applied to require sharp curtailment of operations. When this happens, production for that year may be meager or a complete failure resulting in large annual loss. Likewise, an over-bountiful crop or unpredictably large run of fish may result in a tremendously large pack, a surplus, low prices, and again large losses. Only the fortuitous combination of a pack balanced to demand—over many States—enables the canner in 1 out of 3 to 5 years to obtain earnings sufficient to offset

EXHIBIT A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the years of unavoidable large losses, and possibly to permit a return over the entire period.

These recurrent large losses and occasional years of good profits are not a matter of good or poor management. The fruit, vegetable, or fish canner gets but one annual crop. He can plan his annual operation only once—at the time the crop is planted or the season planned—and can make no later adjustments. Once he enters the season what will happen in terms of profit or loss is beyond his control.

The past 10 years, and typically the 4 years 1936–39, for a large percentage of the industry—for large and small companies, for canners of one and canners of many commodities, for fruit and vegetable canners as well as canners of fish—show this pattern of widely fluctuating annual losses and profits.

An analysis of the earnings of 97 representative canners of fruits, vegetables, and fish, in exhibit A, shows relatively low average earnings for the last 10 years. These companies represent a fair cross-section of the industry in that they consist of small-, medium-, and large-size companies in about the proportions found in the industry. For purposes of studying income, these companies were divided into three groups on a basis of capitalization, as shown on exhibit A.

Seventeen of these companies had a capitalization of $100,000 or less. For the 10 years, 1930 to 1939, the average earnings of these 17 companies was a loss of $688 a year. During the base period (1936–1939) the average earnings of these companies fluctuated a great deal. In 1936, for example, these companies earned on the average 1,363 percent above the 10-year average, whereas in 1937 the average earnings were 512 percent below the average. In 1938, when most companies in the canning industry suffered losses, the earnings of this group were 1,614 percent below the 10-year average.

A medium group having a capitalization of from $250,000 to $500,000 had an average annual earning of $5,379 for the 10 years, 1930 to 1939. In 1936, however, the average earnings of this group were 518 percent above the 10-year average and 2 years later in 1938 the average earnings in this group were 1,077 percent below the 10-year average.

The variations in earnings for the group having $2,000,000 or more capitalization tended to follow the general pattern of the smaller groups except that the fluctuations were not so violent. The average earned for 1936 for this group was 547 percent above the 10-year average of $100,867. In 1938, however, the average income was 460 percent below this 10-year average.

These examples illustrate the violent fluctuations of earnings in the canning industry. They show clearly that violent fluctutions in earnings are characteristic to a greater degree in the case of the small companies, and hence any excess-profits tax on profitable years will prove peculiarly harsh in its operation on small companies. This characteristic, however, appears to be representative of companies of all sizes, the differences due to size being in the degree of fluctuation only.

Such fluctuations have happened to most canners in the past; they were true of the majority in the base period; they may be true of any canner in the next few years.

Use of the average earnings comparison method for most canners thus would be impossible. Wholly apart from the additional flat rate extra 4.1 percent on normal-tax net income, this method would result in an over-all tax in the occasional profitable year which would absorb the bulk of any income.

Nor would the invested capital method in this industry permit any less harsh result. For most of the industry the statutory percentage of return, based on invested capital and earnings in the base period, would be below the 7 and 5 percent minimum specified in section 714. Thus the applicable percentage would be not more than 5 to 7 percent, and earnings in any year above such percentage would be subject to excess-profits taxes running up to 45 percent.

A canner having several years of large losses—due to these inherent factors beyond his control—cannot survive unless in some years he can recoup. As part of its seasonal character, which permits only one annual turn-over, the business of canning fruits and vegetables or fish uses a high ratio of borrowed money. (This borrowed capital can only partially be included in invested capital under the bill.) In a poor year losses therefore may and do make great inroads into net worth, in many cases resulting in impairment of capital. Only by the occasional year of peak profits can the canner stay in business. If the bulk of earnings in such peak year are taken in excess-profits taxes, inevitable destruction of capital and elimination from business will follow.

We propose, and there is attached, a draft of an amendment which will afford partial relief. Since the bill recognizes that a return of 7 percent (or 5 percent on capital over $500,000) is warranted without excess-profits taxes being applied, this amendment affords to processors of seasonal fruits and vegetables and fish a credit in any year of the difference between his actual return and 7 percent or 5 percent. It applies only when the income and invested capital credit method under section 714 of the bill is used. If he earns 7 percent or more, no credit accrues. If he has a net loss, however, he cannot take the entire loss as a credit but only the amount represented by 7-percent or 5-percent return on his invested capital. Such credits are carried forward—but not more than 3 years—to the year of profits and serve to reduce the amount on which excess profits are levied.

For example, a canner who has a statutory invested capital of $100,000, and who made (after Federal taxes) or lost—

	Profit or loss	7 percent	Unused credit
1936	$20,000 loss		($7,000)
1937	$4,000 profit	$7,000	3,000
1938	$15,000 loss	7,000	7,000
1939	$30,000 loss	7,000	7,000
1940	$38,000 profit		

would be permitted, under the proposed amendment, in 1940, his one profitable year out of three, to add to his excess-profits credit ($7,000) for that year, the sum of his unused excess-profits credits for the preceding 3 years ($17,000). The total credit ($24,000) would be deducted from his 1940 earnings ($38,000) to give him an adjusted excess-profits income of $14,000. Deducting the $5,000 specific exemption, he would pay excess-profits taxes on $9,000, instead of on $26,000.

Thus, having lost $33,000 on the 4 years' operations, he would not have his single chance of continuing in business impaired by the excess-profits levy taking $5,500 of his 1940 earnings in addition to the normal corporate income taxes of about $10,000.

This amendment is consistent with the purpose and specific provisions of the bill. It affords only partial relief, not to any taxpayer who abnormally secures large profits out of defense expenditures, but to the producers of essential foods who operate subject to the hazards of agriculture and the vagaries of the season and who must balance years of deficit with an occasional year of good return. The bill recognizes (sec. 711 (b) (2) (A) (iv)) that earlier casualty losses beyond the control of the taxpayer shall not operate to increase his taxes. The amendment proposed is but the equitable extension of this recognized principle—that adjustment is necessary for seasonal agricultural and fishery hazards beyond the control of the taxpayer.

The members of the National Canners Association, therefore, urge the committee to adopt the suggested amendment because it is needed and will avoid hardship and inadvertent discrimination in a great many cases.

If the committee should incorporate in the bill a provision for a 3-year net loss carry-over, or a provision permitting true average earnings for 3 out of 4 years in the base period, or an adequate provision for special relief, these would alleviate the resultant hardships in some degree. As a group, however, the members of the association prefer the amendment suggested.

Respectfully submitted.

PAUL E. SHORB.

SUGGESTED AMENDMENT

SEC. 714–A. UNUSED EXCESS-PROFITS CREDIT FOR SEASONAL AGRICULTURAL AND FISHERY OPERATIONS.

(1) As used in this section the term "taxpayer engaged in seasonal agricultural or fishery operations" means a corporation 50 percent or more of whose gross income is derived from growing, harvesting, processing, or otherwise preparing for market any seasonal fruit or vegetable or from catching, processing, or otherwise preparing for market any fish or other marine life.

(2) As used in this section, base period means base period as defined in section 714 (f) (1); excess-profits net income for the taxable years in the base period means excess-profits net income as defined in section 711 (b) (1) (2); excess-profits net income for any taxable year after the base period means excess-profits net income as defined in section 711 (a) (2); and invested capital in any taxable years during or after the base period means invested capital as defined in section 715.

(3) As used in this section the term "unused excess-profits credit" means for any taxable year during or after the base period in which the taxpayer was engaged in seasonal agricultural or fishery operations the excess of (a) a sum equal to 7 percent of the first $500,000 of invested capital, plus 5 percent of the invested capital above $500,000 over (b) the excess-profits net income for such year.

(4) If for any taxable year after the base period any taxpayer which is engaged in seasonal agricultural or fishery operations and which elects to compute its excess-profits credit under section 714 has excess profits net income which exceeds its annual excess-profits credit as first determined under section 714, it may increase said credit by all or a portion of its unused excess-profits credit from any or all of the 3 years immediately preceding the taxable year. As so increased the excess-profits credit shall be used in determining adjusted excess-profits income under section 710 (b) (2).

(5) If only a portion of the unused excess-profits credit for the 3 years immediately preceding the taxable year is used in a taxable year, such portion will be deemed to have been taken from the year furthest removed from the taxable year, and such portion may not again be availed of or used in any other year.

The CHAIRMAN. Mr. John W. Hooper, Brooklyn, N. Y. Mr. Hooper represents the Brooklyn Chamber of Commerce.

STATEMENT OF JOHN W. HOOPER, REPRESENTING BROOKLYN CHAMBER OF COMMERCE, BROOKLYN, N. Y.

Mr. HOOPER. I have an extended statement for the committee. May I put it in the record?

The CHAIRMAN. Yes. And just cover the high spots in your presentation.

Mr. HOOPER. Yes, sir; that is why I put it into the record.

Senator KING. You testified before the House committee, did you not?

Mr. HOOPER. Yes, sir.

The CHAIRMAN. You were to prepare at that time a suggestion on consolidated returns?

Mr. HOOPER. Yes; and I did, sir. It was filed with that committee. It is in the record, it is in the hearings of the House Ways and Means Committee, page 227.

The announced purpose of the excess-profits tax is to prevent profiteering from the present defense emergency. Business is in accord with this as shown by the record of the recent hearings before the House Ways and Means Committee. Business spokesmen sought to have the bill limited to its intended scope, free from ambiguities, equitable, and sufficiently concise and clear to make the tax liabilities readily determinable.

The joining of the emergency facility amortization measure, that required speedy action, to an excess-profits tax bill, which should have had mature consideration, has resulted in the adoption of a document of some 25,000 words which is generally conceded to be one of the most complicated and baffling legislative measures ever drafted. It represents an effort to provide for all requirements but, unfortunately, it goes so far in this direction that it seems bound to defeat its own purpose.

The incorporation in the law of specific, technical definitions and restrictions is certain to result in hardships which would be greatly lessened if the law were confined to its true function of establishing principles, leaving their application and definition to the customary departmental regulation and understanding administrative application.

In the fog of bewilderment which settles around the reader of the Second Revenue Act of 1940, one fact emerges from the haze, i. e., the prevention of profiteering has become secondary to the production of additional revenues through imposts on normal profits. The result, then, is that business is confronted with an involved and incomprehensible tax bill, the ultimate effect of which would not be determined for years, and then only after exhausting dispute and extended litigation.

Senator KING. As I understand you, your interpretation of that long bill which has come to us, is that it strikes rather at normal profits than at excess profits?

Mr. HOOPER. Yes, sir.

Senator KING. And to that extent injures normal production and normal business and legitimate activity on the part of our economy generally?

Mr. HOOPER. Just about that, it doesn't recapture the so-called excess profits that emerge from the existing emergency.

Application of the existing laws to corporate income has been reasonably well defined through years of experience, and the tax liabilities thereunder can be anticipated. Under the bill now being considered, however, businessmen cannot exercise, with any degree of accuracy, their essential prerogative of estimating their taxes. The introduction of such a speculative element in the midst of business adjustments vital to the defense program will add to the confusion.

The bill can only be corrected, in our opinion, by a thorough redrafting. We recognize that this means delay. Nevertheless, a matter so importantly related to the basic economic structure of the country deserves studied treatment. It seems completely logical and practical that the suspension of the Vinson-Trammell Act and the amortization of emergency defense facilities be given prompt and separate attention so that the proposed excess-profits tax law can receive adequate consideration.

In considering such revision, we submit the following observations and recommendations:

Alternate bases for determining excess-profits credit:

The House, with evident understanding of the inequities inherent in an excess-profits-tax law based on an inelastic formula, has provided for alternate bases for measuring normal profits, in that it permits the determination of profits subject to the excess-profits tax on bases optional with the taxpayer. However, the definition of the optional bases in the bill and the determination of tax rates applicable thereunder indicate an intention to induce corporations generally to use the invested capital base instead of average earnings despite the fact that the latter is frequently accepted as the fair measure of normal profits. The requirement of additional tax at the rate of 4.1 percent on all taxable income, and rates higher by 5 percent on excess-profits net income, are examples of provisions discriminating against election of the base-period income method.

Bases optional with taxpayer for each taxable year:

Section 712 permits the taxpayer to elect in any taxable year one of the alternate bases. However, the bill is silent as to whether that election binds the taxpayer for the particular year involved or would allow the right to change for such taxable year in case determination of the tax for the base or taxable years by the Treasury Department indicates the desirability of a change to the alternate method for claiming the excess-profits tax credit. Since it is the intention to give the taxpayer the right of using either of the alternate methods, we feel that it should be clearly extended to him under these circumstances.

Senator KING. As I understand it, you would eliminate entirely that penalty, the 4.1?

Mr. HOOPER. Yes, sir; I would, and the further penalty of an increase of 5 percent in the tax under the excess-profits tax rating.

Special assessments board:

While providing for alternate bases, the bill does not provide for recognition of special situations that could not be accorded equitable treatment under such methods. Accordingly, we recommend the establishment of a board which would be independent of the Treasury Department, similar to the Board of Tax Appeals, but having available to it the Treasury's advice and information. This body would pass upon such special cases as—

(a) companies actively engaged in experimentation, research, exploration and development;

(b) companies whose base period indicated an increasing trend of profits not resulting from the emergency defense expenditures in any way;

(c) companies whose earnings have been abnormally small during the base period and with a very low invested capital;

(d) Companies whose records are incomplete or unavailable for the determination of invested capital under the act; and

(e) Companies wherein excessive deductions in prior loss years were not beneficially taken as, for example, deductions relating to depreciation, development of processes, production, markets, and so forth.

This Board, in arranging for the levying of assessments to meet special circumstances, should be empowered to designate years, other than for the 4 years now provided in the bill, as the base period. We have in mind the granting of more just treatment through this special board in accordance with the intention of sections 327 and 328 of the Revenue Act of 1918.

The CHAIRMAN. How would this board be appointed?

Mr. HOOPER. Under the law, and I would suggest, by the President, with the approval of the Senate, the same as, I believe, the Board of Tax Appeals.

The CHAIRMAN. You wouldn't want the Treasury to have anything to do with it?

Mr. HOOPER. No, sir.

The CHAIRMAN. You don't believe in the old provision that was in the former law?

Mr. HOOPER. No; I believe in the intent of the provision, but I do not believe in its administration by the Treasury.

The CHAIRMAN. I thought they administered it very well in those days, didn't they?

Mr. HOOPER. It is according to how you were treated. I had some experience with it in those days.

The CHAIRMAN. All right, proceed.

Mr. HOOPER. Application of tax rates discriminatory:

The method of allocating amounts of excess profits subject to the increasing rates set forth in the bill does not equitably recognize the relation of such excess profits to the normal earning power, risks, and other factors of corporations varying in size. It does distinctly discriminate against companies which have large amounts of excess profits, even though such amounts may be very small in relation to the normal profits of such business. Any scheduling of rates should be predicated on a percentage of the excess-profits credit and not based on the dollar volume of the excess profits.

Allowed return on invested capital for determination of excess-profits credit:

The bill does not recognize the vicissitudes of investments in the equities of corporate enterprise.

Senator LODGE. Before you go any further, may I ask whether you have discussed with the Treasury or with Mr. Stam this suggestion of yours on using percentage instead of dollar value, or dollar volume, rather?

Mr. HOOPER. I have not, sir.

The CHAIRMAN. Your time has expired.

Mr. HOOPER. Yes; with the interruptions of the committee.

The CHAIRMAN. Well; you will file that with the reporter.

Mr. HOOPER. It would only take me about 2 minutes more to read it.

The CHAIRMAN. If we give you 2 minutes more, there will be a whole lot of people prevented from testifying this afternoon.

Senator KING. I would like to ask the witness to explain briefly his view concerning consolidated returns, and the feasibility of incorporating it in this act.

The CHAIRMAN. Is that in the report that you have filed?

Mr. HOOPER. It is very brief, it is on page 8.

Senator KING. There is just a brief observation there.

Mr. HOOPER. It is particularly necessary, in my opinion, to have such a provision, in view of the borrowed capital which we, in our statement, have indicated is a very broad item; a great deal of abuse can be made between companies, which, if you don't consolidate you can pass debts between companies, and build up a credit structure for invested capital that would be abused.

In this brief we are recommending, and having in mind consolidated returns, if they are not allowed, a limiting of the definition of borrowed capital. And even then, there will be abuse.

Of course, the filing of consolidated returns simply recognizes the equities and the realities of a business situation. Different enterprises are operated under different departments, and they find it expedient, particularly under State laws, to have different companies, and it can be done very handily, and in fact, at the request of Congressman Treadway, I submitted such a proposal, and it is in the record on page 227 of the printed hearings of the House Ways and Means Committee.

The CHAIRMAN. Thank you very much.

(The brief submitted by Mr. Hooper is as follows:)

STATEMENT RE THE PROPOSED TAX ON EXCESS PROFITS SUBMITTED TO THE SENATE COMMITTEE ON FINANCE, BY THE COMMITTEE ON FEDERAL TAXATION OF THE BROOKLYN CHAMBER OF COMMERCE, THROUGH JOHN W. HOOPER, CHAIRMAN

SEPTEMBER 5, 1940.

To the Members of the Committee on Finance, United States Senate, Washington, D. C.

GENTLEMEN: The Federal taxation committee of the Brooklyn Chamber of Commerce, of the city of New York, is sincerely appreciative of this opportunity afforded by the Senate Finance Committee for further public discussion of the proposed excess-profits tax. As related in more detail in our statement before the House Ways and Means Committee, Brooklyn, as one of the top five manufacturing communities of the country, is vitally concerned in the enactment of this legislation.

In the preparation of the suggestions which I now place before you, we have again had the active assistance of the Brooklyn chapter of the National Association of Cost Accountants.

The announced purpose of the excess-profits tax is to prevent profiteering from the present defense emergency. Business is in accord with this as shown by the record of the recent hearings before the House Ways and Means Committee. Business spokesmen sought to have the bill limited to its intended scope, free from ambiguities, equitable, and sufficiently concise and clear to make the tax liabilities readily determinable.

The members of the House committee are to be commended for their diligent application, under pressure of time, to the preparation of the bill. However, the joining of the emergency facility amortization measure that required speedy action to an excess-profits-tax bill, which should have had mature consideration, has resulted in the adoption of a document of some 25,000 words which is generally conceded to be one of the most complicated and baffling legislative measures ever drafted. It represents an effort to provide for all requirements but, unfortunately, it goes so far in this direction that it seems bound to defeat its own purpose. The incorporation in the law of specific, technical definitions and restrictions is certain to result in hardships which would be greatly lessened if the law were confined to its true function of establishing principles, leaving their application and definition to the customary departmental regulation and understanding administrative application.

In the fog of bewilderment which settles around the reader of the "Second Revenue Act of 1940" one fact emerges from the haze, i. e., the prevention of profiteering has become secondary to the production of additional revenues through imposts on normal profits. The result, then, is that business is confronted with an involved and incomprehensible tax bill, the ultimate effect of which would not be determined for years and then only after exhausting dispute and extended litigation.

Application of the existing laws to corporate income has been reasonably well defined through years of experience and the tax liabilities thereunder can be anticipated. Under the bill now being considered, however, businessmen cannot exercise, with any degree of accuracy, their essential prerogative of estimating their taxes. The introduction of such a speculative element in the midst of business adjustments vital to the defense program will add to the confusion.

The bill can only be corrected, in our opinion, by a thorough redrafting. We recognize that this means delay. Nevertheless, a matter so importantly related to the basic economic structure of the country deserves studied treatment. It seems completely logical and practical that the suspension of the Vinson-Trammell Act and the amortization of emergency-defense facilities be given prompt and separate attention so that the proposed excess-profits tax law can receive adequate consideration.

In considering such revision, we submit the following observations and recommendations:

ALTERNATE BASES FOR DETERMINING EXCESS-PROFITS CREDIT

The House, with evident understanding of the inequities inherent in an excess-profits-tax law based on an inelastic formula, has provided for alternate bases for measuring normal profits, in that it permits the determination of profits subject to the excess-profits tax on bases optional with the taxpayer. However, the definition of the optional bases in the bill and the determination of tax rates applicable thereunder indicate an intention to induce corporations generally to use the invested-capital base instead of average earnings despite the fact that the latter is frequently accepted as the fair measure of normal profits. The requirement of additional tax at the rate of 4.1 percent on all taxable income and rates higher by 5 percent on excess-profits net income are examples of provisions discriminating against election of the base-period income method.

BASES OPTIONAL WITH TAXPAYER FOR EACH TAXABLE YEAR

Section 712 permits the taxpayer to elect in any taxable year one of the alternate bases. However, the bill is silent as to whether that election binds the taxpayer for the particular year involved or would allow the right to change for such taxable year in case determination of the tax for the base or taxable years by the Treasury Department indicates the desirability of a change to the alternate method for claiming the excess-profits-tax credit. Since it is the intention to give the taxpayer the right of using either of the alternate methods, we feel that it should be clearly extended to him under these circumstances.

SPECIAL ASSESSMENTS BOARD

While providing for alternate bases, the bill does not provide for recognition of special situations that could not be accorded equitable treatment under such methods. Accordingly, we recommend the establishment of a board which would be independent of the Treasury Department, similar to the Board of Tax Appeals, but having available to it the Treasury's advice and information. This body would pass upon such special cases as (*a*) companies actively engaged in experimentation, research, exploration and development; (*b*) companies whose base period indicated an increasing trend of profits not resulting from the emergency defense expenditures in any way; (*c*) companies whose earnings have been abnormally small during the base period and with a very low invested capital; (*d*) companies whose records are incomplete or unavailable for the determination of invested capital under the act; and (*e*) companies wherein excessive deductions in prior loss years were not beneficially taken as, for example, deductions relating to depreciation, development of processes, production, markets, etc.

This board in arranging for the levying of assessments to meet special circumstances should be empowered to designate years, other than the 4 years now provided in the bill, as the base period. We have in mind the granting of more just treatment through this special board in accordance with the intention of sections 327 and 328 of the Revenue Act of 1918.

APPLICATION OF TAX RATES DISCRIMINATORY

The method of allocating amounts of excess profits subject to the increasing rates set forth in the bill does not equitably recognize the relation of such excess profits to the normal earning power, risks, and other factors of corporations varying in size. It does distinctly discriminate against companies which have large amounts of excess profits even though such amounts may be very small in relation to the normal profits of such business. Any scheduling of rates should be predicated on a percentage of the excess-profits credit and not based on the dollar volume of the excess profits.

ALLOWED RETURN ON INVESTED CAPITAL FOR DETERMINATION OF EXCESS-PROFITS CREDIT

The bill does not recognize the vicissitudes of investments in the equities of corporate enterprise. Only where base period profits justify 10 percent or more does it provide for a fair return of 10 percent on invested capital. Otherwise, where base profits do not justify such return or where no earnings were reflected during the base period, 7 percent is allowed on the first $500,000 and 5 percent on the invested capital above that amount. These rates do not provide investment incentive in addition to compensating for the risks involved when it is considered that the stockholders of corporations who are really the beneficiaries of corporate earnings are already subject to heavy State and Federal income taxes. The varying percentages stated in the bill tend to complicate and unduly extend the language. Accordingly, we recommend the establishment of one rate and the use of 10 percent on invested capital for determination of the excess-profits credit.

DUPLICATION AND PYRAMIDING OF TAXATION

It is to be regretted that in the drafting of the Second Revenue Act of 1940 it was seen fit to eliminate the duplication of assessment of excess-profits taxes on intercompany dividends only when the invested capital method was used for the determination of the excess-profits credit. We strongly advocate an extension of the elimination to apply generally for the determination of the excess-profits tax. Further, the House has seen fit to pyramid the new excess-profits tax on top of the existing excess profits—capital-stock tax. In the interests of simplicity as well as fairness, we urge repeal of the provision for excess profits—capital-stock taxes contained in the present Internal Revenue Code, and, in substitution, we suggest a revision if necessary in the present rates on normal tax net income.

We urge upon you in the setting of new rates and methods for the taxing of corporate income that you do not lose sight of the fact that corporations, aside from State taxes, are already paying 20.9 percent to the Federal Government against the 2 percent that they were paying at the time of our entry into the World War. Further, you should not overlook the burden that State and local taxes now are to business as indicated in figures recently published, showing for the fiscal year 1939 that the Federal Government looked to business for 75 percent of its tax revenue while, for the same year, business contributed approximately 74 percent of all State taxes.

CONSOLIDATED RETURNS

The failure to permit filing of consolidated returns is an exceedingly unfortunate omission. Corporations, in the determination of their tax liabilities, should be in a position to follow the usual accounting procedure which is used in preparing reports to stockholders and directors, namely, consolidated returns, when the corporations are under common control. Separation of the excess-profits tax from the amortization feature would overcome the assumption that time does not permit the proper drafting of appropriate consolidated returns provisions.

AVERAGING OF TAXABLE EARNINGS

The bill provides that the base period net income shall be the average of the net income for the taxable years 1936 to 1939, eliminating the highest loss year, if any, in such period. If this scheme of averaging is to be so administered that the taxpayer will really get the benefit of his base-period earnings, a provision should be inserted to allow averaging of earnings taxable under the Second Revenue Act of 1940, or to permit carrying forward of any unused portion of the excess-profits credit. If this is deemed inadvisable, then it is recommended that the taxpayer be given the option to choose any 3 of the 4 base years, using a divisor of three in the determination of the average.

CARRYING FORWARD OF NET LOSSES

Net losses may be carried forward for a period of 2 years in accordance with the provisions of the Revenue Act of 1939. This recognizes that the ability to pay taxes cannot be measured fairly by the income of any one year because of fluctuations inherent in business operations, particularly in industries not dealing directly with the consuming public. This bill, however, is intended to tax excess earnings, if any, resulting from the emergency, above those earnings ordinarily received by business.

In view of the fact that the uncertainties resulting from lack of knowledge of the duration of the emergency will be added to the normal uncertainties and fluctuations of business, there is now special reason for claiming that provision should be made for carrying forward net losses for a longer period than the 2 years now provided. We recommend that permission to carry forward losses for a period of at least 5 years be enacted so that the excess profits tax will not become a capital levy.

PROVISION FOR ABSORPTION OF SUBSEQUENT LOSSES

The object of this suggestion, similar to that with reference to carrying forward losses, is to prevent the excess-profits tax acting as a capital levy. Except with respect to amortization, the bill makes no provision for the reopening of tax returns on which excess profits taxes have been paid, to permit of the adjustment of the reported profits to reflect losses realized subsequent thereto, for example, due to decreases in inventory prices upon the termination of the emergency. Adjustments of this nature after the last war bear ample testimony to the necessity for this safeguard.

ELIMINATION OF DEBT RETIREMENT LOSS AS WELL AS INCOME

The provision for the elimination from base period and taxable income of profits from the retirement or the discharge of indebtedness is inconsistent in that it fails to allow the elimination of any loss or expense that might have been incurred in the discharge of indebtedness.

REDUCTION OF INVESTED CAPITAL FOR DIVIDENDS WITHIN FIRST 60 DAYS

Dividend distributions made in the first 60 days of a taxable year reduce the invested capital for such year. This is distinctly unfair as there is no alternative provision to permit inclusion in invested capital of the earnings of the first 60 days or any other part of the year. It also differs from the present provisions of the Internal Revenue Code under which dividends of the current year are treated as being from earnings of that year, to the full extent of such earnings.

BORROWED CAPITAL

The House has adopted the eminently fair proposal of its Ways and Means Committee that borrowed capital be recognized as a part of invested capital. We feel, however, that some limitation should be included in the definition of borrowed capital so that the borrowed money admitted as part of the invested capital shall be in the nature of a true investment in the business as distinguished from short term credit. We recommend further that borrowed invested capital, more strictly restricted as above suggested, be allowed in full rather than in part, as invested capital as provided for in the House bill.

ADEQUATE PROVISIONS FOR PERSONAL SERVICE CORPORATIONS

We heartily approve the bill's recognition of the peculiar conditions under which personal-service corporations operate. However, the definition of a personal-service corporation should be broadened so as to include a corporation whose earnings may be ascribed primarily to the activities of individuals other than shareholders of record. There are many instances in which corporations whose ownership is in process of transfer from senior outgoing managers and owners to incoming managers, wherein severe hardship would result if the latter were not included. The definition should be extended to include within the 80 percent, persons actively engaged in the business who have contracted to purchase or are beneficially interested in the capital stock of the corporation.

PROVISION FOR ABATEMENT CLAIMS

Owing to the complexities of excess-profits-tax legislation, protection should be afforded against the effects of rulings of the Bureau which afterward are declared invalid. We, therefore, recommend that the act provide for permission to the taxpayer to file claims for abatement or suspension in order that injustices resulting from incorrect regulations or Bureau decisions may be minimized pending their consideration by the Board of Tax Appeals or the courts. The granting of such claims should be properly limited to cases where the taxpayer is acting in good faith as, for example, where he is preparing to contest a Bureau ruling or is awaiting decision in a similar case.

ADEQUATE TIME FOR REDRAFTING BILL

In addition to those factors which we have cited, there are a number of errors of omission and commission in drafting. We recognize that this is attributable largely to the extreme haste under which the House committee felt obliged to act, but this further emphasizes the need for adequate time for a thorough and careful redrafting of the bill.

AMORTIZATION

With reference to section 124 (i) we feel that the Government should not be permitted to take over emergency defense facilities except under contractual arrangements satisfactory to the Advisory Defense Commission and the supplier.

Respectfully submitted.

COMMITTEE ON FEDERAL TAXATION,
BROOKLYN CHAMBER OF COMMERCE,
By J. W. HOOPER, *Chairman.*

Members of committee: Chairman, J. W. Hooper, comptroller, American Machine & Foundry Co.; Harry A. Grube, treasurer, Intertype Corporation; C. E. Hicks, vice president and secretary, New York Dock Co.; W. C. Hogue, comptroller, Eberhard Faber Pencil Co.; Louis Klein, comptroller, American Ssafety Razor Corporation; E. S. McClary, treasurer, E. W. Bliss Co.; M. B. Varney, treasurer, Bush Terminal Buildings Co.

Representing Brooklyn Chapter of the National Association of Cost Accountants: Milton Hudders, Recording & Statistical Corporation; J. D. Scholfield, assistant treasurer, the Pilgrim Laundry, Inc.; Charles H. Towns, partner, Loomis, Suffern & Fernald.

The CHAIRMAN. Judge Fletcher.

Judge Fletcher represents the Association of American Railroads, Washington, D. C.

STATEMENT OF JUDGE R. V. FLETCHER, WASHINGTON, D. C., REPRESENTING THE ASSOCIATION OF AMERICAN RAILROADS

Judge FLETCHER. I appear for the Association of American Railroads.

I had the privilege of discussing this general question before the House committee, and my testimony appears on pages 350 to 356.

The CHAIRMAN. Your suggestions were not incorporated in the bill, were they?

Judge FLETCHER. They were not to a very great extent, and, furthermore, I didn't have this bill before me at the time I made that statement.

. The CHAIRMAN. I thought they were very good suggestions.

Judge FLETCHER. I want to reiterate one or two of those, and I don't think I will take the 10 minutes you allow.

The first thing I want to call attention to is what seems to me an apparent discrepancy between the treatment of emergency facilities, as it appears on page 87 of the House bill, in comparison to what appears on page 88 of the House bill.

The railroads were urging, before the House committee, and reiterating the suggestion here, that a great many facilities, railroad facilities, consisting partly of equipment and partly of the construction of new lines to get to the industries that have been set up for the purpose of manufacturing war materials, that they should be included in emergency facilities, and apparently the act would so include them.

But with reference to the date, July 10, 1940, as I read the last clause on page 87, the completion of the facility is the test. If it is completed from and after July 10, 1940, it then may be, if it gets the proper certificate, included in emergency facilities, and be subject to the amortization program.

But over on page 88—and I may be wrong about this, Mr. Chairman——

The CHAIRMAN. I hope the Treasury representatives will take notice of this.

Judge FLETCHER. It says that "there shall be included only so much of the amount otherwise constituting such adjusted basis as is properly attributable to such construction, reconstruction, erection, installation, or acquisition after July 10, 1940," and so forth.

That would seem to indicate, on page 88, that this is language that might be construed as saying that only so much of the total cost as was expended subsequent to July, 1940, should be included; whereas, the clear intendment on page 87 is that if it is completed after that date, then it all may be included.

I may have misread it, Mr. Chairman, I am not a tax lawyer, but I call that to your attention, and I hope that that may be cleared up.

I really am very hopeful that a suggestion which I think came from a number of the committee, as I caught it, that that date be moved back, be acted upon. That would be a very helpful thing, because, in the case of railroads, they certainly were called upon to spend and make contracts for the construction of new equipment to an extraordinary degree in the fall of 1939. So much for that.

The second thing I want to say—and perhaps the most important—is to take care of these numerous railroads that emerge from receivership proceedings, or from bankruptcy proceedings during the period when this act is in effect.

About one-third of the mileage of the railroads of the United States are undergoing reorganization, as you gentlemen know. Now as I read this bill. there is no adequate provision for taking care of the invested income of a railroad which emerges from bankruptcy and has an entirely new capital structure dictated by the Interstate Commerce Commission. Most of these railroads, Mr. Chairman, will have their present capital stock wiped out for the reason that they are declared to be insolvent, and there is no excess of assets over liabilities.

Now the Commission generally proceeds to assign a certain amount of capital stock, which is to be taken over by some of the bondholders. But there is a situation where you are going to have great difficulty—I won't stop to elaborate it—but you will have great difficulty under the terms of this bill in determining, in any rational way, what would be the invested capital of a reorganized railroad company.

I presume that might be true of some reorganizations in other lines of industry, but of course about them I do not know so much.

Senator GEORGE. Does the reorganized railroad go along under the same charter?

Judge FLETCHER. Very often they have to have new corporations.

Senator GEORGE. Then does the reorganization take place tax-free?

Judge FLETCHER. They are tax-free reorganizations in some cases, if by that you mean that there is no tax upon the exchanges which are made; but I have read this bill, Senator George, and I don't think it meets our situation.

I was only going to suggest that if you could put over there in section 721, which is a clause giving the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, a wide discretion about determining invested capital in cases where the bill itself doesn't seem to cover the ground or meet the situation, it would be very helpful, indeed, in the case of the railroads, because we would be hopeful of convincing the Treasury authorities as to what was a sound amount of invested capital.

The CHAIRMAN. Didn't you make some suggestion that the best body to certify to that was the Interstate Commerce Commission?

Judge FLETCHER. Yes, I made the suggestion to the House committee, Mr. Chairman, and it flatters me that you remembered it, that if the law could be so written that the amount which the Interstate Commerce Commission fixed as the value of the capital and allowed to be put upon the books of the new carrier when it started out, could be taken as invested capital, that would be entirely satisfactory.

The CHAIRMAN. Well, I would suggest that you talk to Mr. Sullivan, if possible, on this business. I was impressed with your testimony, and I understand that in the executive session for the formulation of the bill, your testimony was forgotten; you either didn't impress the subcommittee or they overlooked your testimony.

Judge FLETCHER. I should be glad to do that.

The third point I make is on this matter of consolidated returns. I don't intend to go over all of that, because you have had that presented in great length and with great force. But you will remember, Mr. Chairman, that in the case of railroads, that is the only line of industry which is now permitted to make a consolidated return for ordinary income tax purposes; and the reason why that was done may be very well illustrated by a case which I know about because I served the railroad I mention for 22 years, the Illinois Central Railroad. It has two subsidiaries, the Yazoo & Mississippi Valley Railroad Co., and the Gulf & Ship Island Railroad Co., both of which lines are in the State which has honored itself by electing the chairman of this committee to the Senate. The constitution of Mississippi makes it necessary that those corporations should be Mississippi corporations and separately operated and separately incorporated. The railroad might be very glad to consolidate them into one corporation if it had the power to do it. That is a situation that exists all over the United States.

For that reason, this committee some years ago allowed the railroads to make consolidated returns for income tax purposes.

Now that same consideration, Mr. Chairman, applies just as much to this excess profits tax as it possibly could apply to any case of ordinary income tax, and that statement of mine I think is fortified by what has been said here by numerous witnesses, that while in fact it proposes to be an excess profits tax, it encroaches upon the domain of the ordinary income tax. And I suggest for your consideration how easy it would be to provide that in the case of railroads they should have the same privilege of making a consolidated return for excess-profits tax as they do for ordinary income tax, if indeed you do not grant the proposition generally.

My fourth proposition is on borrowed capital. I reiterate what has been said heretofore by many persons who are more competent than I to discuss it, that it would be a great improvement if the corporations were permitted to include borrowed capital or to exclude it entirely. I think it is true that the railroads more than in the case of other industries of the country have probably built more of their property from borrowed capital than have others. There is a reason for that, that I won't take the time to go into. Many of those railroads have had to borrow some of that capital at pretty high rates of interest, and it seems to me that if a railroad company, or any other corporation, for that matter, finds that by excluding all borrowed capital it will be in a more favorable position, it ought to be allowed to do so.

I thank you.

The CHAIRMAN. The R. F. C. would be interested in this problem as to how it affects the railroads, wouldn't it?

Judge FLETCHER. I should think so.

Senator LODGE. Judge, did I understand you to say that you favored giving the Commissioner of Internal Revenue certain discretion in fixing the value of the capital?

Judge FLETCHER. I would rather have that, than have nothing at all. If we could have something written in there which would require the officers of the Treasury to accept the figures given by the Interstate Commerce Commission, and permitted by them to be written on the books of the carrier as its investment, that would be the ideal situation.

Senator LODGE. That would obviate any need for that?

Judge FLETCHER. Yes, sir.

Senator GEORGE. On that point, the invested capital on this income tax act, and the invested capital set up by the Interstate Commerce Commission, are altogether two different things?

Judge FLETCHER. They might be two very different things. I could conceive of situations where they might be very different, although from my point of view they should not be, but they have become so. Take, for instance, the ordinary matter of depreciation. The Treasury doesn't accept the Interstate Commerce Commission figures of depreciation—I think they ought to, but they don't.

Senator GERRY. That would give you a definite figure on which you could act?

Judge FLETCHER. Yes; and I think the Interstate Commerce Commission can be trusted not to make a figure which is excessive because, Senator Gerry, they have radically cut, in their reorganization, the capitalization of these railroads.

The CHAIRMAN. Thank you, Judge Fletcher.

Mr. COWDIN. This is Mr. J. Cheever Cowdin, representing Universal Pictures Co., Inc., Universal City, Calif.

STATEMENT OF J. CHEEVER COWDIN, CHAIRMAN OF THE BOARD, UNIVERSAL PICTURES CO., INC., UNIVERSAL CITY, CALIF.

Mr. COWDIN. Mr. Chairman and gentlemen of the committee: In estimating the Federal income and excess-profits taxes payable by Universal Pictures Co., Inc., under the existing laws and the excess-profits tax bill passed by the House of Representatives, it is startling to find that, based on our current year's earnings, this company would pay over 47 percent of its earnings for such taxes. This is obviously almost double the percentage of tax which would be paid under the same bill by the majority of other corporations upon which the tax will be imposed, this in spite of the fact that this company will reap no benefits from defense or other Government contracts.

Senator CONNALLY. You will be defended just like everybody else, won't you?

Mr. COWDIN. I hope so.

Senator CONNALLY. You will get the same benefits of defense as anyone else?

Mr. COWDIN. I hope so.

Senator CONNALLY. You just said that your company would not get any benefits out of the defense appropriations.

Mr. COWDIN. I said that we would "reap no benefits from defense or other Government contracts."

Senator CONNALLY. You mean that you are not getting any Government contracts?

Mr. COWDIN. Yes; directly or indirectly.

It demonstrates, we believe, that the bill as drawn is discriminatory and inequitable.

The company has no objection to paying whatever taxes the country may require, providing all other corporations pay a like percentage of their net profits.

From our computations, it is obvious that the proposed legislation is grossly unfair to Universal Pictures Co., Inc., which is not benefited but actually harmed by war conditions because of the loss of a substantial portion of its foreign business; nor does the company have anything to do with war contracts. After several years of losses, as I will call to your attention, there was a complete change in the ownership of the company in April 1936, and later in its management, with the result that it has only started to show profits. The net earnings of the company, after Federal income taxes, have been as follows:

Year	Profit	Loss
1932		$1,250,283.00
1933		1,016,893.00
1934	$273,068.00	
1935		677,186.00
1936		1,835,419.00
1937		1,084,909.00
1938		591,178.00
1939	1,153,321.00	
1940 (partly estimated)	2,025,000.00	

The excess-profits tax bill does not fairly provide for such a situation, since it takes an arbitrary 4-year period as a measure of a corporation's normal earning capacity, or a low minimum rate on its invested capital, and is obviously disastrous to any normally growing company, which is the backbone of America.

The CHAIRMAN. You would take that average earnings base period, wouldn't you; you wouldn't take invested capital?

Mr. COWDIN. We would have to take the average earnings base period, I think.

The effect of the bill, as drawn, would be disastrous on Universal Pictures Co., Inc. It was compelled to borrow on a short-term basis, during its years of losses, and currently owes over $4,880,000. It owes accrued and unpaid dividends of approximately $2,958,000 on its preferred stocks. It has a sinking fund requirement on its first preferred stock which must be met. How is it possible for the company to meet these requirements, if it has to pay over 47 percent of its earnings to the Government?

The company has not as yet reached what is believed to be its normal earnings base. The company was purchased on the belief that with adequate management, its normal gross business should be much higher than it had been. Allowing only 8 to 10 percent on its turn-over will result in much larger profits than any shown to date. Certainly an earning of only 8 to 10 percent on its gross business can in no way be considered as excessive and would be far below that enjoyed by many other companies. As this point is reached, the percentage of taxes proposed becomes even higher than 47 percent.

Against corporations which have just begun to recover, after a depression period caused by bad management or other ills, the bill as passed by the House imposes an unconscionable discrimination as compared with the old-line, steady-earning corporations.

Consequently, in all fairness, provision must be made for corporations with such a situation, as we cannot believe that the Congress desires, in effect, to confiscate any company.

We urgently recommend that the pending bill be amended so that:

1. Earnings on invested capital be computed at 8 percent, instead of a minimum of 5 percent, before an excess-profits tax is applied. (This company pays 6 percent on its current borrowings and its preferred stocks carry a 7 percent and 8 percent dividend rate.)

2. Corporations be permitted to select the results of any one of the last 4 years as the base for determining excess profits. (Universal would still suffer, as none of the years in question represent a normal earnings base.)

3. There be included a third alternative basis for determining excess profits, allowing a credit of 8 percent on the company's gross business before the imposition of an excess-profits tax.

4. Consolidated returns be permitted. (Universal does a world-wide business and is compelled to have many subsidiaries and the system should be considered as a whole.)

5. If these specific suggestions are not acceptable, I urge your committee in its deliberations to work out a tax bill which will eliminate the inequitable and discriminatory features of the measure under consideration.

6. If it is the purpose of this bill to tax excess profits resulting from Government or other wartime contracts, then the inequalities and discriminations existing in the present draft of the bill should be eliminated. However, if in reality the purpose of this bill is to raise a specific or certain revenue to help meet Government necessities—let's frankly face it, and increase the normal rate on all corporations sufficiently to make up for any loss in revenue resulting from the elimination of such inequalities and discriminations.

The CHAIRMAN. Thank you very much, Mr. Cowdin.

Senator KING. I would like to ask the witness, before he leaves, one question.

Suppose some of your suggestions should be accepted, to what extent would they be applicable to other corporations, or do you stand in a situation entirely different from that of any other corporation?

Mr. COWDIN. I think we stand in this position, Senator, and I think every other company which we look upon as a growing small company, stands in a like position: Take companies who didn't have a normal period of earnings, or who had just started to exist, and there are many companies that just started to exist in 1934 or 1935; it takes a number of years for those companies to reach a normal earning. I know of no company that hasn't been willing to pay a fair tax, or any tax the Government desires, providing it is based on a normal basis, but no company can start, either through reconstruction or start anew, in a short period of time and reach a normal earning period. That is our premise, and I think that will be borne out by any gentleman familiar with that subject.

Thank you very much.

The CHAIRMAN. Mr. Williams.

You spoke to the clerk, I understand, but he left your name off the calendar.

STATEMENT OF S. CLAY WILLIAMS, WINSTON-SALEM, N. C., REPRESENTING THE R. J. REYNOLDS TOBACCO CO.

Mr. WILLIAMS. First, Mr. Chairman, I want to tie in where the gentleman from Ashland, Ky., yesterday stopped, in talking about a $600,000 refund from the United States Government, which I understand was a refund of income tax, his point being that he was going be penalized heavily by all of that income falling in a year that excess profits would apply to, though it had no relationship to it, or certainly only a small part of it could have relationship to it.

I am affected by the possibility of a return of processing taxes from the United States Government as paid under the Agricultural Adjustment Act applicable in 1933, 1934, and for a little bit in 1935.

You gentlemen will remember that the tobacco industry carried a double burden through that period in that, while they took processing taxes as levied, beginning October 1, 1933, on all of the tobacco that they processed, they also, in September 1933, entered into a marketing agreement with the Triple A, the only one ever entered into, and prosecuted successfully, under which they lifted the price of tobacco upon the floors immediately from 9-and-a-fraction cents to about 16 cents for the farmer.

We carried, as I say, the double burden. Our claims are now pending, or I should narrow my statement to my own company, my own company's claim is now pending in the Treasury Department not in any way affecting the marketing agreements and the money paid out under them, but affecting the processing taxes paid, and later declared unconstitutional.

If that money should be returned to us in 1940, under an agreement we have made with the Bureau of Internal Revenue by way of facilitating the settlement of taxes for prior years, which agreement provides that we will return that money we receive as income for the year in which received, all of that fund would be subject to the excess-profits tax, and under this bill about two-thirds of it would go back to the Government again. I don't think there is any deliberate purpose to levy an excess-profits tax on that item. I think it is just a matter that has not been fixed up, as involved in this situation.

The CHAIRMAN. When did you make that contract with the Treasury?

Mr. WILLIAMS. Probably a year and a half ago. I can give you the exact date.

The CHAIRMAN. It was before this came up, before we thought of an excess-profits tax?

Mr. WILLIAMS. Yes; there was no comtemplation of anything like this. It was made at the suggestion of the Treasury Department only for the purpose of facilitating the closing of previous years' taxes.

Senator GEORGE. If you should receive a refund, of course you would pay the normal income tax upon it?

Mr. WILLIAMS. That is right. My point doesn't go to that.

Senator GEORGE. You simply say that it ought not to fall in the excess-profits bracket?

Mr. WILLIAMS. That is right, because it has no relationship whatever in the premises of an excess-profits tax.

The CHAIRMAN. If we should write into the bill a provision appointing a board, or the Tax Appeal Board, or the Commissioner of Internal Revenue, to take these relief cases up, that might give you a forum, at least, to present your cause?

Mr. WILLIAMS. I had a forum at one time before, Mr. Chairman, and I spent 10 years in the forum. I eventually got out. But that is better than no provision. But I think this is the kind of thing that could be handled by a specific provision in the bill. There is already a skeleton provision in the act to which one provision could be added in a very simple amendment that would throw it out.

I am not resisting your forum, but I am reminding you that they move rather slowly sometimes. This one moved slowly or this question wouldn't be presented.

I have no disposition to go through the general attack upon the 4.1 levy, nor the 5 percent additional that is levied on the companies that take the average earnings. I want to say one thing with respect to it which develops into two branches.

The curse of a company like mine is in the fact that questions of taxing it are always approached from the angle of what somebody in a prior generation put into it. If I may be perfectly specific, Reynolds Tobacco Co., as represented by the investment of Mr. Thomas F. Ryan in it, may today stand to him, if he were living, as representing for him an investment of $15 a share, and figured upon the basis of the present return, the return would be approximately 15 percent upon what he, in a generation that is gone, and whose estates have been liquidated, had directly invested in that company. He belonged to a day, Mr. Chairman and gentlemen, when our company had about 1,000 stockholders. It has 61,000 stockholders today, and to give you a statistic, in the 18 years in which that stock has been on the New York Stock Exchange, with 10,000,000 shares outstanding, the turn-over on the New York Stock Exchange has been somewhat over 20,000,000 shares, two times turned over. I am not attempting to say to you that every share turned over, but that the turn-over has been 20,000,000 against 10,000,000. The lowest price at which it ever turned over a share was $26 and a fraction. The highest price was about $65.

One of them is about two times what Mr. Ryan would have been figured to have in it, and the other one is more than four times. So that the average of three times—and the generation of citizens of this country who are stockholders in that company today have in there, if we may proceed upon the basis of that average—three times what Mr. Ryan and his generation had in that company. That means that what would have figured a 15-percent return to Mr. Ryan, if he were living, and the calculations were made upon that basis, is but a 5-percent return to the generation that now own Reynolds Tobacco Co.

One more word. This act is an excess-profits tax in its original conception. I respectfully submit, on top of that suggestion of difficulty of determining what an excess-profits tax is as affected by situations such as I have just outlined, this further thought. On the very face of the act, and the figures affecting it as related yesterday, it has lost its character as an excess-profits-tax act.

The original figure, $190,000,000, charged with certain deductions, brought the original return down, according to Mr. Sullivan's testimony of yesterday morning, to about $150,000,000. Credited with this 4.1 percent, which is admittedly an income tax paid as a penalty for taking a certain option, and supplemented further by the 5 percent added on the companies that take that method instead of the other, the income from the act goes up to $305,000,000, against $150,000,000 directly attributable to the original excess-profits idea.

I say it has lost its character as an excess-profits tax and has become very much more an income-tax act, and I ask the question, in conclusion—if it is an income-tax act, why not lift the question of that levy upon normal tax, not excessive at all, out of all the intricacies that accompany an excess-profits-tax act, and all of the uncertainties and hazards of injustice, and make it an income-tax levy on all of us?

I thank you.

The CHAIRMAN. Mr. Haberman. Mr. Phillip W. Haberman, of New York City, representing the Commercial Investment Trust Corporation.

STATEMENT OF PHILLIP W. HABERMAN, REPRESENTING COMMERCIAL INVESTMENT TRUST CORPORATION, NEW YORK CITY

Mr. HABERMAN. I am vice president and general counsel of the Commercial Investment Trust Corporation.

I wish to address myself only to two subjects of general application.

The first is a certain phase of the matter of making consolidated returns. I don't think there is much argument about the propriety of consolidated returns. However, I can see one difficulty which would require that the section, if one is prepared, take a somewhat different form than the ordinary consolidated returns provision, similar to section 141 relating to railroads.

And I will just illustrate it for a moment or two. The returns for ordinary income-tax purposes, of corporations for the years 1936, 1937, 1938, and 1939, are all on an individual basis and not on a consolidated returns basis. The income-tax law during that period did not permit consolidated returns.

Therefore, if you undertake to have the advantage of consolidated returns for those years in order to compare them with the results of a consolidated return in 1940, it will require the reconstruction of the returns for those 4 years, both on the part of the taxpayers and their review by the Treasury, being a monumental task in accounting, which might take years to consummate

Now, in lieu of that, there could be drafted very simply, on the basis of section 141, a somewhat different character of return, which I have designated a "combined returns of excess profits" based on the theory that after all, a consolidated return is really the sum of all the individual returns of the concerns in the affiliated group, though the sum of the latter is bound to equal the former.

And all of the 1936 to 1939 returns have naturally been filed. Many of them have already been audited by the Treasury Department. I understand that those for 1936 are practically completed. Those for 1937 are almost entirely completed, and before the time comes for the auditing of 1940 returns, they will all have been completed.

So that if the taxpayer is given the right to file a combined return for those 4 years, and not reconstruct the figures, it will amount to the same thing as a consolidated return.

I have had a section drafted which I would like to submit, Mr. Chairman, which I think will cover this situation in a very simple way.

The CHAIRMAN. We will be very glad to have you put it in the record.

Mr. HABERMAN. Now the other point to which I wish to refer is this matter of the 4.1 admission ticket to the average earnings show. Naturally, every concern filing under a bill of this kind will select that form of return which is most advantageous to it, and there is nothing sinister in selecting either the one or the other, and it would seem, ordinarily, at first approach, certainly unconscionable that there be a penalty for choosing one rather than going to the other.

The assumption has been, apparently, on the part of the Treasury, that there would be more concerns which would be benefited by the average earnings base than the invested capital base.

I think there are some phases of that which they have, perhasps, failed to explore which, when I consider them, lead me to the contrary conclusion, and here is one point that was adverted to in passing by Senator Vandenberg yesterday, but I don't know whether the full significance of it was received.

This is a penalty of 4.1 percent, increasing the normal 20.9 to 25 percent. But its practicaly impact is 6.1, for this reason, that the 20.9 is deductible before ascertaining the amount due for excess-profits tax, whereas, the extra 4.1 is not deductible.

Therefore, a concern which is in, let us say, the 50 percent excess-profits bracket, will pay 6.1, plus 50 percent of that amount which is subject to excess-profits tax, namely, a total of 75 percent.

Now, when a concern also, in addition to that, finds itself all the way up the line in brackets in the one instance, which are 5 points higher than the brackets in the other instance, you have got a differential of a total of 11.1 that the concern has to play with in reaching the determination as to whether it shall go on the one basis or the other.

And in my judgment, it may well be that that will tip the scales so that countless concerns will file their returns on the invested capital basis, rather than on the other basis.

