# EXCESS PROFITS TAXATION, 1940

## JOINT HEARINGS

BEFORE THE

## COMMITTEE ON WAYS AND MEANS
## HOUSE OF REPRESENTATIVES

AND THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

SEVENTY-SIXTH CONGRESS

THIRD SESSION

ON

**EXCESS PROFITS TAXATION, AMORTIZATION, AND SUSPENSION OF VINSON-TRAMMELL ACT**

H.R. 10413

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# EXCESS PROFITS TAXATION, 1940

FRIDAY, AUGUST 9, 1940

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, D. C.*

The committee met at 10 a. m., Hon. Robert L. Doughton (chairman) presiding.

The CHAIRMAN. The committee will please be in order.

As previously announced in the press, and generally understood, the meeting this morning is for the purpose of beginning hearings on the subject of an excess profits tax, amortization, and the suspension of the Vinson-Trammell Act during the life of the excess profits tax, should such tax be imposed.

It was agreed by the Committee on Ways and Means, at a meeting held