Now it was stated by one of the gentlemen from the Treasury Department that it was estimated that the present bill for 1940, would yield $305,000,000.

I think, on this latter point that I have made, that it might well be that he would be seriously disappointed. It wouldn't yield $305,000,000. Senator Harrison asked someone regarding the effect of a 3-percent increase, and Senator George did likewise, and elicited from one of the Treasury experts that a 3-point increase in the corporate tax would yield $225,000,000. In one respect that is entirely true, and in another respect I think it is in error.

The taxes for last year yielded $1,500,000,000 from corporations. The rate was 19 percent. Therefore, each 1 percent was one-nineteenth of that total. Hence, you multiply that by 3, and you come to the $225,000,000. That is quite accurate. But I think what was overlooked was the fact that in the June amendment of this year there was added a supertax of 10 percent which would bring that up to $260,000,000.

Now if these hearings have demonstrated one thing above all others, it is that these taxes proposed in this bill are dreadfully complicated. Corporations generally already have their normal income taxes; they have their capital stock tax with its so-called excess-profits tax implications; they have their intercorporate dividend tax; they have their social-security taxes—and most of them are half in the tax business. If this bill, which will multiply the sum total of all of the difficulties under those other taxes, goes into effect, the situation will simply be burdensome beyond description.

Now there are going to be no war profits in the year 1940. This act relates back to the 1st of January. It would seem reasonable that there be at least no excess-profits tax for the year 1940, and that, corporations, I fancy, by and large would much rather pay an increased income tax for the year 1940, even to the point of 4.1, than have all of the grief that they are going to enjoy—if you want to use that term—as the result of the impact of this tax.

And if there is a 4.1 increase in the regular corporation tax, the net result of that, based on last year's return, will be $354,000,000.

Now I think no one objects to paying taxes, we all know that we have got to be defended, and we have got to pay through the nose, if necessary. Why not adhere to the ordinary corporate system, running the present tax up to 5 percent, if you will, and then increasing further that tax, if necessary, and that tax will fall equally on everyone and not in the absurd manner that this proposal will fall on many corporations.

For example, there is an absolute possibility—you take two concerns, each one having a capital identical with the other, each one having the same volume, and each one, by coincidence, having the same profits. Let's say those profits are $100,000 in each instance.

By reason of time that has passed, by reason of the corporate history made in basic years, which corporate history cannot be retraced, one of those concerns will find itself in the position of paying no excess-profits tax whatsoever, and the other one, running up in the manner I have indicated to perhaps 75 percent of that particular amount.

That is an inequitable basis of taxation. We are all willing to pay the same rate, we are all willing to pay the same tax that everyone else does on each dollar, but industry should be spared; the economy can't be advanced by having a tax which falls differently on different concerns who have the same fiscal experience in the same year.

I would like to leave with the committee a copy of this proposed measure. I gave a typewritten copy yesterday to one of the assistants of the Treasury Department. I have several here if more than one is desired.

I would also like to leave a copy of a memorandum on this subject which, on Monday, I sent to each member of the committee.

The CHAIRMAN. They may be put into the record if you so desire.

Mr. HABERMAN. Yes; I would like to have them inserted in the record.

The CHAIRMAN. That will be done.

(The same are as follows:)

SECTION PROPOSED TO BE INCLUDED IN THE SECOND REVENUE ACT OF 1940

SEC. —. COMBINED RETURNS OF EXCESS PROFITS.

(a) *Privilege To File Combined Returns.*—An associated group of corporations shall, subject to the provisions of this section, have the privilege of making a combined return for the taxable year in lieu of separate returns under this subchapter, and of computing the tax imposed by Section 710 upon the combined adjusted excess profits net income. The making of a combined return shall be upon the condition that all the corporations which have been members of the associated group during the taxable year for which the return is made consent to all the regulations under subsection (b) prescribed prior to the making of such return; and the making of a combined return shall be considered as such consent. In the case of a corporation which is a member of the associated group for a fractional part of the year the combined return shall not include the income of such corporation for such part of the year as it is a member of the associated group.

(b) *Regulations.*—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of any associated group of corporations making a combined return and of each corporation in the group, both during and after the period of association, may be determined, computed, assessed, collected, and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability.

(c) *Computation and Payment of Tax.*—In any case in which combined return is made the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (b) prescribed prior to the date on which such return is made.

(d) *Definition of "Associated Group."*—As used in this section an "associated group" means one or more chains of corporations connected during any entire taxable year of the common parent subsequent to December 31, 1939, through stock ownership with a common parent corporation if—

(1) At least 95 per centum of the stock of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations during all of such year; and

(2) The common parent corporation owns directly at least 95 per centum of the stock of at least one of the other corporations.

An associated group includes all corporations within such group excluding those not liable under this subchapter and those excluded by subdivisions (e), (f), (g), and (h) of this section.

As used in this subsection the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(e) *Foreign Corporations.*—A foreign corporation shall not be deemed to be associated with any other corporation within the meaning of this section.

(f) *China Trade Act Corporations.*—A corporation organized under the China Trade Act, 1922, shall not be deemed to be associated with any other corporation within the meaning of this section.

(g) *Corporations Deriving Income From Possessions of United States.*—For the purposes of this section a corporation entitled to the benefits of section 251, by reason of receiving a large percentage of its income from possessions of the United States, shall be treated as a foreign corporation.

(h) A personal service corporation (as defined in section 723) or a corporation completing contracts under the Merchant Marine Act of 1936, shall not be deemed to be associated with any other corporation within the meaning of this section.

(i) *Subsidiary Formed to Comply With Foreign Law.*—In the case of a domestic corporation owning or controlling, directly or indirectly, 100 per centum of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this title as a domestic corporation.

(j) *Suspension of Running of Statute of Limitations.*—If a notice under section 272 (a) in respect of a deficiency for any taxable year is mailed to a corporation, the suspension of the running of the statute of limitations, provided in section 277, shall apply in the case of corporations with which such corporation made a combined return for such taxable year.

(k) As used in this section the term "combined adjusted excess profits net income" means the combined excess profits net income minus the sum of a specific exemption of $5,000 and the amount of the combined excess profits credit. The term "combined excess profits net income" means the sum of the excess profits net income of each associated corporation, as defined in this subchapter, having an excess profits net income greater than zero and without deduction for any associated corporation having an excess profits net income less than zero. The term "combined excess profits credit" means the sum of the excess profits credit of each associated corporation, as defined in this subchapter, except that the borrowed invested capital of any associated corporation computed under section 719 shall not include borrowed invested capital which is owed to any other associated corporation.

The excess profits credit of the associated corporations shall, if authorized by section 712 or section 741, all be computed under section 713 or all computed under section 714; otherwise all shall be computed under section 714.

Memorandum for Senate Finance Committee Concerning Consolidated Returns Under the Pending Excess Profits Tax Bill, H. R. 10413

Submitted by Phillip W. Haberman, General Counsel, Commercial Investment Trust Corporation

THE NEED FOR CONSOLIDATED RETURNS

An excess-profits tax law cannot be successfully administered by the Bureau of Internal Revenue without consolidated returns being permitted.

The earliest act was silent on the subject. The Treasury, however, considered it so basic that, in the absence of specific statutory authority in the first excess-profits tax law, it provided for consolidated returns by regulations, which were later validated by the Congress.

True earnings cannot be projected without consolidation. Diverse state laws, diverse corporate functions, and many other needs *not connected with tax problems*, result in multiple corporate structures without choice of the taxpayer. An individual taxpayer having two ventures in a taxable year, one of which earns and the other of which loses the same amounts, has no taxable income. If a corporation has two subsidiaries, one of which makes and the other of which loses the same amounts, the total enterprise has no real earnings; yet without consolidation a tax is payable out of capital which, in the final analysis, is owned by individual stockholders.

Accounting difficulties arise because of intercorporate transactions and cause many complications under separate returns. These can be avoided under consolidated returns, and distortion of true earnings can be obviated.

By the 1921 Revenue Act consolidated returns were made optional, and the Senate Finance Committee, in its report on the revenue bill (67th Cong., 1st sess., S. Rep. 275, p. 20), said:

"The consolidated return is necessary to prevent evasion under the excess-profits tax, but this necessity will disappear when the excess-profits tax is repealed."

The first serious attack on consolidated returns came when the 1928 act was being considered, and the Joint Committee on Internal Revenue Taxation proposed that, because of difficulties encountered in administration, consolidated returns be limited to a parent company and its subsidiaries. The House Ways and Means Committee proposed that consolidated returns be abolished; the Senate Finance Committee, on the other hand, recommended that they be continued with certain amendments to eliminate administrative problems, and stated in conclusion (70th Cong., 1st Sess., S. Rep. 960, p. 1):

"Your Committee has considered the matter very carefully and is convinced that the elimination of consolidated returns provision will not produce any increase in revenue, will not impose any greater taxes on corporations, and will in all probability permit of tax avoidance to such an extent as to decrease revenues."

In the 1932 act it was first proposed that the privilege of making consolidated returns be taxed at the rate of an additional 1½% on net income of affiliated groups. The tax was finally fixed at ¾%, and in the following year was increased to 1%. This provision is similar in principle to the proposal in the current bill to penalize selecting the Average Earnings basis by an additional tax of 4.1%. The Senate Finance Committee in 1932 had this to say against taxing the privilege of making a consolidated return:

"The House bill proposed an additional tax of 1½ percent upon the net income of an affiliated group of corporations which elected to file a consolidated return. Your committee recommends that this additional tax be eliminated. It sees no justification for it. The provisions for consolidated returns under the present law and regulations recognize sound accounting practices and require tax liabilities to be determined on the basis of the true net income of the enterprise as a whole. No improper benefits are obtained from the privilege. Your committee believes that it is highly desirable, both from the point of view of the administration of our tax laws and the convenience of the taxpayer, that the filing of consolidated returns by affiliated groups of corporations be continued, particularly in view of the changes made in the revenue act of 1928 and in the regulations promulgated by the Secretary of the Treasury thereunder. *It is difficult to justify the exaction of a price for the use of this form of return.*" (72d Cong., 1st Sess., S. Rep. 665, pp. 9-10.) [Italics mine.]

In 1934 consolidated returns were abolished excepting for railroad corporations.

The Treasury has been uniformly consistent in its desire for consolidated returns. The present Secretary of the Treasury, then Acting Secretary, gave the clearest and most cogent explanation of the need for consolidated returns through

Dr. Roswell Magill when the 1934 Revenue Bill was under consideration. This statement cannot be improved upon. It is short and, although familiar to many members of the Committee, I have thought it important to set it forth in its entirety in Appendix A attached to this memorandum.

The present bill contains no provision for consolidated returns. It is important that the provision be adopted, and that it be not discriminatory. In fairness, corporations 95% owned by a common parent should be permitted to file consolidated returns regardless of the kind of business the subsidiaries may be engaged in, in order that the real "excess profits" of the group may be fairly and correctly reported. In many cases the capital of the subsidiary may be relatively small and its income relatively large in proportion thereto, because its business is handed to it by the rest of the group, which finances it to the full extent necessary. To compel any subsidiary in the group to report separately from the rest of the group would grossly distort the actual profits of the subsidiary and of the group.

There are serious difficulties in drafting a tax which will operate fairly upon businesses whose circumstances vary enormously. The risks in different businesses vary widely. Some are "feast or famine" enterprises, capital structures cover a wide range, so that a legitimate profit in a particular year for one business might well be regarded as excess profit for another.

Corporate tax legislation cannot be regarded only from the point of view of its effect upon the corporation itself. Now that corporate and individual rates are high, it is important to consider: How does it affect the corporate stockholder?

As to stockholders; the tax which the corporation pays comes out of profits otherwise distributable to stockholders. Stockholders actually pay the taxes imposed on corporations. Size has no significance. The stockholder impact is the same whether it be a $10,000 corporation with 10 stockholders, or a $1,000,000 corporation with 1,000 stockholders. Each has $1,000 at risk. In fact, the average holding of stockholders in large corporations is less than in small ones. The excess-profits tax accentuates this situation.

Under an excess-profits tax applicable to all businesses, it is very important that the law contain a provision for consolidated returns of affiliated corporations 95% owned by a common parent. The intercorporate dividend tax has made it unprofitable to use subsidiaries unless state laws or similar requirements necessitate them. Useless subsidiaries have been largely eliminated. It may, however, still be necessary to organize separate corporations to do business in particular states, or to conduct particular lines of business, or to enlarge or diminish their areas of activity, in favor of one and against the other, for reasons not connected with taxes. If these subsidiaries are 95% owned, they are really departments of one enterprise, and are so regarded by its executives. One member of the group may well finance the others; salaries and costs paid by one may operate to the advantage of others; and the income of any one of the group may be entirely due to arrangements with the others. As the Secretary of the Treasury has stated, the income of the group cannot be accurately presented except on a consolidated basis. Administrative difficulties and costs multiply when an essentially artificial allocation is undertaken. The Treasury found consolidated returns absolutely necessary under prior excess-profits-tax laws primarily to insure the fair operation of the tax without evasion. Consolidated returns will not result in a decrease in revenue. In fact, the combination of numerous small subsidiaries into a single return will often result in more rather than less taxes. More important, the artificial shifting of income and investment from one subsidiary to another, which follows the absence of provision for consolidated returns, may result in lower tax collections and higher administrative costs.

If a permissive provision is inserted in the bill, most corporations with subsidiaries will avail themselves of it. Such a provision should not be particularly hard to draw, for we already have a complete model in Section 141 of the Internal Revenue Code. There need only be eliminated paragraph 3 of subdivision (d), relating to railroads. The broad power in the Commissioner to make regulations will enable him to cover the complicated situations which are difficult to anticipate. The provision should be broadly drawn, so that all corporations which are 95% owned by a common parent shall be included in the group, irrespective of the kind of business conducted by any of the corporations in the group.

THE 4.1 PERCENT PENALTY

A corporation in making its return under the excess-profits tax will select either the Average Profits basis or the Invested Capital basis, whichever results in the smaller tax liability. If there is to be a price for selecting the method which is the more favorable to the taxpayer, it is no more logical to attach it to one form of choice than to the other. In fact it is inapplicable to either. No one can say on which side the greater number of choices will fall. There is no implied sharp practice either way that should be penalized. If the purpose of the extra 4.1% is to produce revenue, it may fail of that purpose because the very amount of this tax in an undeterminable number of instances will tip the scales in favor of using the more cumbersome Invested Capital basis, notwithstanding its difficulties of administration.

Before the Ways and Means Committee it was suggested that the excess-profits tax be eliminated for the year 1940, and that for it be substituted a three-point increase in the basic corporate income tax rate, which would yield a minimum of \$260,000,000 on the basis of last year's revenue recepts. The present 4.1% penalty would have an entirely speculative yield beyond all possible forecast. A real service would be rendered to the national economy by the enactment of the foregoing suggestion for an allover basic increase in the corporate rate for 1940 in lieu of an excess-profits tax for that year, and certainly there should not be both an excess-profits tax and also a penalty for using an optional method of reporting. If the excess-profits tax is separated from the noncontroversial parts of the bill and adequate time is take to produce an equitable and understandable measure before March 15th next, it is believed that industry as a whole would rather absorb such an increase (even 4.1%) taken in connection with a broad provision permitting the filing of consolidated returns.

The only plausible argument that has ever been made against consolidated returns is that such a report reflects the total true net income less net losses of the separate members of an affiliated group after eliminating intercompany profits or losses. The very argument defeats its own logic because the true net income is represented by the net earnings aggregate of the group of affiliated companies. To meet this argument it could be provided that the "combined net income" of a group should consist of the sum of the net incomes of the members thereof which show profits, each net income computed on its separate return basis for income taxes. Net losses of members could be made nondeductible.

Under this suggestion the "combined invested capital" of the group would be the sum of the separate invested capitals of the members thereof, except that intercompany indebtedness would not be added as borrowed invested capital. The "combined net income" for the base years 1936 to 1939 would be the sum of the separate net incomes of the members thereof showing profits, with no deduction for companies showing net losses.

The foregoing is relatively simple and would utilize the sum of all of the separate returns already filed without recomputation for 1936 to 1939 of consolidated returns and would eliminate the objection that tax revenue was lost by deductions for companies having net losses. It would also eliminate the objection to including companies of any particular class in a combined return.

APPENDIX A

STATEMENT BEFORE COMMITTEE ON WAYS AND MEANS, WHEN CONSIDERING THE 1934 REVENUE BILL, BY DR. ROSWELL MAGILL, SPEAKING IN BEHALF OF ACTING SECRETARY OF THE TREASURY HENRY MORGENTHAU, JR.

For many years business enterprises have found it desirable for business reasons other than tax considerations to incorporate separately different branches of their enterprises. Thus, if a corporation does business in several States, it may be necessary under State law, as well as convenient, to form separate local corporations to handle the local business. Another illustration of the same general situation appears among the railroads, where numerous lines, legally owned by distinct corporations, have been combined to form a single system. Thus, a traveler over a railroad from New York to Chicago may pass over rights-of-way legally owned by a number of different railroad corporations.

Separate corporations forming part of a single enterprise, of course, have innumerable business relations with each other. Contracts are made, property is transferred, loans are negotiated, and services are performed by and between individual members of the affiliated group. Within broad limits, these arrangements can be made on whatever terms are chosen by the officers and directors of the parent corporation. By means of them, income as well as property can be shifted from one corporation to another as business or tax considerations may be deemed to require. If the arrangement is a palpable evasion of the tax law, it can and should be disregarded, but many contracts, which do shift income from one subsidiary to another or to the parent, are perfectly reasonable in themselves and cannot be proved to be evasions.

Businessmen and their professional advisers, the lawyers and accountants, have long recognized that the one way to secure a correct statement of income from affiliated corporations is to require a consolidated return, including therein the income and deductions of the parent and every subsidiary, with all intercompany transactions eliminated. Such a consolidated statement is simply a recognition of the actual fact that the separate corporations, though technically distinct legal entities, are, for all practical business purposes, branches or departments of one enterprise. This fact has been so thoroughly established for many years that many affiliated corporations today would find it a practical impossibility to determine the income and deductions of any one member of the group. For example, the telephone and telegraph systems are composed of many separate corporations operating in the several States. To determine the income of each individual corporation in the case of each interstate message would require a tremendous number of computations, both by the taxpayers and by the Treasury.

The principal reason given in the subcommittee's report for the abolition of consolidated returns is that this would prevent the loss of one subsidiary from being absorbed by the income of another or of the parent. For reasons already stated, this result is not likely to follow as a practical matter. Subsidiary corporations now showing losses in separate statements, could arrange, by intercompany contracts and by a readjustment of accounting methods, to obtain a fair share of the profits of the affiliated group. There is no way to prevent the bulk of such contracts because the Treasury cannot hold that a contract which enables a company to make a profit is necessarily unfair or evasive. Moreover, a full recognition of intercompany transactions would often result in deductible losses as well as taxable gains. The fact that consolidated returns have been regarded as absolutely essential to check these practices in the past is sufficient basis for the belief that these evils will recur in the future.

For these reasons the Department believes that the abolition of consolidated returns might well be a backward step, which would result in little, if any, additional revenue. On the other hand, there are considerable savings to the Treasury, as well as to taxpayers, in the present arrangement. The administration of the law is simpler since it conforms to established business practice. The Treasury need deal with only one corporation, the parent. On the taxpayer's side, the requirement of separate returns would cause largely increased expense to set up separate sets of books for tax purposes, an undesirable result in itself. The present law permits a return in accord with business practice, and gives the Treasury broad powers to make the necessary rules and regulations to prevent escape from the tax. In the judgment of the Department, the law should not be changed in this particular.

(Revenue Revision, 1934, Hearings Before the Committee on Ways and Means, House of Representatives, 73rd Cong., 2d Sess., p. 84.)

The CHAIRMAN. Mr. Battle? Mr. Battle, I understand, is to file a brief.

(The brief referred to is as follows:)

STATEMENT OF JOHN D. BATTLE, EXECUTIVE SECRETARY, NATIONAL COAL ASSOCIATION, BEFORE THE SENATE FINANCE COMMITTEE, ON H. R. 10413, EXCESS-PROFITS-TAX BILL

NATIONAL COAL ASSOCIATION,
Washington, D. C., September 5, 1940.

The Second Revenue Act of 1940 in the form passed by the House and now before your committee, embodies an excess-profits tax that imposes upon corporate taxpayers, inequitable and in some situations absolutely unreasonable burdens. It is with the hope that the Finance Committee of the Senate may be disposed to rewrite this tax levy along more just lines that we are making this representation, in behalf of the producers of bituminous coal, whose capital investment is in the billion-dollar category, who employ directly half a million miners, and who supply the Nation with more than 50 percent of its fuel requirements for light, heat, and power.

It is pertinent to recall the fact that net income of all business corporations (if it amounts to $25,000 or more) bears a normal Federal income tax at the rate of 19 percent, plus the 10-percent surcharge—the so-called national-defense tax which Congress imposed a few months ago.

This means that before we come to the questions of further taxation of the income or profits of business and industry, the Federal Government is already taking more than one dollar out of every five. There is also the Federal capital-stock tax applicable to all corporations—then Social Security pay-roll taxes, in addition to the real and personal property taxes and other levies imposed by the States. Then there are the special excise and sales taxes, Federal and State, applicable to the output of particular industries.

In the case of the bituminous coal industry—in addition to all the other taxes is the 1-cent-per-ton excise tax imposed by the Bituminous Coal Act of 1937.

Mention is made of these taxes, with which this committee is well acquainted, simply because so much of the discussion of the pending bill in Congress and in the press seems to disregard or make light of the existing taxes imposed upon business and industry.

It may well be that in existing circumstances it is needful to increase the tax load upon all business enterprises in order to obtain additional revenues to meet the huge expenditures which the Government is now undertaking for the sake of national defense.

Insofar as our industry is concerned, we wish to disassociate the complaints and the objections which we raise against the pending bill, with the question of necessity for higher tax as to obtain increased revenues. We are not challenging that proposition. Our objection lies to the inequities and the complexities in the present bill and its deceptive character.

There can be no escape from the conclusion that in the guise of limiting war-contract profits and recapturing any excessive profits in this category, a bill has been framed that imposes a supertax at rates graduated up to 50 percent on all net income and all profits, however the same may originate—above the relatively low and inflexible permissive rates of return specified in the bill.

The bill in the form now before this committee attempts to put all profitable business of any considerable size in a strait jacket and rigidly restrict the permitted rate of return on capital investment, regardless of hardships or inequities. The option which the bill purports to offer to the taxpayer to make his base (in the computation of his excess profits) either average net earnings of prior years of invested capital, is in fact illusory. The penalties which are attached to the taxpayer electing the average-earnings base are so heavy that in most cases it will debar him from resorting to this option, and force him to adhere to the invested-capital plan, even though the latter method be grossly unfair in his case.

We respectfully urge that this committee put back into the bill the original plan of alternate bases of computation—either past average earnings or invested capital—without penalty or discrimination as between the two plans.

We respectfully renew the urgent request which we submitted to the House Ways and Means Committee that there be restored to the corporation income tax section of the Revenue Act the former provision, which permitted corporations affiliated in common ownership to make their tax return on a consolidated basis. We have always believed the consolidated tax return privilege was inherently fair and its denial inherently unfair—a mere device for extracting more tax revenues regardless of the equities of the situation. This provision should be made to apply to normal as well as excess-profits taxes.

With the impending imposition of a heavy super tax on corporate earnings that are classified as excess profits, there would seem to be even greater reason and need for restoring the consolidated return privilege whereby losses in one division of an enterprise could be offset against the profits in another division before the application of a tax, which in good conscience ought to apply only to the net income and profits (fi any) of the enterprise as an entirety.

All that we have said above is of general application and, as we view the matter, is of concern to all business and industry, all corporate taxpayers.

The producers of bituminous coal are in a peculiarly difficult position with respect to the tax proposed to be imposed by this bill, and as to them, if they succeed in shifting past losses to future profits, this so-called excess profits tax will be peculiarly unfair.

The industry taken as a whole has been operating at a loss over since 1925. That assertion is well authenticated by official figures. Losses in 1936 were found to aggregate upwards of $50,000,000. The losses were greater in 1937 and in 1938. The year 1939 was also unprofitable for the industry as a whole.

The plight of the industry was such that in 1937 Congress passed the Bituminous Coal Act for the declared purpose of establishing minimum prices and thereby bringing the industry's realization up to cost. Such price schedules have not yet been made effective and no benefits whatever have so far developed.

from this law. Net earnings, if any, that result from this regulatory effort will flow from the 1937 Coal Act, and not from any emergency conditions.

It is self-evident that, with respect to coal producers as a whole, with deficits every year, in the base period set up in the pending bill the average earnings option (even if its election were devoid of penalty) is of no avail.

It is not so evident, but it is equally true, that with respect to coal producers whose capital investment has been wholly or in large part wiped out by long continued deficit operations, the application to them of the invested capital yardstick as the measure of permissive profits is unfair and inequitable.

The real fact is that in the coal-mining industry there are big ups and downs among individual companies from year to year in the profits account. The profitable years must make good the losses of the profitless years.

If, by good fortune, the producers of bituminous coal now succeed in moving into an area of profitable operations, the application to them of the graduated supertax ranging up to 50 percent provided for in this bill will absorb an utterly unreasonable and disproportionate share.

Almost all the earnings in the case of the coal companies will be caught in the dragnet of this bill if enacted in this present form, and will be treated as excess profits. It is a situation that we believe calls for remedy by this committee, with some provision that in the case of corporations with operating deficits in previous years, and impairment of capital, no earnings and profits in 1940 and future years should be subject to supertax as excess profits until future earnings had equaled previous deficits, and until capital impairment had been made good out of earnings.

To be more specific—

An excess-profits tax should not be applicable to normal profits. It should apply only to excess or improper profits.

On an average-earning basis it should apply to 3 of the last 4 years without attaching special penalties.

In consideration of the hazardous undertaking of the coal mining industry it is respectfully submitted that it is entitled to a minimum of 10 percent on the invested capital before computing excess profits. This is especially true in view of the losses suffered by the coal companies for the last 15 years and the resulting impairment of capital.

There should be provided some special relief through administrative machinery to take care of those industries and/or corporations which have had no earnings or very small earnings during the past few years, together with low invested capital; also those companies or corporations which had some increase in profits not arising from the defense program. Few businesses are profitable all the time—there should be a carry-over provision from loss years to profitable years and an average arrived at; in other words, adjust excess profits if deficiency income prevails in subsequent years.

There should be no excess-profits tax until a corporation has earned at least its dividends on outstanding preferred stock.

The taxpayer should be permitted to include the entire amount of borrowed capital, with the exclusion of interest thereon, in computing net income, or exclude borrowed money from invested capital and deduct for interest, at the taxpayer's option.

The CHAIRMAN. Is Mr. Blake here?

(No response.)

The CHAIRMAN. Mr. Donald A. Callahan; is Mr. Callahan in the audience?

Mr. CALLAHAN. Yes, sir.

The CHAIRMAN. All right, Mr. Callahan. This is Mr. Donald A. Callahan, Wallace, Idaho, of the Idaho Mining Association.

STATEMENT OF DONALD A. CALLAHAN, IDAHO MINING ASSOCIATION, WALLACE, IDAHO

Mr. CALLAHAN. My name is Donald A. Callahan. I live at Wallace, Idaho. I am here representing the Idaho Mining Association. I shall take but 10 minutes of your time.

I am not going to repeat what so many have said as to the complicated and unintelligible character of this bill. As an expert's dream of confusion to taxpayers it is positively tops.

We people who produce precious, base, and strategic minerals are not engaged in a profiteering enterprise. In this year 1940 we shall have no excess profits, if, by that term, we mean an unreasonable return brought about by high prices due to the defense program. We want you gentlemen to know that when you propose to tax the profits of corporations at a rate designed to prevent undue enrichment, you cannot get large revenues out of the mining industry unless you adopt a formula which stigmatizes normal profits as excessive.

That is precisely what this bill proposes to do. It gives us the choice of accepting as normal the income of 4 years of low metal prices and high costs of production, or of adopting a second method of normal profits based on invested capital. The bill would penalize us if we accept the first method. It would limit our profits, if we choose the second method, to a figure which by no stretch of the imagination can be deemed a reasonable return on a mining venture. And if we choose the second method, we shall involve ourselves in the most intricate and costly system of accounting that the mind of man ever conceived.

We are plain people, we metal miners, and we use plain language. Therefore, we designate the methods attempted in this bill by means of differentials and daily computations of capital and borrowings as the work of swivel-chair experts who are intoxicated by their own ability to juggle words to meet every conceivable situation. We would like to take them out into the practical field of conducting business and show them the real facts of industrial life. They seem to think we miners are blessed with accounting staffs equipped to meet any requirement of law which can be put down on paper. Our principal business at one time was taking ore from nature's hidden places, making it of value to human society and spending a large part of the proceeds to develop new sources of metals, either by opening up new veins, developing old ones, or through metallurgical research making theretofore worthless minerals valuable.

Now, however, our most skilled operators are not our engineers and our metallurgists. They are our accountants and tax attorneys who spend their time, not in solving the secrets of nature, but in seeking to protect legitimate earnings from practical confiscation at the hands of Government. They must devote their trained talents to unraveling the mysteries of revenue laws. We prefer to do our mining in Idaho and not in the Bureau of Internal Revenue in Washington.

Mining is a risky business. Money is invested in mining enterprises only when it is possessed by one who takes a gamble for better stakes. It is an up-and-down business, as was described in the canning business so ably a few minutes ago. Years are spent in seeking for and developing mines to a point of commercial production.

The profits of later years must compensate for this if it is to be compensated for at all. No return from a mining venture can truly be called a profit until all the losses of earlier years, as well as the original investment, have been realized.

Mining is a necessary business. Especially is this true in times like these when the products of mines are essential in providing the tools and the machines needed in a defense program. Whether you build tanks or airplanes, or equip men with guns and artillery or other munitions of war, the mines must be kept operating to provide the metals which are used. A defense program looks ahead. New mines must be developed, old mines must be further explored, strategic metals must be found here in our own borders if we are to count ourselves absolutely secure.

All of this requires investment of new money constantly and the plowing back of mine earnings into new development, new equipment, the acquisition of new properties. Do you believe it will be possible to carry on such a program of production and development if the Government adopts a policy which will amount to a practical confiscation of the normal earnings of the enterprise? To talk about 5 percent or even 10 percent as a return on mining is to show a deep ignorance of the nature of the most hazardous business in the United States.

I don't like to come here, and I don't come here, to protest against legislation designed to prevent profiteering and strengthen the defenses of our beloved country. I would be willing to have the Government take all the excess profits due to an increase of metal prices beyond the average of the past 20 years since the World War for that purpose. The mining industry does not welcome a runaway market or fantastic metal prices due to hysteria. It does not wish a repetition of the terrible deflation which occurred after the last war. But it does wish to carry on in an orderly manner, keeping its plants in shape, extending its development, adding to the value of its ores through metallurgical research. It stands ready to do its part in arming this country against foreign attack.

I have these suggestions to make, and they are only a few. Other suggestions were made by Mr. Fernald, representing the American Mining Congress, and I adopt those, because Mr. Fernald has very carefully considered this act as it would apply to the mining industry, but I would like to make these suggestions particularly:

1. That the base period income should be for 3 out of the last 4 years to be selected by the taxpayer. We should not be penalized by being forced to include a year of deficit even at zero, because the last 4 years have been years of small return in the mining industry, and some of them have been years actually of deficit.

2. There should be provided a deficiency carry-over or the excess tax should be levied on the average income of several years. That is because, as I said, this mining business is an up-and-down business, and we have no assurance that the years of taxable income shall be any different than those that have passed.

3. No penalty should attach to the use of the income method. After all, it is a subterfuge inserted in the bill to compel taxpayers to adopt the complicated invested-capital method with its differentials and limitations of profit to a point which will kill new mining enterprises.

4. Broad provisions should be made for special relief through an independent board. Unless this is done our small enterprises, many of them engaged in the production of strategic materials, will be forced to suspend.

In this respect I am going to close with this one example, and that is an example of a concern in the district where I live. Two mining companies own a zinc mine jointly. A number of years ago, to make the product of that mine available for commerce, they entered into a long period of experimentation and of research, and spent a tremendous amount of money to develop an electrolytic process which would make those ores particularly valuable. They built that plant at a tremendous cost, and I am going to give you some of the figures on that business.

They have carried that business on for a period of 10 years during the lowest average prices for zinc, perhaps, in the history of a great many years. Their base period earnings for the 4 years have amounted to an average of $102,660 a year. They have, in money paid in for stock and in paid-in surplus, $5,902,554 of investment. They have subtracted from that $97,773 of inadmissible assets. They have borrowed money, money which has been borrowed from these two parent companies and not evidenced by notes as required in this bill—$3,051,000. Their estimated normal tax net income for 1940 will amount to over a million dollars for the first time.

Why? Not because of excess prices, but simply because, for the first time in their history, they have been able to operate all the units of that particular plant to produce exclusively the purest zinc metal that is produced in the United States—99.99¾ percent pure. That is the metal that is used particularly in making die castings which are so necessary in the manufacture of the machine tools that have been required.

Now that is one thing that this Government has needed, and it is practically the only plant in the United States that is able to furnish that. And if that were not available perhaps the Government would have to have it recognized as a new facility and, under the amortization features that have been proposed here, amortize the cost over a period of 5 years.

Senator DAVIS. Where is that plant located?

Mr. CALLAHAN. Kellogg, Idaho. It is the Sullivan Mining Co.

That work has been done, the owners took the risk, they put in their money, they went over a period when they were making no profits whatever. They have an actual deficit on December 31 from operating of $1,022,517.35, and they are going to have—due not to increased price, but due to the fact that they are working all their units—they are going to have a profit; under this bill anything over and above that average of $102,000 a year will have to go into the excess-profits bracket. Or, if they use their invested capital, they will have to involve themselves in these tremendous complications of figuring invested capital, of figuring borrowed invested capital, and receive only a partial credit for the borrowed invested capital because of the amount.

That is one of the examples that I think should have special treatment, and that is one reason why I particularly urge that there be created some tribunal that can take into account the special cases that arise, particularly in the mining industry, because they are legion, some tribunal that will be able to do justice and equity and keep this very necessary business going at full blast for the purposes of this Government.

The CHAIRMAN. Were you here at the joint meeting of the Finance Committee and the Ways and Means Committee?

Mr. CALLAHAN. Yes; I was.

The CHAIRMAN. You came to the city, did you not?

Mr. CALLAHAN. Yes; and just got there the day that the hearing started.

The CHAIRMAN. Several Senators, I know, spoke to me—you must stand very well with them—because you had plenty of influence working in your behalf to come before the committee. We had made arrangements and you didn't appear. Word came to us that you hadn't given enough study to the bill yet, because you had just been able to procure a copy.

Mr. CALLAHAN. Yes; and if I had been able to, there wasn't any bill, and what has been proposed here is certainly vastly different than the report of the subcommittee.

The CHAIRMAN. That was the Ways and Means Committee, not the Finance Committee.

Mr. CALLAHAN. Yes; I understand that. [Laughter.]

The CHAIRMAN. Thank you very much.

Mr. JUST. Mr. Evan Just, of Miami, Okla. Mr. Just represents the Tri-State Zinc Lead Ore Producers Association.

STATEMENT OF EVAN JUST, MIAMI, OKLA., TRI-STATE ZINC LEAD ORE PRODUCERS ASSOCIATION

Mr. JUST. Mr. Chairman and gentlemen: I represent the mine operators of the Tri-State mining district of Oklahoma, Kansas, and Missouri, which currently produces 40 percent of the zinc and 10 percent of the lead mined in the United States.

After we had studied this bill I was moved to prepare an extensive discourse on the impracticability of this labyrinthian document. However, reconsideration convinces me that in this respect the bill speaks for itself, and I have shortened my remarks accordingly.

Our own industry is composed of a great number of small operators and a few large ones. Congress will hamper the attainment of objectives vital to our defense program by confusing the issue of excess profits with questions of corporate size. It is a plain, unsentimental fact that our local industry, and the whole mineral industry as well, cannot meet the demands of a national emergency except under equitable treatment of both its large and smaller units. Furthermore, half of our "little fellows" would be unable to mine except for the pumping maintained essentially by the larger operators. The surest result of the penalties on size which so complicate this bill will be impairment of our productive capacity. Today, in spite of advancing prices, we are scarcely meeting the needs of a lively market. This circumstance is due primarily to a dearth of high-grade ore deposits which can be mined at present prices, but also, and in no small measure to growing tax burdens and the distressing effects of the tariff treatment concerning which we complained fruitlessly to this committee last spring. We do not assume that the majority of Congress, by imposing an excess-profits tax, really intended to hamstring industries essential to the national defense.

Senator LODGE. Could you be a little more specific in the harm that the tariff situation has done to your industry.

Mr. JUST. Yes, Senator Lodge. We are in a very odd situation. The international blockade has temporarily suspended the foreign competition which was ruining us, with the assistance of a tariff reduction in the Canadian agreement.

Now that has been suspended since the war, but every one of us realizes that a resumption of international competition will simply bring ruin upon our Tri-State mining industry, and that particularly applies to anybody who wants to undertake the development of marginal ore deposits that are less profitable than those now operating.

Therefore we have, as it were, a Damoclean sword hanging over the operator who would go into business and increase production.

Senator LODGE. From what country does the competition come, chiefly?

Mr. JUST. Ordinarily, you mean?

Senator LODGE. Yes.

Mr. JUST. From Mexico, Canada, Poland, Yugoslavia, Australia, and Belgium.

Senator LODGE. Thank you.

Senator DAVIS. They are still shipping from Mexico, are they not?

Mr. JUST. Concentrates, principally, are coming from Mexico.

Senator DAVIS. This conflict abroad, has it helped to increase your business because of the fact that they are unable to ship zinc here?

Mr. JUST. The conflict abroad has affected us, briefly, in two ways: It has, first of all, cut off the competition of foreign metals, and diverted the flow away from this country. It comes in now as ore, rather than metal. And the dislocation of foreign commerce in zinc has created a certain acceleration of demand from this country, because many of these consumer countries can't get it anywhere else. So it has improved the price of zinc, and the demands made upon us, to an extent that the increased imports, as a result of the war, have not hurt the domestic industry as far as price is concerned, because there has been a collateral demand which has taken the surplus.

Senator DAVIS. How many more men have you employed now in the zinc industry in your section than you had prior to the war?

Mr. JUST. About a thousand.

Senator DAVIS. A thousand more?

Mr. JUST. Yes.

Senator DAVIS. What percentage would that be?

Mr. JUST. It is a jump, roughly, from 5 to 6.

Senator KING. The principal injury to the zinc industry grew out of the importations from Canada pursuant to the agreement which was made under the trade agreement with Canada, did it not?

Mr. JUST. No; Senator, it grew out of the importations from countries other than Canada.

Senator KING. I know there was a good deal of complaint about the arrangement made with Canada respecting zinc.

Mr. JUST. Yes.

Senator KING. And many of the mining interests complained to me that the agreement with Canada would prove injurious. Of course, as it applied to Canada, it applied to other countries.

Mr. JUST. Yes, sir. However, the actual injury was principally from countries other than Canada. That was one of the principal points which we tried to argue, unsuccessfully, with the State Department, that it was a violation of their own published policy to include our commodity in a treaty with a country that was not the principal source of import, either before or since.

The CHAIRMAN. Didn't you complain when we had the trade-agreement program up here; you appeared before this committee; did you not?

Mr. JUST. Yes, sir.

The CHAIRMAN. Didn't you raise some question about the Canadian agreement?

Mr. JUST. Oh, very much so.

The CHAIRMAN. And didn't the State Department say they would ask the Tariff Commission to send an investigator and make efforts to remedy that situation?

Mr. JUST. We have had about the same kind of treatment that we had prior to the proceedings before this committee.

The CHAIRMAN. This committee treated you very courteously; didn't they?

Mr. JUST. They certainly did. I am referring to the attitude of the State Department. They keep on telling us that we will be given consideration when we are injured, without doing anything to relieve the anxiety that we face, for example, at the present time. They continue to tell us, "Well, you are not injured; therefore, your case is not in point."

The CHAIRMAN. But the prices have gone up, have they not?

Mr. JUST. Yes, sir; they have.

The CHAIRMAN. So the injury now is not more apparent than it was when you appeared before us on the Trade Agreements?

Mr. JUST. No, sir.

Senator HERRING. You haven't been injured yet, have you?

Mr. JUST. Not specifically, Senator. The damaging effect is the deterrent to development, essentially that.

In the mining industry it is traditional to suffer losses and inadequate profits while waiting for the occasional good year to pull us through. In our district a number of mines can operate only in good years. In the last decade, we have had 5 loss or unprofitable years and 5 fair years, but no good years. With such a background, we cannot achieve a reasonable base, above which to measure excess profits, by either of the alternatives offered in the proposed bill.

Senator CAPPER. How long since you have had good years?

Mr. JUST. 1929.

The CHAIRMAN. Are you looking for some better years so you won't have to pay a big tax on this excess profits?

Mr. JUST. I wouldn't feel competent to say, Senator, what lies ahead.

The CHAIRMAN. But you are a little afraid of something about this proposition that might cost more than you have had to pay in the past in taxes? You didn't pay during this base period, those 4 years, much taxes, because the price was so low and you weren't doing much?

Mr. JUST. That is right.

The CHAIRMAN. Now you are afraid that the situation might arise where the prices are going to get up, and you might have to pay a larger share of taxes than you think you should?

Mr. JUST. No; simply that the taxes will be made upon a basis which is less than a normal base. We don't believe that any citizen of this country today, ourselves included, should be excepted from bearing his share of this enormous burden we all face in the defense program.

The CHAIRMAN. We are delighted to hear you make that statement, and agree with you thoroughly.

Mr. JUST. Therefore, in furtherance of simplicity and justice, we offer the following recommendations to this committee:

1. Remove the discriminations against firms that have had a bad base period experience or who will suffer in the future, by completely removing all deficit years from base period calculations and by permitting deficiency carry-overs in future years.
2. Alter the percentage-of-invested-capital option to a flat rate on the total capital invested without reference to a base period. This will eliminate an enormous load of computations without introducing unfair discriminations.
3. Raise the permissible "normal" return on capital to a flat 10 percent. This rate is certainly not excessive for our industry.
4. Create an independent board of appeals with broad powers to adjust the multitude of injustices that will develop out of this law.
5. Permit consolidated returns. The justice of such a provision is obvious, and will certainly make possible simplifications in the present bill.
6. Remove the penalties on the base period income option. This alternative appears to be equitable without penalties.

Most of our operators realize that our nation is undertaking a defense program whose cost cannot be met except by real sacrifices from all of us. We further realize that the immense expenditures required for national defense may tax our system of private enterprise out of existence. Facing this forbidding future with the determination to do the best we can, we ask Congress to bear in mind that a good driver does not break the back of the horse he expects to pull his load.

The CHAIRMAN. All right; thank you very much.

The CHAIRMAN. Is Mr. Royal Little here?

Mr. LITTLE. Yes, sir.

The CHAIRMAN. Mr. Little is from Providence, R. I., and represents the Atlantic Rayon Corporation.

STATEMENT OF ROYAL LITTLE, ATLANTIC RAYON CORPORATION, PROVIDENCE, R. I.

Mr. LITTLE. Mr. Chairman and members of the Senate Finance Committee, the proposed excess-profits tax presents a most serious problem to rapidly growing smaller companies, particularly those which borrowed money prior to the present defense emergency to expand their facilities. In most cases concerns of this sort are restricted through the limitations of the capital market to expansion through long-term indebtedness.

For several years it has been practically impossible to raise capital through the sale of stock for medium-sized and small industrial enterprises. With the disinclination on the part of private investors to finance ventures of this sort, companies like ours have been forced to borrow capital from banks, insurance companies, the R. F. C., and machinery manufacurers, to finance expansion.

Loans of this sort call for repayment either monthly or quarterly over the relatively short period of from 3 to 5 years. In many cases the amortization rate is set at approximately the full earnings expectancy of the concern.

These contracts were all entered into in good faith prior to the present emergency and must be carried out to prevent foreclosure by their respective creditors. Under the proposed law, however, Congress is saying in effect to such concerns:

> You cannot use your future earnings to pay off the contractual obligations which you undertook prior to this emergency; you must use these earnings to pay increased normal and excess profit taxes to the Federal Government, even though so doing may jeopardize the very existence of your enterprise.

We feel certain that Congress does not intend the proposed law to create any such hardships. Furthermore, we feel certain that Congress still bases its income tax legislation primarily upon the ability of the taxpayer to pay.

Let us recall that even in the ill-fated undistributed net earnings tax law which created many hardships for small rapidly growing concerns, this principle of ability to pay and previously contracted obligations, was recognized in the exemption granted to companies whose indebtedness indentures restricted payment of dividends. In the present case the excess profits tax rates are from 20 to 50 percent as compared with former undistributed net earnings rates of from 7 to 27 percent.

We predict that the present law, unless modified, will create for the small, rapidly growing industries of the country, particularly for those not in any way connected with the defense program, problems and industries twice as great as those brought about by the undistributed net earnings tax.

We strongly urge, therefore, that the following change be made in the bill:

On page 5, section 710 (b) "Definition of adjusted excess profits net income add the following:

> (3) Repayment of indebtedness credit. The amount of debt repayment required and made during the tax year in connection with indebtedness, other than current obligations, contracted by the taxpayer prior to July 1, 1940.

In order to show by example how unfair the proposed law is, let's look at the hypothetical case of Corporations A and B. These two companies are in the same line of business, have the same productive equipment in their plants, do the same volume of business, and will show the same net earnings before excess-profits taxes in 1940 and future years, but have entirely different capital structures.

	Corporation "A"	Corporation "B"
Cash	$500,000	$92,000
Investment portfolio	500,000	
Accounts receivable	1,066,000	1,066,000
Inventory	607,000	607,000
Plant	1,250,000	1,250,000
Total assets	3,923,000	3,015,000
Notes payable		300,000
Accounts payable	100,000	655,000
Mortgage payable		340,000
Total liabilities	100,000	1,295,000
Capital stock and surplus	3,823,000	1,720,000
Total	3,923,000	3,015,000
Excess profits net income	200,000	200,000

	Corporation "A"	Corporation "B"
Less:		
Specific exemption	$5,000	$5,000
Excess profits credit $500,000 at 7 percent	35,000	35,000
Corporation A—$3,323,000 at 5 percent	166,150	
Corporation B—$1,333,000 at 5 percent		66,650
	206,150	106,650
Adjusted excess profits net income		93,350
Estimated excess profits tax:		
$20,000 at 20 percent		4,000
$30,000 at 25 percent		7,500
$43,350 at 30 percent		13,005
Total tax		24,505

If Congress is drafting tax laws upon ability to pay, why should Corporation B, with heavy indebtedness and small cash reserves, be required to pay $24,505 in excess-profits taxes, while Corporation A, with $1,000,000 in cash and securities, is liable for no excess-profits tax in spite of the fact that the companies have identical plants, identical sales, and identical profits, and are in direct competition with each other.

Senator LODGE. Have you asked the Treasury that question?

Mr. LITTLE. I haven't had a chance to yet, sir.

The only other difference between the two cases is that Corporation A started in business first, prospered and built up out of earnings substantial reserves; whereas Corporation B is still suffering from growing pains.

Senator GERRY. In other words, you got under the wire a little late?

Mr. LITTLE. Correct, sir.

Gentlemen, is it wise and fair for Congress, through taxation, to penalize vigorous young expanding business in relation to its well-established competition?

We have more than an academic interest in the hypothetical case referred to. Corporation B happens to be our own company.

In order to be more specific as to the effect of this bill on our company, we are filing a marked copy of our latest statement with these comments, and I would like your permission to hand copies to the Senators so that they may follow them.

The CHAIRMAN. I was going to suggest that you get together with Mr. Blough back there and talk it out with him for a few minutes, and we can get his reaction, if there is an answer to it, when we meet tomorrow.

Mr. LITTLE. Fine.

Item A. Accounts receivable, $1,066,611.06.

Of this amount about $600,000 is owed us by a few small rayon-weaving mills, all of whom have expanded rapidly during the last few years and still owe machinery manufacturers substantial sums for current and future earnings, and this varies from $2,000 to $5,000 monthly in different plants. The proposed bill would not only jeopardize the ability of these companies to meet maturities on machinery notes, but would tend to freeze their accounts payable to us; thereby seriously impairing the credit of our company.

Through the granting of extremely liberal credits to these rapidly growing concerns, we have not only enabled them to expand in the last 10 years from 10 to 20 looms apiece to 200 to 400 loom units, but we have also been responsible for the steady employment of more than 2,500 workers in our own plants and those of a few customers. Why should we and they be penalized so unjustly by this new tax because we have had the vision and courage to use our capital to build up local industries in the face of the country's worst depression?

Item B. Fixed assets (Lowell plant), $465,220.13.

In June 1939 we acquired this plant and have since been equipping and starting it up as a new rayon yarn-throwing plant. This expansion was financed by a 5-year mortgage note which must be amortized out of future earnings. The expenses of starting this mill have been a drain on our working capital and will continue to be so well into 1941. Thereafter, our earnings in excess of mortgage amortization will be required to build up adequate working capital to handle the increasing sales volume from this new plant. Why should the success of this new venture, the equity of our shareholders, and the jobs of our workers, be jeopardized by the inequities of this bill? Why should initiative and the productive use of capital be so heavily penalized?

Item C. Notes payable to banks, $300,000.

Since this statement, notes payable have been increased to $[illegible]00,000. It is important that short-term debt of this sort be paid up completely once a year to preserve first-class credit rating and to obtain low interest rates.

Item D. Mortgage note, $340,000.

Due $8,000 monthly, plus 50 percent of all earnings in excess of $120,000 annually. These payments must be made, otherwise the entire unpaid balance becomes immediately payable in the event of such default. To be required also to pay heavy excess-profits taxes in the next few critical years might cause the collapse of our entire situation.

In closing we wish to state that we have been led to believe that the primary purpose of this bill is to prevent a new crop of war millionaires. With this purpose we are in hearty accord, but we must urge you not to pass a tax law which will instead leave in its wake a trail of war bankruptcies.

Senator KING. Would you prefer a plan, under the terms of which the tax on normal income should be increased, and avoid the plan that is provided here for the excess profits?

Mr. LITTLE. Yes, sir.

The CHAIRMAN. If you desire to ask some questions of Mr. Stam or the Treasury, all right.

Mr. LITTLE. I shall appreciate very much an opportunity to talk with Mr. Stam.

I would like to file the report to the stockholders of the Atlantic Rayon Corporation, which I previously mentioned.

The CHAIRMAN. That may be filed.

(The document referred to is as follows:)

ATLANTIC RAYON CORPORATION,
Providence, R. I.

REPORT TO STOCKHOLDERS FOR THE QUARTER ENDED JUNE 30, 1940

To the Stockholders:

For the 3 months ended June 30, 1940 the company's operations resulted in a net loss of $47,373.02, after all charges including depreciation, and after adjustment of reserves previously set up for Federal income taxes. This compares with a net profit of $13,316.53 during the corresponding 1939 quarter.

Net sales and commissions for the quarter were $1,540,304.44 as compared with $2,046,629.77 during the first quarter this year. Net loss, after all charges, for the first 6 months of the year amounted to $5,977.39.

The primary cause contributing to the disappointing operating result was the unusually low level of processing prices during the period, as well as a sharp decrease in the volume of business available. In addition the management felt it wise to absorb into expense a substantial part of the cost of the current program of machinery improvement. This program should be completed before the end of the year.

ROYAL LITTLE, *President*.

AUGUST 26, 1940.

Balance sheet, Atlantic Rayon Corporation, June 30, 1940

ASSETS—continued

ASSETS

Current assets:			
Demand deposits and cash on hand			$66, 461. 74
[A] *Accounts receivable, trade*		$1, 144, 747. 63	
Less:			
Reserve for bad debts	$70, 405. 50		
Reserve for sales discounts	7, 731. 07		
		78, 136. 57	
			1, 066, 611. 06
Inventories, at lower of cost or market:			
Yarn in stock		$356, 542. 67	
Work in process		184, 703. 96	
Drugs and dyes		34, 029. 03	
Supplies		32, 214. 97	
			607, 490. 63
Cash surrender value of life insurance, pledged (see contra)			26, 433. 00
Total current assets			1, 766, 996. 43
Investment			5, 000. 00
Fixed assets:			

	Cost value	Reserve for depreciation	Net book value
Fixed assets:			
Land	$43, 060. 68		$43, 060. 68
Buildings	383, 643. 11	$76, 589. 13	307, 053. 98
Machinery	883, 518. 62	236, 494. 15	647, 024. 47
Factory equipment	196, 432. 04	62, 476. 20	133, 955. 84
Spools	124, 578. 69	24, 477. 58	100, 101. 11
Office equipment	25, 335. 48	13, 243. 23	12, 092. 25
Automobiles	8, 331. 55	2, 765. 04	5, 566. 51
[B] *Fixed assets, included above, with net book value of $465,220.13 located at Lowell, Massachusetts, are pledged to secure mortgage note (see contra).*			
Total fixed assets	1, 664, 900. 17	416, 045. 33	

Total fixed assets: 1, 248, 854. 84

	Cost	Amortization		
Other assets:				
Patents and licenses	$22, 282. 08	$1, 125. 56	$21, 156. 52	
Prepaid interest and insurance			6, 756. 56	
Deferred items			31, 463. 53	
Total other assets				59, 376. 61
Total assets				3, 080, 227. 88

LIABILITIES, CAPITAL STOCK AND SURPLUS

Current liabilities:				
[C] *Notes payable, banks, unsecured*				*$300,000.00*
Accounts payable, trade				568,466.86
Accounts payable, other				1,500.84
Accrued liabilities:				
Payroll			$8,302.70	
Expenses			46,204.30	
Pay-roll taxes			7,960.76	
Provision for Federal and State taxes			22,734.44	
				85,202.20
Installments on mortgage note, due within 12 months (see below)				96,000.00
Total current liabilities				1,051,169.90
[D] *Mortgage note, due in monthly installments to Dec. 20, 1944 secured by life insurance policies and by mortgage on fixed assets at Lowell, Mass. (see contra)*			*$340,177.34*	
Less: Installments due within 12 months (see above)			96,000.00	
				244,177.34
Capital stock and surplus:				
Capital stock:				
$2.50 cumulative prior preference, par value $49.50, convertible into 5 shares of common through July 31, 1940 and then into 4 shares of common through July 31, 1942, authorized 10,167 shares, issued and outstanding 5,186 shares, including 60 shares held in treasury, at par value			256,707.00	
Common, par value $1, authorized 282,380 shares, issued and outstanding 221,620 shares, at par value			221,620.00	
Earned surplus:				
Earned surplus, Jan. 1, 1940		$505,766.56		
Less: Net loss for the 6 months ended June 30, 1940	$5,977.39			
Dividends declared	28,582.20			
Deduct: Accrued dividends received on sale of prior preference stock	579.45			
	28,002.75			
		33,980.14		
Earned surplus, June 30, 1940		471,786.42		
Less: Cost of treasury stock		1,750.00		
			470,036.42	
Capital surplus			836,517.22	
Total capital stock and surplus				1,784,880.64
Total liabilities, capital stock and surplus				3,080,227.88

COMPARATIVE STATEMENTS OF INCOME

	3 months ended—		12 months ended—	
	June 30, 1940	June 30, 1939	June 30, 1940	June 30, 1939
Net sales and commissions	$1,540,304.44	$1,485,282.20	$7,621,924.72	$7,314,202.90
Cost of yarn sold	1,288,018.35	1,230,871.26	6,268,348.86	6,114,496.72
Manufacturing expense [1]	256,815.60	194,721.71	1,043,183.41	853,030.24
Gross profit	[2] *(4,529.51)*	59,689.23	310,392.45	345,706.94
Selling and administrative expenses [1]	48,101.56	43,756.92	189,484.76	168,801.21
Net profit from operations	[2] *(52,631.07)*	15,932.31	120,907.69	176,905.73
Other income	22,401.31	26,711.13	129,509.82	127,126.60
Other expense	25,853.26	26,701.91	141,405.26	141,124.55
Net profit before provision for Federal income taxes	[2] *(56,083.02)*	15,941.53	109,012.25	162,907.78
Provision for Federal income tax	*(8,800.00)*	2,625.00	20,625.00	7,375.00
Net profit	[2] *(47,283.02)*	13,316.53	88,387.25	155,532.78
[1] Including depreciation	33,075.42	10,082.78	108,030.25	69,168.20

[2] Loss.

The CHAIRMAN. Mr. Chapman? This is Alger B. Chapman of New York City, representing the Controllers Institute.

STATEMENT OF ALGER B. CHAPMAN, NEW YORK, N. Y., REPRESENTING CONTROLLERS INSTITUTE OF AMERICA

Mr. CHAPMAN. Mr. Chairman and members of the committee: I am appearing on behalf of the Controllers Institute of America.

In view of the fact that a number of the institute's recommendations with respect to the House bill have already been urged by prior witnesses, I wish merely to summarize the institute's recommendations for the committee and submit a memorandum in support thereof which has been prepared by the institute's tax committee.

The CHAIRMAN. You may file that, if you will, and just point out the high spots.

Mr. CHAPMAN. This is a very short statement in summary.

The CHAIRMAN. All right.

Mr. CHAPMAN. In the first place, the institute is greatly concerned over the extraordinary complexities of the excess profits tax provisions of the bill. The membership of the institute is made up of those corporate officials who are primarily responsible for corporate compliance with the Federal tax laws; and they have a long background of experience in the Federal tax field. The tax committee of the institute, however, which has made an intense study of the bill since it became available, is forced to confess that it has not yet succeeded in comprehending many of the important provisions.

While it may be that many of the complications are inherent in the subject matter and are therefore unavoidable, the institute is of the opinion that they have resulted in large measure from the sacrific of simplicity and coordination in draftsmanship for the sake of speed. It even appears that a number of proposed modifications to the bill which are recognized as based on sound policy—such as a consolidated return provision, for example—may be rejected solely because of the drafting time involved.

The institute does not believe that a hurried enactment of the excess,profits-tax provisions, involving unnecessary complications and resulting in unnecessary discriminations and inequities, can be justified in the interest of national defense or on any other basis.

In the second place, the institute strongly urges elimination of the additional 4.1-percent tax and the additional 5-percent excess-profits tax imposed upon the use of the income method of computing the excess-profits credit. It is submitted that the actual earnings experience of a corporation during a period preceding inauguration of the national-defense program represents one of the soundest methods of measuring normal profits and it is certainly the simplest. It eliminates the numerous complications involved in the computation of invested capital both during the base period and thereafter. Its use should not be discouraged by the imposition of extra taxes.

In addition to the foregoing, the institute recommends a number of specific modifications in the bill which are aimed at effecting a fair measure of normal profits and the elimination of inequities and discriminations in the application and administration of the excess-profits tax. These modifications, which are discussed more fully in the institute's memorandum, are as follows:

1. The schedule of graduated excess-profits tax rates should be based on the ratio of the excess profits to the normal profits, as proposed by the House committee, rather than upon the amount of the excess profits.

2. The tax should be determined on the basis of the method for computing the excess-profits tax credit which results in the smallest tax, without requiring an advance election by the corporation at a time when it may not be able to ascertain the consequences of its election.

3. A more general special assessment provision should be incorporated in the bill to take care of abnormal cases. Since the special assessment provision is primarily for the purpose of taking care of unanticipated cases, the form of relief should be made flexible and left to the discretion of the Commissioner or an independent tribunal.

4. Instead of adopting the average earnings for all four of the years 1936 to 1939 as a yardstick of normal earnings, the taxpayer should be permitted to use any three of these 4 years, since at least one of these years was a year of subnormal profits in the case of most corporations.

5. The income method of computing the excess-profits tax credit should be made available to any corporation in existience for at least one full year during the base period. The chances are extremely remote that the earnings of a corporation for the first year or two of its existence would be abnormal. The simplicity of the income method justifies the encouragement of its use wherever possible.

6. The invested capital method should be based on a flat rate of return on present invested capital to avoid the complications involved in determining the ratio of earnings to invested capital during the base period.

Senator KING. How do you reach the present invested capital?

Mr. CHAPMAN. That would be reached in substantially the same way that invested capital is reached now under the bill—money paid in for stock, property paid in, and so forth. Then allow a flat rate of return on that invested capital and treat the excess over that rate as excess profits.

Senator KING. Suppose that the corporation had been formed 8 or 10 years ago with $1,000,000 of capital; and by reason of losses, unexpected and unanticipated, the net worth of the capital today would be, only, say, a quarter of a million dollars?

Mr. CHAPMAN. There is, of course, a provision in the House bill now that eliminates deficits except to the extent that they reduce accumulated earnings; but there are going to be cases where the invested capital method simply won't work fairly for corporations and that is why it is essential that the earnings method be maintained to take care of such corporations, and that a special assessment provision, broad enough to grant relief, is included to take care of the abnormal cases. I think the combination of the three is essential in order to prevent extraordinary application of the tax to particular corporations.

The institute also believes that the corporation should be allowed a 10 percent return on invested capital, or perhaps, an 8-percent return if the corporation is permitted to apply deficiencies in earnings against the income of prior or subsequent years in the excess-profits tax period. Such a return cannot be labeled "excessive," it is recognized as reasonable for new capital, and it is in line with the normal rate of return prescribed under the earlier excess-profits laws. If you level off the earnings during the excess profits tax period, perhaps 8 percent would be adequate.

Senator TOWNSEND. You are speaking of net return?

Mr. CHAPMAN. Yes; net return.

7. A corporation should be permitted to determine its invested capital on the basis of the actual value of the property acquired in reorganizations occurring prior to the enactment of the excess-profits tax law.

8. Borrowed capital should be included in invested capital in full. A corporation borrows capital not merely for the privilege of paying interest thereon but to make a reasonable profit thereon in excess of the interest requirements. Its inclusion in full is therefore necessary in order to obtain a proper reflection of normal profits. I haven't been able to find anywhere a proper explanation for the elimination of borrowed capital in the earlier statutes, and I see no justification for the limitation in the present bill.

9. Stocks of corporations should not be included among inadmissible assets if no dividends are received thereon during the taxable year or if the taxpayer elects to treat the dividends as income subject to the excess-profits tax. The only purpose for excluding such assets is that the income realized therefrom is ordinarily excluded from excess-profits net income.

Senator GEORGE. That is done under this bill, isn't it? Dividends earned are not included under this bill to the investing corporation?

Mr. CHAPMAN. I think, Senator George, that the stock is eliminated as an inadmissible asset even though there are no dividends.

Senator GEORGE. I was getting to that. That is, dividends earned are excluded, that is they are eliminated because the stock itself is eliminated. But now you have a great many investments in other corporations where there are not earnings but where there are losses.

Mr. CHAPMAN. That is true, no dividends being received.

Senator GEORGE. And that is what you are talking about?

Mr. CHAPMAN. Yes. Part of the investment is tied up in those stocks not earning dividends, and the corporation ought to be permitted to receive a fair return on its entire investment.

Senator GEORGE. There certainly should be something that would meet that. In part, consolidated returns would meet it, wouldn't they?

Mr. CHAPMAN. They would help. I think the only reason that stocks are omitted is because the dividend income is excluded from income.

Senator GEORGE. Well, that is all right; where the dividend is actually earned but isn't paid into the corporation making the investment, it works out all right.

Mr. CHAPMAN. If the taxpayer is willing to include the dividends in his income, then he should be permitted to include the stocks.

Senator KING. Did the institute give consideration to the proposition of increasing the normal tax and abolishing this concept of excess profits with all of the alleged difficulties in determining what the excess profits are?

Mr. CHAPMAN. No; I do not think the institute considered that exactly. It did consider the desirability of trying to raise revenue by, perhaps, revising the rates on normal income, rather than by imposing these extraordinary taxes on normal income through an excess-profits tax device. But I think that the institute probably would not take the position that an excess-profits tax is undesirable to reach the actual excess profits that may be earned as a result of the defense program.

10. Consolidated returns should be permitted. There are no drafting problems involved if the optional method is employed.

11. Losses occurring for the first year or two after the emergency period should be applied against the earnings during the emergency period in accordance with the policy adopted in the earlier excess-profits-tax laws.

12. Dividends distributed during the first 60 days of the subsequent year should not effect a reduction in the invested capital for the prior year if the earnings of the subsequent year are adequate to cover such distributions.

13. Losses resulting from the retirement or discharge of the corporation's own indebtedness should be excluded in determining in vested capital to the same extent that gains are excluded under the bill. Both are entitled to the classification of nonrecurring items.

14. In view of the extended period which will undoubtedly be involved in the settlement of excess-profits-tax liabilities under the bill, it is urged that provision should be inserted to the effect that any waiver extending the period of limitations for assessment of additional excess-profits taxes shall automatically extend the period within which an effective claim for refund may be filed.

The institute urges the adoption of the foregoing modifications in the House bill with a view to making it a true and workable excess-profits bill which will prevent the realization of excess profits out of the national-defense program, but which will not impair normal business profits by subjecting them to the extraordinary excess-profits-tax rates.

I would like to file this statement on behalf of the Controllers Institute of America.

The CHAIRMAN. That may be filed with the committee.
(The statement referred to is as follows:)

STATEMENT OF CONTROLLERS INSTITUTE OF AMERICA

(Presented to the Committee on Finance of the U. S. Senate at hearings on the second revenue bill of 1940, September 5, 1940)

In its statement to the Ways and Means Committee on August 14, 1940, at the joint hearings on the excess-profits tax proposals, the Controllers Institute of America agreed with the view that the Government's heavy expenditures for defense should be met in part through increased taxation and that corporations, especially those benefiting directly from defense expenditures, should be called upon to bear their just share of this additional burden. The institute also concurred in principle with the announced policy of preventing excessive profits on business arising out of the defense program.

The institute is in accord with the principle that the excess-profits tax shall be imposed on the lesser of (1) the excess of earnings over the average of the earnings for a representative prior period, or (2) earnings in excess of a fair return on invested capital. The first alternative is necessary in many cases to prevent the imposition of the excess-profits tax on normal earnings unrelated to the Government's defense program. In addition, where this alternative can be used, it will be unnecessary to determine invested capital which experience with the excess-profits tax laws of 1917, 1918, and 1921 has conclusively proved is, except in case of the simplest corporate set-up, complicated and uncertain, and results in prolonged controversies between the taxpayer and the Government, and in protracted litigation.

The determination of the excess-profits tax on the basis of invested capital alone without allowing a proper alternative method is also inequitable in the following respects:

(1) The exemption fails to take into account the comparative risks of the business involved. For example, a mine where earnings fluctuate materially from year to year, is not allowed any higher exemption than a public utility whose earnings are fairly steady from year to year. Speculative industries in which the risk is large should be entitled to a higher return than stable industries.

(2) It exempts the overcapitalized corporation thereby penalizing the conservatively financed corporation.

(3) It penalizes efficient management and operation.

(4) It disregards the value of good will, patents, and other intangibles built up in the past by the corporation itself.

The only purpose of the alternative method for determining the excess profits is to ascertain the amount subject to excess-profits tax. Therefore, if the excess-profits tax is to be truly a tax on excess profits and not a tax on normal profits, the schedule of excess-profits tax rates should be the same whether the average earnings basis or the invested capital basis is used to determine the amount of the excess profits. Otherwise, there would be discrimination between two taxpayers having the same amount of excess profits solely by reason of the fact that different methods are used by them for calculation such excess profits.

In prescribing the alternative methods for determining the excess profits and providing the same rates of tax for each, the subcommittee's proposals were sound. However, in the opinion of the institute, improvements in the subcommittee's proposals were essential in other respects. For this reason, at the joint hearings, the institute, among others, made various recommendations which it hoped would be adopted in order to make the excess-profits tax law workable and equitable among taxpayers.

However, in the excess-profits tax provisions of the bill as passed by the House of Representatives very few of these recommendations were adopted and, in addition, undesirable modifications were made in the subcommittee's proposals. In the opinion of the institute, the enactment of the bill in its present form will produce unfortunate and unforseen repercussions.

The members of this organization have a long background of experience in interpreting the Federal tax laws and complying therewith by directing the maintenance of proper accounts and the rendition of tax returns to conform to the requirements of the statutes and the regulations relating thereto. The major responsibility for corporate compliance is theirs. Mindful of this responsibility, the members of the institute's committee on Federal taxation have studied the

House bill carefully and intensely ever since it was made available and we say to you in all sincerity that many of its extremely complicated provisions are still incomprehensible to us. Without such comprehension, it is, of course, impossible to discuss satisfactorily many of these obscure provisions.

In the first place we are seriously concerned about what appear to be tremendous difficulties in compliance and the ascertainment of the excess-profits tax liability under the second revenue bill of 1940 in its present form. The bill is honeycombed with cross-references, exceptions, and exceptions to the exceptions. By comparison, the excess-profits tax provisions in the Revenue Acts of 1917, 1918, and 1921 were simple. It would take many years of controversy and litigation to clear up the complexities of the bill. The cost to taxpayers of determining their tax liability and to the Government for administering the tax will be tremendous.

We recognize that it is exceedingly difficult for Congress to write an excess-profits tax law which will not cause harsh results, unexpected hardships, and economic disturbances, but if there be hastily enacted a highly complicated and involved excess-profits tax law that cannot be understood by taxpayers, the existing multitude of difficulties experienced by taxpayers and the Treasury in ascertaining the tax liability will be multiplied many times over.

Apart from its obscurity and complicated provisions, among the serious defects of the bill are the following:

1. It severely penalizes corporations which use the average earnings basis for determining their excess-profits tax, by imposing much higher rates of tax on these corporations than on those which use the invested capital basis. It almost appears the purpose of this discrimination was to discourage corporations from using the average earnings basis to calculate their excess profits. As a result, the excess-profits tax becomes a tax on normal profits not even remotely resulting from the defense program.

2. It does not allow a fair return on invested capital before imposing the excess-profits tax. Thus, the excess-profits tax as imposed by the bill is contrary to the ability to pay principle.

3. In cases where the capital of a corporation has been increased through the payment in of property (instead of cash) for stock. Invested capital should be increased by the then value of the property so paid in—which is clearly the amount added to the corporation's capital investment. However, in cases where under the income-tax law the basis to the corporation would be that of the transferor, as, for example, in a "reorganization," the bill would measure the increase by the cost of the property to the transferor—thus confusing the income-tax law applicable to capital gains and losses (which are not subject to the excess-profits tax) with a definition of what invested capital is. In this manner it imposes an excess-profits tax even on normal profits and possibly in some cases even on deficits.

4. It penalizes corporations which were in existence during only a part of the base period 1936 to 1939, inclusive, by denying them the right to use the average earnings basis for determining their excess profits.

5. It provides no adequate relief to corporations with abnormalities both in income for the 1936–39 period, and in invested capital.

6. The imposition of graduated excess-profits tax rates on dollar amounts of income instead of on the ratio of excess profits to normal profits, is discriminatory among taxpayers and combines a tax on the size of a corporation with a tax on its excess profits.

The institute is convinced that many of the defects of the second revenue bill of 1940 are attributable to the fact that there has been insufficient time to consider it. The institute realizes that in order to speed up the defense program, it is of paramount importance that there be enacted immediately a satisfactory provision for amortization of facilities constructed for production of defense material. However, it would not seem necessary to combine this provision with the excess-profits tax in one law. In the opinion of the institute, the amortization provision should be adopted now and an excess-profits tax law should not be enacted until Congress has had sufficient time to make the careful study which this important legislation should have.

The institute respectfully recommends that in order to make the second revenue bill of 1940 equitable among taxpayers, certain as to its application and truly a tax on excess profits, the following modifications be made in its provisions:

APPLICATION OF SAME RATES OF TAX TO ALL TAXPAYERS WITH EXCESS PROFITS

Under the present bill, the excess-profits tax on corporations which use the invested capital basis ranges from 20 to 45 percent, whereas corporations which adopt the average earnings basis are taxed at from 25 to 50 percent and in addition to these higher rates, the latter are required to pay an additional excess-profits tax of 4⁹⁄₁₀ percent of their income before deducting the normal income tax. The table which follows illustrates the tremendous burden of the 4⁹⁄₁₀ percent additional tax:

Ratio of excess profits to total profits after deducting normal income tax:	*Effective rate of 4⁹⁄₁₀ percent tax on excess profits* *Percent*
10 percent	52
20 percent	26
30 percent	17
40 percent	13
50 percent	10

This tax is in addition to the 20.9 percent normal income tax and the excess-profits tax which on income in excess of $500,000 is 50 percent.

The excess-profits tax should be only a tax on profits in excess of normal profits. Therefore, the institute urges that the schedule of excess-profits tax rates should be the same regardless of which of the prescribed methods the taxpayer uses to ascertain the excess profits.

II. RATES OF TAX

The schedule of graduated excess-profits tax rates in the present bill is based on the amount of the income rather than on the ratio of the excess profits to the normal profits. The latter basis is in our opinion eminently more equitable under a true excess-profits tax law, provided a fair amount of the excess profits are allocated to the lower brackets of tax.

In addition, many of the cumbersome provisions in the present bill would be unnecessary if the excess-profits tax rates are based on the ratio of the excess profits to the normal profits.

III. ELECTION AS TO BASIS OF DETERMINING THE EXCESS PROFITS

Section 712 of the bill appears to require taxpayers which have been in existence during the full base period to make an election in each year's return as to whether they wish their excess-profits-tax exemption for that year determined under the average-earnings basis or the invested-capital basis. The purpose of requiring a binding election is obscure and there seems to be no apparent justification for this provision. The complications in the determination of invested capital even under the 1917, 1918, and 1921 acts resulted in prolonged delays, disputes, and litigation in the ascertainment of the excess-profits-tax liability. The exemptions based on invested capital in the present bill are infinitely more complicated. For example, there doubtless will be many controversies between taxpayers and the Bureau of Internal Revenue as to the value of property, especially intangibles, paid in for stock and the final determination of this question will in many cases have to be left to the courts. Surely, it is unfair to ask the taxpayer to make a binding election as to the basis to be used for determining its excess-profits-tax exemption when it cannot forecast what invested capital the Bureau will allow, and many of the provisions in the bill with respect to the details of the alternative methods are obscure, especially in the case of tax-free exchanges.

The institute urges that the bill be redrafted to provide that the tax be determined on the basis of the method which results in the smallest tax without requiring any election by the taxpayer.

IV. SPECIAL ASSESSMENT

Even though the bill provides for alternative tests for computing normal profits, exempt from excess-profits tax, an adequate special-assessment provision is necessary in order to assure equitable treatment of corporations with abnormalities both in income for the 1936–39 period, and in invested capital. Some corporations might have had little or no earnings during some of the years in this period because their business was still in the formative state. Examples are new enterprises which require several years of experimentation and advertising to develop their business and mining companies which require a considerable period to explore and prepare the mineral bodies in their property for operation.

Since the special-assessment provision is primarily for the purpose of taking care of the unanticipated cases, the form of relief should be made flexible and left to the discretion of the Commissioner.

V. 1936-39 EARNINGS

The use of the full 1936–39 period does not in many cases result in a fair yardstick for measuring normal earnings.

In 1936 we were only emerging from a long depression and, for many industries, earnings for the period 1936 to 1939, inclusive, were on the average far below normal. This is especially true of the railroads, construction, navigation, and heavy goods industries.

In order to offset in part inequities which might result from the use of this period, subnormal in case of many industries, the institute urges that instead of adopting the average earnings for all the 4 years, 1936–39, as a yardstick, the taxpayer be permitted to use any 3 of these 4 years.

The bill as now drawn provides for the substitution of zero for the year of the largest deficit in this period but requires dividing the resultant aggregate net earnings for the 4 years by 4. As a result the determination of the normal rate of earnings is distorted. This defect would be corrected if the bill is revised as suggested herein to permit the use of the earnings for 3 out of the 4 years in the base period.

VI. CORPORATIONS IN EXISTENCE DURING ONLY A PART OF THE BASE PERIOD

There appears to be no apparent justifiable reason why corporations in existence during only a part of the full base period should be denied the right to use the average earnings basis for ascertaining their excess-profits-tax exemption. The institute urges that, in order to avoid discrimination, corporations in existence during at least 1 full year of the base period be given this right, their exemption to be determined by dividing their actual earnings for any full year or years during the base period by the number of full years they were in existence. Otherwise, such corporations will be taxed without giving full recognition to their normal earning capacity.

VII. DETERMINATION OF EXCESS-PROFITS CREDIT BASED ON INVESTED CAPITAL

Under the present bill the percentages of invested capital, which are allowed in the determination of the excess-profits credit, are dependent on the following factors:

1. The ratio of earnings to invested capital during the base period, with a minimum of 5 percent and a maximum of 10 percent.
2. Whether the corporation was in existence during the base period.
3. Whether the corporation has increased its invested capital after the beginning of the excess-profits-tax period.
4. Amount of the invested capital.

These distinctions are responsible for most of the complicated and obscure provisions of the bill. Furthermore, they make it necessary to ascertain the invested capital for each year of the base period. The institute recommends that in the interest of uniformity, simplicity, and clarity, and in order to permit a fair return on invested capital before imposing the excess-profits tax, the exemption where the invested-capital basis is used should be at a flat rate which in our opinion should be 10 percent if the excess profits are to be determined annually or 8 percent if the institute's recommendation in point XII below is adopted.

VIII. USE OF TRANSFEROR'S BASIS WHERE PROPERTY ACQUIRED BY CORPORATION IN TRANSACTION ON WHICH GAIN OR LOSS NOT RECOGNIZED

It appears that under section 718 (a) (2) of the bill, property paid in to a corporation in a transaction where the gain or loss to the seller is not recognized, would be included in invested capital not at the amount by which the capital of the corporation is actually increased (namely, the then value of the property) but at the basis of the property to the seller.

For example, a corporation acquires a plant by issuing its own stock to the seller. Clearly the corporation's capital is being increased by the then value. However, because the transaction was a "reorganization" where the gain or loss to the seller was not recognized, the bill would include the plant in the purchasing corporation's invested capital, not at the then value which is really being added to the corporation's capital but by reference to the basis in the hands of the transferor which might have been much less. The property might have been acquired by the transferor many years previously.

The whole concept of the bill is that invested capital should be figured at the money or money's worth actually invested in the corporation. Property purchased by a corporation in exchange for its own stock is an addition to capital (in the amount of its then value) just as much as additional cash paid in for stock, and there is no justification whatsoever, so far as an excess-profits tax is concerned, for going back of the then value of the property which is being added. (Purchases by corporations for their own stock in transactions where the intent is to avoid excess-profits tax should of course be disregarded, and the cost to the transferer govern, but obviously this principle should not apply to acquisitions made long before the excess-profits tax was even thought of.)

The income-tax law applicable to the calculation of gains and losses on the sale of capital assets (gains and losses which are not subject to the excess-profits tax) should not be confused with a definition of "invested capital". If property is added to the capital of a corporation, invested capital should be increased by the value added, and it should make no difference whatsoever whether the seller of the property did or did not realize taxable gain or loss when he transferred the property to the corporation.

It is true that in an exchange where gain or loss is not recognized the transferrer is not required to pay income tax on the appreciation in the value of the property transferred. However, it must not be overlooked that, when the transferrer disposes of the securities he received in this transaction, the previously untaxed profit on the exchange becomes subject to tax. The stockholders of our corporations, other than close corporations, keep constantly changing.

The ultimate taxation of the profit to the transferrer on a transaction such as that herein described, and denying the transferee the right to include in invested capital the actual value of the property at the time of the exchange, results in double taxation. Furthermore if the excess-profits tax, which under the present bill runs as high as 45 percent, is to be imposed in accordance with the ability to pay principle, the excess profits of the transferee should be measured by its own investment and not by what the transferrer paid for the property many years ago.

Accordingly, the institute recommends that property paid in to a corporation for its own stock be included in invested capital at the value of such property at the time of acquisition, which is the true measure of the addition to invested capital where property is acquired for stock.

IX. BORROWED CAPITAL

The institute urges that a corporation should be permitted to include borrowed capital in invested capital in full. There is no justification for any limitation.

However, unless the minimum 5-percent rate of exemption based on invested capital is increased as recommended in point VII above, the inclusion in invested capital of borrowed capital should be made optional and not mandatory. Otherwise, in some cases, the exemption based on the borrowed capital would be less than the corresponding interest deduction which is disallowed and the borrowed-capital provision which it is understood was intended to give relief to the corporation which must borrow may actually penalize such a corporation.

Under the present bill, the exemption of corporations which use the average earnings basis is increased by net additions to capital after the beginning of the excess-profits tax period but for this purpose borrowed capital is disregarded. The institute recommends that borrowed capital be included in the determination of the net capital addition in order to avoid discrimination.

X. INADMISSIBLE ASSETS

The purpose of the deduction for inadmissible assets is to eliminate invested capital to the extent it is used for tax-exempt governmental obligations and stocks the income from which is not included in excess-profits net income. It appears from section 720 (a) the intent is to exclude from invested capital all inadmissible assets even those which yielded no income during the year. This results in a departure from the ability to pay principal in the case of companies with a large part of their capital invested in stocks which do not yield any income during the year.

It is recommended, therefore, that stocks of corporations should not be included among inadmissible assets if no dividends are received thereon during the taxable year or if the taxpayer elects to treat the dividends as income subject to excess-profits tax.

XI. CONSOLIDATED RETURNS

The institute is of the firm conviction that the determination of the normal and excess-profits taxes of an affiliated group of corporations should be permitted on the consolidated return basis.

Primarily as a result of the tax on intercompany dividends which became effective in 1936, many companies have integrated their business through the dissolution of their subsidiaries whenever it was practicable to do so. The institute believes that generally when the subsidiary has been retained its dissolution has been found impracticable either because of governmental or legal requirements or business necessity.

A consolidated statement is not only ordinary business practice for a related group of corporations; it is regarded by businessmen, accountants, stock exchanges, and the Securities and Exchange Commission as essential to the fair presentation of the financial position and earnings of a consolidated group. It is only logical that this should be the rule. A subsidiary is generally to all intents and purposes merely a branch of the parent company's business and should be treated in the same manner as a separate department of a single company. The taxation of a group of related companies on a separate return basis has the effect of taxing intercompany profits and allowing intercompany losses which may never be realized, considering the business as a whole.

The requirement for separate returns has complicated the preparation of income-tax returns and has probably increased the amount of tax litigation. In addition, it has made the audit of income tax returns more cumbersome because more returns must be reviewed. It is impossible to forecast whether the use of consolidated returns, rather than separate returns, would reduce the aggregate yield of the normal and excess-profits taxes. Under separate returns, some companies in the group would pay a lesser excess-profits tax by using the invested capital basis and others by using the average earnings basis. However, with consolidated returns, the one basis would have to be used for the group as a whole, the true economic income of the affiliated group would be reflected, and the innumerable administrative complications arising out of the use of separate returns for such a group would be eliminated.

The only reason given in the Ways and Means Committee report (p. 15 of Report 2894) for not permitting consolidated returns in connection with the excess-profits tax is that it was not possible to prepare a consolidated return provision without delaying the bill for a considerable length of time. No delay by reason of drafting difficulties is involved if consolidated returns are made optional and not mandatory. Under the optional basis, broad powers are conferred on the Commissioner to prescribe regulations to which the taxpayer must consent if he elects to use the consolidated return basis.

XII. APPLICATION OF DEFICIENCY IN EARNINGS AGAINST INCOME OF PREVIOUS OR SUBSEQUENT YEARS IN EXCESS-PROFITS TAX PERIOD

For accounting to stockholders, various governmental agencies and taxation, corporations must prepare income statements for each year. However, it is realized that except in the simplest form of enterprise, the determination of income on an annual basis must depend in a large measure on estimates and at best does not produce an accurate picture. Advertising and other expenditures for business development may not begin to show results until a year or more after these expenditures are made.

If a heavy excess-profits tax is to be imposed, its determination on an annual basis is clearly unjustifiable even if an adequte net loss carry-over were permitted. In 1 year, a corporation might have substantial earnings in excess of the excess-profits tax exemption, whereas in another year its earnings might be far below the exemption. To subject the earnings of the very profitable year to an onerous excess-profits tax without reduction by reason of the meager earnings for the other year, is contrary to the ability to pay principle.

To remedy this situation, the institute urges that the deficiency of income (the excess of the excess-profits tax exemption over the income) be applied for excess-profits tax purposes against:

1. Earnings for subsequent years: (This principle was recognized by Congress in the determination of tax under the Vinson-Trammell Act, with respect to aircraft) or—
2. Earnings for previous years for which an excess-profits tax was payable.

XIII. LOSSES AFTER EMERGENCY PERIOD

Because of the stimulus to industrial production by the defense program and because of the war, it is probable that many industries will sustain losses in the period following, which will offset in a large measure or completely the profits during the emergency period. This was our experience after the last war.

If the earnings of the emergency period are subjected to an onerous excess-profits tax without regard to the losses which may follow, many corporations may be left with insufficient resources to withstand the ensuing losses. The ultimate result might be a flood of bankruptcies.

It is recommended, therefore, that the losses for the first year or two after the emergency period be applied against the earnings during the emergency period. Under the 1918 act, the losses for 1919 could be offset against 1918 income.

XIV. INVENTORY LOSSES AFTER EMERGENCY PERIOD

To meet the increased demand for many materials during the emergency period, many corporations will find it necessary to maintain larger than normal inventories. It may be that when this demand subsides after the emergency period, there will be a substantial drop in the prices at which these inventories can be sold. The resultant loss may to a large degree offset the profits earned during the emergency period.

Accordingly, the institute recommends that losses after the emergency period, due to drop in value of inventory held at the end of such period, be offset against income for the prior period. Similar relief was allowed under the 1918 act.

XV. EFFECT ON INVESTED CAPITAL OF DIVIDENDS PAID DURING FIRST 60 DAYS OF THE YEAR

Under section 718 (c) (2) of the bill, after 1940, invested capital at the beginning of the year is to be reduced by distributions made during the first 60 days thereof to the extent they do not exceed the accumulated earnings and profits as of the beginning of the year. This reduction of invested capital should be eliminated if there are sufficient earnings during the year to absorb the distributions made therein inasmuch as under the bill, the invested capital for the year is not to be increased by these earnings. In addition, section 718 (c) (2) is inconsistent with section 115 (a) of the Internal Revenue Code which treats all distributions during the year as having been made out of the profits of that year to the extent of such profits.

Possibly, the thought in making section 718 (c) (2) applicable only after 1940 was that corporations could in the future postpone their dividend payments until after the first 60 days after the beginning of the year. This is impracticable in many cases with respect to dividends on preferred stock.

XVI. EXPENSES OF RETIRING OR REFUNDING BONDS

The bill eliminates from income both during the base period and the excess-profits tax period income from retirement of bonds, debentures, etc., presumably on the ground this income is nonrecurring. For the same reason, expenses on the retirement or refunding of bonds, debentures, etc., including premiums paid and amortization of bond discount and expense, which are allowed as deductions in the ascertainment of the normal tax should be disregarded in the determination of the excess-profits net income.

XVII. PROVISION THAT ANY WAIVER WHICH EXTENDS THE STATUTORY PERIOD OF LIMITATION FOR ASSESSMENT OF ADDITIONAL TAXES WILL AUTOMATICALLY EXTEND THE PERIOD WITHIN WHICH AN EFFECTIVE CLAIM FOR REFUND MAY BE FILED

Under the bill, section 275 (a) and section 322 (b) of the Internal Revenue Code are made applicable to excess-profits tax as well as to income tax. Because of the complications in the determination of excess-profits tax, especially the invested-capital feature, the Commissioner, in many cases, will doubtless require more than 3 years to ascertain the excess-profits tax liability and it will be necessary for the taxpayer to sign waivers extending the 3-year period for assessment of additional tax. At least, for the first years the excess-profits tax is effective the taxpayer may require more than 3 years to accurately determine his excess-profits tax liability.

Under section 275 (a) of the Internal Revenue Code, additional taxes may be assessed, except in certain cases, within 3 years after the return was filed. However, this 3-year period may be extended by a waiver signed by the taxpayer and accepted by the Commissioner. These waivers are offered by the taxpayer where the Commissioner has not completed consideration of the case, in order to avoid the issuance of the 90-day deficiency letter while issues are still under consideration. As permitted by law, the original waiver may be extended one or more times thus prolonging the statutory period for assessment as much as 5 years or even longer after the return was filed.

When waivers are executed, it is entirely possible that some issues will be decided by the Commissioner against the taxpayer, which might not even have been raised if the 90-day deficiency letter had been released within the original 3-year period.

Under section 322 (b) of the Internal Revenue Code, claims for refund are not effective unless filed within 3 years after the return was filed or within 2 years from the time the tax was paid. There is the further limitation that "the amount of credit or refund shall not exceed the portion of the tax paid during the 3 years immediately preceding the filing of the claim * * *." No procedure is provided, except to the limited extent permitted by section 3801 of the Internal Revenue Code, for extending the statute of limitations for filing claims for refund, even though the code specifically authorizes waivers extending the statute for assessment of deficiencies.

In other words, although a waiver opens a way for the Commissioner to introduce new issues adverse to the taxpayer after the expiration of the original 3-year period, the taxpayer is barred, unless he has paid additional tax more than a year after the original return was filed, from filing a claim for refund after 3 years from the date the return was filed.

As a result the taxpayer is at a distinct disadvantage as compared with the Government. This condition should be remedied especially since the overassessment may arise from a favorable Board of Tax Appeals or court decision in another case or from adjustments by the Commissioner for other years, such as disallowance of a deduction on the ground that it belonged in the closed year.

The institute recommends, therefore, that any waiver which extends the statutory period of limitation for assessment of additional taxes should automatically extend to the same date the period during which an effective claim for refund may be filed.

The institute wishes to repeat that the foregoing recommendations are made solely for the following reasons:

(1) To avoid grave injustices through inequal distribution of the excess-profits tax;

(2) to prevent the imposition of a heavy excess-profits tax on normal income unrelated to the defense program; and

(3) to avoid the adoption of tax legislation that would be so complicated and involved as to cause taxpayers and the Treasury vastly increased difficulties and expense in compliance with and in the administration of the tax laws.

It believes that the modifications suggested are essential to accomplish these results. Therefore, it urges their adoption.

Respectfully submitted.

CONTROLLERS INSTITUTE OF AMERICA.

The CHAIRMAN. Is Mr. Jackson in the audience?

Mr. JACKSON. Yes, sir.

The CHAIRMAN. Mr. Herbert C. Jackson, of Cleveland, Ohio, representing the Interlake Iron Corporation.

STATEMENT OF HERBERT C. JACKSON, INTERLAKE IRON CORPORATION, CLEVELAND, OHIO

Mr. JACKSON. Mr. Chairman and gentlemen: I am Herbert C. Jackson of Cleveland, Ohio, and have charge of the tax administration of Interlake Iron Corporation which owns and operates blast furnace plants, coke ovens, and byproduct plants at Duluth, Minn.; Chicago, Ill.; Toledo, Ohio; and Erie, Pa.; and owns interests in iron ore mines located in Michigan, Wisconsin, and Minnesota. Our main product is merchant pig iron which is sold to foundries and processors, and is manufactured by them into finished products such as machinery and general heavy and long-life equipment.

We are fully aware of the need of an excess-profits tax to help finance the national-defense program, and our remarks will be directed at what appears to us to be the major inequities of the proposed bill and their effect upon that large part of the manufacturing industry which is generally referred to as the durable goods industry.

Here we have a bill proposing to levy a tax on so-called excess profits, which we believe is unnecessarily complex in design and in important respects does not accomplish the intended purpose.

In our opinion there is no necessity for the provisions requiring the daily computation of invested capital over the 4-year test period and the taxable year, nor for the numerous classifications, terms, and alternatives relating to invested capital contained in the 12 subdivisions of section 714, nor the several rates of exemption on invested capital under closely similar circumstances and stated in the bill at 5 percent, 7 percent, 8 percent, and 10 percent. Each superfluous classification necessitates other unnecessary exceptions and qualifications to make the bill consistent. The problems of administration by both the Federal Government and industry will be infinite. The bill should be simplified and it can be simplified and would operate more equitably than the present bill, by allowing a single fair flat rate of capital return on invested capital of the taxable year and eliminating the test period as far as invested capital is concerned.

In recognizing a percentage of borrowed capital as invested capital, it is apparently the intention to grant some relief to corporations with large outstanding indebtedness, but actually whatever relief is granted is, for all practical purposes, largely subtracted by denying the right to deduct from income the amount of interest paid on such borrowed capital. In many instances this will result in penalizing the corporations which borrow money, and not yield material benefit to any average group of corporations. Either the entire amount of borrowed capital or some specified percentage thereof should be recognized as invested capital without restriction or the application of the present provisions should be made optional with the taxpayer.

It is our understanding that this bill is to provide a tax on excess profits. Although title I is termed the "Excess Profits Tax Act of 1940," before 10 lines are written in that title, a tax of 4.1 percent is levied on normal tax income, thus taxing and classifying all income as excess profits. In addition to this, the method used in general to determine excess profits is such as to embrace in that classification a large amount of normal profits.

Obviously, not all profits are excess profits. The proposed bill attempts to recognize this fact by exempting from the graduated tax rates the portion of net earnings which the drafters of the bill consider normal. This is accomplished by providing for exemption of normal earnings on an average income credit or on an income and invested capital credit during the 1936–39 test period. The minimum invested capital credit for corporations with over $500,000 of invested capital is 7 percent of the first $500,000 and 5 percent of the balance.

Corporations choosing the earnings exemption alternative must pay a penalty tax of 4.1 percent of normal income and must bear 5 percent higher excess-profits tax rates on so-called excess-profits not income and are not permitted to deduct this penalty tax in computing income subject to excess-profits tax, thus imposing a further penalty by paying excess-profits tax on an excess-profits tax penalty. We believe this 4.1 percent penalty tax is unfair and should be eliminated and that the same excess profits tax rate schedule should apply to corporate income in excess of exemption on either alternative. We also recommend that the excess-profits tax as finally computed by the Federal Government be assessed on whichever method will result in the lower tax. This suggestion is based on the premise that the method elected in the original return may prove to be unfortunate upon a later and more exact computation when audited by the Treasury Department, and therefore unjustly penalize the electing corporation.

While the proposed bill offers corporations an option to determine profits exempted from the graduated excess-profits tax either on the income method or the invested capital method, this option is academic to a large part of industry. The durable goods industries, which are considered as normally employing 20 percent of the employed labor in this country, have not enjoyed normal earnings or any fair earnings return on their invested capital and therefore by force of circumstances have no option, but must use the invested capital method of exemption. It is accordingly important that this large class of industries be offered a fair exemption of their invested capital. We regard 5 percent which such industries will be forced by circumstances to use, an inadequate annual exemption.

While consumer goods industries have enjoyed a substantial recovery from the depression prior to this year, it is well recognized and amply supported by facts that the recovery of durable goods industries had not reached normal proportions. Therefore, in order not to include normal earnings in profits subject to the excess-profits tax, it is doubly important to provide a rate of exemption on invested capital commensurate with the normal return thereon in a normal operating period.

During the 1936–39 test period the employment of workers in durable goods industries averaged approximately 70 percent of normal. There was an average of about 5,500,000 employees in durable goods industries, compared to a normal of about 8,000,000 workers—a decline of 2,500,000 workers, or 30 percent. During the same period, all other workers employed averaged about 38,000,000 compared to a previous normal of about 40,000,000 a decline of 2,000,000 workers, or 5 percent. (The balance of about 5,000,000 more unemployed is the result of approximately a 10 percent increase in population since 1929, accounting for a generally accepted total of 9 to 10 million unemployed at the beginning of this year.)

It should be apparent from these figures that durable goods industries have hopelessly lagged behind the balance of industry in recovery and that no period in the past 10 years can be considered normal for these industries. The effect on the operations of the Interlake Iron Corporation during this 1936–39 test period has been to restrict its operations to an average of 45 percent of rated capacity compared to an average normal rate of operation of about 80 percent capacity. Naturally the average earnings in this test period are less than 5 percent of statutory invested capital, whereas earnings in a normal year would be more than 10 percent of actual invested capital.

To be fair to this large group of industries, including the company which I represent, there should be allowed a flat exemption of 10 percent of statutory invested capital. The rate of exemption on invested capital should not be tied to the previous earnings period with some minimum rate, because this automatically forces a large group of this type of industry to use the minimum, which, at 5 percent, is not representative of a fair return on invested capital nor of the normal return in these industries.

It should also be borne in mind that when the prescribed rate of exemption on invested capital is to be determined by the rate of earnings in the test period, there is not offered an independent alternative for exemption but in part a duplication of the earnings alternative, thus doubly penalizing companies which, through circumstances beyond their control, have been unable to make normal earnings.

We suggest that the rate of exemption based on invested capital be a flat rate without any reference to the test period and that such rate be a fair return on invested capital. We suggest 10 percent as such a fair rate of exemption of earnings on an annual basis for the following reasons:

First. In the present bill, the proposed excess-profits tax will apply annually without a carry-over or an averaging with future years of subnormal income. Thus there is no guaranty that a corporation will be permitted to earn the rate of exemption over the period of the tax. It is therefore imperative that in years in which there are excess profits the corporation be permitted a rate of exemption on invested capital commensurate with the business risks and which would be required on a normal basis to attract capital for investment. Ten percent in our opinion is the minimum necessary for such purpose.

Second. A corporation must earn at least 10 percent on its investment in order to provide funds for expansion, continue pension plans, group insurance plans, and other employee-benefit plans, and pay preferred stock dividends which are not deductions in computing either normal tax income or excess-profits-tax income. Many companies have borrowed large sums of money through the issuance of preferred stock calling for 5 percent or 6 percent dividends.

A company should have the right to a net earning free of excess-profits tax which will permit it to continue in business. Over the past 10 years, corporations in general and durable-goods corporations in particular have been eating up their capital in order to survive. Their stockholders have had small, if any, return on their investments. From the latest figures compiled from Treasury Department analysis of a quarter of a million corporations, the capital invested in these corporations has decreased $30,000,000,000 in the 5 years following 1930, compared to an increase therein of $36,000,000,000 in the previous 5-year period.

Senator KING. How many corporations failed during that period?

Mr. JACKSON. I don't know, sir.

Senator KING. Went out of existence?

Mr. JACKSON. I couldn't tell you, sir.

Senator KING. A very large number?

Mr. JACKSON. I presume so.

More recent figures of the National Industrial Conference Board show that in the 9 years subsequent to January 1, 1930, the net business savings of all corporations in this country have decreased

$44,000,000,000 compared to an increase of $23,000,000,000 in the prior 9 years.

In other words, the business pocketbook has been depleted in the past 9 years by about twice the accretion of the prior 9 years. This emphasizes the necessity of making fair allowances to business so that some savings can be put away for the rainy day which is bound to come. Under these conditions, 10 percent is not too much return on invested capital, before taxing of excess profits.

Three. A 10-percent return on statutory invested capital does not mean a 10-percent return on actual invested capital. Statutory invested capital as defined in the proposed bill is less than actual invested capital by the amount invested in stocks of other corporations and the amounts paid for property in excess of the seller's tax base where property was acquired for stock in a tax-free reorganization.

There also is eliminated, in effect, all borrowed capital. These limitations result in greatly reducing the actual invested capital. In the case of the Interlake Iron Corporation, its statutory invested capital is only 60 percent of its actual invested capital as shown by its books. Therefore, a 10 percent exemption on statutory invested capital is only a 6 percent exemption on its actual investment.

Four. A flat average rate of 10 percent will eliminate many of the complexities in the proposed bill and save both the taxpayer and the Government excessive costs of administration. Such a flat rate is fair under the circumstances and would serve as an incentive to attract new capital and a more permanent taxing basis for the future.

Up to this point we have outlined our suggestions with reference to what we consider the main objections to the proposed bill. Time does not permit further discussion except to say that it is our opinion the bill should also contain provision for the following:

1. Permissive filing of consolidated returns under rules and regulations to be prescribed by the Secretary of the Treasury;
2. Computation of base-period earnings credit by permitting taxpayer to use any 3 of the base-period years in computing the average;
3. Computation of excess-profits tax based on the average results of a 3-year period starting with the first taxable year beginning after December 31, 1939;
4. An independent board, apart from the Bureau of Internal Revenue, with broad authority to grant equitable relief in cases where injustices otherwise would result.

The CHAIRMAN. Thank you very much.

Mr. Claude W. Dudley, of Washington, representative of the Millers National Federation. All right, Mr. Dudley.

STATEMENT OF CLAUDE W. DUDLEY, WASHINGTON, D. C., REPRESENTING MILLERS NATIONAL FEDERATION

Mr. DUDLEY. I shall be very brief.

Senator KING. You represent the Dewey Chemical Co.?

Mr. DUDLEY. No, sir; I represent the Millers National Federation.

Senator KING. I beg your pardon.

Mr. DUDLEY. This Federation represents the flour milling industry. Its membership produces more than 80 percent of the flour commercially produced in the United States. I am interested, primarily, in simplification of this bill. I confess that I can't understand it. I may be a little more concerned than other witnesses about that. I figure it is my job to understand. As a farmer, I get paid for not raising things, but as a lawyer I have yet to receive a fee for not understanding things, so I am very much concerned personally about my inability to understand this bill.

Senator KING. If you make it clear to some of us, you will have rendered a very fine public service.

Mr. DUDLEY. I should be glad to do that, Senator, if I could. I shall limit my few remarks to the high spots of this statement which I am filing with the committee.

Point 1, where the invested capital method of computing the excess-profits credit is used, a straight 8 percent or such other fixed percentage as the committee might find equitable, should be allowed rather than a percentage based upon the base period ratio of income to invested capital.

Other witnesses have made that recommendation. I only want to point out one additional thing. Our experience with our previous excess-profits-tax laws teach us that that is the thing to do. You will remember that the old 1917 act had a sliding scale of 7 to 9 percent, and you will recall that the exact percentage allowed within that minimum and maximum was to be based upon the average earnings of the years 1911 to 1913 in their relation to invested capital of those years.

The difficulty of administering that law caused the Congress, in passing the law of 1918, to abandon that principle and to adopt a fixed percentage of 8 percent on invested capital.

Considering the difficulties that you have in computing invested capital under such a law as that now before you, involving 1,825 daily computations of invested capital and they, in turn, according to Mr. Fernald, involving 180,000 computations, it is an impossible task to administer such a law.

All the king's horses and all the king's men can't do it.

Recommendation number two: The taxpayer should be given the opportunity of including all his borrowed capital in invested capital, in which case none of the interest on that borrowed capital would be allowed as a deduction in computing net income, or he should be given the option of eliminating all the borrowed capital and including the interest as a deduction.

The advantage of that is to do away with all these difficult computations with respect to the portion of borrowed capital which is to be included in invested capital under this bill.

I don't see the logic of including a hundred percent of borrowed capital up to a hundred thousand dollars, 66⅔ percent from a hundred thousand dollars to a million dollars and 33⅓ percent from a million dollars on up. Borrowed capital is borrowed capital. It should all be excluded or included, and without any injustice to the Government the taxpayer can well be given that option.

Point 3. The election of the average earnings method of computing the excess-profits credit should not carry with it as a penalty an increase in the rate of normal income tax.

Now, the average earning method is either a sound or an unsound method of computing the excess-profits credit. If it is sound, it should be used without penalty. If it is unsound, your committee should discard it entirely. I think it is sound as an alternative method of computing the excess profits credit.

Point 4. A binding election as to the method to be used—that is, whether the base period method or the invested capital method should be used—should not be required at the time of filing the return.

I know it is the intention that the taxpayer choose the method which will produce the least tax. It is impossible in many cases for that to be known at the time of filing the return.

The first returns under this law are due to be filed March 15, 1941. At that time, many of the income tax returns for either all or part of the base period years will not have been audited. The net income for those years as finally determined by the Treasury Department and the Board of Tax Appeals will not be known.

The taxpayer whose returns are all audited for that base period would have a real election. The other taxpayers would not. There is no reason for discrimination between the two.

Point 5. The graduation upward of the rate of excess-profits tax should be dependent not merely on the size of the earnings, but upon the size thereof in relation to the normal earnings.

That point has been made by several other witnesses and I will not elaborate upon it. The report of the sub-committee of the Ways and Means Committee did that thing.

Point 6. A deficit carry-over should be permitted in computing the excess-profits credit. By that I mean this: If a corporation has an excess-profits credit of $40,000 and it earns $20,000 in 1940, $20,000 should be carried forward to 1941 and added to its excess-profits credit of that year. So that that corporation then could earn $60,000 in 1941 before paying an excess-profits tax. Its earnings, then, for the 2 years, as you would see, would average $40,000 which is its normal excess-profits credit.

In the case of a net loss in the year 1940, or any other year, that also should be carried forward and that loss should be allowed to be recouped before paying excess-profits tax.

Point 7. Provision should be made for special relief of corporations which would otherwise suffer a disproportionate tax burden.

Our experience with prior laws shows the necessity for that relief, and while I realize that the administration was difficult, perhaps not entirely satisfactory, some provision for special relief is necessary.

Point 8. And other witnesses are not making this point. I think it is very necessary. Present capital-stock tax and the present excess-profits tax should be eliminated upon the passage of such an excess-profits-tax law as is now contemplated.

The present capital-stock tax and excess-profits taxes are a guessing proposition. The amount of taxes paid doesn't depend so much upon ability to pay as upon good guessing or really lucky guessing.

If a corporation's officers are lucky in prognosticating future earnings for a period of 3 or 4 years ahead, their tax will be at the minimum, whereas, if they are unlucky in prognostication, their tax will be at the maximum. That is an unscientific, basically unsound law, and with the passage of an excess-profits-tax law running up to 50 percent, that law is no longer necessary as a separate part of our tax system.

The CHAIRMAN. As a revenue producer, it is a pretty big item.

Mr. DUDLEY. It is, Senator, and I should certainly incorporate provisions in this law which would take care of that $150,000,000 of revenue if the capital-stock tax and the excess-profits-tax law now on the books are eliminated. In other words, it should be provided for.

Finally, I urge upon this committee segregation of the amortization features and a most careful consideration of the excess-profits-tax provisions.

The best excess-profits-tax law is none too good. It is the most difficult law to administer that we have ever had. Experience shows us that. I urge upon this committee a most careful study of it in a real effort to get a sound excess-profits-tax law.

Senator KING. I assume from your statement, then, that the bill before us does not measure up to that standard?

Mr. DUDLEY. It certainly does not.

The CHAIRMAN. Thank you very much.

Senator KING. Have you drafted any provisions which would?

Mr. DUDLEY. I have not drafted any provisions. I have given the committee some recommendations as to points but not amendments.

(Prepared statement of Mr. Claude W. Dudley is as follows:)

MILLERS' NATIONAL FEDERATION,
Washington, D. C., September 5, 1940.

Hon. PAT HARRISON,
Chairman, Senate Finance Committee, United States Senate,
Washington, D. C.

DEAR MR. CHAIRMAN: The excess-profits tax bill, H. R. 10413, as it passed the House, presents an unworkable plan of taxing the profits of corporations and must in my opinion be drastically changed if hopeless confusion is to be avoided. I am appearing before you as tax counsel of the Millers' National Federation, a trade association of the flour milling industry. I am interested primarily in simplification of the bill.

The speed with which the Ways and Means Committee and the experts of the joint committee and the Treasury Department have had to work in an effort to produce quickly an excess-profits tax law is in my opinion largely responsible for the incomprehensible features of the bill. The bill represents obviously a compromise between two schools of thought with respect to excess profits and invested capital. One school apparently thinks that excess profits should be defined as the excess over an average income of a period of years and the other school apparently thinks that excess profits should be defined as the excess over a specified rate of invested capital. In an effort to please both schools of thought the bill presents an intermingling of the two methods of computing excess profits. This leads to endless complications. There is also apparently a compromise between those who believe that invested capital should include only equity invested capital and those who believe that borrowed capital should be included in invested capital, with the result that the bill provides for a hybrid method of computing invested capital, permitting borrowed capital to be partially included in invested capital.

For the sake of simplification, I urge upon your committee two amendments as follows:

1. Where the invested capital method of computing the excess-profits credit is elected by the taxpayer, the credit should be fixed at a flat rate of 8 percent of the invested capital of the taxable year.

2. The taxpayer should be given the opportunity of including all borrowed capital in invested capital, in which case no part of the interest paid on such borrowed capital should be allowed as a deduction in computing excess-profits net income, or of including no part of the borrowed capital in invested capital, in which case the interest paid on borrowed capital should be deductible in computing excess-profits net income.

With respect to the first recommendation, its adoption would eliminate entirely the necessity of computing invested capital for the 4 base years. Previous experience with the war—and excess-profits tax laws of 1917, 1918, and 1921 have taught us that no law should require the computation of invested capital for more than 1 year. The determination of invested capital under the simplest law which can be devised is a very difficult administrative job. It is multiplied a thousandfold in such a bill as that passed by the House. The House bill not only requires the computation of invested capital for the taxable year, but requires the computation of invested capital for each of the base years, making 5 years in all. Furthermore, invested capital during each of these 5 years must be computed daily under the House bill. This makes 1,825 computations of invested capital for each corporation. The excess-profits tax law of 1917 allowed an excess-profits credit of not less than 7 percent nor more than 9 percent on invested capital of the taxable year, the exact percentage to depend on the average ratio of net income to invested capital for the pre-war years of 1911 to 1913. The determination of this pre-war invested capital and net income was such a difficult task that after 1 year's experience with that law this graduated percentage basis was abandoned. The 1918 and 1921 acts adopted a fixed rate of 8 percent and allowed an excess-profits credit equivalent to 8 percent of the invested capital of the taxable year. I recommend that you accept experience under prior acts as a guide for your action in passing a new excess-profits tax law. Based on that experience a fixed percentage on invested capital should be adopted if we are to hope for prompt and effective administration of the law.

With respect to the second recommendation, I see no logic in the provision of the House bill which permits 100 percent of borrowed capital to be included in invested capital until $100,000 of invested capital is reached, 66⅔ percent of the borrowed capital from $100,000 to $1,000,000 to be included, and 33⅓ percent of the borrowed capital in excess of $1,000,000 to be included. Experience with the excess-profits tax laws of the World War period shows that in some cases where the borrowed capital is large in comparison with the equity invested capital, the taxpayer needs relief from an inequitable tax burden. Under those laws this relief was afforded through the so-called special assessment provisions of the law, sections 327 and 328 of the 1918 and 1921 acts. Adequate relief can be afforded without any unfairness to the Government by providing that the taxpayer may at its option include all of its borrowed capital in invested capital if it is willing to forego the privilege of deducting interest on borrowed capital in computing its excess-profits net income. This is especially important with respect to borrowed capital represented by bonded indebtedness. Unless a corporation having bonds outstanding is permitted to include all of its borrowed capital in invested capital and is required to eliminate the interest deduction in computing its excess-profits net income, it is in a seriously disadvantageous position in comparison with the company which has preferred stock outstanding and no bonds.

Unless these two changes are made in the bill, I fear that the administration of the law will break down. The force of the Bureau of Internal Revenue and the force of trained accountants in private employment are entirely inadequate to handle the work of preparing and auditing expeditiously the returns under the bill as it passed the House. It would be a far greater task than was encountered under the excess-profits tax laws of the World War period and they resulted in a backlog of years of work in arrears. The Bureau has only recently worked out from under that load. It is now comparatively current in its work. It is important that it remain so, for corporations cannot plan ahead without some accurate knowledge of their prior accrued tax liabilities. It is impossible for a board of directors to pass intelligently on a question of dividend payments on its stock or on a question as to whether to make an investment in plant expansion if it has 5 years' unaudited income and excess-profits tax returns and an unknown tax liability under those returns. This will be the case under the bill as it passed the House.

I have seven other recommendations to make, the adoption of which will tend to remove inequities in the present bill and result in further clarification and simplification. These are as follows:

3. The election of the average earnings method of computing the excess-profits credit should not carry with it as a penalty an increase in the rate of the normal income tax. The adoption of the average earnings method of computing the excess-profits credit is either sound or it is unsound. If sound, there is no justification for a higher normal tax as a penalty for its use. If unsound, it should not be permitted at all. I am of the opinion that it is sound as an alternative method of computing the excess-profits credit, for there are certain service industries which normally earn substantially more than 8 percent on invested capital and it cannot be truthfully said in such cases that all earnings in excess of 8 percent are excess profits. There is no justification for the increase of 4.1 percent in the normal income tax rate of corporations electing the average earnings method.

4. A binding election as to the method of computing the excess-profits credit should not be required at the time of filing the return. The House bill gives a taxpayer the option of having its excess-profits credit based on the average earnings method or the invested capital method. It is undoubtedly the intention of the House that the taxpayer be given the opportunity of choosing which method

produces the least tax. The House bill as I understand it requires the corporation to elect at the time of filing its return which method to adopt. This requirement that the election be made at the time of filing the return and that the election be irrevocably binding will result in serious inequality between taxpayers similarly situated. The first returns under this bill will be filed on March 15, 1941. At that time the income tax returns for all the base years, 1936 to 1939, will in many cases not have been audited by the Bureau of Internal Revenue. In fact, in some cases the net income for none of the base years will have been at that time finally determined. A corporation which is lucky enough to have had its net income for all the base years finally determined will have a real election. The corporation whose net income is not finally determined for some or all of the base years will be merely guessing as to which method should be elected. In order to prevent inequality among the taxpayers the election as to method should be subject to change. Either method should be available to the corporation at all times until its return is finally closed by the statute of limitations or by a closing agreement between the Commissioner and the taxpayer.

5. The graduation upward of the rate of excess-profits tax should be dependent not merely on the size of the net income, but on the size thereof in relation to the excess-profits credit. Corporations are owned by individual stockholders and it is they who bear the ultimate tax burden. One corporation may have $1,000,000 of earnings and a thousand stockholders. Another corporation may have $1,000,000 of earnings and five stockholders. It is impracticable to make the graduation dependent on the size of the earnings in relation to the number of stockholders. It is inequitable to make it dependent on mere size alone. It is logical to make it dependent on the excess of earnings in relation to the normal earnings as the latter are reflected in the excess-profits credit.

6. A deficit carry-over should be permitted in computing the excess-profits net income. The deficit carry-over should be defined as the excess of the excess-profits credit over the excess-profits net income. In other words, if a corporation fails in any year to earn the amount it is entitled to earn free of the excess-profits tax, the amount not earned should be carried forward and added to the excess-profits credit in the following year. The deficit carry-over should be allowed to be carried forward for at least 2 years. If there is an actual net loss in any year the deficit carry-over should consist of the sum of the excess-profits credit and the net loss for that year.

7. Provision should be made for special relief of corporations which would otherwise suffer disproportionate tax burden. This was provided for in previous excess-profits tax laws of the World War period and our experience under those acts shows the special need therefor. If such special relief is not provided for serious inequalities in tax burden between competitive concerns will develop.

8. The present capital-stock tax and excess-profits tax laws should be repealed. These taxes are very unscientific. The amount of tax paid is more dependent on good guessing than ability to pay. If a corporation is lucky enough to prognosticate accurately its earnings for a period of years it will pay the minimum of tax, but if it is unfortunate and makes a bad guess it pays the maximum tax. The need for these taxes as a separate part of our tax system ceases upon the passage of a real excess-profits tax law at rates graduating upward to 50 percent. The required revenue will be collected under the new tax law and will fall upon those able to pay.

9. The provisions for amortization of the cost of defense facilities should be segregated from the bill and passed promptly, but the passage of the excess-profits tax law should be deferred pending the most careful consideration by this committee and by the Congress. There is need for prompt enactment of the amortization provisions in order to speed up national defense but there is no need for haste in enacting an excess-profits tax law. The excess-profits tax is the most difficult tax that we have ever had to administer. The best bill possible is none too good. It is important that full opportunity be given the Government experts and business representatives to study the provisions of the bill and report fully their views to this committee. It is important that this committee take adequate time to study them. Only in this way can a workable excess-profits tax law be hoped for. It is important that it be workable.

Respectfully submitted.

CLAUDE W. DUDLEY,
Tax Counsel.

The CHAIRMAN. Mr. J. Marvin Haynes, representative of the Cardox Corporation.

Mr. HAYNES. Mr. Chairman and members of the committee——

The CHAIRMAN. Mr. Haynes, may we put in the record at this time a letter that I have just received from the Secretary of War?

SEPTEMBER 5, 1940.

Hon. PAT HARRISON,
Chairman, Committee on Finance, United States Senate.

The War Department has been advised by the Advisory Commission to the Council of National Defense that the Commission has recommended to the Committee on Finance of the Senate that subparagraphs (i), (j), and (k) of the Second Revenue Act of 1940 as set forth on pages 91, 92, and 93 of H. R. 10413, as printed August 30, 1940, be deleted. It is understood that some question has been raised as to the attitude of the War Department toward such deletion.

It is the intent of the War Department to take all measures necessary to protect the interests of the United States with respect to any new facilities contributed to directly or indirectly by the Government. It is believed that such protection can be obtained in connection with individual contracts entered into and dealing with the facilities to be created. To limit or restrict by legislation the use which a taxpayer may make of facilities against which amortization or accelerated depreciation has been charged, is, in the opinion of the War Department, unnecessary and illogical, and would undoubtedly engender reluctance on the part of industry to enter into contractural relations with the Government. Such legislation would be difficult of equitable application to the various situations which may be expected to arise.

In order to avoid so far as possible any legislative restrictions which might impede the accomplishment of the national defense program, I concur in the recommendation of the Advisory Commission to the Council of National Defense that the three paragraphs referred to be deleted from the bill.

Time has not permitted submission of this report to the Director of the Bureau of the Budget. Therefore, it involves no commitment as to the relationship of the report to the program of the President.

Sincerely yours,

HENRY L. STIMSON,
Secretary of War.

All right, you may proceed.

Mr. HAYNES. If it please the members of the committee, the calendar of witnesses shows my address as Chicago, Ill. That is an error.

Senator KING. Shows what?

Mr. HAYNES. Shows my address as Chicago, Ill. My address is Washington, D. C. I am a local representative of Roth Bros. & Montgomery, which has an office in Illinois, which, in turn, represents the Cardox Corporation, and I am appearing in behalf of that corporation.

The CHAIRMAN. All right, sir.

STATEMENT OF J. MARVIN HAYNES, WASHINGTON, D. C., REPRESENTING CARDOX CORPORATION

Mr. HAYNES. In order to conserve the time of the committee, I have prepared a very brief statement in order to set forth the thoughts I wish to convey to you.

The particular problem which I wish to bring before the committee is the plight of a company which has been in existence through a period of years, but is just now coming into earnings for no reason connected with the present emergency. By no means do I think the problem is related only to the company for which I appear. I am advised that there are many companies which will be somewhat similarly affected, and a great many of these companies have appeared here today.

From my study of the bill, which necessarily has been limited, it appears that such a corporation will be taxed at excess-profits-tax rates on earnings which in no true sense are excess profits.

I wish to say emphatically that I am not appearing for a corporation which wishes to avoid its just share of taxes for the present emergency. This corporation asks only that it not be placed completely at the mercy of its competitors by having to bear extraordinarily heavy taxes on normal profits which its competitors, as long-established business concerns, will not have to bear.

My company's plea to you is to write the law so as to grant relief to this type of case.

More particularly I am appearing in behalf of the Cardox Corporation of Chicago, Ill. This company is a comparatively small corporation whose business is entirely based upon patents. The product resulting from these patents it has developed over a long period of years, in the face of strangling competition from some of the largest combinations of capital in the country, which have thrown every possible difficulty in the way of the successful application of the product.

The company has had relatively heavy losses from its incorporation in 1927 through 1934. During the depression its losses were reduced from year to year, and since that time its earnings have increased substantially from year to year, from a small profit in 1935 and 1936 until the present year the earnings will be two and a half times what they were last year, and three times what they were in 1938.

Profits from 1935 to 1937 were used to eliminate the operating deficits of prior years, and no dividends were paid to date due to the necessity of paying off indebtedness which accumulated during the loss years.

Senator KING. When you say "to date" you mean now?

Mr. HAYNES. That is correct.

Senator KING. At the time of the preparation of that memorandum?

Mr. HAYNES. That is correct

Thus the earnings picture is a long period of deficits, due to large sums spent for experimental work in introducing the product and having it accepted by the public.

The product in question is Cardox. This is carbon dioxide gas, confined in a tube in such a manner that it may be used in blasting in lieu of blasting powder. Its value lies in the fact that it is safer in mining operations, since it causes no sparks, thereby avoiding mine fires and explosions and many injuries to miners.

In mining coal it produces larger lumps and facilitates the loading of mine cars. Just recently the company has developed apparatus in which carbon dioxide is used for extinguishing fire, which some of the large companies are installing for use as a quick means of extinguishing fire.

This explanation has been given to show that the competitors of this taxpayer as to Cardox are the large and long established powder companies, which we all know represent large concentrations of capital. Just now, through years of education, the safety and efficiency of the company's product over blasting powder is being accepted by the public. The result is that the long period of losses is bearing fruit in increasing profits.

There is no provision in the present law to deal fairly with this situation. If the company's excess profits are computed on the earnings basis, its present earnings are not properly measured by the earnings of the base period because of the rapid rise in the current year. This rise will be greater in the 2½ remaining years of the life of its basic patent, and then decline, due to the expiration of the patent. Thus these higher profits are not and will not be due to the emergency, but will be the fruit of years of overcoming difficulties and sustaining losses

The earnings of the base period cannot possibly measure any excess profits due to the emergency in the present case. The result will be the taxation of normal profits at excess-profits tax rates. For the present year it will pay a tax of over 50 percent of its income.

Likewise the use of the invested capital method would work even a greater hardship in this case because the invested capital can never be large on a patent and product developed as in this case.

Due to its losses and heavy expenses which could not properly be capitalized, the company has had no opportunity to build its capital to the point where invested capital under the law would justly tax the excess of normal earnings on a normal invested capital.

Furthermore, this business has to a very large extent been developed by the use of borrowed capital. As this borrowed money has been repaid, no part thereof can enter into invested capital under the proposed law, notwithstanding the fact that such borrowed money, together with the deficits, have brought about the present profits.

As previously stated, I am convinced that this is not a problem of this single taxpayer, but is a problem which affects many other companies for one or another reason. The company presents no particular solution since it believes this committee is most capable of writing the remedy. However, a provision similar to sections 327 and 328 of the 1918 act should bring about the desired result if such a section is properly administered.

Senator KING. Could I ask you one question?

Mr. HAYNES. Yes, sir, Senator.

Senator KING. If you seek to apply the rule imposing the tax upon invested capital and you have, as the basis of your capital structure, merely patents, how do you determine the value of those patents? Supposing they have not been applied, it is problematical as to what the result will be.

I was wondering if you only have patents as the basis of your capital, how you determine its value.

Mr. HAYNES. If it is a patent you have had some experience with from an earnings standpoint, it is possible to place a value on that patent on the basis of what it will produce; but where a patent, as in this case, has been turned into a corporation and then a large amount of experimental work thereafter has been going on through pouring of earnings back into the business through the borrowing of capital and repaying of the same, there is no way to arrive at an invested capital to measure the excess-profits tax.

Senator KING. I recall the question was suggested in the consideration by the Temporary Economic Committee, of which I am a member, when we had before us a large amount of testimony concerning patents of all kinds as to the value of those patents and how to determine their value as a basis for estimating sales or the basis of estimating or determining taxes which should be paid.

Mr. HAYNES. As I say, if you have had any earnings experience with a patent, you can base it on the actual experience.

There is also the method of an expert figuring out the field that the patent will operate in, the possible sales that might come in, the estimated expenses in order to carry on the operations, and in that way estimate what would be the net income from those particular patents or that particular patent during a particular year. That is, based upon the expert judgment of a man that knows the uses to which that patent will be put.

We appreciate that Congress does not want knowingly to place this company or any other company at a serious disadvantage as compared with its wealthy and long-established competitors who, either from the standpoint of earnings or of invested capital, will have their excess earnings fairly measured under the bill as at present drawn.

Senator KING. That is all?

Mr. HAYNES. I might make a reply to a question that Senator Harrison asked one of the witnesses as to whether it would be fair to have the administration of a section similar to sections 327 and 328 vested in the Treasury Department. I have been practicing before the Treasury Department some twenty-odd years and a rather extensive practice and I think that if the Treasury Department in the first instance was given the right to administer such a provision, with the provision that wherever a taxpayer wanted to take an appeal to the United States Board of Tax Appeals, I believe that in 90 percent or 80 percent of the cases that they would work out a solution in the Treasury Department.

In other words, I think that from 80 to 90 percent of the cases arising under this special provision would probably be taken care of in the Treasury Department.

Senator KING. We have had too many appeals now in the Board of Tax Appeals.

Mr. HAYNES. I think, when you consider the large volume of cases that have been handled in the Treasury Department, probably the percentage of appeals to the United States Board of Tax Appeals is not very large.

Senator KING. And no complaint was made about the stupendous record that they had in the Board of Tax Appeals and the number of cases before them.

Mr. HAYNES. In the early days I think there was a very large accumulation.

The CHAIRMAN. Was there something else now you wanted to say?

Mr. HAYNES. I just have one more statement, Senator, and that is this:

I predict that if the proposed law does not carry some kind of a relief provision for new businesses that are being developed, experience will show that this tax will work such a hardship upon these new business enterprises that the same will be retarded, and in some instances actually destroyed.

The company presents the problem and prays for relief against otherwise ruinous results.

The CHAIRMAN. Thank you very much.

Mr. HAYNES. Thank you, sir, very much.

The CHAIRMAN. Anyone in the audience that has got to leave for this reason or that reason who wants to file their briefs?

(No response.)

The CHAIRMAN. All right.

A VOICE. Is this the end of the hearing?

The CHAIRMAN. No; I have got about 40 here left.

A VOICE. I mean is it the close of the hearing?

The CHAIRMAN. We are going to close the hearings today. We will have to meet again tonight. I was just trying to bribe somebody into filing a brief.

Senator KING. Call your next witness.

The CHAIRMAN. Mr. Ingebretsen, representing the Los Angeles Chamber of Commerce.

STATEMENT OF JAMES C. INGEBRETSEN, REPRESENTING LOS ANGELES CHAMBER OF COMMERCE

Mr. INGEBRETSEN. Thank you, Mr. Chairman.

The CHAIRMAN. Have you got a brief?

Mr. INGEBRETSEN. My name is James C. Ingebretsen. I do not have a prepared statement for you this afternoon. I am the attorney and Washington representative of the Los Angeles Chamber of Commerce. We comprise a membership of some 10,000 firms and individuals which are engaged in business in Los Angeles County.

A very complete statement of the chamber's position in opposition to this legislation was presented to the House committee by Mr. Leonard Read, the general manager of the chamber of commerce and I will not undertake at this time to repeat the arguments which are contained in that statement.

The CHAIRMAN. Was that on this bill?

Mr. INGEBRETSEN. On the subcommittee report, but, of course, a good many of the arguments in principle as set forth in that statement, I think, are equally applicable to the bill as reported by the committee.

The CHAIRMAN. We have that hearing here.

Mr. INGEBRETSEN. Yes, sir; that is contained at page 452 of the hearings before the House committee and I respectfully call your attention to that statement.

It received very extended consideration at the hands of some of the leading economists in the Southern California area and I think it is a very sound presentation.

We are opposed to profiteering and the creation of war millionaires. We recognize the necessity of increasing governmental revenues.

We are opposed to this bill as it stands. We were opposed to the bill as it was proposed by the subcommittee report because we do not think that this bill is the best way to accomplish either purpose. We think that both for the purpose of preventing profiteering, to the extent that that isn't prevented by the other restrictions and regulations to which business is subjected, and to the extent that it isn't prevented by the negotiating skill of your government negotiators and agents, and for the purpose of raising revenue, the sound approach is by taxes levied at the point where these profits are syphoned off from industry in the form of dividends and salaries and bonuses to individuals. After all, you can't have a millionaire until some individual extracts from the corporation the profits of the industrial enterprise in the form of salary, dividends, or bonuses.

We think that the logical solution of the problems confronting the committee would best be found in an extension of the current tax rates, current income taxes. We are very seriously concerned over the possible effect of this bill upon businesses that have been efficiently operated with a small capital basis and particularly those that have a growth record over the base period.

Now, we have a number of such industries in the Los Angeles area. Several representatives of industrial and business concerns from that area have gone to the time and expense of coming back to testify both before this committee and the House committee.

We have many concerns that will be seriously affected by the bill as it is now drawn. This bill will not tax their excess profits, and I suppose none of us would object to a tax which really reached excessive profits, but instead will add heavy and inequitable increases to their tax load on normal, or even subnormal profits.

So far as I am personally concerned, I would see no reason why truly excessive profits should not be fully recaptured by the Government to 100 percent.

After all, if those profits represent unjust enrichment, represent emergency profiteering, the Government is simply getting back what was unfairly taken from it in the first instance even under a 100-percent tax, and I would see no objection to that, if such excessive profits, if any, could actually be separated from normal profits, which we think cannot be done, but apart from that situation, we are alarmed at the possibility that in seeking to prevent the making of millionaires, which is only really something that we are indirectly concerned about, after all the thing we are vitally concerned about is developing our defense program and most business people would be glad to make some normal profits and in attempting to keep a few people from making money, you are liable to disrupt the entire defense program. We think our defensive machinery can only be developed through a rapid expansion of our industrial plants.

If mere manpower could build a modern army China would be the greatest military power in the world. The only way we can get it is to build machines, and the only sure way to get a rapid expansion of our industrial plants will be by the reinvestment of profits by these people who have been efficiently conducting their business enterprises in the last few years.

We make the following recommendations which were not made to the House committee because we did not have the bill before us. We think that the taxing portion of the bill should be withheld by the committee for further consideration. We think that when the bill is reported, there should be some form of special-relief provision to take care of these businesses that I have described.

We think there is no possible justification for the penalties which have been imposed on those companies which must elect to use their earnings as their base rate. With respect to amortization, we think that the provisions of subsections (i), (j), and (k) should be eliminated, and we think that the amortization provisions should be extended to the first of the year.

Senator KING. Have those last suggestions been reduced to writing?

Mr. INGEBRETSEN. No; they have not been, but I will be glad to do that and make it a part of the record.

The CHAIRMAN. If you want to elaborate on it, you have that privilege.

Senator KING. I wish you would prepare it this evening and let me have it tomorrow morning.

Mr. INGEBRETSEN. I will be glad to do that. Thank you very much.

(The letter to Senator King is as follows:)

1615 H STREET NW.,
Washington, D. C., September 5, 1940.

Hon. WILLIAM H. KING,
Member of Senate Finance Committee,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR KING: I am writing this letter in response to your request for a written outline of the specific suggestions which I offered to the Senate Finance Committee this afternoon at the conclusion of my testimony in opposition to the pending excess-profits tax bill.

We suggest:

1. That the taxing provisions of the bill be separated from the rest of the bill and be withheld by the committee for further study and consideration.
2. That when, if ever, an excess-profits tax bill along the lines of that now under consideration is reported, special consideration should be given to the protection of those concerns which have operated on a small capital basis and which show a growing earning record throughout the base period as a result of efficient operation and the reinvestment of profits. We think it is particularly important that the continued growth and expansion of such firms be encouraged in every way possible.
3. That adequate special relief provisions be included in the bill.
4. That the penalties created by the bill with respect to those corporations electing to adopt an earnings base be eliminated.
5. That the amortization provisions of the bill be extended to cover improvements constructed since January 1, 1940.
6. That subsections (i), (j), and (k) of section 124, relating to destruction of facilities be entirely eliminated.

With kindest regards.

Sincerely yours,

JAMES C. INGEBRETSEN,
Washington Representative,
Los Angeles Chamber of Commerce.

JCI:HD

The CHAIRMAN. Mr. Richard Pass of Pass-Seymour, Inc.

STATEMENT OF RICHARD PASS, REPRESENTING PASS-SEYMOUR, INC., SYRACUSE, N. Y.

Mr. PASS. Do you wish me to restate who I am or do you have it on the record?

The CHAIRMAN. I have it on the record.

Mr. PASS. We appear before you to make certain suggestions in connection with the proposed excess-profits tax which we believe would make such tax more equitable than the provisions of the bill under consideration. In the interest of saving time I will not give the background of our situation.

I don't think there is anything unusual about it. We are in a business which may be called a durable-goods business. We are largely dependent upon construction. We have had a number of years of depressed earnings.

During the base years of 1936 and 1939, we have just been getting on our feet again, just regaining our health. Our income in the first 3 of those base years was quite subnormal and that is the basis of our difficulty. For the 4 years, the 4 base years, our average net earnings were only 4.9 percent of the average net invested capital and in a business of this kind which suffers with fluctuations with the building cycle, that is not an adequate profit in order to maintain the business on a healthy basis.

It was not until 1939 and 1940 that we had so far regained our strength as to make earnings approximately normal. The improvement has not been due in any considerable degree to war conditions abroad nor to the defense program here. In fact, I believe that our business would be better than it is today if there were no war abroad and no necessity for a defense program here.

Our objection to the provisions of the excess-profits tax bill under consideration is principally to the use of earnings in recent years as the basis for judging what constitutes excess profits at the present time and for the future. In the excess-profits-tax bill under consideration, the extent of the tax is based primarily on the average earnings experience during the 4 base years from 1936 to 1939 and this is true under the bill's average earnings option and it is largely true also under the so-called invested capital option, since the tax under the latter is, itself, tied in with average earnings in those base years.

The CHAIRMAN. Do you believe that could be simplified?

Mr. PASS. I do and I am going to suggest how it might be simplified. Fundamentally, sir, I object to the principle that excess earnings can be properly measured by what earnings may have been during a base period in which there were many abnormal conditions and I think that applies particularly to businesses in the durable-goods industries which have not as yet, generally speaking, recovered fully from the impact of the recent depression.

The CHAIRMAN. Will you pardon me just for a second?

Mr. PASS. Yes, sir.

The CHAIRMAN. I have just been handed from the Navy Department a letter which I think ought to go into the record in connection with the other matter which I put in from the Secretary of War.

DEPARTMENT OF THE NAVY,
OFFICE OF THE SECRETARY,
Washington, September 5, 1940.

MY DEAR SENATOR HARRISON: I have read Mr. Knudsen's statement on the subject of subsections i, j, and k of the Second Revenue Act of 1940. Because of the diversity of arrangements that the Navy is faced with making in regard to proposed expansion of plant and facilities, it seems to me that his point is well taken and that the provisions would lead to difficulties in application. There is a distinct advantage to covering these problems by contract provisions which in their very nature are flexible and can be made to fit each type of case as it arises rather than to attempt an omnibus coverage of an inflexible nature in the law itself.

The development of this situation will conclusively demonstrate whether or not the contracts are effective and I consequently take the liberty of suggesting that legislation of the type now included in the draft of the pending bill can at any time, if necessary, be written into law by the Congress.

For these reasons I find myself in agreement with the point of view expressed by Mr. Knudsen.

Sincerely yours,

[Signed] JAMES FORRESTAL,
Assistant Secretary of the Navy.

Hon. PAT HARRISON,
The United States Senate, Washington, D. C.

That is signed by the Assistant Secretary of the Navy.

So they seem to be getting in harmony; more in accord.

All right, pardon me.

Mr. PASS. Mr Chairman and gentlemen, I am going to try to show very briefly why I don't think that excess profits should be defined as profits in excess of what the profits of a company may happen to have been in a base period of 3 or 4 years irrespective of whether those were normal years or subnormal years.

It is our understanding that the purpose of this excess-profits tax was to prevent profiteering under our defense program, by the imposition of a tax on excessive profits, and to do so without discrimination.

Also to raise revenue in such manner that the burden will be equitably distributed according to ability to pay. Now, analyzing those intentions, I should like to speak first of the profits from the defense program.

As far as I can see, our company, as an example, is not profiting this year either directly or indirectly from expenditure of the money appropriated by Congress under the defense program and yet the proposed excess-profits tax applies to us in the year 1940.

As to excess profits, certainly the base years from 1936 to 1939 do not furnish a measure of excessive profits for those companies which experienced very small earnings in those years.

Under the bill, these companies with small recent earnings are taxed more heavily on their current earnings than are companies which had good earnings in the base period. In fact, the companies with subnormal earnings in the base period may be taxed heavily even on earnings less than necessary to their survival, whereas the companies which were prosperous in the base years may have current earnings far in excess of what are necessary to survival and yet they may pay comparatively little tax under the present bill.

In short, sir, it seems to be a case of the devil take the hindmost. It appears to us that an excess-profits measure, which under both options, as in the present bill, predicates the tax principally on past earnings, does not fulfill the specifications of being nondiscriminatory nor of taxing in accordance with ability to pay and, indeed, in many cases, would tax, as excessive, profits which are very moderate.

We realize that for many companies, the average earnings option is highly desirable and we are not suggesting that this option be removed. We do suggest that the option based on recent earnings on invested capital—that is, the second option—be changed so that the invested capital option will not be tied in with past earnings but will be based entirely on current earnings and current invested capital.

The CHAIRMAN. Do you think that can be done?

Mr. PASS. Yes, sir. That is to say, a figure should be set as a fair percentage of return on invested capital before application of the excess-profits tax and the tax calculated on current earnings in excess of that figure. In the present bill there is an allowance of 10 percent and 8 percent earnings on the invested capital of new corporations and also on new capital in old corporations, whereas, only 7 percent and 5 percent are allowed on old capital.

This distinction does not seem to us equitable and, furthermore, for a great many companies a 5 percent return cannot be considered a normal return for normal years in our opinion.

It has been suggested that the 5 percent establishes a floor at a reasonable rate of return, but it is my opinion, based on a good many years of business experience and speaking primarily of the smaller or moderate sized companies with which I am most familiar, that in most cases, a higher rate of return than 5 percent is essential in times such as this if a company is to survive for long.

The CHAIRMAN. What would you suggest?

Mr. PASS. I am coming to that, sir.

We believe that the 10 percent and 8 percent earnings allowed new companies and allowed on new capital under the present bill should apply to all corporations, be they new or old, who choose the invested capital option. That is to say, for each taxable year, all who choose this option should be allowed, before application of the excess-profits tax, 10 percent of the first five hundred thousand of net invested capital at the beginning of the taxable year and 8 percent of the balance of invested capital as of the beginning of said taxable year.

The CHAIRMAN. Do you take into consideration loss of revenue?

Mr. PASS. Yes, sir; I am going to mention that. Not only would these percentages be, in our opinion, more equitable and more in accord with actual need, but also the method herein suggested would also obviously prove much simpler in administration and application.

Before concluding, I should like to say that I think the present bill is in some respects a definite improvement over the original proposal of the subcommittee. I haven't heard many comments in that direction. They seem mostly critical but I do think there are some points of improvement.

The CHAIRMAN. We are thankful for the kind words as said in regard to that bill.

Mr. PASS. Well, sir, I would like to point out just why that is, if I have a moment more.

The present method of figuring the excess-profits tax after deduction of credits is definitely fairer than the original method and I say that based on calculations that I have made in actual cases.

The original method in the subcommittee proposal placed a double penalty on companies which happened to have poor earnings in the base period, the very companies, incidentally, which in most cases could least afford to pay a heavy tax.

Those companies were penalized doubly because, in the first place, they had a small credit due to the fact that they had small earnings and, in the second place, because they had a small credit their rate of tax on all earnings above that credit worked out to a higher and more unfavorable figure than the rate of tax on a company with a large credit because of large earnings. It doubly penalized and pyramided the penalty against those companies.

Now, this is a very important point and in that respect the present bill is a definite improvement over the provisions of the subcommittee proposal.

Furthermore, the present bill has, of course, the 7-percent and 5-percent exemption in the so-called invested capital option which is an improvement over the original 6-percent and 4-percent figures, although, as we have already pointed out, the figures should be, in our opinion, 10 percent and 8 percent, the same as for new companies and for new capital.

In conclusion, I wish to emphasize that we have no desire to escape necessary taxation, and I think, sir, that that applies to manufacturers generally.

Our appeal is simply that the method of taxation be equitable and allow companies with moderate capitalization and with abnormally low earnings in recent years to survive and to maintain corporate health. Otherwise, they certainly will not be able to make their proper contribution (and the contribution which they wish to make) to our national well-being in this time of stress.

Now, coming to your question about the loss of revenue, Mr. Chairman. If, after trial, the option we have suggested of a 10-percent and 8-percent earnings allowance on current net invested capital, before application of the excess-profits tax, together with the average earnings option, fail to raise as much revenue as you believe to be necessary, then, instead of attempting to raise more revenue by an excess-profits tax, which would be discriminatory, may we respectfully suggest that additional revenue might better be raised by a statute drafted solely with that purpose in mind.

Senator KING. What do you say about raising the tax upon normal profits, increasing the rate upon normal profits?

Mr. PASS. I think, sir, that that is a more logical way of trying to raise necessary revenue, definitely so.

The CHAIRMAN. Thank you very much.

Senator KING. It wouldn't need a very great increase upon normal profits to raise the two or three hundred million dollars which at the outset was suggested would be raised by the excess-profits tax?

Mr. PASS. No, sir; it would not. It would not take a very large increase.

Senator KING. And then we could avoid all of these complications against which so much testimony has been presented?

Mr. PASS. Yes, sir.

The CHAIRMAN. You may put in the record, if you have any more statements.

Senator KING. Did you finish your answer to my question?

Mr. PASS. Not quite. What I was going to say in brief was, let us confine our excess-profits tax to the fundamental purpose of trying to avoid excessive profits under the defense program and let us raise our revenue by a revenue measure.

The CHAIRMAN. Thank you very much.

Is Mr. Dewey here? Mr. Bradley Dewey, of Cambridge, Mass., president of the Dewey Chemical Co. Go right ahead, sir.

STATEMENT OF BRADLEY DEWEY, PRESIDENT, DEWEY CHEMICAL CO., CAMBRIDGE, MASS.

Mr. DEWEY. My name is Bradley Dewey, president of Dewey & Almy Chemical Co. of Cambridge, Mass.

In appearing before the House Ways and Means Committee, with reference to their subcommittee proposals that were under consideration at the time their hearings were held, I took occasion to say that I thought most of the subcommittee proposals and options then under consideration were equitable and that many of the necessarily inequitable features of any excess-profits-tax bill would be cared for if a single optional relief were included to provide—

> that any excess-profits-tax law contain a provision that corporations which pay out in dividends within sixty days after the close of their taxable year all of their excess earnings, plus two-thirds of their base earnings, shall obtain a credit equal to the excess-profits tax that they would otherwise pay.

If time were available, I would like to present these same arguments to you. However, the bill as written now contains such other inequitable features that to conserve time to discuss two of these features, I ask to be allowed to present for the record a memorandum of the arguments submitted in favor of the above proposal and the reasons why it would better our national economy, facilitate the growth of new industries, and help the defense program.

The CHAIRMAN. We can read that?

Mr. DEWEY. Yes; I have that here and I would like to put that in the record if I may.

Senator KING. One of the witnesses who followed you commended your statement but it seemed to be a little obscure.

The CHAIRMAN. We may come back to it and we hope to make a little more progress in it than was made in the Ways and Means Committee in that respect.

Mr. DEWEY. Thank you.

The subcommittee of the Ways and Means Committee met proponents of a right for corporations to use consolidated returns with the argument that under either optional method the necessity for consolidated returns had been done away with by the allowance of a credit for dividends received from subsidiary corporations.

Paragraph 2 (a) of section 711 allows for the crediting of dividends received when excess profits are calculated upon the basis of invested capital. But such a deduction is not allowed in paragraph 1 (a) of section 711 when calculating credits on the basis of average earnings.

I haven't heard any discussion of that or the reason for not allowing it.

Many United States corporations have foreign subsidiaries and bring the earnings of these into this country in the form of dividends. When distributed, these result in increased personal income taxes and surtaxes. They are in no way due to moneys spent for defense in this country. If such dividends are not exempted from the determination of the excess profits of a company which wishes to use the average earnings method, it stands to reason that they will be kept abroad in one form or another until this tax is modified. Inasmuch as such dividends from foreign companies would, of course, be excluded when determining average earnings for prior years, such a credit would not be costly.

It would help the economy of this country and bring money back here where it could go to work and wouldn't cost anything to the tax.

Furthermore, not to allow under section 711–a–1 a credit for dividends received from foreign subsidiaries would discourage American companies from tapping rich markets such as South America at a time when the Government should be making every effort to encourage just such activities.

Now, I think that is a pure oversight there and I think it is one that should be corrected.

What reason is there for saying that companies which have had good earnings in the past and wish to use the average earnings method should be penalized by the levy of an extra corporation income tax and the payment of 5 percent higher rates? A doctrine of "He who hath shall pay" may be defensible when levying surtaxes, but it will not help the national economy to say that he who has been successful in the past shall pay greater taxes in the future.

Somebody called it a ticket to a show. I think it should be called a ticket to a lottery or the numbers racket because you can't tell how it works out until you have tried it.

Senator KING. One man suggested to me those tickets were a graveyard.

Mr. DEWEY. Yes.

How could the Government more effectively destroy incentive? The provision for the extra 4.1 percent income tax should be eliminated.

Now, one thing I would like to say in addition, because it has been brought up here by some of you. I think that every businessman I know or have talked to so far would rather pay more tax in the form of an increased normal tax and call it a day. I don't see why you can't label that an excess-profits tax is you want to put any type of ticket on it, but have it something that is fair and levies against one's own earnings and one's competitors' earnings equally and you will do better for the country.

Senator KING. It would save many hundreds of thousands if not millions of dollars in expenses in determining what the taxes were.

Mr. DEWEY. To me, the accountants and lawyers have been perfectly wonderful in coming here and arguing against this bill. I think it would cut a lot of their revenue but it would certainly let the business men in the country go to work.

Senator KING. Thank you very much.

Senator LODGE. This provision of yours offers an inducement to pay out dividends, is that right?

Mr. DEWEY. Yes, sir.

Senator LODGE. Is it substantially the same theory as the excess profits tax?

Mr. DEWEY. It is purely optional. It is based on an acceptance of the doctrine that no excess profits tax has yet been devised which is equitable to all and it is an additional optional provision to let some who would otherwise be crucified—growing young industries—to escape if they are in a position to tap the capital markets and get money back or if their stockholders will stand for stock dividends, warrants and things of that type.

It is not anything that will cure all of the cases, but I think you gentlemen have heard enough here today to know that this bill is going to cripple a lot of industries. It is simply an attempt to solve some of these problems. The right answer, as I say, would be to raise the income tax and levy equally on all.

Senator LODGE. Have you discussed this proposal with any people?

Mr. DEWEY. Yes, I have had a lot of encouragement but nothing else.

Senator LODGE. Well, that is a lot more than a lot of people have had.

(The paper filed by Mr. Bradley Dewey is as follows:)

MEMORANDUM OF ADVANTAGES OF A PROPOSED EXCESS-PROFITS TAX CREDIT PROVISION, SEPTEMBER 4, 1940

The following is presented in support of a proposal that:

Any excess-profits-tax law contain a provision that corporations which pay out in dividends within 60 days after the close of their taxable year all of their excess earnings, plus two-thirds of their base earnings, shall obtain a credit equal to the excess-profits tax that they would otherwise pay.

1. In the first place, since such a provision would not apply in any way to companies which have only normal rather than "excess earnings" and would not apply to *all* the earnings of companies which have "excess earnings," it cannot be legitimately claimed that it is a revival of the old undistributed-profits tax and that it is being used as a means of reviving a discarded tax. Above all, it is optional.

2. Since it is a natural ambition of managements to build up a record of earnings, it is clear that, if growing corporations are permitted to distribute their excess earnings in lieu of paying an excess-profits tax, managements will not be subject to the temptation (emphasized by Secretary of the Treasury Carter Glass, in 1919) to justify expenditures of doubtful business expediency by reasoning that the Government is sharing a proportion of such expenditures according to the rate of the highest bracket that applies. In consequence, when the fighting in Europe is over, our business will be in much sounder condition (*a*) to compete for world trade with foreign nationalized low-cost-labor industries which do not have to make a profit in order to exist and (*b*) to resist depressions.

3. The proposed credit will not deprive the Government of any revenue which it would otherwise receive and has the distinct advantage of increasing the turnover of money. Industries with excess earnings as a rule are of a somewhat speculative nature. Their stock is more likely to be held by individuals with money, who take risks and pay high surtaxes. Extra dividends to them of necessity pay maximum surtaxes. In addition, the very fact that more concerns will be paying handsome dividends will tend to liberalize the dividend policies of even those who are earning only normal profits. Obviously the resulting increase in the velocity of money is something that is highly desirable.

Our system of free enterprise is based on the idea of profit and encouragement of initiative and efficiency. If these incentives are taken away many industries here will ultimately reach the same condition as industries in totalitarian countries. The proposed divided credit preserves these incentives without depriving the Government of revenue. It promotes the employment of both capital and labor.

4. Most important of all, the proposed credit will facilitate the growth of new industries. During the last two decades there has been built up in this country the finest body in the world of trained research workers (mechanical, electrical, and chemical engineers, physicists, chemists, biologists, etc.) organized into well-directed units and ready to give the country new things and a leadership through which wage levels and the markets for our farm products and natural resources will be increased.

These men are ready to go forward and will go forward unless their progress is impeded by a law which deprives capital of the opportunity of profit commensurate with risk. The cost of developing new industries is greatest after processes leave research laboratories; changes must be made; improvements involving expensive engineering and obsolescence must be financed; markets must be developed. Consequently, the risks are so great that experienced men refuse to finance such developments unless they see a chance for high profits, at least until competitors discover alternate methods and processes.

5. Growing businesses are benefited by the insertion of the proposed dividend credit in the law. Since it is optional, they need not avail themselves of it but those who do are enabled thereby to build up a record of earnings and dividends which will attract new capital with which to finance desirable expansion.

6. An excess-profits tax with no credit for distributed earnings will tend to promote monopoly.

When there is no escape from a high excess-profits tax, it is but natural for industries with varied lines to use profits from certain lines to finance price cuts in other lines which are competitive with lines of companies who do not enjoy similar diversified profits with which to fight back. The Government pays a proportion of such price cuts and in this way assists in driving the competitor out of business.

If the opportunity to make profits commensurate with risk is denied to new inventions, they are driven into the hands of corporations who are seeking an outlet for excess earnings. This also tends to promote monopolies.

Such a dividend credit should tend to speed up the defense program. Without it many companies will wish, before making unusually large commitments, to study their probable impact upon earnings and taxes. With the credit available, they will forge ahead without waiting for such studies.

Senator KING. Who is the next witness here? Any volunteer?

Mr. TANZER. I believe I am.

Senator KING. Come forward. I don't know whether you are in order or not.

STATEMENT OF LAURENCE ARNOLD TANZER, REPRESENTING MERCHANTS ASSOCIATION OF NEW YORK

Senator KING. State your name, please.

Mr. TANZER. Laurence Arnold Tanzer. I appear as chairman of the committee on taxation and public revenue of the Merchants Association of New York.

I have here a statement which, with the permission of the committee, I will submit and in the interests of conserving the committee's time I shall limit my remarks here to stating very briefly the basis for our fundamental objection to this bill——

The CHAIRMAN. Thank you very much.

Mr. TANZER (continuing). Which is that it is not a genuine excessive profits tax bill but a hodgepodge of penal provisions, complicated, incomprehensible, containing uncertainties in almost every line and calculated to be productive of litigation rather than of tax revenue and tending to hamper the defense program.

Business is prepared for higher taxation to pay for the defense program but the occasion for higher taxation is no justification for adding to our already complicated taxes a new additional complicated tax with arbitrary and penal provisions and which is not really an excess-profits tax.

Now, the only justification for an excess-profits tax is the purpose of reaching, by taxes at rates higher than those imposed on normal income, abnormal profits resulting from the defense program. That cannot be reached—those profits cannot be measured nor reached by using an invested capital basis such as is proposed here.

In normal times some corporations make a small return on a large capital, others a large return on a small capital, and in none of those cases can it be said that the rate of return shows any excess profits or has any relation to excess profits. We submit that the invested capital basis has no place whatever in an excess-profits tax bill excepting as an alternative method of relief for corporations whose earnings during the basic period were so low as not to afford an adequate return on capital.

Then, the invested capital basis can be used as a relief, but when so used it can be greatly simplified without the complications that are in this bill and resort to it should not be forced by penalizing, as is proposed in this bill, the use of the normal period basis by imposing in the first place an additional income tax of 4.1 percent under the guise of an excess-profits tax and again penalizing it by imposing higher rates on the use of the earnings method.

Senator KING. Have you found any reason in any rational system of taxation or in morals for the imposition of that additional tax?

Mr. TANZER. None whatever, sir.

Senator KING. I didn't know whether I was becoming obscure in my thinking but I confess, not to prejudge the matter, that I could find no reason for it.

Mr. TANZER. We could find no basis whatever for it. We believe that the rates of excess-profits taxation should be based not on the dollar amount of the excess profits, but on the proportion of increase over the normal basis.

Now, we believe that this committee can render a great service to the country and to the defense program by rewriting this bill along the lines indicated and incorporating other provisions concerning which I shall not take the time of the committee to go into in detail.

They are mentioned in the statement. But they are such as the granting of special relief in cases where the normal period of years that is selected is not really a normal period, averaging over a longer period with a greater choice of years, the determination of the normal income, taking, for example, 3 out of 4 years, in giving taxpayers the option to deduct their entire borrowed capital and then not take a deduction of the interest on it or to deduct the interest and not include the borrowed capital.

Senator KING. What instrumentality do you suggest might be set up for the purpose of accomplishing the result to which you have just referred—instrumentality in the Treasury or an independent organization?

Mr. TANZER. For the relief?

Senator KING. Yes.

Mr. TANZER. For that I have no specific means to suggest excepting this, that the great defect of the excess-profits tax in the last war, of the relief provisions in there, was that it required the Secretary of the Treasury or the Commissioner of Internal Revenue, by a purely discretionary determination to apply the rate of representative corporations, according to methods which were not communicated to the taxpayer.

Now, whatever method is used should be used in a fair and aboveboard fashion so that the taxpayer is apprised of the method that is used with proper opportunity for hearing and review.

We believe that consolidated returns should be permitted as they were under prior laws and the double taxation of dividends should be eliminated.

Now, the preparation of such a bill will take time and we believe that it will be in the interest of the defense program to take the necessary time and in the meantime to enact promptly the provisions relating to amortization and to the elimination of the limitation of profits.

That can be done with very simple amendments. In the case of amortization, eliminating the arbitrary power given to the Secretary of War or the Secretary of the Navy, to recapture facilities at a price of $1 or more, a method which we have heard here today, the Departments of War and of the Navy do not ask for, and which the Advisory Defense Commission has advised against, and with respect to the limitation of profits we believe that in enacting an excess-profits tax as a substitute for the limitation of profits, the present provisions for limitation of profits should be repealed and not merely suspended by provisions, the application of which is very uncertain and arbitrary and discriminatory. If that is done, I think this committee will further the defense program instead of hindering it as would be done by the passage of the House bill in its present form.

The CHAIRMAN. Thank you very much.

(The paper filed by Mr. Laurence Arnold Tanzer is as follows:)

STATEMENT BY LAURENCE ARNOLD TANZER, ESQ., CONCERNING THE EXCESS-PROFITS-TAX BILL SUBMITTED TO THE SENATE FINANCE COMMITTEE ON BEHALF OF THE MERCHANTS' ASSOCIATION OF NEW YORK, SEPTEMBER 5, 1940

Mr. Chairman and gentlemen of the committee, the Merchants' Association of New York accepts the principle that business should not profit unduly from the present national emergency. It also agrees that a genuine excess-profits tax affords a practicable method of preventing such profiteering.

The bill (H. R. 10413) passed by the House of Representatives last week, however, is a perversion of these principles, and proposes neither a sound nor a reasonable excess-profits tax.

If adopted in its present form, far from expediting the execution of the national defense program, it would delay it because for every existing uncertainty which it would remove others would be added in a situation which is already seriously complicated.

We believe the Senate has the opportunity to make a major contribution to the welfare of the country in general and to the national-defense program in particular by drastically revising the House bill along the following lines:

AMORTIZATION AND PROFIT LIMITATIONS

There are only two parts of the House bill upon which immediate action is necessary. These are the sections relating to amortization and the limitation of profits on what may be called "defense contracts." We believe that the need for amendments to the existing laws to permit adequate allowances for amortization of investments in facilities for producing defense equipment and relaxing the existing restrictions upon maximum profits under "defense contracts" has been so clearly and repeatedly stated that no elaboration is necessary.

We object specifically to the provisions of section 124, paragraph i (Destruction, etc., of Facility, p. 91 of the House bill) on the ground that the authority vested in the Secretary of War or the Secretary of the Navy to fix the price at which facilities may be recaptured by the Government is arbitrary and not sufficiently inclusive.

We recommend that this paragraph be amended so as to permit the Government to recapture such facilities on the basis of proven cost of the entire facility less depreciation; and that the price to be paid be settled either by the Federal courts or by arbitration.

We believe that the limitations on profits from defense contracts contained in section 2 (b) of the act of June 28, 1940, are seriously hampering the execution of the defense program; and that the present bad situation would be made worse if the corresponding provisions in the defense appropriation bill and the Burke-Wadsworth selective service bill are enacted. These provisions apply only to primary contractors and raise other important practical difficulties. We also believe that section 301 of the House bill (p. 93), is so loosely drawn that it would be difficult to interpret and apply. We further believe that the passage of an excess-profits tax would remove any justification for the existing provisions, and we, therefore, recommend the outright repeal of section 2 (b) of the act of June 28, 1940 (Public, No. 671, 76th Cong., 3d sess.).

If this suggestion is not accepted, we believe the provision should be suspended with respect to profits which are subject to the excess-profits tax rather than to contracts entered into or completed in taxable years when the excess-profits tax is in force.

Prompt action upon these amortization and profit-limitation provisions would remove important handicaps upon the execution of the defense program, and we, therefore, strongly recommend that they be enacted separately and as quickly as possible.

EXCESS-PROFITS TAX PROVISIONS

The arguments for separate and immediate action upon these provisions are greatly strengthened by the valid and weighty objections against the remainder of the House bill. Those remaining provisions are not really a straightforward, sound excess-profits tax but a mongrel hodge-podge of increased income taxes, proposals for so-called social reform, and penalties against certain corporations merely because they are large. They are so unsound, both in principle and details, and drafted in such involved and incomprehensible language as to make it imperative that they be completely rewritten and simplified. That will, of necessity, require a considerable period of time.

We know that one of the main arguments advanced for hasty action is the desirability of letting businessmen know what excess-profits taxes they will have to pay. That argument is not valid as to the present bill because its provisions are so unintelligible and complicated, and would be so difficult to apply in practice that in innumerable cases corporations would not know their tax liabilities for years to come.

Businessmen already know that higher taxes are inevitable to pay the cost of an adequate national defense. Businessmen are on notice and generally agreed that excess-profits taxation should and will be enacted. They should, therefore, set aside ample reserves from earnings to pay whatever excess-profits taxes are eventually enacted, and if they do not set aside such reserves they are entitled to no sympathy.

On the other hand, they are fully justified in asking that, when an excess-profits tax is adopted, it be a clean-cut excess-profits tax, sound in principle, and as simple as may be.

Experience with the 1918 law has amply demonstrated that the percentage of profits to invested capital is not a proper basis for an excess-profits tax because it is not a fair measure of excess profits and because of practical difficulties in determining the true capital investment and because of inequity in its application to differently situated corporations.

We believe the earnings basis is preferable, but that the invested capital basis should be permitted as an alternative to corporations which during the basic period did not earn a fair return upon their investment.

The House bill ostensibly grants an option to use of either of these methods, but severely penalizes the use of the earnings basis, first, by imposing a 4.1 percent additional tax upon corporations electing to use this method, and second, by imposing a 5 percent differential as against the rates under the capital basis.

We submit that the 4.1 percent provisions is an increase in the ordinary income tax and has no place in an excess-profits tax act.

We recommend that the bill be revised to permit the use of either the earnings or the capital basis on exactly equal terms as to rates of taxation.

Under both bases the House bill fixes the rate of tax upon the amount of excess profits rather than the proportion of the excess to the earnings of the base period. That is grossly unfair.

Under the House bill a corporation which had normal earnings of $20,000 and earnings for the current year of $40,000 would be subject to a tax of 20 or 25 percent on $15,000, while a corporation whose normal earnings were $500,000 and whose earnings in 1940 were $1,000,000, exactly the same proportion, would be subjected to a tax of 40 or 45 percent upon $495,000. The only possible excuse for such provisions is that there is something iniquitous in a large corporation. These provisions utterly ignore the fact that a large corporation is much more likely to be able to make a real contribution to the national-defense program than a small one, and they further ignore that the owners of a small corporation are not necessarily persons of small means, whereas in many cases the owners of the great bulk of the shares of a large corporation are persons of small means.

In order to make the excess-profits tax apply to the real excess earnings of corporations in a fair and equitable manner we most strongly urge you to base the rate of tax upon the proportion of the excess profits to the profits of the base period.

Experience has shown that no general rule of law, such as would be necessary to embody either the earnings or the capital basis, could be applied to all corporations equitably. For this reason we believe it would be right to provide for a special method of assessing the excses-profits tax upon such corporations as, for example, those which were in process of development during the base period and began to earn profits thereafter, or those which had both a relatively small capital investment and depressed earnings during the base period, such as many corporations manufacturing "producers' goods."

A sound excess-profits tax law would recognize that the earnings of many corporations fluctuate widely from year to year. This recognition should be in the form of provisions permitting the use of an average earnings basis, for example, 3 out of 4 years, and also permitting the carrying of a net loss either forward or back, and similar treatment of excess profits. It would also be reasonable, if such privileges are extended, to fix a flat average rate of return on the capital basis of 8 percent. If you should, however, insist that a single year's profits be used, then, in order to provide for an offset for unprofitable years, the flat rate of return should be increased to at least 10 percent.

Another of the very bad features of the House bill is its treatment of borrowed capital. We cannot see any justification for limiting the amount of borrowed capital to be recognized. If the capital basis is to be permitted we recommend that the House bill be revised so as to permit the inclusion of all borrowed capital, and to exclude any deduction for interest paid on such capital from the earnings, or at the taxpayer's option the deduction of all interest and the exclusion of all borrowed capital.

The House bill could be greatly simplified and improved, and at the same time proper recognition given to a sound principle of taxation and accountancy, by permitting consolidated returns by corporations on the same general basis as in earlier tax laws. We heartily recommend that you make such provisions, and believe that you would be completely justified if you made these provisions apply to the normal income tax as well as to the excess-profits tax.

The final objection which we have to make at this time to the House bill is that it provides for double taxation of dividends if the earnings basis is used. Since the earnings from which corporate dividends are paid are already heavily taxed and, in many cases, will be still further taxed under the excess-profits tax law, we recommend that the House bill be changed so as to make clear that there shall be no excess-profits tax on dividends received from another corporation, and that stock held by a corporation shall be considered an inadmissible asset. In this connection we believe that foreign corporations should receive the same treatment as domestic. Certainly that should be true with respect to the income of foreign corporations from earnings within the United States.

CONCLUSION

If time permitted we could make many other suggestions for the improvement of the House bill, but if you will adopt those which we have submitted we are firmly convinced that you would have a clear-cut, comprehensible and workable tax law which would prevent profiteering out of the necessities of the national-defense program, and that you would deserve the gratitude of the business community at the same time that you were serving the broad public interest.

The CHAIRMAN. Mr. J. W. Oliver.

STATEMENT OF J. W. OLIVER, REPRESENTING THE LINEN THREAD CO.

Mr. OLIVER. Mr. Chairman, gentlemen of the committee, I would like to refer to one or two things in the brief which I will ask be received. My statement will take less than 10 minutes' time.

The CHAIRMAN. I hope you will take less than 10 minutes.

Mr. OLIVER. I should like to read the six major exceptions which are very briefly stated here, but elaborated on further over. The bill:

Taxes to some extent and in certain ways dividends received.

That is an exception that I take to what one of the prior witnesses just brought out. We have heard a little about that today.

Penalizes those corporations which elect section 713 as basis of credit to extent of 9.1 percent of excess profits net income.

A previous witness referred to that 9.1 percent as being slightly more than that. I think he made a mistake there.

He calculated that as though there was a duplication and a failure to allow the proper credit and I followed that all the way through, starting with that same theory that he had and came back to this, that it is really only a penalty of 9.1 percent, but I maintain that that penalty should not be there.

Applies excess-profits tax rates to absolute amounts without taking recognition of any basic degree of excess.

Grants exemptions to and favors small corporations beyond administrative necessity.

The whole theory of excess-profits taxes breaks down when proper ratios and uniformity are disregarded.

Does not uniformly suspend the profit limitations of the Vinson Act as of January 1, 1940.

Fails to provide for consolidated returns in case of affiliations that require consolidation in order to present true net income and invested capital.

I maintain that the only way in which you would be justified in taxing dividends at all would be to go on the absolute theory that there will never be any dividends declared hereafter except those which were earned prior to the imposition of this new tax bill and I don't see any other theory on which you could tax dividends received.

I will grant you they are not taxed on other methods, just a certain portion of it.

Now, I am going to ask you that instead of imposing less taxes that you make it an excess-profits tax in fact and apply it on all corporations and raise the amount rather than lower it.

I am not here arguing a case for the large or small corporation, but I do show on page 3 a table on which the small corporation with $200,000 capital, earning normally $10,000, having suddenly an earning of $30,-000, which would be the maximum amount of the first bracket, he would have an earning of 300 percent of his normal earnings and still be taxed at the lowest bracket.

I maintain that that is absolutely fallacious so far as the absolute theory——

The CHAIRMAN (interposing). I wish the Treasury representative would make a note of that and get a copy of this brief.

Mr. OLIVER. There is one other point I want to bring to your mind. I feel that practically all witnesses have opposed your failure to provide for consolidated returns. One point about this I do not believe has been brought out as well as might have been and that is that most of the corporations that operate on borrowed capital are, in fact, subsidiary companies.

I think, if you will obtain from the Treasury Department a statement of the corporations wherein the borrowed capital is equal to or a great deal more than their equity invested capital, you will find that 95 or 99 percent of those corporations are corporations that should be affiliated and would have been affiliated under prior laws.

I would like to urge the committee to ask for that information from the Treasury Department.

The CHAIRMAN. All right. The Treasury Department will take note.

Senator KING. What advantage or disadvantage would result from the plan which you suggest?

Mr. OLIVER. Consolidated returns, you don't need to be bothered with this borrowed capital competition that seems to be causing so much trouble here, if the borrowed capital is among intercompany borrowings, and that is what I maintain it is. Ninety-nine percent of the larger corporations in the country who operate chiefly on borrowed capital are borrowing from a brother and sister or a parent company which would all be eliminated from consolidated returns and that problem would be eliminated from the consolidated returns.

Senator KING. You may be right as to the relation between many of the small corporations and a number of the large ones, but a number of years ago I remember making some considerable investigation and I found that the mortality of corporations was largely among small corporations who were not affiliated in any way with large corporations.

Mr. OLIVER. That is quite true.

Senator KING. And it seemed to me that out of the several hundred thousand corporations, the mortality was very great among those small corporations that had no affiliates.

Mr. OLIVER. Yes; I grant you that. The affiliation I say is the one which actually causes a great number of subsidiaries to operate on borrowed capital just for convenience. You might have started a subsidiary company on a nominal $10,000 and it had grown to be a $4,000,000 corporation operating purely on intercompany indebtedness. That kind of company, if it made it stand on its own feet, would have no capital, so your bill proposes to allow them one-third of their borrowed capital and then there are a number of other complications about this borrowed capital, whereas if you permit that corporation to be consolidated with the parent, all those complications would be eliminated.

The CHAIRMAN. Thank you very much, Mr. Oliver.

(The paper filed by Mr. J. W. Oliver is as follows:)

STATEMENT OF J. W. OLIVER, COMPTROLLER-SECRETARY OF THE LINEN THREAD CO., INC., REGARDING H. R. 10413, SECOND REVENUE ACT OF 1940, SUBMITTED TO THE SENATE FINANCE COMMITTEE

Mr. Chairman and gentlemen of the committee, I respectfully urge your consideration of the following main objections to the Second Revenue Act of 1940 as passed by the House of Representatives last week:

1. Taxes to some extent and in certain ways dividends received.
2. Penalizes those corporations which elect section 713 as basis of credit to extent of 9.1 percent of excess-profits net income.
3. Applies excess-profits tax rates to absolute amounts without taking recognition of any basic degree of excess.
4. Grants exemptions and favors small corporations beyond administrative necessity—the whole theory of excess-profits taxes breaks down when proper ratios and uniformity are disregarded.
5. Does not uniformly suspend the profit limitations of the Vinson Act as of January 1, 1940.
6. Fails to provide for consolidated returns in case of affiliations that require consolidation in order to present true net income and invested capital.

Further brief explanation of the foregoing exceptions, as they apply to the foregoing numbered paragraphs, follows in order.

Objection No. 1.—It seems to me that under the House bill some part of dividends received, at least under some methods, is allowed to enter into the computation of excess-profits taxes. This can only be justified on the theory that all dividends received throughout the life of this tax bill will be paid from earnings accumulated prior to 1940. With the recent expiration of the undistributed-profits tax, it would seem that there is no ground to assume that any substantial future dividends (while excess-profits taxes are in effect) will be paid out of earnings other than those accruing during the excess-profits-tax period. Personally, I take exception to our present normal tax rate applying to the 15 percent of intercorporate dividends, but there is no bill before you that would permit consideration of this phase.

Objection No. 2.—I respectfully maintain that if it is necessary to allow the taxpayer a choice of methods, either from the standpoint of simplicity or from the standpoint of that which he thinks to be the correct way of determining his excessive income, the final rate of tax should be the same. Why, under any condition, one taxpayer should pay more normal income tax than another or net income (otherwise computed in the same manner) is not explained. It seems to me that this, coupled with the higher rates of excess-profits tax in the different brackets, is a penalty for an election. To offer the taxpayer an election and then penalize him for making such election may be interpreted by the taxpayers affected by this provision as nothing but trickery.

Objection No. 3.—I take exception to the failure of the bill to apply percentage taxes into ratio to the proportion of excessive income. I refer to the fact that the bill would deal with definite amounts in an arbitrary way rather than to afford a graduted tax on the different proportions of the excessive income that may bear some relationship to normal income or the amount that should be earned on invested capital. The bill provides that the first $20,000 of excess is to be taxed at the lowest rate. This means that many of the smaller corporations, no matter how disproportionate their excessive earnings, will escape the higher rates that should be imposed. In the following table I show an example of concerns having an invested capital ranging from $200,000 to $20,000,000, each having a 5 percent normal earning on their invested capital, and the effect of the $20,000 additional income:

Invested capital	5-percent return on capital (normal)	Normal income plus $20,000	Percent of normal income
$200,000	$10,000	$30,000	300
$500,000	25,000	45,000	180
$1,000,000	50,000	70,000	140
$5,000,000	250,000	270,000	108
$10,000,000	500,000	520,000	104
$20,000,000	1,000,000	1,020,000	102

You will see from the above table that the $200,000 corporation with a $10,000 normal income, should it earn $20,000 additional, would have a total taxable profit in the excess-profits tax year of 300 percent of its normal income whereas the $20,000,000 corporation by earning only $20,000 additional would only have 102 percent of its normal income. Thus, by taxing flat amounts rather than proportionate excesses, you fail to take any recognition of varying degrees of true excess earnings. Surely the small corporation which realizes 300 percent of its normal earnings in an excess-profits tax year should have to pay a maximum tax on some portion of such excess earnings.

Objection No. 4.—It is the larger corporations that will be called upon to furnish the Government the major portion of prime materials and products for national defense. However, I am not here to argue a special case for the large corporations. I do think, however, that all corporations should pay proportionately and when you consider that the small corporation is most likely to benefit by increased production, I do not understand why that corporation should not pay the maximum tax when its excessive earnings may be many times over the proportion that brings the larger corporations under the maximum rates. If it is fair to assume that the larger corporations will be the ones who will be compelled to tie up their production on large Government contracts, I think it may be equally assumed that the small corporations will be the ones to reap an even greater commercial advantage. The large corporations whose plant capacity may be taken up primarily with Government contracts is the corporation which will be less able to look after the requirements of its own trade. Thus, if they are unable to supply their own trade, numerous small corporations will reap a tremendous benefit and thus, in all probability, share proportionately larger in the amount of increased earnings that may obtain during this period of national-defense reconstruction.

If you make the larger corporation share this burden so disproportionately it is bound to have an adverse effect on capital investment at a time when many of the larger corporations need more capital in order to adequately serve the Government.

Now let us assume that the $20,000,000 corporation made an honest attempt to keep its earnings down to normal, that is, it gave due recognition of its manufacturing cost to the requirements of labor and other increased costs which would face it, and then attempted to supply the National Government at a price which would not cause it to have any excess earnings. The $20,000,000 corporation could not avoid slight deviations in cost. Such an item as the recovery of bad debts previously charged off might cause considerably more than a $20,000 variation without it being fully established that such was excessive income within the meaning of this law. On the other hand, for the small corporation, normally earning $10,000, to increase its taxable earnings to $30,000 in 1 year would be nothing short of profiteering. Thus, the failure to tax the small corporation in the same proportion that you tax the large corporation would be a violation of the principles of ability to pay in prescribing the statutory tax. Surely such would not be a true excess-profits tax.

From a reading of the Act and especially in the light of comments in the report of the Ways and Means Committee, it would appear that the bill which passed the House was designed to reach only about 14 percent of all the corporations. The failure to provide that the small corporations should be relatively taxed and the provision that they be allowed higher proportion of borrowed capital in the computation of invested capital indicates to me that this is not a tax bill. It is a special privilege bill for the small corporations and a penalty on the very existence of the larger ones. There is absolutely no occasion for the preferential treatment of borrowed capital as part of invested capital in the case of the smaller corporations. Surely, if it is the intention of the Congress to make the taxpayers, who share in a degree of increased earnings which result from the Government spending in the preparation for national defense carry part of the burden, an excess-profits tax should be uniformly imposed or, if administratively impossible, some other form of taxation should be adopted. Why should any corporation be exempt from the first $5,000 of excess profits? It may be argued that administrative cost would be proportionately greater but it must not be overlooked that each and every corporation must file corporation tax returns whether or not it makes any income. Thus, such additional information as would be specifically required for an excess-profits determination would be incidental. On the other hand, if under the present law, no corporation was required to file a return at all unless it had net income in excess of, say, $10,000, then it might be held that a $5,000 excess income exemption, from an administrative-cost point of view, might have merit. While I strongly advocate simplicity in revenue acts and tax administration, I realize that it would be futile to stress that point on this occasion but if the advocates of this tax bill promote the cost of administration as justifying the exemptions granted in this bill, then I must point out the lack of consistency by contrasting such proposed exemption with the absolute requirement that every person receiving (or presumed to have received) unjust enrichment under title III of the 1936 Revenue Act was required to file Form 945—the most burdensome type of report ever inflicted upon taxpayers. The administrative cost of such peculiar reports overshadowed anything ever contemplated to meet the requirements of an excess-profits tax bill. It is unfortunate that taxpayers generally in this country are beginning to look upon their Government in a sense of distrust. If you pass this tax bill in its present form, it will, in my opinion, demonstrate to the majority of taxpayers that those seeking to raise revenue for the maintenance of our Government are not primarily guided by principles recognized as cardinal to the application of a fair tax law.

Objection No. 5.—The Vinson Act should be repealed as of a definite date even though such repeal might possibly be construed as favoring the corporation operating on a fiscal-year basis. The application of the Vinson profit limitation was ill-conceived in the first instance. All corporations in this period of emergency should be expected to pay their fair proportion and no one should be allowed to become unduly enriched as a result of Government contracts. The Vinson Act, however, in its present form, provides for no such thing. It simply provides that under certain peculiar contracts and conditions some corporations are not allowed to earn over a stipulated small percentage on those contracts. However, where a corporation in good faith so ties up its plant facilities with the production of governmental requirements to the extent that it cannot take care of its normal customer demands, it limits its own profits under such circumstances to a very small amount. As a consequence, some of, if not most of, its best customers are compelled to take their business elsewhere. Thus, the competitor who under normal conditions would have had no chance to gain this business has it thrown in his lap, enjoys an unusual amount of income therefrom, and pays nothing under the present application of the Vinson Act. What a tax on patriotism for the corporation which performed its public duty, realizing thereon an extremely limited amount of statutory net income, only to find when the Government contracts are completed that it is no longer in business.

Furthermore, under the House bill it would be excedingly difficult to determine the proper effect to be given to any contracts entered into but not completed prior to the imposition of the excess-profits tax. By suspending the profit limitations of the Vinson Act on January 1, 1940, and applying profit limitations on earnings prior thereto, this complication is avoided.

Objection No. 6.—Excess-profits taxes in the case of affiliated corporations can only be dealt with properly in consolidated returns wherein you deal with consolidated invested capital and consolidated net income. About the only place in the case of the average corporation, wherein borrowed capital really takes the place of invested capital is to be found in the case of subsidiary corporations. Here you will find that perhaps the majority of subsidiary companies operate on a limited capital actually invested in the form of capital stock but primarily upon intercompany indebtedness. I daresay in most instances the intercompany indebtedness that is back of the working capital of the average subsidiary is not evidenced by notes, bonds, etc. If you insist that these corporations must be taxed separately you do a great injustice if you do not permit the use of borrowed capital to take the place of invested capital. All of this could and should be easily overcome by permitting consolidated returns in line with the provisions of the 1918 Revenue Act.

Gentlemen, I am convinced that the businessmen of this country are reconciled to the fact that higher taxes are unavoidable. They recognize also that business enterprise is the only source from which these higher taxes can be paid. Thus, I say with positive assurance that the organization with which I am connected, and others with which I have had contact, will not even flinch if this statute is so worded as to show an honest attempt to spread this burden on an equitable basis.

There is one matter, however, not dealt with in the foregoing, purposely left until the last, which should receive your attention. This has to do with nonoperating or extraordinary income. Income received during the tax year actually belonging in prior years should not be included in the computation of excess-profits taxes. I have in mind the recovery of bad debts or a claim for refund under title VII of the 1936 Revenue Act. Certainly, a claimant who recovers illegally collected processing taxes in 1940 or later should be exempted from excess-profits taxes on such income. I should find no fault, however, with a provision that would require appropriate prior years' normal taxes being paid, notwithstanding it might be barred by statue, as a condition of the exemption in the year of recovery.

The CHAIRMAN. Mr. E. R. Clark.

STATEMENT OF E. R. CLARK, REPRESENTING THE W. P. BROWN & SONS LUMBER CO, LOUISVILLE, KY.

The CHAIRMAN. Mr. Clark represents the W. P. Brown & Sons Lumber Co. He is from Louisville, Ky. All right Mr. Clark.

Mr. CLARK. Mr. Chairman, gentleman of the committee, I am going to make my remarks very short and file a supplementary brief.

The bill, as passed by the House, makes certain adjustments in base period income, so as to properly reflect a normal income for that period, but I want to point out to you gentlemen two or three additional adjustments that I think should be made, in arriving at the base period income.

One has already been talked on at length this afternoon and that is the matter of bond discount.

Now, our Brown Hotel Co. in 1939 charged against its profits about $50,000 for unamortized bond discount and expense, because in that year it paid off its bonds and refinanced the loan with an insurance company.

There was no income resulting from this only a charge against profits. In the same year, W. P. Brown & Sons Lumber Co. had a smaller charge for a premium paid on the retirement of its bonds, and, unless these income accounts for 1939 are adjusted by this bill, our base period income will be greatly distorted from normal.

The present exclusion in the bill as passed the House should also exclude from the base period not only the income realized from the retirement of one's own bonds but the premium paid and discount and expense amortization charged.

In 1936 W. P. Brown & Sons Lumber Co. had a most unusual bad debt charged off, of $1,240,000 and a worthless stock loss of $100,000, which caused our company to show a very sizable loss for that year, the only one in our base period.

For about 10 years we had been making cash advances in very large amounts to another company to meet its mortgage retirements. The secured creditors got dissatisfied with the way the debt was being paid and, since W. P. Brown & Sons did not feel like they could put any more cash into that company, the secured creditors took the assets and consequently we had our loss.

Without those two items of loss, our company would have shown a net operating income in that year of about $300,000 which I think should be added to our base-period income, instead of starting at zero for that year.

At no other time in the history of our company's 22 years of business experience have we had any such loss anywhere near those proportions.

So I want to point out that it is a very unusual and out-of-the-ordinary item.

Had these items resulted from the sale of one of our plants or from some of our cut-over timberlands the adjustment provided for in the bill, as it passed the House, on capital gains and losses, they would be taken out of our base-period calculations.

I respectfully urge you, gentlemen, to provide for the exclusion from base-period income losses on unusual situations of this kind, so that our base-period income will more nearly reflect the normal operating conditions of that period.

Senator KING. Thank you very much.

(The prepared paper filed by Mr. E. R. Clark is as follows:)

SEPTEMBER 5, 1940.

Honorable FINANCE COMMITTEE,
Senate of the United States of America.

GENTLEMEN: To amplify my statements to you this afternoon and to point out to you that an excess-profits-tax bill should provide an adjustment in arriving at the taxable excess profit for unusual bad-account charges during the base period, W. P. Brown & Sons Lumber Co. in 1936 had an unusually large bad-debt deduction and a worthless-stock loss, which left the company with a net loss that year of a large amount. This company, over a period of 10 years, had made cash advances to another company, Brown-Florida Lumber Co. In 1936 other creditors of that company "closed in" and took the assets, leaving our company high and dry.

Without these two unusual deductions, W. P. Brown & Sons Lumber Co. would have had a net income of $396,674, about $94,000 of which was capital gain, or an operating income of about $302,000, which we feel should be included in our base-period income instead of counting that year's earnings as zero.

Had we suffered these losses on the sale of a plant or piece of land, adjustment would be made under the bill as now drawn, and the loss we suffered is just as unusual. Unless adjustments are made for conditions like these, our normal operating profit for 1940 and later years will appear to be, abnormally and artificially, in excess of our normal operating profit for the base period.

Then, too, the Brown Hotel Co. had a deduction of about $50,000 in 1939 because of bond discount and expense charged off in the year in which its bonds were paid off in full and its mortgage debt refinanced.

The bill as now written makes adjustments to take out of income for the base period, income earned by the retirement of bonds. I think the exclusion should also take care of the reverse situation so that expenses and losses charged off because of the retirement of bonds should also be excluded.

I also think that the difference in interest expense for the taxable year and the average interest expense for the base period should be included in the excess-profits-tax credit so that the excess operating profit can be properly stated without penalizing a company by applying the excess-profits tax on a reduction in its operating expenses because of lower interest charges in the taxable year than there were in the base period resulting from substantial payments on the company's debts.

To picture this situation to you, I give you below actual figures taken from the income-tax returns that have been filed, showing the interest deductions:

Year	W. P. Brown & Sons Lumber Co.	Broadway & Fourth Ave. Realty Co.	Brown Hotel Co.
1936	$44,976	$89,372	$107,548
1937	35,676	75,039	91,876
1938	24,520	70,821	[1] 68,658
1939	15,367	64,251	77,517
4-year total	120,539	299,483	345,599
4-year average	30,135	74,871	90,156
1940 deduction will be about	2,500	54,500	54,000
Base-period excess over 1940	27,635	20,371	36,156

[1] The Brown Hotel Co. figures for 1938 are for 10 months only; so its total is divided by 46 months, then multiplied by 12.

All three of these companies are located in Louisville, Ky.

Under the foregoing circumstances, these taxpayers respectfully submit that they are entitled to some relief at the hands of the Congress of the United States. What has been said in the foregoing presentation applies no doubt to a large number of corporate taxpayers throughout the United States.

Respectfully yours,

W. P. BROWN & SONS LUMBER CO.,
EDWARD R. CLARK, *Secretary*.

Senator KING. Call your next witness.

The CHAIRMAN. All right, Mr. Brown.

Mr. MCIVER. Mr. Chairman, do you still want volunteers for the filing of briefs without comments?

The CHAIRMAN. Well, that is up to the volunteers, if they want to.

Mr. MCIVER. I would like to volunteer, sir. I would like to file my brief, and, instead of taking 10 minutes later on to explain the reasons in my brief, I would like to take 45 seconds to explain why I am filing the brief.

The CHAIRMAN. You can take 25 seconds right now.

Mr. MCIVER. Thank you, sir.

Senator KING. I move we increase it and make it 60 seconds.

The CHAIRMAN. We will just say 25 seconds.

Mr. MCIVER. I said 45. I think that will be sufficient.

STATEMENT OF R. S. McIVER, REPRESENTING THE TAYLOR FIBRE CO., NORRISTOWN, PA.

The CHAIRMAN. What is your name, please?

Mr. MCIVER. My name is R. S. McIver. I am the treasurer of Taylor Fibre Co., of Norristown, Pa.

My name does not appear on the list of witnesses, but I think Senator Guffey requested that it be added later this morning.

The CHAIRMAN. All right.

Mr. MCIVER. It was my intention to point out the unfavorable situation under this proposed bill on companies such as ours, which had been formed during depression years and had invested considerable amounts of capital.

I find that the points that I had expected to bring out have been quite comprehensively covered by some of the previous witnesses and also some of the remedies that I was about to suggest have been covered by the witnesses for Universal Pictures Corporation, Cardox Corporation, and in several other cases.

I don't think that I can add anything further to what those witnesses have suggested, but I would like to file this memorandum, in the sincere hope that the committee will realize that the problems facing companies such as mine, under this tax, are very real and very dangerous to us.

Thank you, sir.

The CHAIRMAN. Thank you very much.

(The prepared paper filed by Mr. R. S. McIver is as follows:)

MEMORANDUM REGARDING THE SITUATION OF TAYLOR FIBRE CO. WITH RESPECT TO THE PROPOSED EXCESS-PROFITS TAX

Taylor Fibre Co. of Norristown, Pa., was organized in December 1936. On December 31, 1936, it acquired, by purchase, from Taylor & Co., Inc. (a Delaware corporation), the manufacturing assets of the latter company at Norristown, Pa., and assumed the liabilities pertaining to the said manufacturing business. In exchange for the net assets Taylor Fibre Co. issued its 6-percent debenture to Taylor & Co., Inc., in the amount of $1,131,482.60.

On December 31, 1936, the paid-in capital of Taylor Fibre Co. was $688.60, representing cash paid for 6,886 shares of common stock, at 10 cents per share. The subscribers to these shares (three individuals) were the owners of all of the capital stock of the Delaware company. In effect, therefore, the original stockholders were identical with the debenture holders.

The manufacutring businss at Norristown was started by Taylor & Co., Inc., in 1933, and its investment in the project at the close of various years was as follows:

Dec. 31, 1933	$675,574	Dec. 31, 1935	$785,025
Dec. 31, 1934	772,353	Dec. 31, 1936	1,131,483

The project was conceived, and the major portion of construction completed, during the depths of the depression. The responsible individuals involved were experienced in the business; were aware that it required heavy investment in plant and equipment; were aware of the hazardous nature of the business and of the probability that losses would be incurred during the "development" period of several years.

The transfer of the manufacturing business to Taylor Fibre Co. on December 31, 1936, was made for the purpose of segregating in a separate company the manufacturing assets located in Pennsylvania. The other properties and activities of Taylor & Co., Inc., have no relation to the fiber business.

It is obvious that the major portion of the capital of Taylor Fibre Co. is technically "borrowed capital." The results of operations of the company have been as follows:

	Income (+) or loss (−) before interest and taxes	Taxes	Interest	Net income (+) for loss (−)
1937	+$48,156		$67,889	−$19,733
1938	−64,555		[1]	−64,555
1939	+70,787	$1,585	67,889	+1,313
Total	+54,388			−82,975

[1] Interest of $67,889 for 1938 was waived by the holder of the debenture.

Problems of factory production and sales organization, characteristic of the development years, have only recently been overcome, and the company within the past year has begun to emerge from its formative period. During 1940 it is expected that the company will have net income of about $110,000 (after interest and income taxes, but before excess-profits taxes).

The company is not a war-industry company. In general, its prosperity is dependent upon activity in the electrical, radio, and automobile industries, and its earnings will fluctuate with changes in those industries. Experience indicates that war is detrimental to the fiber business in general.

The company is young, and its normal earning power has not yet been established. The rate of return earned to date by the capital advanced has been insufficient to warrant the risk involved in the venture. It is believed that some relief should be provided in the excess-profits tax bill which will permit this capital to earn a fair return, commensurate with the risk involved, before the imposition of excess-profits taxes. This is the objective which the company seeks.

In view of its loss experience since incorporation, the average-earnings method of computing credits under the proposed law is obviously of no value to the company in obtaining its objective.

The invested-capital method permits earnings of only 7 percent and 5 percent on certain portions of borrowed capital before imposition of excess-profits taxes. These rates are insufficient, compared with the capital risk, particularly in view of the following facts:

(*a*) The fiber industry requires an unusually heavy investment in plant and equipment (about $1 per dollar of annual sales). This plant and equipment is at risk over a long period of years.

(*b*) Fluctuations in earnings in the fiber business are wide, as is the case in other "heavy industries." It is necessary for capital to earn a high rate of return in profit years (as in the steel industry, for example) in order to compensate for inevitable losses in other years.

(*c*) The Taylor Fibre Co. has a goodwill asset which is not reflected on its books nor in its capital structure, but which is substantial. This goodwill arose from the fact that members of the Taylor family, including the present principals, were engaged in the fiber business for many years prior to 1929 (as early as 1890), and were well known to the trade. This intangible asset is in reality paid-in capital which is not reflected on the books and for which no credit is provided under the invested-capital method.

The invested-capital method does not permit the company to obtain its aforesaid objective. Provisions in the bill at present permit new capital to earn 10 percent (up to $500,000) and 8 percent (in excess of $500,000) before imposition of excess-profits tax. Some relief would be granted to taxpayers such as Taylor Fibre Co. if these percentages were extended to cover capital placed in a new business during the 8 years preceding January 1, 1940. Surely capital which was invested so as to result in needed employment of labor during the recent depression is as deserving of consideration as new capital to be invested under conditions now prevailing.

It is believed, however, that even the aforesaid rates of 10 and 8 percent are insufficient to attract new capital to hazardous industries.

In addition to the aforementioned suggested relief provisions, corporations such as the Taylor Fibre Co., which have sustained substantial losses in the majority of the base-period years, should be permitted to carry forward to the taxable years amounts which are in substance equivalent to unused credits in the base period. For example, the excess-profits-tax bill, as now written, recognizes that corporations are entitled to a return in each year of at least 7 percent on the first $500,000 of invested capital and 5 percent on invested capital in excess of $500,000. It would therefore be only fair and equitable to permit a corporation which has not earned an amount equivalent to those percentages in each of the base-period years to utilize the unused portion thereof as a credit in subsequent taxable years.

Some further comment should be made concerning changes in the capital structure of Taylor Fibre Co., namely:

(*a*) During the years 1937, 1938, and 1939, there were issued to certain officers, for services rendered, 1,375 shares of stock having a fair value of $13,914. This increased the number of shares from 6,886 to 8,261, and increased the equity capital from $688.60 to $14,602.80. By December 31, 1939, the stockholders had increased in number from 3 to 9. The company in the future will, under contracts already entered into, issue additional capital stock for services rendered by officers. Since there is some doubt whether the present bill permits such stock issue to increase invested capital some provision should be made in the bill to make it clear that stock so issued does increase invested capital.

(*b*) During the years 1937, 1938, and 1939, Taylor Fibre Co. made further plant additions of $161,808, of which $81,808 was paid for out of earnings or working capital ($80,000 additional capital was borrowed to pay the balance).

Owing to these demands on working capital, the company was unable to pay in cash its debenture interest, and to assist the struggling company, Taylor & Co., Inc., accepted additional debentures covering interest for the 6 months ended December 31, 1937 ($33,944.46), and interest for the year 1939 ($67,-888.96). These additional debentures increased the debenture indebtedness from $1,131,482.60 to $1,233,316.02.

EFFECT OF PROPOSED BILL ON PROBABLE 1939 EARNINGS

We have estimated that the company will make a profit for 1940 of about $140,000, less normal income tax of $29,260 (20.9 percent), or $110,740 net.

The invested capital would be as follows:

Equity capital, Jan. 1, 1940	$14,600
Borrowed capital:	
$85,400 at 100 percent	85,400
	100,000
000,000 at 66⅔ percent	600,000
247,916 at 33⅓ percent	82,638
1,233,316	782,638

The "credit" against excess-profits tax will then be:

7 percent times $500,000	$35,000
5 percent times 282,638	14,132
Total	49,132

An estimate of the excess-profits tax would be as follows:

Estimated earnings		$110,740
Add portion of interest equal to:		
782,638 times $73,999		46,958
1,233,316		
Total		157,698
Exemption as above	$49,132	
Plus	5,000	
		54,132
Subject to excess-profits tax		103,566
20,000 at 20 percent		4,000
30,000 at 25 percent		7,500
53,566 at 30 percent		16,070
103,566		
Excess-profits tax		27,570

Together with normal tax of $29,260, as aforesaid, the company's total tax bill will be in the neighborhood of $56,830, on income (before taxes) of $140,000. The total effective tax rate on this basis is 40.6 percent.

In the present case where the stockholders hold the stock in the company which owns the debentures, the situation should be viewed as if the stockholders in fact own the entire investment in the corporation's assets. On this basis, let us determine the return which they receive on their investment in the year 1940. Of the $140,000 net income, $56,830 is applied as aforesaid to normal, defense, and excess-profits taxes, leaving approximately $83,000 for the stockholders. Adding to this the amount received indirectly by the stockholders as interest on debentures, namely, the sum of $73,999, gives approximately $157,000 as the return to stockholders for 1940 on their investment. As of January 1, 1940, the total invested capital of the corporation, including borrowed money (which total represents the total investment of the stockholders in the company) amounted to approximately $1,278,000. The aforesaid sum of $157,000 (income after taxes, plus interest on debentures) represents a return of approximately 12.3 percent on the investment of the stockholders. During the years 1937 to 1939, inclusive, the average return on the investment of the stockholders was approximately 1½ percent. As a practical matter, stockholders in this line of business should expect to receive at least 20 to 25 percent in a good year in order to compensate for inevitable losses (or years of nominal earnings only) in a widely fluctuating business. It is not unreasonable in a business of this kind, which requires a heavy capital investment, to expect an average return of 10 to 15 percent over a period of years, and in order to attain this it is obviously necessary to earn the aforesaid 20 to 25 percent in good years.

A method which would grant this corporation some degree of relief would be the insertion in the bill of a "ceiling" provision for corporations situated similarly to the Taylor Fibre Co., that is, corporations which have been formed in recent years and which are just emerging from the development period. Such a ceiling provision would provide that in no case shall the total of the normal corporation income, defense tax, and excess-profits tax exceed 30 percent (or some similar figure) of the taxable net income.

SPECIAL RELIEF PROVISIONS

Suggested amendments to the bill as passed by the House of Representatives which would grant this corporation some measure of relief have been previously referred to in this memorandum. Summarizing these amendments, they are as follows:

(1) In determining the excess-profits tax credit under section 714, corporations starting a new business at any time within the 8 years prior to January 1, 1940, should be permitted to receive an excess-profits tax credit for those years equal to at least 10 percent on the first $500,000 of invested capital and 8 percent on the invested capital in excess of $500,000.

(2) Corporations which during any of the years in the base period have failed to earn an amount equal to 10 percent on the first $500,000 of their invested capital, plus 8 percent on their invested capital in excess of $500,000, should be permitted to accumulate as a credit the difference between such amount and the amounts actually earned in each of the base period years. Corporations having such accumulated credits should be permitted to carry them forward and add them to the credit provided by section 714 in taxable years in which their income exceeds the credit provided by section 714. This amendment would in effect permit newly organized corporations to earn 10 percent on the first $500,000 of their invested capital and 8 percent on their invested capital in excess of $500,000 during their formative years.

(3) A ceiling provision should be written into the bill which will provide that in no case shall the total of normal corporation, defense, and excess-profits tax exceed 30 percent (or some similar figure) of the taxable net income.

(4) The definition of equity invested capital as set forth in section 718 (a) should be amended so as to provide that stock issued for services rendered should be considered as the equivalent of money paid in in the amount of the fair-market value of such stock at the date it is issued. Should this company in the future, instead of issuing stock to its officers for services rendered, pay such officers in cash with the understanding that the cash would be invested in stock it is clear that the company's invested capital would be increased to the extent of the money paid in for stock. The amendment suggested herein simply produces the same result when the facts are substantially the same.

The CHAIRMAN. Mr. W. W. Schneider, of St. Louis, Mo., Monsanta Chemical Co.

STATEMENT OF W. W. SCHNEIDER, REPRESENTING THE MONSANTO CHEMICAL CO., ST. LOUIS, MO.

Mr. SCHNEIDER. I am the secretary of the Monsanto Chemical Co.

I want to point out a defect or omission on page 40 of this bill, which has to do with corporate reorganizations which took place under section 112 of the revenue law. I think the omission is an oversight—I am not sure.

If you will refer to section 740 you will find that there are 4 cases listed, in which cases the earnings of an acquired company are added to the earnings of the acquiring company for the purpose of determining the average income during the base period.

There is one important type of reorganization, tax-free reorganization, that has not been included in those 4 cases.

Senator KING. What do you mean by the "four cases"?

Mr. SCHNEIDER. Four cases in section 740 (a). The first case there covers a typical reorganization.

Senator KING. I beg your pardon. You are referring to the——

Mr. SCHNEIDER (interposing). Section 740 (a) of the bill; that is, supplement (A).

The CHAIRMAN. You think it was an oversight?

Mr. SCHNEIDER. I am not sure. It is taken care of properly in the portion of the bill that has to do with invested-capital basis, but not in the average-income basis.

Now, to cite the case, we have a typical case: On April 1, 1938, which was during the middle of this 4-year base period, we acquired all of the business, assets, goodwill, employees, plant properties, customers, and so forth, of a Massachusetts corporation, in exchange for about $9,000,000 worth of stock.

That was a tax-free reorganization under section 112. That company we acquired had been in business for many years prior to this base period and, of course, they had had earnings.

Now, as soon as we acquired that company they ceased to carry on business, their employees became our employees, their stockholders became our stockholders, and they were united with us, and we have been carrying on the business ever since.

The other company has since liquidated and dissolved and gone out of business.

Now, I don't know of any reason why the earnings of that company, during the 2 years prior to their being acquired by us, '36 and '37, should not be added to our earnings for the purpose of determining the average income during that 4-year period.

In other words, the two businesses have been united in one. They are now going forward as one business, and, in order to have a comparable basis, you have to add the earnings of that company to ours for that purpose.

Now, it is taken care of under the invested-capital basis. Their earnings and their invested capital are added to ours for the purpose of determining our credit under the invested-capital basis, but for some reason or other—oversight or otherwise—their earnings for that 2-year period prior to their going out of business is not added to our earnings for the purpose of determining our credit on the average-income basis.

I just want to mention further that that type of transaction is not a statutory merger. It has all the effects of a statutory merger, so far as income, invested capital, and other purposes are concerned, but it is not technically a statutory merger.

Therefore it does not come under No. (3), and I am at a loss to understand why that type of transaction, in which the former company goes out of business—just as they do in the case of a statutory merger—why that type of transaction is not included for the purpose of determining the average income during that 4-year period.

Senator KING. Is there any provision in the bill which might be lifted from its present position and attached to No. (3).

Mr. SCHNEIDER. You could take care of it very easily in No. (1) [reading]:

A corporation which has acquired all the assets of another corporation and the whole or a part of the consideration for the transfer of such assets is the transfer to such other corporation or its shareholders of all or a part of the stock.

That is the way the other sections of the bill read. If you will refer to section 750——

Senator KING (interposing). What page?

Mr. SCHNEIDER. Page 47, I believe it is, in the definition of "exchange."

Senator KING. Just 1 minute.

Mr. SCHNEIDER. It comes under supplement B, "Credit based on income and invested capital." You will find this definition:

The term "exchange" means an exchange, described in section 112 (b) (4) or (5)—

Which covers this transaction—

or in so much of section 112 (c), (d), or (e) as refers to section 112 (b) (4) or (5), by one corporation of its property wholly or in part for stock or securities of another corporation.

Senator KING. What page are you reading from?

Mr. SCHNEIDER. I think that is on page 47. I have the original House bill here. It is section 750, in the definition of "exchange."

Senator KING. Seven hundred and fifty?

Mr. SCHNEIDER. Yes, sir.

Senator KING. Now, what suggestions do you make there?

Mr. SCHNEIDER. That language is entirely proper, and it covers the case, and my suggestion is that that same language be incorporated in section 740.

The CHAIRMAN. We thank you for bringing it to our attention.

Mr. SCHNEIDER. The subject is properly taken care of in one case and not in the other.

The CHAIRMAN. Thank you very much.

Mr. Eberstadt? Is Mr. Eberstadt in the committee room?

(No response.)

The CHAIRMAN. W. R. Ogg?

STATEMENT OF W. R. OGG, REPRESENTING AMERICAN FARM BUREAU FEDERATION

Mr. OGG. Mr. Chairman, members of the committee, I have a statement here that I would like to——

The CHAIRMAN. You represent the American Farm Bureau Federation?

Mr. OGG. Yes, sir.

I have a statement here, and it is obvious, you have so many witnesses, I would like to have permission to have this inserted as though read—this statement on behalf of the American Farm Bureau Federation, before the joint committee.

The CHAIRMAN. All right.

Senator KING. I remember your statement then, and it was a very clear and elaborate one. Is the statement you are submitting now substantially the same?

Mr. OGG. Well, I would like the privilege of pointing out two or three things that we are calling the attention of this committee to.

Unlike many of the witnesses who appeared before you, we would like to commend the improvements that have been made in this bill.

We presented certain recommendations to the joint committee and we feel that in part those recommendations have been carried out, and we want to commend the progress that has been made.

We feel that some further improvements can be made and have offered some additional suggestions.

The principal one of these suggestions relates to the proposal which we suggested, but which has not been included, namely, to provide a definite limitation—over-all limitation—in connection with the average-earnings options, so that any profits in excess of this over-all limitation would be considered as excess profits and subject to the schedule of rates.

Now, we don't know what that level should be. We are willing to leave it to the judgment of this committee and the Treasury Department and the Defense Council, but, as a fundamental principle of excess-profits-tax legislation we do not believe it is fair to the American public to allow corporations to be completely free of taxation, excess-profits taxation, at the time of emergency, when we are expending $14,000,000,000, to permit them to earn unlimited earnings up to the level of their maximum earnings during the base period, without collecting any excess-profits taxes, particuarly in view of the very liberal provisions for amortization.

The CHAIRMAN. What do you think of the idea of a little higher percentage—or reasonable percentage—of increase on those corporations that make profits, high profits, or reasonable profits, as may be, to tax the profits that enter into contracts with the Defense Council or any Government agency that has anything to do with this preparedness program?

Mr. OGG. Well, I believe that would be in accord with the spirit of our recommendations.

Our organization went on record, through its board of directors last spring, urging that appropriate steps be taken to stop and prevent all profiteering during this emergency period.

The CHAIRMAN. I thought they were in agreement with the suggestion I made.

Mr. OGG. Yes, sir.

I don't want to take your time. The resolution to which I refer is in this statement [indicating].

The CHAIRMAN. Thank you very much.

Mr. OGG. We are not asking for any excess profits for agriculture.

I want to say here that it is a matter of considerable concern to farm people, representing a large segment of the population, to see certain groups of industry come in here before Congress and demand this guaranty and that guaranty of normal profits before they are asked to assume the burden of this increased defense expenditure.

Our boys are going to be conscripted, serve for $30 a month. They are going to sacrifice their normal earnings during that period. They may have to risk their lives. And we believe that capital should be willing to risk its capital—that business should be—if our boys are going to be asked to risk their lives.

In conclusion, Mr. Chairman, we feel that this is a time when we must all look forward to sacrifices in doing our part to put over the national-defense program, and the farmers of this country, at least our organization, has so expressed itself, that we stand squarely behind the national-defense program and are willing to do our part, and the farmers have done their part.

They are going to suffer as a result of the war, as a matter of fact, and we feel that at a time of grave emergency when the security of everyone is at stake, that it is no time for any group, whether in industry or labor or agriculture, to jeopardize our security by insisting on excessive profits before excess-profits taxes are levied.

The CHAIRMAN. Thank you very much.

(The prepared statement filed by Mr. W. R. Ogg is as follows:)

STATEMENT ON BEHALF OF AMERICAN FARM BUREAU FEDERATION TO SENATE FINANCE COMMITTEE CONCERNING SECOND REVENUE ACT OF 1940 (H. R. 10413)

SEPTEMBER 5, 1940.

During the hearings held jointly by the House Ways and Means Committee and the Senate Finance Committee, certain recommendations were made on behalf of the American Farm Bureau Federation.

We desire to commend the improvements which have been made in the proposed legislation by the House of Representatives, especially the efforts to safeguard the amortization provisions, to equalize more nearly the benefits accruing under the invested capital option, as compared with the average earnings option, to eliminate undue hardship upon small corporations and corporations that have had very low earnings, and to provide a higher schedule of rates on excess profits. These improvements carry out, in part, recommendations made by the American Farm Bureau Federation.

The liberality of the pending bill is evident from the fact that, on the basis of 1937 income statistics, only 67,000 corporations out of approximately 500,000 active corporations in the United States will pay any excess-profits taxes at all under this bill. Thus 86 percent of all the corporations in the United States will be entirely exempted from any excess-profits taxes by reason of the exemption of the first $5,000 of excess profits.

Furthermore, according to the Statistics of Income of Corporations in 1937, compiled by the Federal Bureau of Internal Revenue, on which the foregoing estimate is based, among these less than 70,000 corporations subject to the proposed excess-profits taxes 248 corporations with net incomes in excess of $5,000,000 annually received 39.7 percent of the total income of all reporting corporations in 1937.

Another small group of corporations earning from $1,000,000 to $5,000,000 and representing only 1 percent of the total number of reporting corporations earned 22.7 percent of the total income of all reporting corporations. In other words, less than 2 percent of all the reporting corporations earned 62.4 percent, or nearly two-thirds of the total income of all reporting corporations. In view of these facts, the hue and cry that has been raised against this legislation to the effect that it will impose undue burdens upon American corporate industry is without proper justification. These facts show conclusively that the great mass of American corporations will escape the proposed taxes entirely and that the major burden will fall on a graduated basis on the corporations which have had the largest earnings and therefore are most able to pay such taxes. Moreover, these large corporations, in the main, stand to benefit greatly from the large national-defense expenditures not only in contracts for war materials but also from the increased purchasing power resulting from these defense expenditures. Therefore, from the standpoint of benefits derived and from the standpoint of ability to pay, the proposed excess-profits taxes do not impose an undue burden upon American corporate industry.

We believe that still further improvements can and should be made in this legislation, in order to provide a more equitable distribution of the tax burden in connection with the national-defense program and to prevent profiteering during this period of national emergency. Specifically, we respectfully recommend:

1. *Average earnings.*—There should be fixed a reasonable ceiling above which all profits would be considered excess profits and subject to the schedule of rates on excess profits. The average earnings for the so-called base period 1936–39 is not a satisfactory limitation. Under this option a corporation will be exempted from any excess-profits taxes on its average earnings during the base period, no matter how high these average earnings may be. The full significance of this privilege does not become apparent until it is coupled with the amortization provisions. Under these two provisions a corporation is permitted to write off its entire extra investment due to defense at the rate of 20 percent per year, so that at the end of 5 years (or less if the emergency ends sooner) it has paid in full for its additional plant expansion out of the proceeds of Government contracts, and during this period it is exempted from any excess-profits taxes on all its earnings which do not exceed its average earnings during the base period, no matter how high these earnings were, and finally, on the earnings in excess of this amount the Government will recapture at the very maximum only 50 percent of all excess profits, no matter how great they may be, plus an additional 4.1 percent of the normal-tax net income.

In sharp contrast with this liberal provision in the average earnings option, corporations which elect to use the invested capital option must pay excess-profits taxes on all earnings in excess of the average rate of return on their invested capital in the base period. The effect is to permit inordinate profits by corporations which enjoyed large earnings during the base period, while corporations which were making only modest earnings in relation to their invested capital will be much more drastically restricted in their profits. The inequity between these two options has been substantially lessened by the changes made in the House bill, wherein a higher schedule of rates was provided for corporations using the average earnings option, and the penalty tax of 4.1 percent on normal net income is applied to companies electing the average earnings option. We believe this inequity can be further corrected by providing an over-all limitation in connection with the average earnings option wherein all profits above such limitation would be considered excess profits and would be subject to the schedule of rates on excess profits. This would appear to be simpler and more equitable than the penalty tax plan now provided in the bill.

2. The proposed schedule of rates for excess-profits taxes is not excessive and, in fact, is very liberal for a period of grave national emergency such as we are now passing through. Our Nation has been repeatedly warned by the highest authorities that we are in the midst of a period of grave national emergency when the security of our lives, our property and the ideals and institutions of democracy which we hold

dear stand in jeopardy. To meet this situation, we have embarked on a far-reaching program of national defense in which Congress has already appropriated or authorized appropriations totalling approximately $14,000,000,000. No doubt additional large expenditures will be necessary. Obviously, in order to pay for these enormous outlays essential to our national security, it is inevitable that the entire Nation must be willing to make some sacrifices for the common good and security of all. Under such conditions, the same standards and definitions as to what constitutes excess profits necessarily differ from those which should prevail in normal times. The insistence, therefore, of certain corporations which enjoyed handsome earnings during the so-called base period 1936–39 that they be allowed to continue to earn this high level of profits before paying any excess-profits taxes is not valid in such a time of emergency and is grossly unfair to corporations which have had very low earnings during the same period.

Nor is there any sound justification for exempting from excess-profits taxes corporations which do not have national defense contracts with the Government. It should be pointed out that many industries which will not receive governmental contracts nevertheless will profit greatly from the increased purchasing power which will result from the large expenditures for national defense. Recent estimates indicate that by 1941 about three or four million additional workers will receive employment as a result of the expansion of industrial production. Surely in a time of grave national peril no industry has any vested right to demand the continuation of its previous record of earnings, free from excess-profits taxes, no matter how high these past earnings may be.

3. As a safeguard to industry during this emergency, a reasonable amortization of extra costs of plant expansion due to defense should be permitted, provided due account is taken of the extent to which such risks are assumed by private capital and proper safeguards are provided to protect the public interest, in cases where the cost of plant expansion has been amortized out of the proceeds of Government contracts.

4. We urge that every possible effort be made to simplify the provisions of this legislation to the end that the tax liability may be readily computed and evasions of taxes prevented and unnecessary litigation avoided.

5. It is further recommended that Congress instruct the Treasury Department to continue its studies of the problems involved in these tax proposals, with a view to improving and perfecting such proposals during their first year of operation. We recognize that there are many complex and difficult problems involved in formulating such legislation.

6. We renew the recommendation made to Congress at the time the national-defense tax was enacted, namely that Congress with the assistance of the Treasury Department, undertake at an early date a thorough study and revision of our Federal tax structure with a view to providing the additional revenue that will be required for national defense and for necessary domestic requirements and to distribute the burden of such taxes on the basis of ability to pay and benefits derived.

We sincerely hope these recommendations will meet with the approval of the committee.

Every reasonable person would concede that business uncertainty as to amortization provisions and as to excess-profits taxes should be ended as soon as possible by the enactment of constructive legislation at the earliest practicable date, that reasonable amortization provisions be established for industries that are required to expand their plant facilities for national defense, that liberal treatment be afforded to small struggling enterprises and companies with low earnings, that every effort be made to simplify such tax legislation, and that this emergency should not be used by selfish groups as an excuse for the oppression of labor.

But the American people are in no mood to tolerate, in this time of grave emergency, any group demanding inordinate profits or special privileges as the price of producing the supplies and materials that are vitally necessary to our national security. The rank and file of citizens cannot but be deeply concerned over the frequently recurring reports in the press and elsewhere that the national defense program is being delayed and interfered with by the unwillingness of industrial management to enter into defense contracts unless they are given this guaranty or that guaranty, or unless they are permitted to earn their normal profits, no matter how high they may be, without payment of excess-profits taxes during the period of this emergency. There is also concern over the threats of strikes on the part of minority groups in labor in essential defense industries.

At such a time as this when it is imperative that our Nation bend its every energy to achieve adequate national defense before it is too late, obviously it is imperative that every group do its part. It is a time that calls for sacrifice and not for profiteering at the expense of national security. The achievement of adequate national defense necessarily entails some sacrifice on the part of all groups in the Nation. In such an emergency, no group has any vested right to demand not only their normal profits but, in addition, to demand that the Government underwrite their capital risks, take off restrictions upon profits, and let them keep a major part of all excess profits.

To jeopardize our national defense by such an attitude, if persisted in, obviously could only result ultimately in forcing the Government to conscript industry and labor to get the job done without dangerous delays. If everyone will do his part, this should not become necessary.

It is indeed distressing to see groups demanding this guaranty and that guaranty with respect to its profits and avoidance of capital risks as the price of doing its part for national security. If our Nation is going to conscript our manpower to serve for a year of special training at $30 per month, in order to learn how to shoot guns, operate tanks, and fly airplanes and, if need be, give their lives, the American people are going to insist that the industries which manufacture guns, tanks, planes, and other military equipment be willing to do their part without excessive demands and guaranties. Our boys who are called to give a year's training will in most cases lose their normal earnings. They are not demanding their average earnings during any base period and then a major share of excess profits above that level. The Government will not underwrite their losses in promoting the national defense. If they risk their lives, industry should be willing to risk its capital. If they give up their normal earnings and serve for a subsistence wage, then industry and labor should be satisfied with reasonable earnings.

So far as farmers are concerned, they are ready to do their part. American agriculture does not seek any special preferred position or excess profits out of the war. They are not going to refuse to produce essential food and fiber unless they are guaranteed not only their normal profits but a liberal share of excess profits as well. We have confined our request to repairing the damage done by these trade dislocations and to maintaining a parity relationship between industry, agriculture, and labor. The fact is, agriculture, particularly the producers of export crops, will suffer tremendously as a result of the trade dislocations resulting from the present war.

We are against profiteering whether it be in agriculture, industry, or labor. We issued such a declaration last summer when the Neutrality Act, which we supported, was under consideration by Congress. I quote from the statement issued by our board of directors at that time:

> * * * Profits on such transactions, however, should be restricted by law to normal peacetime levels with all profiteering effectively prohibited. As farmers, we ask only for parity prices for our commodities, and we condemn any practice by middlemen of pyramiding commodity-price advances into exorbitant prices of food and fiber to the consumer.
>
> Farmers as a group are opposed to profiteering by industry, by agriculture, or by labor; and will vigorously resist such methods with every means at their command.
>
> We believe we should hold prices, wages, and interest rates during wartime to reasonable parity levels in order to prevent excessive inflation and the ruinous deflation that is the inevitable aftermath of speculative excesses. We invite industry and labor to cooperate with us in a concerted movement to forestall the economic anguish that will surely follow the present war unless effective steps are taken to prevent it.

Again, when the national-defense tax was under consideration, a short time ago, we reiterated that declaration, as follows:

> We wholeheartedly support steps being taken by the President and Congress of the United States to strengthen our defenses in the present emergency. We recognize that this will impose new burdens upon the finances of this country and feel that the farmers and people of the country will willingly pay taxes that are levied equitably and expended efficiently for this purpose. We feel that it is important that burdens be imposed in accordance with ability to pay and that adequate tax provisions be made to check all profiteering.

We therefore respectfully urge that Congress speedily enact an equitable and effective excess-profits tax law which will prevent profiteering during this emergency and recapture excessive profits to help finance the national-defense program.

The CHAIRMAN. Mr. Maurice L. Bein, of Bridgeport, Conn.

STATEMENT OF MAURICE L. BEIN, REPRESENTING MAURICE L. BEIN, INC., BRIDGEPORT, CONN.

The CHAIRMAN. All right, Mr. Bein.

Mr. BEIN. My name is Maurice L. Bein. I am in the building construction business, as a general contractor.

In general, the building construction industry, especially, the small corporations, which are by far in the majority can conduct their business on a very small amount of capital. This is true, because payments on construction contracts are made at least every 30 days, thereby requiring the financing of a project for only a 30-day period. As a result, we handle contracts that run into an enormous amount, with very small capital. We either create these profits or suffer losses, through our own effort, initiative, and experience.

Senator KING. Are you speaking of subcontractors, as well as contractors?

Mr. BEIN. Definitely. Yes, sir. For example, we can run a million dollar job, with a maximum of $50,000 to $60,000 in cash. It is not out of the ordinary for us to net 5 percent, which would be $50,000.

According to the proposed bill, the Government says to us that because, through the use of our brains and experience, we make $50,000 and only need $50,000 of invested capital to do it, we are out of order and must be penalized; whereas if we had a million dollars in capital and took the same construction job and made the same $50,000, that would be proper and considered normal operation.

What are excess profits? In my own experience we lost money in 3 out of the last 5 years. We carry our organization 3 years on what we make in 1 year. Would you consider what we make in our 1 good year, excess profits, especially, when it can be shown that the money we make in that year is used up in the lean years to come?

I have listened to the testimony, practically all day. The thought that was running through most of the testimony was that the bill, as drawn, contained innumerable inequities and inequalities. All I heard was: "This is inequitable and that is working a hardship, and this provision will put us out of business." Why not call a spade a spade, then?

Why not increase all income taxes alike?

The majority of witnesses have been trying to correct one inequity or another.

Now, gentlemen, you have only had a very minute percentage of inequities called to your attention. As pointed out, these inequities will affect millions of people and thousands of industries, as indicated by the concensus of opinion of the witnesses. How, therefore, can you possibly administer fairly, a bill that does so much damage to business?

If, in my business, I were to work on a 5 or even 10 percent basis of profit I would be snuffed out in a few years, if I had to carry an organization without work, as I have done in the past. As an example, from the years of 1938 to 1940, I bid and spent approximately, $58,000 bidding, without getting a job. For the year 1939, my operating loss was $58,000. For the year 1938, I paid an income tax of $65,000, but for 6 years before that, I did not make a nickel. All those years show operating losses.

Now, if you feel that it is necessary to levy a 50 percent tax on business, as long as it affects everyone in the same way, nobody will have any complaint. If the tax is spread in a fair and equitable manner, even if 50 percent of the earnings are needed to take care of our defense program, no one will object, but if you are going to enact an excess-profits tax law that will not touch those firms that have millions and billions of dollars in stock, held widely by the public in most instances, because these firms, who in reality are the ones getting defense orders and whose earnings have been an average of 3 and 4 percent, over a period of years, will not be affected by this law, whatever measures you use to determine excess profits, you are being most unfair and inequitable. These firms are going to earn millions of dollars, because they have millions invested and they are not going to pay any excess-profits tax.

We fellows who earn our income mainly by our own effort and ingenuity and who stand to bear the losses if there are any, are the ones that are going to be penalized and are the ones who are going to pay this tax. I think the most unfair thing that any government can do is to penalize me, because I don't need much capital in my business, and take 75 percent of everything I make, because I don't need large amounts of capital to produce the income, and on the other hand, exact very little tax from firms, just because their income is produced by the use of tremendous amounts of capital.

If you don't see fit to just increase all income taxes in general, then at least appoint some board that can sit and listen to these inequities that are being worked by this bill.

Senator KING. What suggestion would you make in order to reach your case, where for several years you had no capital, except a small amount, you had losses, in 1 year you had a very large gain? How would you impose taxes upon someone like you, to be fair and just? What suggestion do you make?

Mr. BEIN. I cannot see sow anything that is called an excess-profits tax can be used as a measure in cases of business such as mine. I mean not only the construction business, but a good many others that capital does not play an important part in producing income. How can you define excess profits in cases such as mine? We have gone along for the last 10 years. Some years we have made money and this money was used to keep us going during the years in which we had no work or lost money. Otherwise, I could not have survived in business or would have been compelled to discharge my organization, which I would have to do, if in the year that I did make money, the greatest part of it would be taken away.

If you want to hit profits that are considered war profits, that can be done through your defense board, who can let armament contracts on a cost basis, plus a reasonable profit which you can control. The amortization of plants certainly is something that is aside from this issue and need not be delayed because of this bill. Contracts are being let every day on a cost-plus basis. No one can fool the Government on what costs are. The elements that go to make up costs can easily be determined by accounting methods. Give armament contractors a reasonable profit for this emergency period. You are then really guarding against war profiteering. Then, to raise money for defense purposes, increase income taxes in general. Let everybody pay their shares of the burden.

But if you enact the bill the way it is designed, you are going to actually crucify, I say, the majority of firms, and those that it is designed for are absolutely going to escape without any excess-profits tax at all.

Senator KING. You prefer an increase, if necessary, in order to raise revenue from normal tax, rather than from the so-called excess-profits tax?

Mr. BEIN. By all means, Senator, because—well, you have listened to, well, just a small number of people. I am surprised to have heard that only a few advanced the idea that it should be an increase in normal taxes. That more or less confirms my feeling that firms that have large amounts of capital are only looking to remove those little inequalities that are really going to cost them money. They are really not going to suffer by an excess-profits tax. The average firm that has a lot of money invested and has a lot of the public's money, that has been earning 3 or 4 percent normally, you are not going to hurt them, and those are the ones that are getting the orders—Bethlehem Steel, U. S. Steel—those are the ones that have averaged 3 and 4 percent; they are getting the armament orders, and they have averaged only a small percent.

The CHAIRMAN. Very much obliged.

Mr. Forstall, of Chicago.

Senator KING. Let's adjourn. The reporters look to me as though they would like a little sustenance. I suggest the chairman of the committee bring in some sandwiches and some liquid refreshment.

STATEMENT OF JAMES J. FORSTALL, REPRESENTING THE MICKELBERRY FOOD PRODUCTS CO.

Mr. FORSTALL. James J. Forstall.

The CHAIRMAN. Have you got a brief?

Mr. FORSTALL. No; I haven't a brief, but I will submit one.

The CHAIRMAN. All right, Mr. Forstall.

Mr. FORSTALL. Representing Mickelberry Food Products Co.; I represent that company as a director.

I would like to jump right into the discussion that just went on. I want to put it on a little higher plane still. I don't want to put it on the plane of the effect to the little individual corporations but to the effect on the country of the passage of this law.

I don't have to say to any of you that democracy is on trial and a lot of people in the world say it is sunk.

I have had a little experience with taxes. I was in the Treasury Department as an assistant solicitor when the Revenue Act of 1918 went into effect. I am one of the people who have worked on taxes under that and subsequent Revenue Acts and who believe that our present tax laws are much too complex.

Senator KING. Hear, hear.

Mr. FORSTALL. The English income-tax law covers a few pages of the statute and I think that experience with our income-tax laws proves that the law should be much simpler and much more should be left to regulations and to administrative discretion.

I think the greatest disservice that could be done to the country at the present moment would be to pass a law like this and put it on the statute books.

If someone tampered with a plane at one of the California airplane plants, we would put him in jail, but the passage of a law like this, seriously affecting so many corporations and wasting so much gray matter of leading corporation executives for the next 2 or 3 years—years that ought to be devoted to production to help defense—would cause much greater damage to the country than any minor sabotage in an industrial plant.

I want to raise one point that hasn't been mentioned at all, and that is that in working on the former income-tax laws in 1919, 1920, 1921, and 1922, I was tremendously impressed with something I have practically never seen mentioned at any time, namely, that a large part of the time and gray matter of the leading executives of the United

States was devoted in those years to income-tax problems, because of the complexities of those laws. That was not a time of national peril. You might say it didn't make any difference in the twenties what they did, but if there is a defense problem in this country now we certainly ought not to pass a law which would cause them to spend a great deal of their time on taxes because of the complexities of this bill.

Senator King has asked everyone for their program, so I am going to say what I think the program should be.

If you believe the amortization provision is necessary it should be promptly passed, separated from the rest of the act.

If you think the revenue act of 1940 will not give enough revenue from 1940 corporate income, simply increase your rates just a little. That would be a simple one-line law.

Senator KING. A normal tax?

Mr. FORSTALL. Yes. It doesn't cause any complexity at all; and then, if you think you can pass a satisfactory excess-profits tax bill, if you think it is necessary, and if you think you can make one which can be administered—which I frankly doubt—it can be passed and put into effect for 1941, with due consideration.

I want to urge one thing and to emphasize it just a minute or two by the experience of my own company, and that is that it is absolutely essential, if you pass any such law, to have a special assessment provision such as that contained in Sections 357 and 358 of the Revenue Act of 1918.

It would be as proper to have a capital-punishment law without the pardoning power as to have an excess-profits tax law without some provision under which the Treasury Department would have the discretion, at least, to save a corporation that would otherwise be manifestly treated very unjustly.

The CHAIRMAN. To have some tribunal take care of the extraordinary cases.

Mr. FORSTALL. Yes, sir. Now may I add one word here about our company. It lost money for three straight years because of an internal situation which had nothing to do with the depression. It has made a little money since but in the last 7 years it is still $50,000 in the red. Our earnings this year will probably wipe that out and put us, before Federal taxes, about $100.000 in the black for the 8 years.

But, upon this first occasion that we get into the black on balance for these last 8 years, this tax, added to the Federal income tax, will take 50 percent of this $100,000 and leave us only $50,000 for the 8 years. This is what a so-called "excess-profits tax" does to a company that sells sausage and meat to dealers and has nothing to do with war orders or defense programs. It is just one of many examples of the unfairness that this law would cause.

It seems to me that the most important thing is to avoid putting on the statute books a law of this sort. I think that history will not give a very high mark to the United States democracy if they function so inefficiently as to put this so-called excess-profits tax on the statute books.

(The brief referred to is as follows:)

UNITED STATES SENATE,
COMMITTEE ON FINANCE.
September 5, 1940.

SUMMARY OF STATEMENT BY JAMES J. FORSTALL, REPRESENTING MICKELBERRY'S FOOD PRODUCTS CO., OF CHICAGO, ILL.

SUGGESTED PROGRAM

1. Enact promptly the provisions of sections 201 and 202 of H. R. 10413 with the modifications suggested by the Defense Commission and approved by the Secretary of War and the Secretary of the Navy.

2. (*a*) Delay enactment of any additional revenue act provisions until the whole matter can be properly considered; or

(*b*) If there seems any good reason to make immediate provision for additional revenue, then enact promptly a simple revenue act of a few lines, increasing the present rate of the normal corporation income tax.

DISCUSSION

1. As the need for the immediate enactment of amortization provisions in substantially the form contained in sections 201 and 202 seems almost universally conceded, no discussion on this point is necessary.

2. The testimony given before the Committee on Finance this week has clearly demonstrated that—

(*a*) The so-called excess-profits tax contained in title I of H. R. 10413 does not in fact constitute an excess-profits tax at all. If enacted and administered, it would add oppressive tax burdens to many struggling corporations, not benefitting at all, directly or indirectly, from the war or the defense program; on the other hand, it would entirely fail to tax many prosperous corporations on large profits realized by them from defense-program orders. In other words, the law, if enacted, would fail to tax many true excess profits even though received by prosperous corporations, and, moreover, would tax heavily, to many struggling corporations, profits which not only were not excess profits but could not even properly be called normal profits.

(*b*) The taxes laid by these provisions would not only definitely weaken the economic welfare of the country at this most important time by interfering with the operations of many small corporations, but would actually imperil the existence of a number of them, and probably cause business failures and loss of employment.

(*c*) These so-called excess-profits tax provisions are so infinitely complex as to make efficient administration impossible.

(*d*) These so-called excess-profits-tax provisions are so infinitely complex as to cause an immense and entirely unnecessary waste of time and energy on the part of all concerned, namely, the Bureau of Internal Revenue, the bookkeepers and accountants of the corporations, their tax advisers, and, worst of all, the chief executives of the corporations, who ought to be devoting their time and their best energy and intelligence to more productive endeavors. The fact that this waste of time is already reaching substantial proportions is shown by the large number of corporation executives who have felt it necessary to come to Washington to take part in these hearings.

We know that many students of the present Federal income-tax laws agree with us that many disadvantages have arisen from their being as lengthy and complex as they are. They make a very striking contrast to the extremely brief English income-tax statute, which, though so concise that it covers only a few pages, has been administered with relative smoothness and efficiency for over a hundred years, in spite of very heavy rates of tax imposed. We submit, therefore, that only some very compelling reason of necessity or fairness would justify piling on top of our present complicated income-tax laws the complex monstrosity contained in the excess-profits-tax provisions of H. R. 10413.

That there is no necessity for any such action is clear, because no returns under the act will be due before March 15, 1941, and no revenue could be received from it until that date. It has been suggested that it is necessary that this law be passed promptly to let corporations know what is in store for them, so that they can make their plans intelligently. But the testimony has clearly shown that this law is so unintelligible and complex that it does not give any real information to corporate executives. Moreover, it is so unfair and discriminatory that corporate executives would have a right to believe, even if the law should be passed at this time, that Congress, before March 15, would awake to the injustice and damage which this law would cause and would repeal it before that date, substituting for it some much more satisfactory act.

However, if this Excess Profits Tax Act should, in spite of everything, be enacted, we respectfully urge that the testimony shows the absolute necessity of a so-called special-assessment provision, providing (as was done by sections 327 and 328 of the Revenue Act of 1918) some satisfactory method of preventing too much injustice being done to corporations abnormally situated in respect to income for the base years or invested capital or both.

No one will deny that the times are critical, that democracy is on trial. In fact, many voices throughout the world confidently proclaim that its day has passed forever. This being so, the United States, the greatest democracy of all and almost the sole hope of all other democracies, must indeed use the utmost care to function efficiently. It cannot afford to make any bad mistakes.

In the light of conclusive testimony, we submit, the enactment of this so-called excess-profits tax would definitely weaken our country at a time when it needs all its strength—would in effect seriously sabotage our defense program.

Respectfullyy submitted.

JAMES J. FORSTALL,
MICKELBERRY'S FOOD PRODUCTS CO.,
Chicago, Ill.

The CHAIRMAN. Mr. Marsh will be the last witness, and then we are going to recess until 7:30 and finish up the balance of the witnesses tonight so we can get into this matter in executive session tomorrow.

STATEMENT OF BENJAMIN C. MARSH, REPRESENTING THE PEOPLE'S LOBBY

The CHAIRMAN. Benjamin C. Marsh.

Mr. MARSH. Benjamin C. Marsh, appearing on behalf of the People's Lobby, Washington, D. C.

I would say that I have been very much depressed by most of the testimony here this afternoon because the idea of having war brides for economic royalists and celibacy at $30 a month for the draftees strikes me as highly incongruous, not to say undemocratic; and I am going to make some specific suggestions to you with reference to this bill, because I think I gather from reading a good many papers and magazines that this committee is not going to run away from the problem of financing the most expensive war in the world's history.

You have got to meet it. Let me assure you that, if war be hell, as has been stated, what is going to follow in America if you finance this campaign as you have suggested—the President has, not you; I apologize—that the President has suggested, we are going to have a darn sight worse than hell after the war is over, whoever wins, because we have been going on the theory that we could pile up debts, and the magnificent achievement of the Democratic Party in the last 7½ years has been the free and unlimited coinage of deficits, with interest, nontaxable, paid to the economic royalists whom the President hates—maybe.

But I want to give some specific suggestions. This war must be paid for as you go, otherwise we lose it. Our defense program, financed by conscripting the income of unborn children, as contemplated by America's ruling-class profiteers, with bonds bearing nontaxable interest to pay these economic royalists, is moral treason.

You have already passed several conscription bills in this administration. You have conscripted the income of the next generation. Of course, they are not going to pay it back. You can't always have a notary public which approves what the President does, as Mr. Jackson did on the ships. The day is gone when there can be both profits and defense, and America must choose which.

This fact has a vital bearing on this tax bill and also on "Weary" Willkie's chances of pitting his plan to perpetuate profits against the President's plan.

Large reliance upon taxing profits, whether of big concerns or little contracting outfits, means we are paying a darn sight too much for defense.

Defense now must be profitless defense, if we are going to have any. We can't get away from it, with apologies to the gentlemen who expected to make another killing.

If cost of defense be, as some claim, $100,000,000,000, and total profits be $25,000,000,000, or even $40,000,000,000, it is obvious taxes on profits won't pay $100,000,000,000.

Let me put that in percentages. If your profits are 25 percent, or even 40 percent, you will see that all this talk about financing the war out of taxing war profits is nonsense.

You just can't finance a dollar by taking a quarter or a third of 25 percent or 40 percent of a dollar.

What are we going to spend? The United States News says the Budget this year will be $12,000,000,000 and next year $15,000,000,000.

We will be running behind five to seven billions each year. It can't last.

I can see why some folks would rather get us into war than face the music for the last 7½ years.

Senator KING. We are starting into this period with a large deficit, too.

Mr. MARSH. We are starting into this period with a deficit due to the fact that democracy has been afraid to face the facts.

Hitler didn't create world chaos. Hitler capitalized on world chaos. And we don't want to give him anything more for him to capitailze on, I reckon. I don't; I hope you don't.

If all corporate profits be this year, as Standard Statistics Co. estimates, about $9,000,000,000—I think that is too high; I think $7,000,000,000 would be nearer it, or 8—even taking all those profits in taxes won't meet the Federal Budget of about $12,000,000,000.

And don't forget this: 20,000 people get about one-third of all dividends.

Now, I have a peculiar statement to make. I presume that, if you adopt the suggestion which I am proposing, that the members of our organization, collectively, will pay at least a million dollars more taxes—I think it would be a good deal more because most of us are middle class; but there are 2 or 3 wealthy people, and they will pay a lot more; they should, they are willing to.

I ought to pay a lot more. May I suggest that the Members of both branches of Congress should. And I haven't seen you object to it either—I will add that.

Nothing will convince the American people that Hitler is a military menace till Congress taxes personal incomes about as heavily as

Britain does, and takes over—paying for value, not for water—all industries and enterprises essential to defense.

Let me add: This does not include the press and radio, but I will suggest to you that we have held up our defense program over this tax program.

Now, if Hitler is a menace we should be far ahead on a defense program. Some folks evidently think he is not. And let me also say, I hope you won't let any politicians run any industries, nor any profiteers.

If we are going to get results in peace or war we have got to have production technicians—not even reformers like me; I wouldn't be much good though I made money in college running a boarding club at $2 a week, but I couldn't do it now, probably.

Senator KING. But you will admit that Mr. Knudsen is a good technician?

Mr. MARSH. I think Mr. Knudsen is a very good production technician and an engineer, and we have a good many more of them.

If you take the grasping financiers out of control of those enterprises and put the technicians in control under the direction of the Government, we could get, I am sure, much better and much cheaper defense.

A writer recently reported Barney Baruch said that we wasted $13,000,000,000 during the World War. I don't know whether that is true or not. Certainly a lot was wasted because of lack of organization.

Look at the airplane record. We spent about a billion dollars and we got 168 of what were called flaming coffins. Why we are not getting airplanes now I don't know.

I am afraid I am imposing on this committee, but I want to say to the chairman, for his own interest, that I received a letter this morning from Mr. E. C. Davison, secretary-treasurer of the International Association of Machinists on how much quicker we could get defense than is now contemplated, and also what Government munitions plants we have which for some reason—I think the United States Steel and the Bethlehem Steel explain it, and a few others—have not until recently been used.

Now, I come to hitting our own members and show you where you could get $3,000,000,000 more a year by personal income taxes, and without impoverishing us. I don't want to give a lot of figures, because it is late. I am going to ask the privilege of submitting an analysis of Federal incomes for 1938—the report recently came—showing how much more could have been paid, but, just to give you two or three illustrations—because, to my mind, the real test is not how much tax a man pays, but what he has left after paying taxes. For 1938 the three people, each of whom reported $5,000,000 or more net income after paying all Federal, State, and local taxes, had left an average of $5,046,000.

Now, quite obviously they could have paid more. I could and should pay $500 or $750 a year more than I do, and at that I wouldn't be making the sacrifice which my son, 22, unmarried, who is subject to the draft will, and I couldn't look him in the face if I didn't offer to pay a darn sight more than that, and I so offer, only please make the other fellows do the same.

Now, we could get $3,000,000,000 I think, in corporation-profit taxes, and I agree with what has been said. Don't figure, if you are trying to defend America, whether it is an excess profit or a profit. If it is a profit, it should be subject to the defense of America, whether it is excess or very minor.

And I suggest that you get after the land speculators, and there are a lot of them—and after monopolizers of natural resources. A lot of expenditures of the Government are going to benefit landowners. You know what the Government generally has to pay for land it gets. Incidentally, I own a piece of land. I suggest an excise tax on the privilege of holding land and other natural resources, based on the value of it, with a small exemption for little home owners and farmers. We will get them through consumption taxes. We raise roughly 61 or 62 percent of all taxes, Federal, State, and local, by consumption taxes. You should get after the oil interests and the steel interests owning iron ore, and so forth, and big landed estates, which should pay a billion and a half dollars.

It would be a heavy tax, but we have got to pay heavily, as we are going to have a smash after this war, such as the world has never seen unless we are men enough to face paying for the war as we go.

I know how hard it is to suggest this in an election year, but I am rather confident that the American people want to face up with the facts and that Congress will do very well to face these facts.

We have been pretty soft in America. We have paid people not to produce and not to raise trouble. We can't end that situation by this defense program.

For Labor Day Government economists put out this statement: We have 9,000,000, roughly, unemployed. The defense program, they said, may employ three and a half million, and they gave the case away when they said a milion or so will be drafted.

We have been told the well-to-do will be drafted, but apparently it will be the unemployed.

What does that mean? Four and a half million people still unemployed. And I know this Congress doesn't want to run away from that issue.

If I were here pleading for exemption for our members I would be ashamed of myself. If members of the People's Lobby want to resign because I have advocated our program they will resign, but I think they are all of them loyal enough to want to pay more taxes, but to avoid profiteering. In conclusion, may I file this analysis of personal incomes, by groups?

The CHAIRMAN. All right.

Mr. MARSH. I want to thank this committee for its patience, and also for not letting that Ways and Means Committee bill go before the country as the mature judgment of people who are one-half percent sane, as to what a defense tax bill should be.

The CHAIRMAN. Thank you.

(The documents filed by Mr. Benjamin C. Marsh are as follows:)

STATEMENT OF BENJAMIN C. MARSH, EXECUTIVE SECRETARY THE PEOPLE'S LOBBY AT FINANCE COMMITTEE TAX HEARING

PEOPLE'S LOBBY DEMANDS PAY-AS-YOU-GO DEFENSE

A defense program financed by conscripting the income of unborn children, as contemplated by America's ruling class profiteers, with bonds bearing non-taxable interest to be paid economic royalties, is moral treason.

The day is gone when there can be both profits and defense, and America must choose which.

This fact has a vital bearing on this tax bill, and also on Weary Willkie's chances of putting his plan to pereptuate profits, against the President's plan.

Large reliance upon taxing profits, whether of big concerns or little contracting outfits, means we are paying a darn sight too much for defense.

Defense now must be profitless defense.

If cost of defense be as some claim $100,000,000,000, and the total profits be $25,000,000,000 or even $10,000,000,000, it is obvious taxes on profits won't pay $100,000,000,000.

If all corporate profits be this year, as Standard Statistics Co. estimates, about $9,000,000,000—taking all those profits in taxes won't meet the Federal Budget of about $12,000,000,000.

Twenty thousand people get about one-third of all dividends.

Nothing will convince the American people Hitler is a military menace tell Congress taxes personal incomes about as heavily as Britain does, and takes over, paying for value not for water, all industries and enterprises essential to defense. This does not include the press and radio.

PERSONAL-INCOME TAX SHOULD YIELD $3,000,000,000 MORE

The total net income in 1938 of the 591,780 persons reporting net incomes over $5,000 was $6,775,000,000, upon which they paid in Federal income taxes and surtaxes only $701,600,000, or 10.4 percent.

Their average tax was only $1,186, and after paying all direct taxes, they had left an average of $10,262—and a total of $6,073,000,000.

The net income of persons getting over $5,000 will this year probably be $7,775,-000,000 to $8,000,000,000, and they should pay at least $2,500,000,000 more in Federal income taxes than on 1938 income.

For 1938, 2,456,765 returns were made of taxable incomes under $5,000, with total net income of nearly $5,900,000, upon which total tax only $63,630,000—or less than 1.1 percent, with average payment of $25.90. People in this class will probably get at least $7,000,000,000 this year, upon which they can pay at least $500,000,000, while those with nontaxable incomes under $5,000 can pay at least $100,000,000.

Corporation profits taxes should yield $3,000,000,000, or some $1,900,000,000 more than the last fiscal year.

A Federal excise tax on the privilege of holding land, based on the value, with a small exemption for home owners, and on natural resources, would yield $1,500,000,000.

With these additional taxes, total Federal revenue from this year's national income would be about $11,800,000,000—or $1,000,000,000 more than double the Federal Governments revenue the past fiscal year.

Such a tax bill, which should be enacted before the Burke-Wadsworth bill, and taking over defense industries, would convince Hitler America means business—and not just business as usual, for the biggest profits of deserving Democrats and undeserving Republicans.

PERSONAL-INCOME TAX COULD YIELD $3,000,000,000 MORE

The recent report of the Bureau of Internal Revenue on personal income and taxes for 1938, shows that the Federal Government could obtain at least $3,000,-000,000 more from the personal-income tax than the present yield—in addition to increased revenue from the excess-profits tax.

Tax rates in some brackets have been increased only slightly since 1938, and the Department of Commerce reports that national income paid out in 1938 was $65,007,000,000, and in 1939 it was $68,600,000,000, while during the present calendar year (1940) it is estimated at $70,000,000,000 to $72,000,000,000—an increase of $5,000,000,000 to $7,000,000,000 over 1938.

A very large part of that increased income will go to people with incomes over $3,000, and on the basis of past years, at least a fifth to a quarter will go to those with income over $5,000.

For 1938, 591,780 persons reported net incomes over $5,000 with a total net income of $6,775,000,000.

They paid in Federal income taxes and surtaxes only $701,600,000, which was 10.4 percent of their net income.

Their income tax averaged only $1,186, and after paying all direct taxes, they had left $6,073,000,000—an average of $10,262.

The true picture of what the income tax could yield is given by analyzing incomes and taxes of grouped income brackets.

1. The 414,930 persons reporting net incomes of $5,000 to $10,000 received a total net income of $2,780,000,000, upon which they paid in income taxes only $71,600,000—an average of $172 or 2.6 percent.

After paying all direct taxes these 414,930 persons had left $2,708,700,000—an average of $6,528.

2. The 167,117 persons reporting net incomes of $10,000 to $50,000 had a total net income of $2,946,200,000, upon which they paid in income taxes only $254,-800,000 of 8.6 percent.

After paying all direct taxes they had left $2,691,400,000—an average of $16,111.

3. The 7,259 persons reporting net incomes of $50,000 to $100,000 had a total net income of $484,800,000, upon which they paid in income taxes only $117,000,000 or 23.9 percent.

After paying all direct taxes, they had left $367,800,000—an average of $50,665.

4. The 2,417 persons reporting net incomes of $100,000 to $1,000,000 had a total net income of $473,200,000, upon which they paid in income taxes only $210,200,000—or 44.4 percent.

After paying all direct taxes they had left $263,100,000—an average of $108,859.

5. The 57 persons reporting net incomes of $1,000,000 to over $5,000,000 had a total net income of $90,200,000, upon which they paid in income taxes only $48,000,000—or 53.4 percent.

After paying all direct taxes, they had left $42,200,000, an average of $739,749.

In this group—the 3 persons reporting net incomes of $5,000,000 and over—had a total net income of $21,800,000, upon which they paid in income tax only $6,700,000—or 30.5 percent, which was a smaller percentage than that paid on the average, by all those with incomes over $100,000.

Although these three persons paid in Federal income taxes an average of $2,221,-333, they had left after paying all direct taxes an average of $5,046,666.

INCOMES OVER $5,000 CAN PAY $2,500,000,000 MORE

The people with net income this year (1940) of $5,000 and over—and there will probably be at least 600,000 of them will have a total net income of at least $7,775,000,000, and probably nearer $8,000,000,000.

If they have only $7,775,000,000, they could pay $2,500,000,000 more in income taxes than people with incomes over $5,000 in 1938, and still have left an average of $8,708.

Of course, income-tax rates and surtax rates would be progressive, and the heaviest increases would be on net incomes above $10,000.

Usually a quarter to a half of incomes from $10,000 to $50,000, is from ownership or control of property, and nine-tenths or over, of most incomes over $500 000.

For 1938, 2,456,765 returns were made of taxable incomes under $5,000, and the total net income reported was $5,897,000,000, upon which only $63,630,000 was paid in income taxes, or less than 1.1 percent. The average payment was only $25.90.

After paying all direct taxes these persons had left an average of $2,372.

The net income of such taxpayers will this year (1940) certainly be about $1,000,-000,000 more than in 1938.

They could pay $500,000,000 more income tax than in 1938, or $463,630,000 in all—and have left (assuming the same number) an average of $2,620.

For 1938, 3,155,112 returns were made of net incomes under $5,000 "nontaxable." and the total nontaxable income reported was $6,226,000,000, an average of almost exactly $2,000 per return.

High exemptions for adults and dependents made this income "nontaxable."

The total income of persons—about 3⅛ million—with such nontaxable returns, will also probably be this year (1940) at least $500,000,000 more than in 1938.

They could and should pay at least $100,000,000 in direct Federal income tax—an average of about $30, though, of course, single persons would pay much more than this, and heads of families with dependents might be exempt.

Nearly 356,000 "nontaxable" returns reported for 1938 were for incomes from $3,000 to $5,000.

The Bureau of Internal Revenue recently reported total Federal receipts for the fiscal year ended June 30, 1940, $5,340,500,000, as follows:

Corporation tax, $1,120,600,000; individual tax, $982,000,000—total income taxes $2,102,600,000.

Other internal-revenue taxes—$2,404,400,000.

Employment taxes—$833,500,000.

Standard Statistics Co. estimates that corporation profits for 1940 will be about $9,000,000,000.

This is probably a high estimate, as the "defense" program will not get into heavy operation until October.

It would be much more socially advantageous not to have such high profits.

ALTERNATIVE TO DRASTIC TAXATION IS INFLATION

The masses of the American people will be much better off under drastic taxes—than under World War and New Deal financing—which has resulted in paying this year (1940) about 1½ percent of the national income in interest on the national debt alone.

Much of that interest is tax exempt.

The alternative to drastic taxation is ultimately destructive inflation, which is usually the last step of a collapsed economy to complete dictatorship or repudiation.

Conscription of wealth by the Federal Government is not essential to pay for the war as we go.

As proposed in the Senate, it would endanger that efficient operation of basic industries essential to national defense against the enemies we have helped to create, and equally essential to winning the war on poverty here.

Essential industries must be taken over intact by the Government.

Of course, needed defense—not profiteers' defense—can be paid for currently by income and surtaxes on present incomes over $2,500—which could yield $5,000,000,000 a year more than now—and by a Federal excise tax upon the privilege of owning land (with exemption for home owners) and other natural resources, based on value, which could yield at least $1,500,000,000 a year.

Such a tax system would end fear of Hitler's invasion of America, or the Western Hemisphere, overnight.

INTERNATIONAL ASSOCIATION OF MACHINISTS,
Washington, D. C., September 3, 1940.

Mr. BENJAMIN C. MARSH,
Executive Secretary, The People's Lobby,
Washington, D. C.

DEAR MR. MARSH: This is the first opportunity I have had of answering your communication of August 14. This is due to the tremendous activity in the association and the preparing for our convention, which will open in Cleveland, Ohio, this month.

In reply to the inquiries you make, I must say that the replies would have to be so general in character that I doubt their value.

First, your question about how many qualified machinists and mechanics are unemployed now?

According to the statement made by the Social Security Board a short time ago, which I have had occasion to check and found to be as nearly correct as our records will support, there were, at least, 23,000 skilled machinists who were unemployed, and approximately 080,000 semiskilled unemployed, in addition to which there are a large number of machinists and mechanics who have never registered with the Social Security Unemployment Board.

May I suggest that you get a copy of the press release from the Social Security Board, which will give you the accurate figures that will answer this inquiry.

Second: How nearly could they meet the present need for construction of naval ships, airplanes, bombers, and guns?

The contracts let, from information appearing in the public press, and those contemplated, have had very little effect on the unemployed situation as yet. There is every reason to believe, from our records, that there are sufficient numbers of skilled machinists and mechanics available to carry through the national defense program, provided employment is given to men over 45 years of age.

Third: What length of time is required to construct a large battleship, cruiser, submarine, airplane, tank? Is existing plant adequate to produce these agencies of defense if two shifts were used?

The answer to the question on battleships depends entirely on the need. In other words, it has usually required 5 years where they were used as fillers in shipyards, because there was no urgent need for them. It has been generally considered to be about a 3-year program to construct a large battleship where the work is performed with an idea that it is something needed immediately.

A cruiser on the type of the 10 that were last constructed in shipyards, would require about 2½ years to construct. If cruisers are to be built on a basis of need, with the employment of sufficient men, my opinion is that they can be constructed in a period of 2 years.

A submarine requires about 18 months.

In reference to airplanes, that depends on the type of the plane. If aircraft industry should desire to go to work for the purpose of building airplanes under the national defense program, making it their principal work, it would not be beyond their ability, as a whole in this country, to construct more than 2,000 planes per day.

As to tanks, I am of the opinion that if the idle railroad shops and other manufacturing plants were put to work at capacity, it would not be beyond reason to believe that at least 5,000 tanks per month can be turned out with present equipment.

In reply to your question—"Is existing plant adequate to produce these agencies of defense if two shifts were used"?—in my former answer I have contemplated the use of three shifts. The existing plant equipment in the United States that is now idle, or partly idle, by working one shift, in my opinion, is sufficient to meet the needs as expressed by the Government as to what their needs will be.

There is an angle to the proposition, however, that appears necessary to be solved, and that is, that many of these plants must be decentralized for a national emergency, and smaller plants constructed in areas that are better protected than the large plants are at the present time.

Fourth: Does the Government own now unused munitions factories, which could expedite the construction of tanks and large guns for battleships.

Up until a very short time ago the plant at Charleston, W. Va., was idle. This is a large munition plant, capable of manufacturing guns, shells, and armor plates, but my last information was that they were contemplating putting this plant to work very shortly.

Should they do this, and also put to work the plants at Dayton, Ohio, that were constructed during the last war for the manufacture of airplanes, it would be a large contribution toward meeting the need as expressed at the present time.

Fifth: Would conscription of men, as provided in the Burke-Wadsworth bill, be necessary if fair wages were paid for defense work?

That is a difficult question to answer, unless we assume that your question covers the point of the conscription of men to do civilian work in other words, the conscription of labor. It is difficult to follow the change made in the bill on the question of conscription. Labor organizations are opposed to conscription. They feel that conscription will be blanketed in order to conscript civilians, which is not necessary, or even desirable in a democracy.

Personally, I am a believer in voluntary action, and to so protect our Nation by starting in the protection of the home and the giving of opportunities, there will be more than enough volunteers who are ready to fight for a country that is designed and functioning in the interest of all of the people.

I wish it were possible for me to give you more correct answers to your inquiries, but preparing for our convention does not give me an opportunity of making a research in order to answer accurately the questions that you have asked.

Yours very truly,

E. C. DAVISON,
General Secretary-Treasurer.

The CHAIRMAN. The committee will meet in this room at 7:30—it is now 20 minutes after 6—and we will finish up as quickly as we can.

(Whereupon the hearing was recessed at 6:20 p. m., until 7:30 p. m., the same evening.)

NIGHT SESSION

(The hearing was resumed at 7:30 p. m.).

Senator KING. The committee will be in order.

The next witness is John R. O'Neal, of Washington, D. C.

STATEMENT OF JOHN R. O'NEAL, WASHINGTON, D. C.

Mr. O'NEAL. Mr. Chairman, and gentlemen of the committee, I would like to ask for 20 minutes in this case.

Senator KING. I do not think you can have that much time.

Mr. O'NEAL. We have had a good dinner, now.

Senator KING. Proceed, and we will see how you get along.

Mr. O'NEAL. If you test me on that, we will be very well satisfied.

Senator KING. Proceed as rapidly as you can, because there are a lot of witnesses here, and they do not want to stay here until midnight.

Mr. O'NEAL. Senator King, I oppose this bill, because I do not think it will raise anywhere near the revenue we will need for this defense. As I understand, we passed a bill last week for defense for $1,400,000,000, and this bill, the way I understand it, expects to produce $700,000,000 the second year, and I do not think it is fair for the private people to put up that amount of money for defense and ask industry for only $700,000,000.

In the second place, I don't think industry will pay that $700,000,000. A burnt child dreads the fire. We know before, with the excess-profits taxes and the processing taxes, that industry did not pay the tax. It is the consumer and the farmer that paid the tax, and we all know that, and it cannot be denied.

I am afraid that is what will happen in this case now. I am here as representing the farmers. I am a farmer and representing myself. And I got down, from at the Commerce Building, the income in 1910—I am not going to talk about anything but billions, because we are billionaires now—and it was $28,000,000,000. And the same year, the farmers had $5,000,000,000 income. That is the highest income that they ever had from that time on. And it went down all the time. Now, we have got $65,000,000,000 income and the farmers have got $7,000,000,000 income.

I want to give you the value of the farms in America. All of the farm land in America with the dwellings from 1910. In 1910 it was $34,000,000,000; in 1939 it was $35,000,000,000.

The farmer has been furnishing the food and the fiber for this country for much less than it costs to produce it, and he has been paying the taxes for industry. There is no question about that in my mind.

Here is the first time I ever found the farmers in the billionaire class. It was in 1910. I find them in the billionaire class at that time, that they owed $3,000,000,000, and they had an income of $5,000,000,000, and gentlemen, if you will just give me a little time, I will just tell you how that debt ran. That was under Taft in 1910. In 1910, 1911, and 1912, they owed $3,000,000,000. It was not cut down any. And then under Woodrow Wilson in 1913, the debt was raised the first year to four billion. In 1914 it was still four billion;

in 1915, it was four billion; in 1916, it was five billion of debt, in 1917 it was five billion, in 1918 it was six billion, and in 1919 it was $7,000,000,000.

We got in debt, gentlemen, on the farm during the war when there was made millionaires all over this country, because we were furnishing the food, and you Congressmen—the bill you passed—I am a farmer—and you passed a bill, gentlemen, and you set the price of my wheat at $2.10 a bushel, but you failed to put a price on industry's product. They robbed England and France for war materials; there is no question about that in my mind, and made millionaires, and you also passed a bill to draft two of my boys, one of them 18 and one of them 19, and I resented it because they were 18 and 19 years old—not that an O'Neal is afraid to fight, but because you drafted them when they had no vote, but I tell you my church is not for bearing arms, but I never got religion enough to keep me from fighting when anybody tackled me, and when they called them before the board, I went in and we would not claim exemption on account of religion. And there the boys were, gentlemen.

I am the last one that will ever stand for a dictator. You also passed a food law, and they come to my place in 1917—I am the father of 14 children, and I had 9 in my home at that time. I lost 4 babies, but there was one married, and they said, "You can have 1 pound of sugar a day, and you got to go to the store every day to get it; you cannot get 2 pounds at once." We accepted it and we used molasses to make it up. I could have went to the store and bootlegged sugar, but I tried to teach my children to be law-abiding citizens of America, and we done without.

In June 1918, under Hoover, you set the price on wheat, and then you told me when I sent my sonny to the mill to get flour for a barrel of flour for 5½ bushels of wheat, they said that he could not get only 66 pounds. We would not accept that, and I told them that I had 120 acres of wheat and I would not get four to eat then I would not cut it, and they give me the flour.

But, gentlemen, I am behind this defense. There is neutral about me in this European war, and I want to raise the revenue and I want to raise it, but I want the men to pay for it that ought to pay for. I have got the same opinion, gentlemen, about paying for this war that Abraham Lincoln had before he was assassinated. He believed, gentlemen, in printing the money to pay for this war, but when the bankers of this country assassinated him, they assassinated his soul when they assassinated him the first time, and he changed his mind and Wall Street has been running it ever since until 1933.

Ever since and until 1933, and gentlemen I offer an amendment to this bill to let the Government take over the banks of the United States, because the banks of the United States have fallen down on the job. The Federal Government today has to put up the money for the trains that don't look so good. Old Jesse Jones can lend money, more money, than any bank in the world, and he has done it. The debts that the banks would not take, he has done it and he has made a profit, and he has done it on eight or ten thousand dollars a year, and he is going to take another job at the same wages, I understand, and the banks in this country, the two by fours, they get $100,000 or $200,000 a year for being a president of one of them.

Yes, gentlemen, if you let Roosevelt take over the banks of this country, and let them withdraw this paper money they have got and let that gold down there in Kentucky—gentlemen, I read something that money was the root of all evil, and I also read somewhere that man had a living soul and you drafted us last week, and I was right behind you. You drafted the boys, yes, a boy with a soul. You say you draft him for 1 year, but he is drafted for the duration of this war, and we are in this war, but the American people, some of them don't know it. Hitler declared that war long ago. You read his writings and take his actions, and he has declared war on all democratic countries, and if we are a democratic country, God help us. But I accept the challenge, and I don't mince words about it.

I would furnish England everything that she wants, and we ought to wipe out that debt of hers. She fought that other war for us, and she is fighting for us now. If I saw that there was a bunch of wolves in another field close to me killing off my neighbor's children, I would not wait for them to come over to my place, but I would fight them on the wolves' ground. That is what I would have done with Hitler. We were ready and we are ready anytime to fight Hitler.

The only dictator I am afraid of, gentlemen, is Wall Street. We are like England—we have got two wars; we have got a war, another war in America to fight, we have got Hitler to fight, I think, if we don't get too strong to scare him.

But, gentlemen, we are in a worse state today than when George Washington was at Valley Forge with his ragged, barefooted army, but he won. I cannot find anywhere in history where we had only one Benedict Arnold in America then, but my God, history will tell you a different tale now about the Benedict Arnolds—and we have got them—Roosevelt has them in his own way, and they have knifed him in the back for years.

The CHAIRMAN. Mr. O'Neal, your time has expired.

Mr. O'NEAL. I am very sorry. I could talk to you a week about this. I would like to put these statistics into the record.

The CHAIRMAN. You may do so.

(The matter referred to is as follows:)

Farm real estate: Estimated total value of farm land and buildings by geographic divisions, 1910–39

Year	New England	Middle Atlantic	East North Central	West North Central	South Atlantic	East South Central	West South Central	Mountain	Pacific	United States [1]
	Million dollars	*Million dollars*	*Million dollars*	*Million dollars*	*Million dollars*	*Million dollars*	*Million dollars*	*Million dollars*	*Million dollars*	*Million dollars*
1910	719	2,443	8,874	11,615	2,486	1,738	3,129	1,319	2,478	34,801
1911	721	2,446	9,099	12,091	2,557	1,787	3,260	1,441	2,649	36,050
1912	723	2,449	9,316	12,583	2,625	1,835	3,394	1,560	2,819	37,306
1913	728	2,451	9,552	12,973	2,668	1,885	3,541	1,702	2,962	38,463
1914	715	2,453	9,761	13,418	2,736	1,934	3,643	1,762	3,165	39,586
1915	699	2,381	9,794	13,763	2,604	1,854	3,510	1,801	3,191	39,597
1916	710	2,432	10,333	15,056	2,875	2,025	3,657	1,886	3,207	42,271
1917	768	2,571	10,901	16,083	3,135	2,231	4,092	2,073	3,640	45,495
1918	793	2,655	11,819	17,674	3,543	2,580	4,743	2,335	3,845	49,987
1919	820	2,704	12,529	19,526	4,225	2,985	5,088	2,651	4,011	54,539
1920	917	3,002	14,938	24,469	5,202	3,664	6,291	3,163	4,669	66,316
1921	897	2,842	14,048	23,092	4,545	2,930	5,597	2,844	4,680	61,476
1922	907	2,696	12,184	19,761	3,801	2,655	4,817	2,621	4,576	54,017
1923	894	2,724	11,937	18,698	4,166	2,657	4,660	2,465	4,509	52,710
1924	900	2,744	11,392	17,274	4,101	2,525	4,726	2,311	4,495	50,408
1925	906	2,800	11,024	16,531	4,099	2,481	4,959	2,173	4,495	49,408
1926	926	2,828	10,571	16,090	4,181	2,536	5,170	2,196	4,546	49,052
1927	926	2,828	9,908	15,450	3,898	2,508	5,215	2,213	4,598	47,634
1928	933	2,821	9,674	15,306	3,879	2,514	5,384	2,287	4,667	47,495
1929	934	2,838	9,599	15,339	3,882	2,608	5,578	2,373	4,728	47,880
1930	941	2,818	9,337	15,159	3,852	2,685	5,806	2,458	4,824	47,880
1931	960	2,654	8,453	13,546	3,504	2,466	5,233	2,444	4,732	43,993
1932	918	2,407	7,149	11,370	2,958	2,058	4,280	2,029	3,978	37,236
1933	862	2,148	6,054	8,943	2,470	1,691	3,618	1,698	3,240	30,724
1934	878	2,124	6,191	9,298	2,650	1,787	3,886	1,728	3,221	31,764
1935	901	2,141	6,597	9,385	2,702	1,915	4,030	1,772	3,325	32,859
1936	907	2,213	6,980	9,759	2,919	1,984	4,177	1,857	3,450	34,246
1937	921	2,236	7,445	9,851	3,113	2,096	4,248	1,919	3,595	35,425
1938	915	2,262	7,553	9,717	3,182	2,209	4,390	1,911	3,584	35,722
1939	910	2,243	7,527	9,497	3,177	2,244	4,314	1,919	3,524	35,356

[1] Owing to rounding of figures the geographic divisions will not always add to United States total.

NOTE.—Bureau of Agricultural Economics; based on values of all land and buildings in census years. Values in intercensal years derived from index of land values per acre and adjusted for changes of acreage of land in farms.

TABLE 11.—*Fruits: Cash income, by States, calendar years 1936–39*

[In thousands of dollars]

State	Cranberries				Total fruits and nuts [1]			
	1936	1937	1938 [2]	1939 [2]	1936	1937	1938 [2]	1939 [2]
Maine					1,476	1,950	1,615	1,776
New Hampshire					718	1,254	814	1,161
Vermont					512	1,148	609	1,032
Massachusetts	4,567	4,520	3,542	4,882	8,023	8,237	7,262	8,457
Rhode Island					481	504	380	380
Connecticut					2,402	3,034	2,416	2,126
New York					20,985	23,630	20,403	22,223
New Jersey	1,072	1,715	666	696	7,921	9,359	7,504	7,530
Pennsylvania					10,794	13,545	10,906	13,735
Ohio					6,262	9,632	6,358	9,242
Indiana					1,993	3,108	2,129	2,821
Illinois					3,695	9,132	5,198	8,018
Michigan					16,246	17,207	10,677	14,527
Wisconsin	868	1,116	755	1,145	1,959	3,209	2,514	2,830
Minnesota					895	867	849	833
Iowa					819	1,040	1,141	1,248
Missouri					2,170	3,938	2,463	3,551
North Dakota					1	1	1	1
South Dakota					9	3	47	20
Nebraska					387	533	689	623
Kansas					640	1,875	1,216	1,406
Delaware					2,928	3,042	2,379	2,542
Maryland					3,055	3,574	3,236	3,095
Virginia					9,997	11,448	9,487	9,963
West Virginia					4,044	5,054	3,698	4,108
North Carolina					4,584	5,633	4,089	3,853
South Carolina					1,655	1,562	1,554	1,956
Georgia					9,692	5,166	6,292	7,672
Florida					42,900	57,691	38,009	41,668
Kentucky					1,178	3,173	1,772	2,147
Tennessee					2,210	4,628	2,321	4,461
Alabama					2,187	1,980	2,017	2,397
Mississippi					1,353	1,238	1,375	1,464
Arkansas					2,683	4,534	4,296	5,301
Louisiana					6,231	6,072	4,643	5,396
Oklahoma					367	2,102	854	1,524
Texas					8,551	15,222	10,569	11,530
Montana					263	535	456	482
Idaho					3,936	3,564	3,023	2,623
Wyoming					26	56	48	38
Colorado					3,404	3,413	3,024	2,939
New Mexico					1,017	1,095	692	746
Arizona					2,473	2,384	2,204	1,599
Utah					1,305	1,170	1,414	1,202
Nevada					48	40	40	28
Washington	267	176	175	120	33,307	35,993	27,260	28,461
Oregon	74	34	88	66	14,883	13,615	10,605	11,307
California					181,601	212,033	145,025	151,014
United States	6,848	7,561	5,226	6,909	434,266	519,223	375,663	413,056

[1] Includes also apricots, avocados, dates, cherries, figs, nectarines, olives, persimmons, pineapples, plums pomegranates, prickly pears, prunes, quinces, small fruits, almonds, filberts, pecans, and Persian (English) walnuts.

Realized national income, 1910–38 [1]

[Millions of dollars]

Year	Income	Year	Income	Year	Income
1910	$28,166	1920	$68,434	1930	$72,398
1911	28,104	1921	56,689	1931	60,203
1912	29,422	1922	57,171	1932	46,708
1913	31,450	1923	65,662	1933	44,713
1914	31,213	1924	67,003	1934	51,560
1915	32,538	1925	70,051	1935	56,254
1916	38,739	1926	73,523	1936	65,246
1917	46,376	1927	73,966	1937	69,419
1918	56,956	1928	75,904	1938	62,286
1919	62,945	1929	79,498		

[1] 1939 about $65,700,000,000, based on Department of Commerce estimate.

Source: National Industrial Conference Board, New York, N. Y., *National Income in the United States, 1799–1938.*

TABLE 12.—*Cash income from farm marketings and Government payments in the United States, 1910–39*

Year	Cash income from farm marketings	Year	Cash income from farm marketings	Government payments	Cash farm income and Government payments
	Million dollars		*Million dollars*	*Million dollars*	*Million dollars*
1910	5,785	1926	10,529		
1911	5,581	1927	10,609		
1912	5,966	1928	11,024		
1913	6,251	1929	11,221		
1914	6,015	1930	8,883		
1915	6,391	1931	6,283		
1916	7,755	1932	4,682		
1917	10,648	1933	5,278	131	5,409
1918	13,464	1934	6,273	447	6,720
1919	14,436	1935	6,969	573	7,542
1920	12,553	1936	8,212	287	8,499
1921	8,107	1937	8,744	367	9,111
1922	18,518	1938 [1]	7,590	482	8,072
1923	9,524	1939 [1]	7,733	807	8,540
1924	10,150				
1925	10,927				

[1] Preliminary.

FLUCTUATIONS IN OUTSTANDING FARM-MORTGAGE DEBT, 1910–39, BY DONALD C. HORTON, SENIOR AGRICULTURAL ECONOMIST

Changes in the volume of farm-mortgage debt are frequently regarded as indicators of changes in the general financial position of agriculture, increases being interpreted as evidence of a less favorable position and reductions as evidence of a more favorable position. Such an interpretation of mortgage-debt movements does not apply to all situations.

On the one hand, a rise of mortgage debt may accompany a general expansion of agriculture and may be associated with rising agricultural income and general improvement in the financial position of farm owners. On the other hand, a rise of mortgage debt may be associated with depressed agricultural conditions in which many farm owners have to borrow to tide over temporary periods of low income or give real-estate security as added protection for non-real-estate loans. Likewise, a drop in outstanding farm-mortgage debt may be associated either with an improvement of the financial position of agriculture, which enables farm owners to repay debts, or with depressed agricultural conditions, which force many heavily indebted farmers to give up their farms in satisfaction of their debts. Changes in outstanding farm-mortgage debt usually involve a combination of these several factors. To understand the significance of mortgage-debt trends it is necessary to analyze the many other related movements which have a bearing on the financial position of agriculture.

With the completion of a series of annual estimates of outstanding farm-mortgage debt for the period 1910–39, it is not possible to relate mortgage-credit movements more directly to the other important movements in the agricultural economy. These new farm-mortgage debt estimates are shown by geographic divisions in table 1 and by States in appendix table 6.[1] The movements of mortgage debt for the country as a whole are shown in figure 1, together with data showing the trend of land values and gross farm income.

THE WAR AND POST-WAR RISE OF MORTGAGE DEBT

During the first part of the decade, 1910–20, there was a substantial rise of farm-mortgage debt which was associated largely with the general expansion of agriculture that had been in progress for many years (fig. 2).

[1] These new series represent revisions of the Department's estimates for the census years 1910, 1920, 1925, 1930, and 1935, and new estimates for all other years of the period. The methods used in the preparation of these estimates are described later in this article.

TABLE 1.—*Estimated amount of farm-mortgage loans outstanding, by geographic divisions, Jan. 1, 1910–39*

[In thousands of dollars]

Year	United States [1]	New England	Middle Atlantic	East North Central	West North Central	South Atlantic	East South Central	West South Central	Mountain	Pacific
1910	3, 207, 863	70, 202	269, 716	807, 008	1, 276, 944	130, 334	108, 777	260, 505	99, 455	184, 922
1911	3, 522, 121	70, 525	273, 296	870, 488	1, 419, 750	139, 915	118, 550	305, 971	121, 819	201, 807
1912	3, 929, 758	75, 032	289, 728	949, 313	1, 570, 724	170, 971	118, 502	371, 857	142, 891	240, 740
1913	4, 347, 679	83, 911	317, 966	1, 017, 526	1, 717, 743	177, 327	126, 470	421, 479	175, 413	309, 844
1914	4, 707, 358	91, 057	337, 557	1, 083, 543	1, 870, 562	184, 816	145, 667	448, 243	191, 829	354, 084
1915	4, 990, 785	98, 442	338, 810	1, 135, 733	2, 033, 042	193, 046	141, 441	451, 187	214, 338	384, 746
1916	5, 256, 425	102, 586	326, 437	1, 181, 374	2, 202, 430	197, 310	138, 805	478, 016	233, 826	395, 641
1917	5, 825, 851	108, 392	314, 939	1, 288, 375	2, 497, 278	220, 894	149, 248	518, 876	280, 173	441, 676
1918	6, 536, 860	109, 405	341, 481	1, 398, 655	2, 793, 831	231, 019	187, 247	598, 134	375, 001	502, 087
1919	7, 137, 365	105, 763	359, 611	1, 457, 560	3, 032, 137	267, 497	240, 198	687, 106	461, 930	525, 503
1920	8, 448, 772	114, 757	406, 047	1, 662, 678	3, 506, 470	391, 069	358, 440	805, 184	592, 675	611, 452
1921	10, 221, 126	125, 328	446, 685	1, 964, 232	4, 370, 022	505, 770	447, 640	902, 149	719, 962	733, 338
1922	10, 702, 257	133, 054	459, 197	2, 039, 436	4, 591, 790	548, 372	445, 402	978, 472	759, 065	747, 469
1923	10, 785, 621	142, 129	463, 382	2, 091, 083	4, 636, 928	530, 457	406, 305	1, 015, 690	771, 600	727, 357
1924	10, 664, 919	140, 810	459, 773	2, 100, 145	4, 629, 411	504, 705	394, 909	1, 000, 372	695, 467	733, 327
1925	9, 912, 650	141, 117	446, 620	1, 938, 810	4, 277, 934	491, 410	378, 036	923, 342	581, 088	734, 293
1926	9, 713, 213	142, 860	457, 527	1, 887, 197	4, 008, 648	555, 490	399, 881	963, 988	533, 710	763, 912
1927	9, 658, 422	140, 878	467, 939	1, 854, 988	3, 807, 772	600, 170	426, 453	1, 034, 316	525, 035	800, 871
1928	9, 756, 957	152, 607	473, 185	1, 880, 987	3, 778, 713	588, 726	446, 916	1, 092, 225	529, 509	814, 089
1929	9, 756, 559	162, 858	472, 613	1, 917, 596	3, 734, 571	546, 157	439, 773	1, 091, 781	551, 371	839, 839
1930	9, 630, 768	171, 708	456, 463	1, 883, 614	3, 570, 279	519, 348	432, 732	1, 109, 328	575, 012	912, 284
1931	9, 458, 281	176, 170	464, 033	1, 818, 684	3, 474, 157	494, 501	418, 479	1, 089, 845	587, 874	934, 538
1932	9, 214, 004	184, 500	469, 020	1, 757, 707	3, 342, 008	465, 927	401, 762	1, 081, 423	577, 436	934, 161
1933	8, 638, 383	185, 799	459, 317	1, 657, 756	3, 082, 199	423, 008	366, 538	1, 020, 388	540, 400	902, 978
1934	7, 887, 119	176, 969	424, 824	1, 522, 624	2, 700, 665	401, 704	341, 806	941, 117	481, 768	835, 642
1935	7, 785, 971	176, 003	413, 578	1, 535, 006	2, 694, 140	421, 644	354, 212	934, 687	474, 214	782, 487
1936	7, 638, 867	177, 571	411, 207	1, 517, 589	2, 610, 766	418, 166	348, 800	906, 683	476, 788	771, 297
1937	7, 389, 797	180, 458	408, 443	1, 471, 281	2, 466, 544	408, 348	341, 931	879, 928	463, 423	769, 441
1938	7, 214, 138	183, 099	404, 345	1, 433, 019	2, 376, 056	401, 799	339, 730	852, 785	453, 855	769, 450
1939	7, 070, 896	186, 574	400, 681	1, 409, 046	2, 290, 887	397, 024	340, 396	881, 806	445, 915	768, 567

[1] Totals differ slightly from those in the October 1939 issue of the Agricultural Situation because of adjustments in certain States.

The CHAIRMAN. The next witness is Mr. Howard Finney, of New York City, representing the Chamber of Commerce of the State of New York.

STATEMENT OF HOWARD FINNEY, NEW YORK CITY, CHAMBER OF COMMERCE OF THE STATE OF NEW YORK

Mr. FINNEY. We have not acted on this particular bill. However, we anticipated legislation, and a month or so ago they did take some action along these lines.

I have made a little synopsis of the actions we have taken which bear on this, some of which have been talked about this afternoon.

The Chamber of Commerce of the State of New York, by monthly regular votes at monthly meetings, are on record in favor of additional taxation for national defense. It, however, has urged upon Congress a careful restudy of the entire Federal tax system, and removal of the existing curbs on business expansion.

The chamber is against an excess-profits tax similar to that enacted during the World War. We have not had time to study how that compares with this legislation, but a committee is working on it now. The World War Act was unsound, not only because of the curb on business expansion, but also because of other and various economic consequences, such as price advances on the ordinary necesities of life, as well as other commodities.

Furthermore, the taxation committee firmly believes that the amortization features in the tax bill should be a separate measure rather than incorporated in the tax legislation.

That is all that I have to say.

The CHAIRMAN. Thank you very much.

The next witness is James V. Toner, representing the Boston Edison Co., of Boston, Mass.

STATEMENT OF JAMES V. TONER, BOSTON, MASS., REPRESENTING THE BOSTON EDISON CO.

Mr. TONER. I am the executive vice president and treasurer of the Boston Edison Co., but very few of my remarks will have anything to do with that particular company. It is based more on my general practice.

Knowing the problems that are now before Congress, it is with some reluctance that I appear before this committee to discuss some features of this proposed Second Revenue Act of 1940. In this discussion, based upon more than 22 years of tax practice, 18 years of lecturing on taxes as professor of Boston University, and as an operator of both small and large businesses, I submit some suggestions which may be helpful in reaching the objective of the Government, and at the same time be less burdensome to the taxpayer.

The first suggestion, possibly, which might be given some consideration is the deferring of the effective date.

May I recall to your minds that only a few weeks ago the First Revenue Act of 1940 was passed and made retroactive to January 1, 1940. We are now approaching the fourth quarter of the year, and you are now considering the imposition of the Second Revenue Act of 1940 which is also to become effective retroactively to January 1, 1940. Business cannot be operated on a retroactive basis, nor can business be intelligently managed without some degree of certainty as to the measure of taxes to be imposed upon it.

Adam Smith in this regard said, "A large degree of inequity is preferable to even a small degree of uncertainty." To be sure, we had two revenue acts in 1917, but the conditions then and the conditions now are different. In 1917 our taxes on business were negligible, while today, even before the passing of the 1940 laws, we are paying taxes at a very high rate.

Consideration should also be given to the fact that very little of the expected revenue from the defense program will be reflected in the 1940 business of most operations. We are told that haste is necessary, but many times better progress is made by moving slowly and by knowing that you are on the right route.

The proposed Second Revenue Act of 1940, while its ostensible purpose is to tax corporations which benefit from defense expenditures, yet it actually reaches all corporations irrespective of whether their earnings result from defense expenditures or not. It is based on an entirely different philosophy, or had I better say philosophies, of taxation from other tax laws. It proposes to take a very generous portion of the profits so that one might justly fear that this law may prove a deterrent rather than a help to the objectives of the Defense Committee.

This all presents financial problems.

The generous portion of the profits that this proposed law is to take on top of the slice already taken by the other existing Federal laws causes a financial man to wonder just how these taxes are going to be paid. Profits are not often reflected in the cash account, but may be reflected in increased fixed assets, inventories, accounts receivable, and in other assets which are not legal tender. If a business has to pay Federal taxes in cash amounting to any percent from 20.9 percent up to more than 50 percent, the first question is, Where is this cash coming from? And the second question is, Where is the owner of the business going to get cash to recompense him for his investment and his business risks? Federal taxes, as you are well aware, are not the only taxes that corporations must provide cash to pay. State and municipal taxes must also be paid and they must be paid in legal tender.

The law is technical and complicated. I did a great deal of work with the 1918 act, and the subsequent problems that came from it.

The proposed Second Revenue Act of 1940 can only be understood and applied by a professional tax practitioner. It is far beyond the comprehension of the layman, which again imposes an additional burden on the small corporation taxpayer. While very obvious attempts have been made to avoid the difficulties and objections of the 1918 law, yet in the application of the provisions of this proposed law, new problems and new difficulties will be encountered which will be as troublesome to administer as those which arose under the prior excess-profits law. Time taken to simplify this law would be time profitably spent for both the Government and the taxpayer.

In regard to consolidated returns, for the purposes of excess-profits tax consolidated returns should be permitted at the option of the taxpayer. After all, the investment of capital by identical interests in several corporations kept as separate entities for legal or other reasons is no different than investment of capital in one corporation carrying on several different types of business. This proposed law takes cognizance of the capital invested and should take as a unit for purposes of the excess-profits tax the entire capital of identical interests, even though this capital is divided by investment in separate corporations.

Consolidated returns under prior laws were mandatory or permissible. Under the present Internal Revenue Code, section 45—

SECTION 45. ALLOCATION OF INCOME AND DEDUCTIONS

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

provision for permissive consolidated returns at the taxpayer's option would be consistent with section 45, and in the initial operation of this proposed law would be some safeguard against inequities.

The proposed law provides, in the computation of excess-profits credit and in the determination of the average earnings, for the exclusion of income derived from the retirement or discharge of any of its bonds, debentures, and so forth. To be consistent, provision should also be made for the exclusion of losses from such retirement, and if the true measure of the stable earning power of the business is sought, then this provision might well exclude all items of nonrecurring-income profits, expenses, and losses.

I do want to emphasize that point. The law provides for the elimination of income from the retirement of bonds. We have many cases of losses on such retirement, and it would seem to be very consistent, if the one is excluded, to exclude both.

Variation in rates is not justifiable. It is extremely difficult to understand why one who computes his excess-profits net income after using the excess-profits credit based on income as provided in section 713, should have to pay an initial penalty of 4.1 percent plus a 5-percent higher rate on each bracket of the excess-profits tax than one who computes his excess-profits income after using the excess-profits credit based on income and invested capital. If these two methods of determining excess-profits net income are to be alternative they should be at the same rates so that the taxpayer could readily see which is the better for his particular business.

The determination of the excess-profits net income after using the excess-profits credit based on the income and invested capital complicates this law without much guidance in taxation.

After all, the object of this credit is to allow a reasonable return on the capital invested in the business, and before the imposition of the excess-profits tax. It would simplify this provision immensely if a rate of return was specified which would apply irrespective of the earnings of the 4 prior years. Under the former excess-profits-tax law, 8 percent was considered as a reasonable return on the invested capital. During the imposition of that tax, dividends when received by stockholders were not subject to normal tax but were subject only to surtaxes. Under the present conditions, and in view of the fact that dividends to stockholders are now subject to both normal tax and surtaxes, a reasonable rate of return should not be less than 6 percent. That is extremely low. This rate, when contrasted with the present and contemplated rate of tax to be collected by the Federal Government, simply seems most moderate and fair.

In the old excess-profits-tax law the major difficulty arose from the determination of the invested capital. These difficulties will again arise in the proposed law, and added to these we will have the problems of the determination of the rate on investment for the purpose of the excess-profits credit.

In the 1918 law there was a relief provision for corporations who, for a variety of reasons, could not determine their true invested capital. This provision was extremely beneficial to many such corporations, and a relief provision consistent with the provisions of the proposed Revenue Act of 1940 should be included in the law. It is a well-known fact that the receipts of operation of small businesses vary widely, which corporations may go through several years of no profits and then strike something that is extremely profitable, and for one or more years show very good profits. Also, there are corporations which for the 4 years contemplated in the law for the determination of earnings may have no profits and for the year 1940 have a very good year. A relief provision should be included in this law as a safeguard against inequities which may arise from the application of the basis for invested capital and average earnings.

I respectfully submit these comments and suggestions for your consideration, not with the intent of interfering with your program but with the firm conviction that this is too important a law, both for the Government and the corporation taxpayers, to be passed without every possible consideration.

Senator KING. Have you any suggestions to make about amortization and whether that might be segregated?

Mr. TONER. I heard that discussed here so much, Senator, that I did not want to take your time with that. I feel that the amortization provision is very fair, and I believe that in simplifying this law you could simplfy the excess-profits part of it very much if you split and separated those provisions. After all, they are not related; and if you are going to tie that amortization provision with anything, it ought to be tied up with your general law rather than your excess-profits law.

The CHAIRMAN. Thank you very much.

The next witness is Dwight Brigham, Waterville, Maine, representing Keyes Fiber Co.

STATEMENT OF DWIGHT BRIGHAM, WATERVILLE, MAINE, REPRESENTING THE KEYES FIBER CO.

Mr. BRIGHAM. I hesitated to come down to speak for a relatively small company, because I felt that there must be a great many others which would have the same problem, but I finally decided that they might all feel the same way. I find several today have a similar problem but I don't think quite as extreme.

I am the president of the Keyes Fiber Co., which makes molded pulp articles, and has about 500 employees and an investment by the stockholders of something over $4,000,000. They received no benefit whatever from the war and do not expect to. As a matter of fact, we have lost $200,000 a year of business because of the war in our export business.

This company was founded in 1902 originally and it was reorganized in 1935 under section 77–B, and with the approval of the court, not because of operating deficits but because of maturities which could not be refinanced.

The business suffered during and prior to that reorganization, due to the lack of capital and to the doubts as to the company's future.

Since the reorganization, the business has been very much diversified and has increased substantially each year. The principal statistics, briefly, are that the number of employees has increased from about 250 to almost 500. In 1936, our net income before Federal taxes was, in round figures, $15,000. In 1937, it was $35,000; in 1938, it was $130,000, and in 1939, $273,000, and our budget for this year calls for something over $300,000. The average for that 4-year period is $113,-000, and if the bill were passed in its present form, in addition to paying this year something like $62,000 in normal taxes, we would pay something over $80,000, or one and a third times more in excess-profits taxes. If we used the basis of invested capital, that excess would run between $26,000 and $50,000, depending upon what our invested capital is determined to be.

Having been through a reorganization, we still have had no adjudication as to whether we carried through the investment of our present stockholders in the prior company, which we wrote down for reasons which we think were conservative at that time, so that we do not know what it will be, but in either case it would be an increase, in the one case, of 50 percent, and in the other case, of nearly 100 percent in our present tax.

Senator KING. That would take more than your are making?

Mr. BRIGHAM. No, sir; not more. We do not object to paying taxes, but we want to pay them when we make them, and we think—as a matter of fact, we have a sinking fund on our bonds of $125,000 a year, and we have, as I say, stock which represents the actual cash investment of over $4,000,000, and with the exception of a small amount of common stock, the bonds and the preferred stock all carry a rate of 6 percent, so that it is impossible to give any special treatment on earnings before—and frankly, I have no suggestions, but I do not see how a company of this kind can make any suggestions that would be fair.

It has been just a question of building up the business by diversifying its product and by utilizing our machines up to their fullest extent and leaving out 1 year is not going to make any particular difference, but I do feel that we should be permitted to earn—I don't think 10 percent is at all unreasonable, and in any event, it seems to me that the provisions for new capital of 10 percent and 8 percent is certainly the minimum which should be allowed.

Along about in 1930 or 1931, the business was going down and various complications had developed, and about half of the money which is represented by our preferred stock was put in at that time. Certainly I think the money that was put in in 1930 was put in on the basis of a good deal more risk than the money that would be put in in 1940, and I cannot see any reason why there should be that distinction between the money that is in there and the money which might be put in there. If nothing of that kind is possible, of course, I hope that the committee will recommend some board which can deal with propositions of this kind, but with an adequate return on the invested capital, I think that would meet the situation.

We should much prefer to pay a higher normal income tax—I mean if it is necessary. We do not want to. I think there is a limit to that, but it seems to me in our case it is absolutely not an excess-profits tax at all, and that it involves inequities which I am sure the bill never intended by those who drafted the bill.

The CHAIRMAN. Thank you very much. The next witness is Mr. George Rogers, Washington, D. C., representing the Electrolux Corporation, New York City.

STATEMENT OF GEORGE ROGERS, WASHINGTON, D. C., REPRESENTING ELECTROLUX CORPORATION

Mr. ROGERS. Mr. Chairman, this corporation manufactures vacuum cleaners and sells vacuum cleaners on the installment plan. Up to 1939 it reported income by the installment method of accounting. In March of this year the company went to the Commissioner of

Internal Revenue and asked for the privilege of changing its accounting method from the installment to the accrual system, and the Commissioner granted that or proposed to grant that permission upon the usual terms and conditions. Those terms are that the company shall accrue as income for 1940 all of the profit on its 1940 sales, and in addition report as additional income for 1940 the profits on the 1938 and 1939 sales previously unreported under the installment plan employed by the company.

The company submits that it is perfectly fair and appropriate to require the reporting of this carry-over of 1938 and 1939 previously unreported income for normal tax purposes, but believes that it would be quite unfair and inappropriate to tax that carry-over of 1938 and 1939 earnings for excess-tax profits purposes in 1940, in addition to the entire 1940 income.

As an example, the company's income under the accrual method for 1940 is approximately $2,000,000. There will be over half of that amount carried over from 1938 and 1939, and that third million would be subjected to excess-profits tax as the bill is now written, because it would be includible in the normal income, which is the starting point for a computation of the excess-profits net income subjected to the tax.

We request therefore and respectfully submit to the committee that it would be entirely fair and equitable in this instance to make provision for excluding the carry-over from 1938 and 1939 which is required to be reported as 1940 income, because of the change of the accounting method.

Senator KING. If you had not asked for a change in your accounting method there would have been no insistence on the part of the Treasury that you carry that over for the excess-profits tax?

Mr. ROGERS. That is correct. The request was made for substantial business reasons. It has proven to be very embarrassing to the company to be required to report income and show its stockholders the statements on the installment method, and it is much more in accordance with sound accounting to report on the accrual method, and it was in order to get the affairs of the company on a sound accounting basis that the request was made.

Senator KING. Then the change would not increase or diminish the receipts which the company had?

The CHAIRMAN. You want to create a tribunal in this law as an extraordinary case for special relief?

Mr. ROGERS. To cover this case of this corporation and other corporations which likewise will request a similar change, Mr. Senator. The Treasury Department will tell you, I believe, that in the usual course of business over a year there are a large number of changes of this same kind.

The CHAIRMAN. What I am suggesting is that you would like to get that in this bill?

Mr. ROGERS. Yes, sir; that is correct.

Senator KING. I anticipated from what you stated that you would prefer that there be some legislation that would make it definite what the taxes should be, rather than leaving it to some tribunal to guess or determine and exercising such discretion as was conferred upon it?

Mr. ROGERS. Mr. Senator, I think the correct way of stating what I have asked for is that the law specifically provide for an exclusion from the excess-profits income of the carry-over income due to the change in the accounting method. A general provision permitting the Commissioner to do equity or make a fair adjustment might meet it, depending upon the terms of that provision.

The CHAIRMAN. You would like to have a forum so that you can present your case?

Mr. ROGERS. Yes, sir; either a forum or a specific section in the law.

The CHAIRMAN. Thank you very much.

(Mr. Rogers submitted the following memorandum:)

ELECTROLUX CORPORATION,
New York, September 5, 1940.

Re: Provision in proposed excess profits tax law to prevent discrimination in the peculiar case of corporations changing in 1940 from the installment to the accrual method of reporting income.

THE CHAIRMAN AND MEMBERS OF THE SENATE FINANCE COMMITTEE,
Washington, D. C.

GENTLEMEN: For substantial and compelling business reasons, the Electrolux Corporation, of New York City, in March 1940 applied to the Commissioner of Internal Revenue for permission to change from the installment method of reporting income for Federal income tax purposes to the accrual method of reporting income. The Commissioner has indicated that such permission would be granted upon the usual terms and conditions prescribed by the income-tax regulations.

Treasury Department Regulations 103, on page 188, provide, in part, as follows:

"A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. * * *

"The foregoing requirements relative to a change of accounting method * * * are applicable if a taxpayer desires to change from such basis [installment basis] to a straight accrual basis. In cases where permission to make such change is granted, the taxpayer will be required to return as additional income for the taxable year in which the change is made, all the profit not theretofore returned as income pertaining to the payments due on installment sales contracts as of the close of the preceding taxable year."

In other words, if the Electrolux Corporation in 1940 carries out its plan of changing its method of accounting from the installment to the accrual basis, it will be required to report not only all the profits derived from its 1940 sales but also and in addition that portion of the profits derived from its 1938 and 1939 sales which remained unreported (under the installment method) on December 31, 1939.

It is entirely appropriate that Electrolux Corporation should pay a normal income tax, in the year of change of accounting methods, on both its entire accrued 1940 income and such portion of its prior years' income as remains unreported under the installment method. However, it is submitted that Electrolux Corporation should not be required to pay excess-profits taxes in 1940 upon the portion of its 1938 and 1939 profits reportable in 1940 as additional income solely and only because of the change in accounting methods. The company's entire 1940 profits, determined under the accrual method, are in themselves a fair basis for the excess-profits tax.

It is, therefore, respectfully requested that the proposed bill include a provision eliminating from the income subject to excess-profits taxes in 1940 the profit derived from 1938 and 1939 sales but reportable as additional 1940 income because of the change in accounting methods.

A suggested draft and a more complete analysis of the problem are contained in the attached printed memorandum, to which your attention is invited.

Respectfully submitted.

ELECTROLUX CORPORATION,
By GARDNER, MORRISON, ROGERS & MCGUIRE,
Washington, D. C.

MEMORANDUM SUBMITTED TO THE FINANCE COMMITTEE OF THE UNITED STATES SENATE IN REGARD TO THE POSITION OF CORPORATIONS CHANGING FROM THE INSTALLMENT BASIS TO THE ACCRUAL BASIS OF REPORTING INCOME

[A special provision should be inserted in the proposed excess-profits-tax act to cover the peculiar case of corporations changing from the installment basis of reporting income to the accrual basis of reporting income, to avoid subjecting 1939 profits to the 1940 excess-profits tax]

SCOPE OF THIS MEMORANDUM

This memorandum does not presume to offer any suggestion as to what the nature of the proposed excess-profits tax should be. The only point submitted is that the statute, whatever its nature, should be so worded as not arbitrarily to discriminate against a company which has reported its income on the installment basis as compared with the treatment the same company would receive if it had filed its return on the accrual basis.

The memorandum is submitted in behalf of Electrolux Corporation, believed to be the largest manufacturer and seller of vacuum cleaners in the United States, most of whose sales are made on the installment plan. Many other corporations engaged in the business of installment selling stand in a precisely similar situation.

Section 44 (a) of the Internal Revenue Code gives a corporation which sells on the installment plan the option to file its returns either on the usual accrual basis or on the installment basis. The difference between these two methods of accounting is that under the accrual method profit is treated as realized when the sale is made, while under the installment method recognition of profit is deferred until the installment payments are collected. This option was intended by Congress to help corporations making installment sales. In practice filing on the installment basis has proved to be a detriment which seriously prejudices a corporation using this method as compared with a similar corporation which uses the accrual method.

Corporations which have found that filing their returns on the installment basis results in undue hardship should be permitted to change to the accrual basis. The Treasury Department and the Bureau of Internal Revenue have always recognized that such corporations should have this right. It is clear that Congress intended to give them this option. House bill 10413 does not contain an appropriate provision to cover this special class of cases; and the result would be, if the same language were used in the law as enacted, that these corporations could not exercise the right to change their method of accounting—a right which they clearly should have and which the Government clearly intends to give them—without being subjected to prohibitive excess-profits taxes for the year of change.

Unless a suitable provision is inserted in the pending excess-profits tax to cover the peculiar case of corporations which have filed on the installment basis, they will be compelled either: (1) To continue to file on the installment basis, which is a very great hardship for the reasons hereinafter explained, or (2) to pay prohibitive and wholly unwarranted excess-profits taxes for the year in which the change to the accrual basis is made for the privilege of making such change.

This memorandum does not seek to procure preferential treatment or even special consideration for corporations which have filed their returns on the installment basis. The one point submitted is that any discrimination under the proposed law between two corporations which are exactly alike except as to their methods of accounting would be arbitrary and unjust.

SUGGESTED DRAFT OF PROVISION TO BE INSERTED IN THE PROPOSED ACT FOR THE PROTECTION OF CORPORATIONS WHICH HAVE FILED THEIR RETURNS ON THE INSTALLMENT BASIS

The draft of such a provision given below is respectfully submitted merely as a suggestion and in the hope that it may prove of some assistance to those engaged in preparing the act:

"CORPORATIONS ON THE INSTALLMENT BASIS.—If, with the approval of the Commissioner, a corporation which has filed its return for the preceding year on the installment basis under section 44 (a) changes the basis for filing its returns from the installment basis to the accrual basis, there shall not be made for the purpose of computing this excess-profits tax the addition to its income for the year of change which is required in computing the tax under section 13 in respect of that part of the profits on installment-sales contracts made in prior years which has not yet been returned. Should the change in accounting methods take place in a year later than 1940, amended returns shall be filed for all years subsequent to December 31, 1939, in which all profits on installment-sales contracts shall be reported as of the year in which the installment-sales contracts were made, but excluding all profits on installment-sales contracts made prior to January 1, 1940."

The language of the above draft has been revised to include changes suggested at conferences with experts of the Treasury Department. The last sentence was added to cover the point that without such an addition a company which changed from the installment basis to the accrual basis in any year after 1940 might obtain an unfair advantage.

The intention and we believe the effect of this provision is not to procure more favorable treatment for companies which have reported on the installment basis than is accorded similar companies on the accrual basis, but to avoid unfair discrimination against the former by permitting them to change to the accrual basis without excess-profits taxes being imposed on income earned in sales made before January 1, 1940.

THE PECULIAR POSITION OF COMPANIES WHICH REPORT ON THE INSTALLMENT BASIS INSTEAD OF THE ACCRUAL BASIS

Section 44 (a) of the Internal Revenue Code provides:

"(a) DEALERS IN PERSONAL PROPERTY.—Under regulations prescribed by the Commissioner, with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized, or to be realized when payment is completed, bears to the total contract price."

The purpose of this permissive provision is self-evident. It is intended to relieve companies selling on the installment plan from the hardship of paying income taxes on a profit which though actually earned when the installment sales contract is made will not be reduced to possession until the installment payments are made.

A simple example will illustrate how this provision works. The X company in 1939 sells for $1,600 an automobile which cost $1,000 to manufacture. The sale is made on the installment basis, and $400 of the purchase price is payable in 1939 and the remaining $1,200 in 1940. If the company elected to file its return on the accrual basis, as may companies do, it would report a gross profit on the sale of $600 in 1939. But a company which, like Electrolux, has elected to report on the installment basis would report only $150 gross profit on the sale in 1939, and the remaining $450 of gross profit would be reported in 1940. The effect of all this is that the company reporting on the installment basis is permitted to defer until 1940 payment of the normal corporate income tax on a part ($450) of a gross profit of $600 earned in 1939.

IN GRANTING THE OPTION CONTAINED IN SECTION 44 (A) TO REPORT OF THE INSTALLMENT BASIS, INSTEAD OF THE ACCRUAL BASIS, CONGRESS INTENDED TO CONFER A FAVOR ON CORPORATIONS MAKING INSTALLMENT SALES. FILING RETURNS ON THE INSTALLMENT BASIS HAS PROVED TO BE A MAN TRAP. BEFORE THE NEW EXCESS-PROFITS TAX WAS PROPOSED—EARLY IN THE CURRENT YEAR—ELECTROLUX HAD APPLIED TO THE COMMISSIONER FOR PERMISSION TO CHANGE TO THE ACCRUAL BASIS, AND THE BUREAU HAD INDICATED THAT SUCH PERMISSION WOULD BE GRANTED

When, years ago, Electrolux Corporation exercised the option offered by section 44 (a) to file its return on the installment instead of the accrual basis, the company supposed that it was being given a favor extended to corporations engaged in the business of installment selling, which is obviously what Congress intended. In practice, this privilege, instead of turning out to be a favor which both Congress and the company supposed it would be, has resulted in penalizing companies which took advantage of the option to file on the installment basis as compared with companies which continued to file on the usual accrual basis.

If the rate for the normal tax on corporate incomes were constant, any company would ultimately pay the same normal income taxes regardless of which basis it used. But the normal tax on corporate incomes has been progressively stepped up, with the result that a company deferring the return of profits on installment sales until the installment payments have actually been collected has paid higher and higher taxes as compared with the taxes the same company would have paid on the accrual basis. If Electrolux changes from the installment basis in 1940, so that it gets a fresh start on the accrual basis for subsequent years, the company for the period 1928-40, inclusive, will have paid about $400,000 more in normal income taxes than it would have paid if it had made its returns on the accrual basis throughout this period.

In addition to this, accounting on the installment basis has caused Electrolux serious troubles from a business point of view. Balance sheets prepared on the installment basis are so misleading that Electrolux and similar companies, although they file their tax returns on this basis, are obliged to keep a duplicate set of books and render their annual reports to the stockholders on the accrual basis. Competitors are in a position to use Electrolux's balance sheets, prepared on the installment basis, for the purpose of misleading customers as to the facts. The ratio of current assets to current liabilities in a balance sheet prepared on the accrual basis, when taxes are paid on the installment basis, is entirely distorted and seriously prejudices the company.

To enumerate the difficulties which reporting on the installment basis has raised for Electrolux Corporation would extend this memorandum to undue length. Perhaps we may be excused for citing one concrete example. After the Government declared that it was against public policy to transact business through the set-up of a holding company and a subsidiary, and made it clear that this method of transacting business would be penalized by discriminatory taxation, Electrolux, in order to comply with the public policy announced by the Government, determined to dissolve its operating subsidiary. For the purpose of facilitating such liquidation of a subsidiary, Congress had enacted section 112 (b) (6) of the Revenue Code to provide that no taxable gain or loss should be recognized. It was found, however, that under the wording of section 44 (d) an unjust and prohibitive tax would be imposed on such dissolution in the case of a company reporting on the installment basis. Congress, at the request of Electrolux Corporation, and upon the recommendation of both the Bureau of Internal Revenue and the Treasury Department, added an amendment [1] to section 44 (d) to correct this injustice.

This illustration emphasizes the fact that the position of companies on the installment basis is so unusual that any general revenue enactment is calculated unfairly to discriminate against these companies unless care is taken to insert a provision covering their peculiar situation.

Early in the current year Electrolux made application to the Commissioner of Internal Revenue, as permitted by the regulations, for permission to change the method of filing its returns from the installment basis to the accrual basis. The Bureau of Internal Revenue had indicated that such permission would be granted subject to an agreement on certain accounting items of relatively minor importance. But an unforeseen difficulty arose when this country's program of preparedness to meet the unfortunate European situation indicated that the passage of an emergency excess-profits tax will be necessary.

UNLESS SUCH A REMEDIAL PROVISION IS CONTAINED IN THE NEW LAW, ANY CORPORATION WHICH EXERCISES ITS RIGHT TO CHANGE FROM THE INSTALLMENT BASIS TO THE ACCRUAL BASIS, FOR THE PURPOSE OF RECEIVING THE SAME TREATMENT ACCORDED SIMILAR CORPORATIONS ON THE ACCRUAL BASIS, WILL BE SUBJECTED TO DISCRIMINATORY AND PROHIBITED EXCESS-PROFITS TAXES FOR THE YEAR OF CHANGE

A change from the installment basis to the accrual basis would involve prohibitive penalties for the year of change under any excess-profits-tax law irrespective of the basis of such tax unless an appropriate provision is inserted to avoid such unjust discrimination.

Regulations 103 (p. 188) in regard to change in the method of accounting on which returns for normal corporate income taxes are filed provides in part as follows:

"A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. * * *

"Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

[1] This amendment reads as follows:

"* * * If an installment obligation is distributed by one corporation to another corporation in the course of a liquidation, and under section 112 (b) (6) no gain or loss with respect to the receipt of such obligation is recognized in the case of the recipient corporation, then no gain or loss with respect to the distribution of such obligation shall be recognized in the case of the distributing corporation."

"The foregoing requirements relative to a change of accounting method are not applicable if a taxpayer desires to adopt the installment basis of returning income, as provided in section 19.44–1, but are applicable if a taxpayer desires to change from such basis to a straight accrual basis. In cases where permission to make such change is granted, the taxpayer will be required to return as additional income for the taxable year in which the change is made all the profit not theretofore returned as income pertaining to the payments due on installment sales contracts as of the close of the preceding taxable year."

If Electrolux Corporation or any other company on the installment basis for 1939 changes to the accrual basis for 1940, it is entirely just that such company should add to its net income subject to the normal tax for 1940 the profits made in 1939 on installment contracts made prior to the close of that year which were not reported as part of the net income subject to normal tax during that year. It would be entirely unjust to compel such a company to pay the emergency excess-profits tax for 1940, not only on its entire net income during 1940, but also on the carry-over from 1939. The purpose of the emergency excess-profits tax on corporate incomes for 1940 is to surtax any extraordinary increase in the net income of any company for that year which results from war or near-war conditions. The proposed tax will probably be a heavy one to prevent companies benefiting by such conditions from reaping an excessive profit unreasonable either as compared with their invested capital or their average earnings for prior years. The injustice of adding, for the purpose of computing such excess-profits tax for 1940, a carry-over of past earnings from 1939 on top of the entire net earnings during 1940 is obvious.

If Electrolux stays on the installment basis for 1940 it will have to pay the normal tax on profits from installment-sales contracts made in 1939 not reported in that year; but, as compensation for this, Electrolux will not have to pay a tax on profits from installment contracts made during 1940 to the extent that the installment payments thereon do not fall due before the end of that year, as these profits will be carried over into 1941 under the installment method.

On the other hand, if Electrolux Corporation changes to the accrual method of return for 1940, it will be required to pay both the normal and emergency excess-profits tax on its entire net profits for that year, including all profits on installment-sales contracts made during the year, even if the installment payments will not be collected until 1941. If Electrolux were required to pay the excess-profits tax not only upon the entire amount of its actual income in 1940, but also upon a carry-over of income from 1939 and prior years, the tax would be so tremendous and unjust that a change from the installment to the accrual basis would be out of the question.

Electrolux's actual net income for 1940 is estimated at $2,000,000. Because the company used the installment method, the carry-over income from 1939 subject to the normal tax amounts to about $3,000,000. This additional $3,000,000, as explained above, represents profits made in prior years, the recognition of which for normal income-tax purposes has been deferred under the installment method of accounting, and on which the company should and is perfectly willing to pay the normal tax for 1940. But it would be most unjust to the company to pay the emergency excess-profits tax for 1940 on a theoretical net income of $5,000,000 when its actual net income for this year will be only about $2,000,000.

A return on either the installment basis or the accrual basis results in a company's only having to pay a tax on its net income for the year in question, and the difference is merely that the year's income is computed in different ways according to the method used. But if a company, say, in 1940, changes from the installment basis to the accrual basis, the result is that for the purpose of computing the normal tax the company in effect has to pay (and ought to pay) for 1 year a tax on the earnings of 2 years, because there is the carry-over from 1939 to 1940 with no corresponding carry-over for 1940 to 1941. For the purpose of the excess-profits tax, however, it would obviously be unjust to have the company taxed for a single year on the earnings of 2 years. The doubling of the earnings subject to normal tax for 1940 is purely an accounting adjustment, and the excess-profits tax obviously should not be imposed on a figure representing twice the actual earnings of the company for that year.

The proposed provision will accomplish, in the peculiar case of corporations which have filed their returns on the installment basis, exactly what Congress intends to accomplish by the proposed act. The purpose of the new law is, not to tax income earned on transactions which took place prior to January 1, 1940, but to tax all income earned after that date. The proposed provision does just this. Without such a provision, a large amount of income earned prior to January 1, 1940, would be unjustly subjected to the excess-profits tax, whereas (equally unjustly) a large amount of income actually earned during the last years to which the excess-profits tax applies would escape the tax, because such income would not be reported under the installment method until after the law has expired.

Respectfully submitted in behalf of—

ELECTROLUX CORPORATION,
CHADBOURNE, HUNT, JAECKEL & BROWN,
New York, N. Y.
GARDNER, MORRISON, ROGERS & MCGUIRE,
Washington, D. C.

SEPTEMBER 5, 1940.

The CHAIRMAN. The next witness is Leonard Bush, of New York City, representing the Compton Co.

STATEMENT OF LEONARD BUSH, NEW YORK CITY, REPRESENTING THE COMPTON CO.

Mr. BUSH. My name is Leonard T. Bush. I am the vice president and treasurer of the Compton Advertising, Inc., an advertising agency located in New York City.

As I have read this bill, I take it that it is intended that personal-service corporations under certain conditions are not to be subjected to excess-profits taxes. I believe that we are a personal-service corporation, but I cannot be sure of it based on the definition as set forth in the bill. It is not clear, to me at least, what the word "primarily" means where it says:

> A personal-service corporation means a corporation whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the owners—

Et cetera. I would like to ask that "primarily" be defined more clearly, and would suggest that it say words to this effect:

> That "primarily" means due to the activities of management, supervision, and professional skill and reputation of the stockholders who control the business.

Such a definition would make it clear to the management of this sort of a concern whether they could qualify as a personal-service corporation or not. I would hate to have it left to the interpretation of someone in some department of the Government as to whether this is, or this is not, a personal-service corporation. We would not know how to act if we had to wait until after the fact. If we filed our income-tax return on the assumption we were a personal-service corporation and had constructively distributed all of the profits, and the various stockholders had paid their income tax thereon on moneys which they had not received at that time, and conceivably might never receive, because this is a hazardous business, and if the corporation should lose all of its earnings due to circumstances that took place subsequently, and if maybe a year or maybe 2 years hence—I don't know when—it turned out that because of somebody's interpretation of that language it was said that we did not qualify, it would be very serious.

The CHAIRMAN. There is a Treasury representative here. There is someone here also representing our own committee, and I would suggest that you have a talk with them tonight before going back. Get their viewpoint, and they will report to us in the morning when we go into executive session. You desire to do that, don't you?

Mr. BUSH. I would like to go on a little more, if I may.

The CHAIRMAN. I am not stopping you now; I am just making a suggestion that you see the representative of the Treasury Department and the technical representative of the committee before you go away and have a conference with them, and they will doubtless take the matter up with you as the result.

Mr. BUSH. Thank you very much. I would like to reinforce what has been said here many times today—in the event that we do not qualify as a personal-service corporation—in the position that we are in, I may say that we acquired this business in 1935 from a group of men who had carried it on successfully for a number of years and who no longer had any interest in carrying on the business. In order to pass control they wanted their money right then and there, and we, the present owners, were employees of long standing of that former management, and not very well paid, and we had not much money, and we had to go out—first of all, they wanted all of their capital out of the business right away, and we had to give it to them. We had to have capital, so for that purpose we, if you will pardon the word, we hocked everything we owned to get capital to put into this business to continue to operate it.

Then, additionally, they wanted to be paid not only their capital, but they wanted to be paid their share of the goodwill of the business spot cash, and to get that we went out and mortgaged our future earnings. We have not paid those off yet.

We also decided, upon thinking it over, that we wanted to build it up and not let it run down, so we adopted the policy of moderate salaries for the owners and also practically no earnings for the corporation, and I will recite to you the earnings that we did have, the percentage of our gross income.

We earned in 1936, 3.82 percent; in 1937, 7.76 percent. This is not on the invested capital; we had none of it to speak of. This is of our gross volume of business.

In 1938 it was 5.85; in 1939 it went to 15.48. That was our first year in which we took any share of the profits.

I compared that with the other advertising agencies for those same 4 years in our volume group. Most of them report to the American Association of Advertising Agencies, who give us the figures in percentage form without any identification. We don't know who is who, except here is company A, B, C, and D, and the combined group of agencies doing the volume of business that we are doing was, in 1936, 15 percent; in 1937, 14.5 percent; in 1938, 11 percent; and in 1939, 15 percent.

So that in 1939, for the first year, we came out with about the same earnings per dollar of business that they had, and if we did not qualify under this law as a personal-service corporation, two-thirds of our profits would be classified as excess profits.

Then we would not have the money to pay the bills we owe.

Senator KING. What do you suggest?

Mr. BUSH. I suggest that the wording—pardon me, but let me say this—here are about 10 firms that are currently in exactly the same position that we are in, as to the volume of business being done, and are earning currently about what we are earning, yet because of the past history, they would not have to pay any excess-profits taxes, whereas we would have to pay about two-thirds of ours, and yet there is no difference between us except that they are better able to pay it than we are.

I think that is true not only of our business, but of corporations and businesses such as ours in all lines of business, and I do not think than an excess-profits tax—I may be wrong but this is my opinion—that an excess-profits tax can be devised that is fair and equitable. I think that the fair thing to do for everybody would be to make a flat tax in the form of an increased income tax, so that everyone has to pay in proportion to their ability to pay, and that it would produce the revenue which the Government needs, and then we would be happy to pay.

The CHAIRMAN. Thank you very much. If you want to talk to these gentlemen, you may talk to them.

Mr. BUSH. I would like to.

The CHAIRMAN. Is Mr. K. T. Norris representing the Norris Stamping & Manufacturing Co., Los Angeles, Calif., in the room?

(No response.)

The CHAIRMAN. I understood that he would not appear.

Mr. James K. Polk, 40 Wall Street, New York City.

STATEMENT OF JAMES K. POLK, REPRESENTING WHITMAN, RANSOM, COULSON & GOETZ, NEW YORK, N. Y.

The CHAIRMAN. You are not on our list, but we will hear you.

Mr. POLK. I appreciate very much the opportunity to speak.

The CHAIRMAN. How much time do you desire?

Mr. POLK. Three to four minutes.

I do not reiterate any of the comments that have been to date on the present bill. I merely want to put into the record, and for your consideration, one matter that has not been commented upon, and which I think is rather vital. It is vital in that unless adjusted, there will be required more thousands of calculations. It is an unforeseen result, I really believe.

I assume that in any act there will be some invested capital calculations. The invested capital as defined in the act includes earnings and profits of the corporation. The act contains a sleeper, a section which does not apparently relate to anything having to do with excess-profits taxes, and apparently is designed to catch and correct some inequities in computing gains or losses to individual shareholders upon dividends out of surplus or out of capital paid in, or something of that sort.

I refer to section 401 at page 94. Under this definition contained in section 401, provision is made that whenever a corporation has sold a capital asset at a loss the loss shall be recalculated, and their earnings and profits restated on a different basis from that which the books were kept and the returns originally filed.

Let me illustrate. It is easier to do that than to explain it in narrative form.

If a corporation in 1910 bought an asset for $10, and in 1918, 1920, 1925, or 1935 sold that asset for $5, it would normally have a $5 loss. That $5 loss, if booked, would reduce its surplus by $5 and it reported a $5 loss for income-tax purposes, which may or may not have been allowed, due to the $2,000 limitation, but, in any event, did not report more than that amount. It did not sustain a loss of any more of its embarked capital than $5 on that illustration I have given.

Suppose, however, that the assets at the date of March 1, 1913, had a value of $15. Then, under this section of the law, it is proposed to reduce its earnings, its accumulated earnings and profits, by $10, the difference between the March 1, 1913, value at $15 and the sales price of $5. It never sustained but a $5 loss and never reported but a $5 loss and there is no reason and no sense to reducing its surplus by $10.

There is, therefore, so far as I can see, no equity in the section. I do not, however, ask that you consider it solely from an equity standpoint. I do not know what reason there may be to reduce the statutory investment capital by nonexistent losses, but let us assume there is some reason. I cannot see any equity in it, but let us assume there is some equity in it. Thousands and thousands of calculations are going to have to be made on facts that are impossible to determine. You are going to have to have witnesses to find out what the March 1, 1913, values were of all of the assets that were sold at losses in order to find out what your invested capital is for any one of the base years or today.

Now, Mr. Sullivan did not comment on this section at all. Mr. Stam made no comment on it. I have been here 3 days listening carefully for some comment, because it would aid in constructing the returns which will have to be done next March. Mr. Stam told me informally that he did not father the proposal.

There is a provision in the section on invested capital which apparently would take care of so much of the property as had been paid in originally and later sold at a loss, but I personally represent a client that has over $300,000,000 of property on March 1, 1913, that had been bought for cash. It had not been paid in the way of stock, and if any of that property was sold at a loss at any time between 1913 and 1940, I have got to find experts alive and familiar with the property to establish a March 1, 1913, value to report my first invested capital.

That seems to me to be an unconscionable requirement on the taxpayer, and it is inequitable, anyway.

Senator KING. Isn't that provision about 1913 value a hangover from a measure that was enacted during the war or right afterward?

Mr. POLK. Of course, the date of March 1, 1913, is the date of the first revenue act after the adoption of the sixteenth amendment, and there was a theory that all property values were frozen at that date, and that all gains could not exceed the difference between the sales price and the March 1, 1913, value or cost, whichever was higher. And there was a construction by the Supreme Court that there could be no loss in excess of the difference between the cost and the sales price regardless of how much higher the March 1, 1913, value was.

The old rule was phrased by the auditors and accountants dealing with it in the Bureau of Internal Revenue that you got the least gain and the least loss, and if the sales price fell in between the two, there was no gain and no loss.

Senator KING. What amendment would you suggest on page 94?

Mr. POLK. I don't know. They may need the section 401 for individual cases. I cannot guess as to that, but you can amend on page 29 at the bottom of the page a sentence which reads:

Nothing in section 401 of the Second Revenue Act of 1940 shall affect the extent to which accumulated earnings and profits are increased by reason of increase in value accrued before March 1, 1913.

That sentence can probably be changed to read that the provisions of section 401 of the Second Revenue Act of 1940 shall not apply in the computation of earnings or profits.

Senator KING. Would you add that after the period on line 2 of page 30?

Mr. POLK. I would prefer, if my proposal is sound, that that be considered by Mr. Stam, and leave it to his discretion. He may have some reason for this sentence in here which I cannot understand. I do not know at the time, but if there is any sound reason for that sentence remaining in there, of course it should remain, but I think there should be no requirement that the actual dollars embarked in the business be reduced by a fictitious nonexistent loss of which the taxpayer has had no benefit in any income-tax return, never recorded on the books, and which just does not to my mind make sense.

The CHAIRMAN. I would like to announce that as soon as this witness is finished, that we will adjourn, and the committee will meet tomorrow in this room at 10 o'clock in executive session to finish up this bill.

Before we close the hearings, I wish to have incorporated in the record, for the information and study of committee members, numerous briefs, statements, etc., submitted by the following: Mr. Robert P. Smith, of Washington, D. C., in behalf of Miller Electric Co., Jacksonville, Fla.; Mr. Floyd B. Odlum, president, Atlas Corporation; Mr. C. J. S. Williamson, of San Francisco, for the California State Chamber of Commerce; Mr. Harvey Campbell, executive vice president, Detroit Board of Commerce, Detroit, Mich.; Mr. John J. Burns, general counsel, American Merchant Marine Institute, Inc.; Mr. E. P. Thomas, president, National Foreign Trade Council, Inc., New York, N. Y.; Mr. M. L. Seidman, of the New York Board of Trade, Inc.; Mr. James L. Donnelly, of the Illinois Manufacturers' Association; and Mr. K. T. Norris, of Los Angeles, Calif.

AUGUST 31, 1940.

BRIEF IN BEHALF OF MILLER ELECTRIC CO., JACKSONVILLE, FLA., IN THE MATTER OF THE PROPOSED EXCESS PROFITS TAX ACT, H. R. 10413

The Honorable Chairman of the Finance Committee, United States Senate: In reference to the new proposed excess-profits bill (H. R. 10413), which has just recently passed the House and is now pending before your committee, please be advised that I represent the Miller Electric Co., of Jacksonville, Fla. This company is engaged in electrical contract work and during the year 1940 will complete certain contracts which it secured in 1937 and 1938.

The company has filed its income-tax returns on the completed-contract basis, which is permissible by the revenue act now in effect, and will have a profit in 1940 of approximately $135,000. It sustained operating losses during each of the years 1936 to 1938 and had a very small profit in 1939. The income which it will derive in 1940 results entirely from work and labor done during the preceding years and has no reference whatever to the war profits that will result from current spending by the United States Government.

I estimate that its taxes for 1940 under the present proposed excess-profits-tax law, exclusive of the normal tax now imposed by the present revenue act, will be approximately $35,000. This company has no invested capital as of January 1, 1940. In fact, it has a capital deficit of approximately $30,000, and owes a large amount of money to creditors, which will have to be paid from the income derived from these contracts. As you can readily see, it will be impossible for my client to pay the large amount of tax that would be due under the present proposed legislation during the year 1940 and also pay its creditors.

There must be a large number of taxpayers similarly situated who are reporting their income on a long-term-contract basis permissible under the present revenue act, and we submit that some relief should be granted in the proposed excess-profits-tax law for this type of taxpayer.

Contractors who received contracts through competitive bidding prior to the imposition of the proposed excess-profits law could not have anticipated such an act. Contractors who bid on new contracts in the future, after the passage of the act, will naturally take into consideration the imposition of this tax and can protect themselves. The contractors who bid and received a contract in 1939 and prior years, or even during the early part of 1940, had no means of protecting themselves against these unexpected emergency taxes.

Unless some relief is granted for this type of taxpayer, the Miller Electric Co. will simply have to cease operations and go into bankruptcy, as it will not be able to pay the new proposed excess-profits tax, plus the amount due its creditors, and continue in business.

Under the proposed bill as passed by the House, section 711 provides:

"(a) Taxable years beginning after December 31, 1939.—The excess-profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13 (a) (2), for such year, except that the following adjustments shall be made: * * *"

The normal-tax net income as defined by section 13 (a) (2) of the present revenue act is as follows:

"(a) Definitions.—For the purposes of this chapter—

"(2) Normal-tax net income.—The term 'normal-tax net income' means the adjusted net income minus the credit for dividends received provided in section 26 (b)."

We submit for the consideration of the Finance Committee, the following proposed amendments, which we believe will remedy one of the most inequitable situations that can possibly arise under this proposed act.

Insert after line 13, page 6, a new subsection (D), as follows:

"(D) There shall be excluded, in the case of any corporation, income derived from long-term contracts entered into prior to July 1, 1940, as defined by section 19.42–4 of the Internal Revenue Code."

Section 19.42–4 of the Internal Revenue Code provides, as follows:

"*Long-term contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term 'long-term contracts' means building, installation, or construction contracts covering a period in excess of 1 year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

"(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

"(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

"A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this section only after permission is secured from the Commissioner as provided in section 19.41–2."

If the aforesaid proposed amendment is not acceptable, at least you should provide that, for the purpose of imposing the excess-profits tax under this act, only that portion of the income from the long-term contract which is applicable to 1940 and subsequent years would be subject to excess-profits tax, and for this purpose we submit the following alternative amendment. Insert after line 13, page 6, a new subdivision (D) alternative.

"(D) Alternative: Income derived from long-term contracts. There shall be excluded in the case of any corporation, reporting its income from long-term contracts on a completed contract basis as provided by section 19.42-4 on the Internal Revenue Code, that pro rata portion of the income based on the number of months that the contract was in existence prior to July 1, 1940, bears to the total number of months of duration of contracts which were completed within the taxable year 1940, or any succeeding taxable year."

The reason for suggesting July 1, 1940, as the determining date is that prior to that date there was little or no discussion regarding the defense program, and there was no thought in the minds of the American people that there would be any necessity for such high taxes as are now proposed, and, consequently, contractors bidding on competitive contracts could not have taken into consideration this additional expense.

We submit further that this type of taxpayer is entitled to relief, and that the situation can probably be better taken care of by amending section 725 of the proposed act, pertaining to exempt corporations, by adding a new subsection, as follows, beginning after line 3, page 39:

"So much of the income of domestic corporations derived from long-term contracts as defined by section 19.42-4 of the Internal Revenue Code which contracts were entered into on or before July 1, 1940."

We trust that you will give the above suggestions careful consideration. I believe that it is more profitable to the Government to have a company continue in business and pay the normal tax under the circumstances, such as I have related, than it would be to enact a law that will confiscate a particular class of taxpayers' property and force them out of business, so that they will no longer be employers of labor or taxpayers.

If there is any assistance I can give the committee in the refinement of the proposed amendments, I will be glad to have you call on me.

Respectfully submitted.

ROBERT P. SMITH,
Counsel, Washington, D. C.

The exemptions in the excess-profits tax bill (subdivisions (c) and (d) of section 725 of H. R. 10413) should be enlarged to include all three types of investment companies that are jointly or commonly classified as "management companies" under the Investment Company Act of 1940; rather than to include only two of these types as the bill now does and which by so doing operates to unjustly discriminate against and harmfully penalize the third type.

A statement bearing on the above point made to aid members of the Committee on Finance of the Senate of the United States by

FLOYD B. ODLUM,
President, Atlas Corporation.

SEPTEMBER 5, 1940.

The House draft of revenue bill (H. R. 10413) exempts so-called mutual or open-end investment companies and also so-called diversified investment companies from the excess-profits tax. This seems right as far as it goes. But these companies are only two of the three types that are together classified as "management companies" in the Investment Company Act of 1940. The third type is the so-called nondiversified investment company. It, too, should receive the exemption.

To accomplish this all that is necessary is to substitute the word "management" for the word "diversified" in subdivision (d) of section 725.

Unless this change is made, an arbitrary and completely unjustified discrimination will be made as between the so-called "diversified" investment companies and the so-called "nondiversified" investment companies, which, in fact, operate in the same field, will be registered with the Securities and Exchange Commission under the same section of the Investment Company Act of 1940, will be regulated under the same law, will have no distinguishing differences in their capital structures, and will serve precisely the same purpose as a vehicle or conduit for investment by small investors.

There is no sound reason for such distinction or discrimination.

The business of both the "diversified" and the "nondiversified" investment company is to invest in securities. Central management through this means is given to the investments of large numbers of scattered small investors. The only difference between the "diversified" and the "nondiversified" investment companies in the definition set forth in the Investment Company Act of 1940 is that that "diversified" company may have not more than 25 percent of its assets in blocks of stocks of other companies if any such block amounts to more than 5 percent of the assets of the investment company or more than 10 percent of the outstanding stock of the issuing company; whereas a "nondiversified" investment company may have more than 25 percent of its assets so invested. The "nondiversified" company may in fact be more diversified than the so-called "diversified" company. The "diversified" company may in fact have at any particular time more than 25 percent of its assets when taken at their market or fair value invested in these so-called special investments, and the "nondiversified" company may have less. The terms used to define these companies are general terms not necessarily indicative of their true distinction. Atlas Corporation, which will register as a "nondiversified" company, will have in its portfolio more diversified holdings than most companies classified as "diversified" companies. Its stockholders will thus have great diversification. A company registered with the Securities and Exchange Commission under the Investment Company Act as "diversified" may change its registration to that of a "nondiversified" company at any time and the registered "nondiversified" company may change its registration to that of a "diversified" company. The error in granting exemption to one and not the other seems apparent.

If an investment company is to be exempted from taxes in whole or in part on the theory that it serves only as a conduit for investment by small investors and that to tax it would be to impose a double tax on such small investors (a theory which the writer believes entirely sound), then both the "diversified" and the "nondiversified" companies should receive precisely the same tax treatment for they both serve equally in the capacity of such conduit.

If an investment company is to be exempted on the theory that it serves as a means of diversification of investment by the small investor, then both types should receive the same treatment. Diversification for any particular stockholder depends not so much on how many different securities are in the company's portfolio (and there may be more in the portfolio of the "nondiversified" company than in the portfolio of the "diversified" company) as on the ratio of his holding to all other stockholders and the size of the particular investment company. It depends very little on whether a particular stock held in the portfolio amounts to more than 10 percent of the outstanding stock of the issuing company. Diversification must be gaged in its true sense. A "nondiversified" company may have less than $1,000 invested in the stock of a small business and still have more than 10 percent of the stock of such business; a "diversified" company may have $1,000,000 invested in the stock of a large business and still have less than 10 percent of the stock of such business.

If an investment company is to be exempted from taxes on the theory that it is a mere vehicle for performing a particularly necessary or useful economic or financial function, then the "nondiversified" investment company should at least receive no less favorable treatment than the "diversified" company. For it is the "nondiversified" company that is qualified and equipped to finance small business and to provide working capital to industries in cases where the bank or the investment banker cannot function. The "diversified" companies must, on the other hand, for the most part limit their investments to securities already outstanding and traded in on the markets.

There seems to be sound reason for exempting all management-type investment companies from the excess-profits tax because of the function they perform as a conduit for small investors. But before any act is passed that attempts to exempt part of these companies only, it is recommended and urged that the views of the Securities and Exchange Commission should be ascertained as to the propriety and fairness of such differentiation. It is the understanding of the writer that the Securities and Exchange Commission has neither been asked to express views on this basic question nor has it done so. That Commission has made a study of investment companies extending over 4 years and is about to take regulatory jurisdiction over investment companies of all types under the

Investment Company Act recently passed by Congress. Its views on the basic merits as distinct from any specific answer to a technical or narrow question not involving basic equities or approaches, should be important.

The President of the United States in his statement of August 23, 1940, which accompanied approval of the Investment Company Act, said that he had great hopes that the law would permit the investment trust industry "to provide a valuable source of equity capital for deserving small and new business enterprises which the investment bankers have been unable to finance."

H. R. 10413 in its present form will have just the contrary effect because it places under a tax disadvantage the very type of investment company that is qualified and organized to provide such equity capital to small and new business enterprises, namely, the "nondiversified" company. It will, in the very nature of things force such companies to become and register as "diversified" companies and by that very act estop themselves from carrying on as a primary function involving a substantial part of their capital the taking even temporarily of more than 10 percent of the stock of any small or new business enterprise.

This type of investment company that ventures or risks its capital outside the field of "blue chip" securities and in new or small enterprises which are not served properly as to capital requirements by bankers or investment bankers and that finances development enterprises and reorganizes companies was considered specially meritorious by the agencies of the Government who promulgated the Investment Company Act. This is evidenced by the testimony of Mr. David Schenker, chief counsel, Investment Trust Study, Securities and Exchange Commission, on June 14, 1940, before the subcommittee of the Committee on Interstate and Foreign Commerce of the House of Representatives. And this should be so because it is a type of investment company particularly designed to give aid directly to industry. Yet it is the only type of management investment company that has been forgotten in the tax exemption provided in H. R. 10413.

The President of the United States in his message to Congress of June 19, 1935, indicated the desirability of special tax treatment for meritorious investment companies that submit to public regulation, which regulation is now here.

Following such indication the Congress passed an act exempting from tax the so-called "open-end" investment trusts.

The present H. R. 10413 recognizes, and properly so, that the question whether the investment company redeems its stock at stockholders' option, which was a distinguishing feature of the so-called "open-end" companies, is not controlling as to whether there should be exemption. H. R. 10413 seems to take diversification more as the criterion than other factors. But it takes the name more than the substance. And for very sound reasons, some of which are touched on above, diversification should not be the criterion. In attempting not to carry over the error of the present income-tax law into the excess-profits-tax bill, such bill has not gone far enough and a second error has been committed of not including all management type investment companies. The correction is simple and easy, as above stated.

Mr. Alfred Jaretski on August 12, 1940, appeared before the Joint Committee on Ways and Means of the House of Representatives, and the Committee on Finance of the United States Senate, and argued in favor of exemption of the so-called "diversified" investment company. That exemption was granted by H. R. 10413. Mr. Jaretski spoke only on behalf of "diversified" companies. He was not arguing that "nondiversified" companies should not be likewise exempted. His arguments, if read, will be found to apply also to the so-called "nondiversified" companies.

H. R. 10413, in this provision, is even more inequitable than hereinabove stated. It not only eliminates the registered "nondiversified" company from the benefits of the exemption, but prohibits such company as to any year from getting the benefits of the exemption even though during such year it has become a so-called "diversified" company through qualification and registration as such, as it has the right to do under the Investment Company Act of 1940. If this type company is to be penalized and consequently forced out of business, it should at the very least have the right for tax purposes to be a "diversified" company for the year during which it in fact becomes such and so registers.

Respectfully submitted.

FLOYD B. ODLUM,
President, Atlas Corporation.

MEMORANDUM REGARDING CONSOLIDATED RETURNS IN CONNECTION WITH THE PENDING EXCESS-PROFITS-TAX BILL

Recommendations from many quarters are now pending before Congress regarding the inclusion of permission for filing of consolidated returns in the excess-profits tax measure now under consideration. The California State Chamber of Commerce wishes to add its voice to these recommendations and, in doing so, respectfully calls the committee's attention to the following significant points:

1. In recommending at this time that the privilege of filing consolidated returns be included in the excess-profits tax bill, the California State Chamber of Commerce wishes to emphasize its recognition that Federal revenues must be maintained, and suggests that if the filing of consolidated returns is permitted as optional and the Treasury Department estimates that such option will lead to material reduction in the yield of this tax, that Congress then give consideration to balancing such deficiencies in total revenues caused by the filing of consolidated returns by a special additional tax applied at a percentage rate to corporations exercising the option of consolidated returns.

2. It is the opinion of the State chamber that by requiring separate statements of income from each corporate unit of an enterprise, nonexistent paper profits are often taxed, and the enterprise may be subject to a tax in an amount which is grossly disproportionate to its true income. The financial position and earnings of a parent company and its subsidiaries, or of affiliated companies, can only be presented fairly by means of consolidated statements wherein the entire group is treated as a single unit, with intercompany transactions eliminated. Such inequalities become exaggerated when rates varying from 25 to 45 or 50 percent are superimposed upon the normal income-tax rate.

3. The first excess-profits-tax law, namely, the 1917 act, was silent as to consolidated-profits-tax returns. After the passage of the War Profits Tax Act of 1917, a committee working upon the drafting of the rules and regulations to carry out the act recommended to the United States Treasury Department, and the recommendation was accepted, that corporations which were affiliated in such a way as to constitute in actual fact only one corporation, be required to file a consolidated return whenever it was found by the Commissioner of Internal Revenue to be necessary in order to more equitably determine the invested capital or taxable income. In the 1918 act, it was made mandatory that all corporations affiliated within the meaning of the act file consolidated returns for both income- and profits-tax purposes. Under later revenue acts, filing of consolidated returns was made optional. The 1917 consolidated-profits-tax regulations were confirmed retroactively by special legislative enactment in the Revenue Act of 1921.

The history of this legislation indicates that the necessity of consolidated-profits-tax returns was clearly recognized soon after the enactment of the first excess-profits-tax law, and we cite this as a precedent.

SEPTEMBER 3, 1940.

DETROIT BOARD OF COMMERCE,
Detroit, Mich., September 5, 1940.

COMMITTEE ON FINANCE,
The Senate of the United States, Washington, D. C.

GENTLEMEN: The Detroit Board of Commerce, Detroit, Mich., desires to bring to the attention of your committee its views on certain provisions of H. R. 10413, the Second Revenue Act of 1940.

The members of the committee will appreciate that printed copies of the Second Revenue Act of 1940, which was passed by the House of Representatives on Friday, August 30, 1940, have been available to us only during the current week. In consequence it has been impossible to give this important and complex piece of legislation the study which would be necessary to a complete understanding of all of its provisions. Therefore, this memorandum cannot purport to represent our views on the entire bill. Nevertheless, certain of the provisions of the bill are so drastic in character and the effect which they will have upon the business of this community promises to be so serious that we deem it essential to put our views before you at once. This is especially the case since it is our understanding that hearings on this bill will be concluded before your committee some time during the present week. Because of the outstanding importance of this bill, we ask the indulgence of the members of the committee to make this brief presentation of our views on certain provisions of the proposed law.

The Detroit Board of Commerce and in general the business interests of this community are aware of the requirements of the national-defense program, both from the point of view of the necessity for cooperation between Government and industry for production of materials for defense purposes and in respect to the need for financing the defense program by adequate taxation. Furthermore, we appreciate that it may be desirable and necessary to enact an excess-profits tax law to the end that the "rearmament program should furnish no opportunity for the creation of new war millionaires or the further substantial enrichment of already wealthy persons." We earnestly believe that every industry in this community would approve of the enactment of an excess-profits tax for these purposes, provided only that the legislation is fair and equitable and its provisions clear and practicable. We know that it is the purpose of Congress to enact such legislation. Nevertheless, we believe that in the haste with which the present bill was drafted and passed by the House of Representatives many provisions have been incorporated which are neither fair nor practicable; provisions which, in fact, would work great hardship and inequity upon business corporations in this community and throughout the country.

While it is obviously impossible to discuss all of the provisions of this bill in detail, we, nevertheless, wish to invite your attention to the following matters which we believe constitute major objections which merit serious consideration by your committee.

COMPLEXITY

In the first place, it is apparent that the present bill attains a degree of complexity unprecedented in the tax legislation of the Federal Government. The computations required for the determination of any tax under this bill are so involved and elaborate that the average corporate taxpayer will find it quite impossible to determine, or even to estimate with any accuracy, what its excess-profits tax liability will be. We understand that one of the purposes of the enactment of excess-profits tax legislation at this time is to enable corporations called upon to contribute to the defense program to know where they stand from the point of view of taxation. The bill should accord a reasonable degree of certainty as to the liabilities it imposes. It signally fails to do this. For example, all corporations which will determine their tax by the invested capital method will be required for the year 1940 to compute their average daily invested capital for both 1940 and the 4 years of the base period. Computation of invested capital for any day is complicated by permitting the inclusion of only a portion of the borrowed capital. When the corporation has determined its so-called equity capital and the percentage of its borrowed capital which may be added thereto, it is further required to reduce the total to eliminate so-called inadmissible assets, in itself a computation which will require a determination of the adjusted bases day by day of every asset the corporation owns. We estimate that in the case of a corporation whose borrowings fluctuate from day to day and which owns stock of other corporations, some 3,000 separate computations will have to be made to determine the amount of invested capital as required for computation of 1 year's tax under the bill. It is apparent that the bill will impose upon corporate taxpayers a tremendous burden of cost for the mere purpose of making a determination of the amount of their liability.

SIMPLIFICATION BY FIXING THE NORMAL RATE OF RETURN

We believe that the major portion of these involved and complex calculations can readily be dispensed with. In large part the complexity of the invested capital provisions is due to the attempt to determine an exempt rate of return on invested capital by reference to the actual rate which the corporation earned on its invested capital during the base period. This rule not only unnecessarily complicates the act, but in itself is unwarranted. A principal reason for resort to the invested capital method lies in the fact that some corporations had abnormally low earnings during the base period. But if this is the case, such abnormal earnings should not be made the criterion for determining a proper rate of return under the invested capital method. If your committee will determine that a corporation should be permitted to earn 10 percent on its invested capital before the excess-profits tax applies, all reference to the base period could be eliminated for corporations using the invested capital method. In this manner the act would be immensely simplified and made much more certain, and we believe that the resulting tax would be fair and equitable.

THE REORGANIZATION PROVISIONS

The foregoing refers to the relatively simple case of a taxpayer whose corporate structure has remained unchanged since January 1, 1936. Far greater complications are introduced by part II of title I of the bill (secs. 740 to 760) relating to corporations which have gone through any sort of reorganization, merger, consolidation or split-up since January 1, 1936. The sections modifying the basic terms of the act when it applies to this numerous class of corporations are so involved and complex as substantially to defy comprehension. A reading of these sections would leave any corporate official hopelessly bewildered and quite unable to form any opinion as to the probable effect of this act upon his own corporation. Again it seems to us that the major part of these complexities are quite unnecessary. We believe that they arise very largely out of the improper attempt to use a base period in connection with the application of the invested capital method. We earnestly recommend to your committee the simplification of these provisions and of the entire bill, to the end that taxpayers may more readily and easily determine their tax liabilities without incurring enormous expense in so doing.

PENALTIES ON THE ELECTION OF THE AVERAGE EARNINGS METHOD

The bill before your committee quite properly provides that corporate taxpayers shall be given an option to adopt either an average-earnings method or an invested-capital method for the determination of the excess-profits tax credit. We believe that in general the use of the average earnings of a corporation over a properly selected base period is a proper way to determine what constitutes normal profits. We recognize at the same time that the act must provide an alternative invested-capital method, both for corporations whose earnings during the base period were abnormally low and for corporations which came into existence after the end of the base period. We submit, however, that if this election of methods is to be granted, the election should be fair and the bill should not penalize any corporation for electing one method in preference to the other.

The bill now before your committee imposes two serious penalties upon any corporation which elects to adopt the earnings basis for determining its excess-profits tax credit. In the first place, such a corporation will be required to pay an additional tax of 4.1 percent upon its entire net income. This is, in effect, an increase in the normal tax rate for such corporations to 25 percent. At the same time this additional tax of 4.1 percent may not be deducted (as the corporational normal tax of 20.9 percent may be) in determining the income to which the remainder of the excess-profits tax applies. In the second place, such a corporation is to be required to pay a level of excess-profits taxes which is 5 percent higher in each bracket than those to be imposed upon corporations using the invested-capital method. Thus two penalties are imposed, presumably for the purpose of deterring corporations from electing the average-earnings method. We believe this is contrary to the essential purpose of fairness and equity which dictated the granting of this option in the first instance. Moreover, it is apparent that the tax as proposed to be levied on this class of corporations is in no sense an excess-profits tax. This is clear since, in part, the tax is imposed upon net income without any exemption of normal profits. We urge that the taxes levied under this act be restricted to actual excess profits and that, in whatever manner excess profits are determined, all corporations be taxed at the same rates.

THE AVERAGE-EARNINGS METHOD OF COMPUTING THE EXCESS-PROFITS TAX CREDIT

In addition to granting a fair option between the earnings method and the invested-capital method, the provisions for the application of each of these methods should be fair and equitable. The bill now before you requires a corporation adopting the earnings method to determine its normal profits as an average of its actual profits over the 4 years from 1936 to 1939, inclusive. The only modification of this method in the case of corporations whose earnings were abnormally low during these years is to permit the deficit of any one of the 4 years to be counted as zero in this determination. It is well known, first, that the year 1938 was one of abnormally low corporate earnings and, second, that many corporations engaged in industries of a fluctuating character commonly sustain deficits in 1 or 2 years out of every 4. It is clear that the purpose of selecting any base period is to arrive at an average which will represent the true normal earning power of corporations. We submit, accordingly, that your committee should permit corporations electing the earnings basis to select any 3 of the 4 years from 1936 to 1939, inclusive, in order to secure a more accurate figure of normal earnings for the great mass of corporate taxpayers.

It is further suggested that the privilege of electing the average-earnings basis should be extended to the many corporations which were in operation during a part of the base period, but were not in existence on January 1, 1936. The present bill requires such corporation to use the invested-capital method. We recommend that any corporation which was in operation during 1 full year of the base period should be permitted to use its average earnings during that period in the determination of the amount of its normal profits. Unless such a provision is written into this act, many small corporations that have started in business since January 1, 1936, will be unfairly discriminated against and their ability to continue in business will be jeopardized.

THE INVESTED-CAPITAL BASIS OF COMPUTING THE EXCESS-PROFITS-TAX CREDIT

As already pointed out, the provisions of the bill relating to the invested-capital basis can be immensely simplified by the specification of a fixed rate of normal profits on invested capital and the elimination of all reference to a base period. Further simplification of the invested-capital provisions could be secured, and greater equity achieved, by permitting corporations at their option to include in their invested capital both their equity invested capital as defined in the act and the total of their borrowed capital. The bill provides a complicated set of restrictions which permits larger corporations to include in invested capital only a limited percentage of their borrowed capital. It is apparent that the proceeds of borrowings constitute a commitment to the enterprise in a similar degree as do proceeds from the sale of stock. Both funds contribute to the capital of the enterprise and consequently influence the amount of return which should be regarded as normal for it. The present bill favors the corporation which has financed its capital requirements by the sale of stock and discriminates against the corporation which has issued bonds or has been forced to resort to bank loans or other borrowings. We can see no basis for any such discrimination. Moreover, we can see no basis for a discrimination in this respect between corporations, based on considerations of size.

The borrowed capital of a so-called large corporation is just as essential to the enterprise as the borrowed capital of a so-called small corporation. Likewise, from the point of view of promotion of the present national-defense program and the maintenance of full employment, it is certainly just as important to facilitate borrowing and expansion by the so-called large corporation as by the so-called small one. For these reasons we believe that your committee should alter the definition of invested capital, to permit the inclusion of all capital—whether borrowed or invested by stockholders—in the invested-capital basis.

THE RATE STRUCTURE

We do not presume to advise your committee in respect to the level of rates which you may feel it necessary to impose upon excess profits. We do desire to call your attention, however, to one feature of the present bill which differs from anything in the tax experience of this country. The bill now before you proposes, in effect, to measure "excess" profits by defining such profits in dollar amounts. In both of the rate schedules provided in the bill, the brackets to which the several rates apply are measured in specific numbers of dollars. It seems to us apparent, however, that the excessivity of profits cannot be measured in dollars, but must be measured in terms of a relation to normal profits. This was the practice in all excess-profits-tax legislation enacted by this country during the World War. We submit, therefore, that graduation in the rates of the excess-profits tax should be made to depend upon the percentage by which realized profits exceed normal profits, which are exempted by the bill, and not by the mere dollar amount of such excess profits.

CONSOLIDATED RETURNS

In our view one of the most serious defects of the bill now before you consists in the failure to permit an affiliated group of corporations to file a single consolidated return. It is apparent that in the case of a parent corporation with a number of subsidiaries, the earnings of the group as a whole, compared to the total invested capital of the group or to the average earnings of the group during the base period, is the only factor which correctly measures excess profits. The report of the House Ways and Means Committee on the Second Revenue Act of 1940 recognizes the undesirability of this omission. The failure of the bill to contain any provision—permissive or mandatory—for the filing of consolidated returns is explained only by the statement that: "It was not possible to prepare a consolidated return provision without delaying the bill for a considerable length of time."

We do not believe that considerations of difficulty of drafting should be permitted to excuse the omission from the bill for a provision so essential to its fairness in operation. Moreover, if the invested-capital provisions of the bill are simplified as already urged in this memorandum and if the filing of consolidated returns is made permissive, we believe that the drafting difficulties referred to by the House Ways and Means Committee will largely disappear.

SPECIAL RELIEF PROVISIONS

The present bill, unlike the excess-profits tax laws in effect during the World War period, contains substantially no provision for the special relief of corporations which may suffer undue hardship by reason of its provisions. There is nothing analogous to the special-assessment provisions of the wartime legislation. It is a matter of general knowledge that there are some industries and many corporations whose earnings do not bear a standard relationship to invested capital. There are businesses which commonly earn large profits in 1 year out of 4 or 5 and suffer large deficits in the remaining years. There are growth industries in which the investment of capital in research, exploration, or development has produced meager returns in the past, but may produce substantial profits during one or more of the years while the excess-profits tax is in effect. For cases such as these some system of special relief is required in order to prevent the tax from substantially destroying the industries or corporations so situated. We believe the omission of any effective special relief provisions from this bill would render its enactment in its present form disastrous to a substantial proportion of American industry.

AMORTIZATION

The bill now before you consists in reality of two separate and distinct pieces of legislation, having entirely diverse purposes. The major portion of this bill is devoted to the imposition of the new excess-profits tax. Nevertheless, the problem which in the first instance called the bill into existence was the need of providing special amortization provisions in connection with new investment in plant and facilities required for the purposes of the national-defense program. It has been quite generally recognized that the new capital investment which American industry has been and will be asked to make for the production of armament in all of its varied forms will, in large measure, be worthless upon the passing of the present defense emergency. The present bill accordingly provides that industry making special investment after July 10, 1940, may, with the approval of the Advisory Commission to the Council of National Defense and either the Secretary of War or the Secretary of the Navy, elect to amortize the cost of the facilities so acquired over a period of 5 years. The necessity for the enactment of fair amortization provisions has been recognized by the Government and throughout the country. In the present bill, however, the privilege of using the special amortization provisions is circumscribed with conditions which make its value to American industry highly questionable. In the first place, substantial investments were made at the request of the Army and Navy Departments prior to July 10, 1940, with the understanding that the corporations involved would be permitted to amortize such investments over a reasonably short period of time. In the second place, it is required in certain instances that the certificate required by the act must be issued by the Advisory Commission and one of the Secretaries within 60 days after the enactment of the act. It is suggested that if a corporation which has made investments after July 10, 1940, for the benefit of the national-defense program applies for a certificate within a specified period of time, and such certificate is subsequently granted, the privilege of the amortization sections should be available. Finally, the act provides (sec. 124 (i)) that no taxpayer who avails himself of the amortization provisions may thereafter "destroy, demolish, impair, or substantially alter such emergency facilities without the consent in writing of the Secretary of War or the Secretary of the Navy." If the Secretary in question does not give such consent, he is directed to purchase the facilities at a price which he shall fix, with merely the restriction that such price shall not exceed the adjusted basis of the facility and shall not be less than $1. In the face of a provision such as this, threatening substantial confiscation of property, it may be doubted whether any corporation will dare avail itself of the so-called privilege of the amortization provisions.

SEPARABILITY OF THE AMORTIZATION AND EXCESS-PROFITS PROVISIONS

The Detroit Board of Commerce recognizes the great importance of immediate enactment of fair and reasonable provisions for special amortization of investment required for purposes of national defense. It therefore urges upon your committee, first, the revision of the amortization sections of the present bill and, second, their immediate adoption. At the same time we are impressed by the very serious defects of the proposed excess-profits tax and we recognize the grave difficulties which must be overcome in order to devise a substitute measure, which will be at the same time reasonably simple and reasonably equitable. The amortization provisions and the excess-profits tax are clearly separable. We respectfully urge, therefore, that your committee give most serious consideration to the desirability of separating these two sections of the bill, of immediately enacting the amortization provisions, and hereafter devoting such time and study to the excess-profits tax provisions as may be required to eliminate the present difficulties.

The immediate enactment of the present bill will accomplish nothing in the direction of rendering more certain and definite the prospective tax liabilities of American corporations. No return under the excess-profits tax provisions will be due until March 15, 1941. There is therefore no reason whatever for undue haste in the enactment of the excess-profits tax. There is every reason to enact a law which will operate fairly on American corporations, will not discourage new investment and much needed industrial expansion and which will not, under the guise of levying heavy taxes upon improper and excess profits, in fact burden corporations in respect to normal and necessary profit returns.

We believe that American industry is anxious to cooperate with the Government in every respect in connection with the present defense emergency. We anticipate that the industry of this community will make a very substantial contribution to such cooperation. These corporations have already been asked to contribute substantially to the financing of the defense program, by reason of the defense tax included in the First Revenue Act of 1940. We urge for them only that the additional tax legislation under which they will be asked to continue to function shall be given the serious study by your committee which it deserves.

Respectfully submitted.

DETROIT BOARD OF COMMERCE,
HARVEY CAMPBELL, *Executive Vice President.*

AMERICAN MERCHANT MARINE INSTITUTE, INC.,
New York, N. Y., September 5, 1940.

Re: H. R. 10413.

Hon. PAT HARRISON,
Chairman, Senate Committee on Finance,
United States Senate, Washington, D. C.

MY DEAR SENATOR HARRISON: On behalf of the American Merchant Marine Institute, Inc., a trade association comprising in its membership the operators of over one-half of the American seagoing shipping engaged in the foreign and domestic trade of the United States, I respectfully request that this letter be made a part of the record before your committee on H. R. 10413.

Members of the institute object strongly to the provisions of the bill before the committee defining "invested capital" and the limited extent to which borrowed capital may be included therein.

The bill, in its present form, would permit inclusion of invested capital of 100 percent of borrowed capital up to $100,000 total of such borrowed capital and equity capital; 66⅔ percent of borrowed capital up to $1,000,000 of the total borrowed and equity capital and 33⅓ percent of all over $1,000,000. Where, because a corporation has not been in existence throughout the base period, it is necessary to use the invested capital method of determining liability for excess profits, marked unfairness results.

A recently formed corporation may, for example, own a single ship costing $3,000,000, of which $2,250,000 may be financed with borrowed capital and $750,000 with equity capital. Its invested capital under the bill would be approximately $1,600,000. This company under the bill may earn a maximum of $143,000 without becoming subject to the excess-profits tax—a return of only 4.8 percent on the value of the vessel. A company identical in every respect but which had no borrowed capital would be allowed an invested capital of $3,000,000 and would be entitled to earn without excess-profits tax $255,000—a return of 8.5 percent on the value of its vessel.

It must be emphasized that these two companies undergo exactly the same business risk, make identical charges to the public, and have identical costs. The only difference is that one company is fortunate enough to be able to purchase its vessel outright while the other must borrow. It is of course true that the contributors of the equity capital of the company which has been borrowed will, if operations prove profitable, realize a larger return than the contributors of the capital of the company with no debt. On the other hand, if losses occur, they will fall much more heavily on the stockholders of a company largely financed by borrowed capital. This, however, is entirely as it should be and as it must be. Equity capital which takes the primary risk of loss has from time immemorial been entitled to a higher return in successful periods. Borrowed capital, which has the added security of the cushion of the equity capital has been traditionally satisfied with a smaller return.

Comparisons, however, between appropriate rates of return on equity and borrowed capital have no place in the consideration of an excess-profits tax bill. The Government should not be concerned in such a bill with the distribution of the contributed capital among shareholders or bondholders. The correct approach is to consider the business enterprise as a whole. Is it earning more in these times of emergency than is considered fair? The distribution of whatever income is considered fair is immaterial. The bondholder gets a lower return with comparative safety; the shareholder gets a higher return in compensation for taking the risk. It may be pointed out that this principle has been universally followed in utility rate regulation. The public-service commissions uniformly ignore the financial structure of a utility in determining a fair rate. They hold that a utility is entitled to earn a fixed percentage of its total investment in the business and do not concern themselves with the division of earnings between bondholders and stockholders. In the example I have cited of two steamship companies there is no justification whatsoever for discriminating against the excess-profits-tax-free income (before interest on indebtedness) permitted the borrowing company and that permitted its more fortunate nonborrowing competitor.

The institute also wishes to concur in the objection raised by certain witnesses to the crusade against bigness—or even moderate size—which is shown in the bill by permitting all borrowed capital to be considered as invested capital when the total is less than $100,000 and two-thirds of borrowed capital when less than $1,000,000 but only one-third of borrowed capital to be considered as invested capital insofar as the total is over $1,000,000.

The steamship industry has one further point in connection with this bill: Section 23 of the Merchant Marine Act, 1920 (46 U. S. C., sec. 878), provides for an exemption from the excess-profits tax of 1918 of any amounts earmarked for new-ship construction provided that the shipowner devotes an additional amount of twice such tax to such construction. The language of this existing statutory provision is as follows:

"*Deductions allowed owners of documented vessels of United States for income and excess-profits-tax purposes.*—The owner of a vessel documented under the laws of the United States and operated in foreign trade shall, for each of the ten taxable years while so operated, beginning with the first taxable year ending after June 5, 1920, be allowed as a deduction for the purpose of ascertaining his net income subject to the war-profits and excess-profits taxes imposed by title III of the Revenue Act of 1918 an amount equivalent to the net earnings of such vessel during such taxable year, determined in accordance with rules and regulations to be made by the Board: *Provided*, That such owner shall not be entitled to such deduction unless during such taxable year he invested, or set aside under rules and regulations to be made by the board in a trust fund for investment, in the building in shipyards in the United States of new vessels of a type and kind approved by the board, an amount, to be determined by the Secretary of the Treasury and certified by him to the board, equivalent to the war-profits and excess-profits taxes that would have been payable by such owner on account of the net earnings of such vessels but for the deduction allowed under the provisions of this section: *Provided further*, That at least two-thirds of the cost of any vessel constructed under this paragraph shall be paid for out of the ordinary funds or capital of the person having such vessel constructed."

The United States is even more concerned than it was in 1920 with the construction of an adequate merchant marine sufficient to care for the needs of our commerce and to act as a vitally necessary auxiliary to the Navy in times of emergency. The Government, under the able supervision of the United States Maritime Commission, has taken vigorous steps to secure the rebuilding of this auxiliary arm of defense. The wisdom of the present program can readily be realized now. We believe that the present is just as much an appropriate time as 1920 to look forward to conditions after the emergency has terminated when American ships will again be receiving the competition of low-cost foreign nations anxious to rebuild their trade and foreign exchange.

It is well known among persons informed with respect to shipping that the business is of the feast or famine type. If new ships are to be constructed, it is necessary to lay aside earnings in the few good years to provide funds for replacements which cannot be earned in the lean years. For the Government to take out half of such good year earnings would destroy the economy of the business. On the other hand, adequate safeguards should be provided to assure that the moneys exempted from excess-profits tax be actually devoted to replacement purposes.

Accordingly, the shipping industry proposes that this section of the Merchant Marine Act, 1920, be brought up to date by including a reference therein to the Second Revenue Act of 1940 and making the necessary reference to the United States Maritime Commission rather than the Shipping Board. To do so will not vary existing statutory purposes and will merely carry out continuing congressional intent.

Respectfully yours,

JOHN J. BURNS, *General Counsel.*

NATIONAL FOREIGN TRADE COUNCIL, INC.,
New York, N. Y., September 5, 1940.

The Honorable PAT HARRISON,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

MY DEAR SENATOR HARRISON: Unfortunately, lack of time precluded preparation for the listed appearance on Tuesday afternoon of Mr. Mitchell B. Carroll in our behalf, and although there are various amendments that could be proposed to assure more equitable treatment under our tax laws of companies engaged in foreign trade, I wish to bring to your attention two situations which might be corrected by simple amendments to H. R. 10413.

1. As this bill is now drafted, the proposed excess-profits tax will impose upon some of our members an unfair and excessive burden because the system of accounting they have been following, with the approval of the Commissioner of Internal Revenue, will reflect in 1940 or 1941 large amounts of income attributable to work done in prior years.

In a case which may be taken as an example, an engineering corporation entered into contracts in the years 1938 and 1939 covering work in Peru, Colombia, and Venezuela. As it is unable to ascertain the net profit on each job until completed, the corporation, in agreement with the Bureau of Internal Revenue, keeps its accounts for these operations on a completion basis, with the result that it will determine its net income therefrom for tax purposes when the work is terminated later in 1940 or in 1941. As a consequence, the corporation will apparently be subject to an unreasonably high excess-profits tax because the income to be shown for 1940 or 1941 will be far in excess of the average earnings for the years 1936 to 1939 inclusive, and the expected earnings will also bear an inflated relationship to the invested capital of the corporation for the base period.

This method of accounting has been and still is satisfactory for purposes of computing liability to the normal tax on corporations, but you are doubtless aware of the difficulties that would be involved in now changing the method of accounting, especially as the allocation of income to past years on an accrual basis would involve a redetermination of the ordinary corporation taxes due for those years.

May we not, therefore, urge you to consider the adoption of an appropriate provision in the contemplated legislation which will permit a corporation with accounts on a completion basis to exclude, for the purposes of the excess-profits tax, from its net income determinable upon the completion of the work in 1940 or thereafter the proportion of such income which is attributable to work done during taxable years ending on or before December 31, 1939? For taxable years beginning after December 31, 1939, the net income should be apportioned, for the purposes of the excess-profits tax, to each year on the percentage of completion basis, that is to say, in proportion to the work done during each year.

Where contracts for work to be done in foreign countries were entered into prior to and have no connection with the preparedness program in the United States, it would seem proper to ask if the exclusion of such foreign income from adjusted excess-profits net income would not be in harmony with the general purpose of the contemplated legislation. However, if this is not considered reasonable, we hope that you will find it wholly in conformity with the objects of the proposed legislation to permit corporations in the above situation to continue their present basis of accounting for the purposes of the normal tax on corporations but to apportion income in the suggested manner for purposes of the excess-profits tax.

Obviously, if some such provision is not included in the law, certain corporations which have adopted an accounting procedure approved by the Bureau of Internal Revenue for the purposes of the normal income tax will be subject to the excess-profits tax for 1940 and succeeding years on earnings properly attributable to operations in 1939 or prior years. Would this not in effect constitute a retroactive application of the tax which is contrary to our basic principles of taxation?

Our members will greatly appreciate your approval of certain sections in the bill which are helpful to foreign trade, such as section 727 (c) and section 725 (g), and it is only in view of the recognition in the last mentioned of the principle of exempting from the excess-profits tax, with certain limitations, income derived from foreign sources that we are venturing to ask if it would not be possible to provide relief in the equally meritorious case described above.

2. In a number of foreign countries income produced in prior years has been blocked by exchange restrictions. The Board of Tax Appeals has held that such income need not be included in gross income for purposes of the United States tax until the income is unblocked (*International Mortgage & Investment Corp.* v. *Commissioner*, 36 B. T. A. 187, acq. 1937-2 CB 15).

However, the benefits of this decision are reduced, if not nullified, by the fact that foreign taxes on such income may be taken as a credit against the United States tax only in the year when they are paid or accrued. Because of the fact that the credit is limited by the ratio of net income from sources in the foreign country to normal-tax net income, no credit can be obtained if the income taxed abroad and blocked is not treated as net income for United States tax purposes until a later year. Hence, in such a case the foreign income will not only be subject to double taxation, i. e., at home as well as abroad, but it may also greatly increase the excess-profits-tax liability of the recipient corporation.

Two solutions are suggested:

a. Broaden H. R. 10413 so as to exempt all corporations in respect of income produced abroad in taxable years ending prior to December 31, 1939, and, therefore, prior to the years to which the excess-profits tax is applicable (sec. 710 (a), H. R. 10413); or

b. Amend section 727 (c) of H. R. 10413 and possibly also section 131 of the Internal Revenue Code so that foreign taxes on blocked income may be taken as a credit the year when the income is unblocked and included in gross income for taxation in the United States.

In view of the importance of avoiding the imposition of any unnecessary burdens upon American commercial interests abroad, particularly in Latin America, we trust that these suggestions will receive your sympathetic consideration.

Very truly yours,

E. P. THOMAS, *President.*

NEW YORK BOARD OF TRADE, INC.,
New York City, September 5, 1940.

COMMITTEE ON FINANCE, UNITED STATES SENATE,
Washington, D. C.

Attention: Hon. Pat Harrison, Chairman.

GENTLEMEN: The excess profits tax bill now before you is probably the most intricate piece of tax legislation that has ever required your consideration. Nevertheless, the bill was passed by the House under rules which almost completely prevented debate.

The New York Board of Trade commends your committee for ordering further public hearings on this bill. To the statement of this board already on record, we would like to add the following brief comments directly applicable to the proposed bill, since at the time of the previous hearings, no bill had as yet been drafted:

(1) The proposed law makes no provision for amortization of defense facilities to be allowed to individual and partnership businesses. Amortization is allowed only to corporations. Certainly there is no intention to exclude individual and partnership businesses from participating in our defense program. It is necessary, therefore, that these businesses be permitted the same amortization deduction as are allowed corporations.

(2) It is inconceivable to businessmen who have found it necessary to incorporate sections of their business, either to meet State law requirements or for other conveniences of operation, to discover that these corporations must be taxed as if each were a separate business. The tax result must necessarily be arbitrary and in many cases cause severe hardship and distortion. The fact of the matter is that much of the haze and many of the incomprehensible provisions of the present bill could be eliminated if consolidated returns were provided for. The only reason officially advanced against consolidated returns is that sufficient time is not available to carefully work out such a provision and embody it in the proposed law. Consolidated-return provisions were part of our earlier excess profits-tax laws. They are indispensable in any tax scheme where invested capital is a factor in the calculation and where tax rates are as high as those proposed. Under no circumstances should an excess-profits-tax law be enacted without such provisions.

(3) The very nature of a general excess-profits-tax law implies complications and inequities in specific cases. No such a law should be therefore enacted without some provision being made for special treatment under extraordinary circumstances. Such a relief provision was made part of our last excess-profits tax and war-profits laws. The Commissioner of Internal Revenue should be given power to grant special assessment relief in cases requiring such treatment and his determination should be made subject to review by the U. S. Board of Tax Appeals and by the courts.

(4) In attempting to tax excess profits, the House bill in fact increases substantially the tax rate on normal profits. It seeks to accomplish this by penalizing the use of average earnings as a yardstick for determining excess profits. Such an arrangement is discriminatory and objectionable.

(5) No revenue can be received from the excess-profits tax before next March and, while it is important for business to know where it stands as soon as possible, that is no good reason why an ill-considered bill should be rushed through Congress at this particular time. Furthermore, if what is sought is a tax upon profits flowing from our defense program, then it should be evident that there can in any event be mighty little of such profits before 1941. We accordingly recommend that the amortization provisions of the bill be enacted now and that action on the tax provisions be deferred pending further careful study.

(6) More important than anything else, a tax bill should be written so that the taxpayer can understand what is required of him. The clearest thing about the bill in its present form is that it will cause confusion and lead to endless controversy and litigation.

These six points are in no way directed to completeness of comment upon the proposed law. Others will undoubtedly call your attention to details of the bill which require your careful consideration.

We respectfully urge that our recommendations be given effect to in the Senate draft of the bill. We further respectfully request that this communication be made of record together with the testimony that you are now taking at the public hearings on this subject.

Respectfully submitted.

NEW YORK BOARD OF TRADE, INC.,
M. L. SEIDMAN,
Chairman, Federal Taxation Committee.

ILLINOIS MANUFACTURERS' ASSOCIATION,
Chicago, September 5, 1940.

HON. PAT HARRISON,
Chairman, Senate Finance Committee, Senate Office Building,
Washington, D. C.

DEAR SIR: The Federal taxation committee of the Illinois Manufacturers' Association desires to submit to the Senate Finance Committee the following recommendations in regard to the excess-profits tax bill of 1946. We respectfully urge the consideration of these recommendations by the committee.

1. *Simplification.*—Our members are appalled at the confusing and incomprehensible contents of the 105-page bill. They fear that, in addition to the high tax levies provided for in the bill, very substantial fees will have to be paid to accountants and attorneys to first apply these most complicated provisions to their book figures to determine the tax liability and later to negotiate with the Treasury Department the numerous differences of interpretation of the act. Doubtless, as in the case of the previous law when invested capital formed a part of the tax formula, there will be much litigation in the courts to settle these differences of opinion.

We respectfully urge a redrafting of the bill to give the taxpayers an understandable law.

2. *Option as to use of invested-capital or base-year's income.*—We join with other witnesses in urging the grant in the law of not only an option but a provision that the tax shall be the lesser of the sums computed under the two methods. Otherwise taxpayers in many instances will choose a taxing basis with blindfolded eyes because taxable net income for the base years has not yet been determined by the Treasury or the courts in numerous instances. Then, too, invested capital will be hard to determine in too many cases due to loss of records or incorrect interpretation of the law.

3. *Elimination of penalties for use of base-period earnings.*—We earnestly protest the imposition of a 4.1-percent additional tax on normal tax net income and an added 5 percent in each excess-profits tax bracket for the reason that such a differential is unwarranted if the true purpose of the bill is merely to tax excess profits. It must be readily apparent that as presently drafted the bill will tax ordinary profits because of the limitations of excess-profits tax-free returns on invested capital.

4. *Use of 3 out of 4 years' earnings.*—We urge in the interest of equitable treatment to corporations having suffered severely in one of the base years that taxpayers be permitted to select 3 out of the 4 base years' earnings in determining average net income for the years 1936–39.

In the alternative, we recommend that all loss-years be elimiated or at least be recorded at zero. The present bill permits only 1 loss-year to be so recorded.

5. *Consolidated returns.*—It is our opinion that many of the difficulties that attend intercompany transactions, both for the Treasury Department and the taxpayer, will be eliminated if provision is made in the law for consolidated returns. We urge that the law make such consolidation permissive and that the terms under which consolidation is permitted be stated in broad terms, leaving the details relating to treatment of income or invested-capital items in preconsolidated years to be covered by Treasury regulations. In so doing the passage of the new law will not be delayed and so desirable a provision as consolidated returns will be granted to taxpaying corporations.

6. *Special relief.*—There appears to be no doubt but that a number of our association members will be taxed in an unconscionable manner if a special relief provision is not included in the act. We recommend that such relief be administered by a board independent of the Treasury and that the hearings be informal and private and records be no more available to the public than are present proceedings before officials of the Treasury Department.

Such privacy is necessary to safeguard the records of not only the petitioner for relief but also of the comparatives that the board would review in determining if and to what extent relief should be granted.

Yours very truly,

JAMES L. DONNELLY,
Executive Vice President.

NORRIS STAMPING & MANUFACTURING CO.,
Los Angeles, Calif., September 5, 1940.

MR. CHAIRMAN AND MEMBERS OF THE SENATE FINANCE COMMITTEE,
Washington, D. C.

GENTLEMEN: On August 12 I had the privilege of appearing before the House Ways and Means Committee and members of the Senate Finance Committee in connection with the proposed legislation covering amortization of defense facilities, suspension of the Vinson-Trammell Act, and the excess-profits tax. At that time I pointed out to the committee the injustice of the proposed excess-profits tax when applied to small, efficient, growing corporations. I have since had an opportunity to examine the bill passed by the House, H. R. 10413, now under consideration by the committee, and not only have none of the conditions complained of been corrected but the bill is actually more severe than the original subcommittee's recommendations.

Testimony of representatives of the Treasury Department, the Army, and the Navy, at the House committee hearing indicated that the primary purpose of the excess-profits tax was to permit the Government to recover from defense contractors unreasonable or exorbitant profits made in connection with defense contracts. The bill, as now written, will actually result in the imposition of heavy taxes on strictly normal profits made under highly competitive conditions where such profits result solely from the efficiency of the company and not from unreasonable or exorbitant profits on defense contracts.

I would like to go on record as being in favor of the application of excess-profits taxes on actual excess profits; also I realize that this defense program must be paid for and that we all must do our part. I have no objection to any necessary increases in tax rates for this purpose, and my present criticism is that the proposed excess-profits tax penalizes most heavily the conservatively capitalized and efficiently operated corporations and will, to a large extent, exempt the overcapitalized or inefficient corporation.

Two means of determining normal profits are provided, as follows:

(*a*) Average base period net income method, section 713.

(b) Average base period net income ratio to invested capital method, section 714.

The average net-income method presumably was intended to permit corporations with a normally high ratio of income to invested capital to continue such earnings before an excess-profits tax applied. This result would be accomplished and would be fair to the taxpayer where the amount of invested capital remained approximately the same over the base period, but it penalizes a corporation which has had rapid growth and increase in invested capital. The average earnings of such a corporation would not truly represent the normal earning capacity of that corporation on December 31, 1939.

The second method using the base period net-income ratio to invested capital would permit corporations to earn on currently invested capital the average rate of return obtained during the base period 1936 to 1939, inclusive, but such profits would be limited to 10 percent on the invested capital. This limitation definitely discriminates against corporations which in normal times earn substantially in excess of 10 percent on invested capital. Most small- or medium-sized growing corporations, if efficiently managed, earn in excess of 10 percent on invested capital, particularly if the ratio of sales to invested capital is high. I am attaching hereto a table giving information with respect to my own company during a period of 10 years, from which it will be noted that our profit in relation to sales has been 8.18 percent. The sales have averaged four times the invested capital, resulting in an average rate of return on invested capital over the 10-year period of 31.8 percent.

These earnings have not resulted from any monopoly or patent situation but have been made on business secured on strictly competitive bidding basis. The business we have secured from the Navy and the Army is the result entirely of the low prices quoted and any profit we have made on these contracts is the result of ingenuity and improved methods of manufacture. I feel safe in saying that we are considered by the Army and Navy as one of the most satisfactory suppliers of ordnance materials.

With further reference to what constitutes a reasonable profit, I would like to point out that under the Vinson Act prior to the last amendment, a profit of 10 percent on the selling price, before income-tax deductions, was permitted. After adjustment for corporation income taxes there would be left a permissible profit of approximately 8 percent on the selling price. This was considered a reasonable profit and is approximately the average profit we have made for 10 years. However, if 10-percent return on invested capital is to be considered a maximum permissible profit before excess-profits tax, and if we maintain our past ratio of $4 of sales to $1 of invested capital, any profit in excess of 2½ percent on our selling price will be considered as excess. This profit is not at all commensurate with the risks involved in this type of business.

The tax bill, as written, therefore provides not a true excess-profits tax but a graduated corporation income tax increasing in proportion to the efficiency of the corporation.

Our accountants have applied the proposed tax rates to our 1939 profit, which profit I contend is a strictly normal profit, and the result is an 88-percent increase over the 1939 corporation tax rates.

Most small companies grow through reinvestment of earnings. Generally speaking, these companies are managed by the principal owners who are not willing to reduce their percentage of ownership by bringing in outside capital. Consequently, these firms grow only by reinvestment of earnings. This situation applies to my company where almost the entire earnings over a 10-year period have been plowed back into the business for expansion. Without this reinvestment of earnings it would have been impossible to expand for the defense contracts we now have. In fact, this expansion requires not only accumulated profits but borrowed capital and some anticipated profits. If a large percentage of profits is to be taken by the proposed excess-profits tax, it will be difficult, if not impossible, for most small, efficiently managed, and growing businesses to make the expansion needed to handle defense contracts.

I would like to make the following specific recommendations to remove some of the inequities in the bill, as written:

1. (*a*) The limitation of 10-percent return on invested capital provided in section 714, should be removed and no profit should be considered as excess profit until the rate of return on invested capital exceeds the actual average rate of return during the base period — or —.

(*b*) Provide a third method of computing normal profit whereby the taxpayer will be permitted to earn, before application of the excess-profits tax, the same percentage of profit to gross sales as the average percentage earned during the base period with a reasonable maximum somewhere between 7 and 9 percent after allowing for normal corporation taxes.

2. Where a corporation has been formed specifically for the purpose of acquiring an entire going business previously conducted as an individual proprietorship or partnership, the earnings of the acquired business should be the basis for determining the excess-profit credit of the corporation.

Our business was for 10 years conducted as an individual proprietorship and was only incorporated on April 1, 1940. There was no change in the business itself, no change in name, and the entire former business was acquired by the corporation. In other words, the form in which the business was operated was changed, but that was the only change. Under such conditions it is only fair that the earnings of the preceding business should be the basis of determining the normal earnings for the corporation.

3. If the excess-profits tax is to be made applicable to 1940 income the special amortization provision should apply to defense facilities completed or acquired after January 1, 1940, instead of July 10, 1940.

Unless this provision is made, those concerns which voluntarily expanded their production facilities to handle defense contracts on the assumption that a fair and reasonable plan for amortization would be made available, will be unfairly discriminated against. This point was emphasized in the testimony before the House Ways and Means Committee by Mr. Lewis Compton, Assistant Secretary of the Navy.

4. Some provision should be made for a special relief board or commission with authority to make adjustments in instances where the law results in undue hardship.

5. The privilege of amortizing special defense facilities over a 5-year period should be made available to individual proprietorships and partnerships as well as corporations.

The Ways and Means Committee recognized that there was no necessity for an excess-profits tax applicable to individuals and copartnerships because of the high surtax rates on the individual incomes. However, in many cases individuals and partnerships will be required to install additional defense facilities, and I feel they should be treated the same as corporations with respect to the amortization privileges.

Respectfully submitted.

K. T. NORRIS,
President, Norris Stamping & Manufacturing Co.

	1930	1931	1932	1933	1934	1935	1936	1937	1938	1939	Average 1930-39
Ratio of sales to invested capital (capital turn-over)	3⅓	4+	2½+	2	2½	3	3⅓	4+	3⅓	6	4
Ratio of net profit to gross sales	5%	11.75%	2.8%	1.42%	4.9%	10.5%	10%	10.4%	7.67%	7.6%	8.18%
Ratio of net profit to invested capital	17.4%	49.6%	7.4%	2.8%	12.4%	31.3%	32.1%	43.3%	26%	43.9%	31.8%

NOTE.—All calculations based on earnings of individual proprietorship with proper adjustments for corporation income taxes and salaries so as to reflect earnings which would have been available to a corporation had the business been operated as a corporation.

The CHAIRMAN. Is there anybody else in the room who wants to be heard. We have finished the calendar.

(No response.)

If not, the hearings are now closed and the committee will adjourn.

(Whereupon, at 8:30 o'clock p. m., the hearing was closed.)

O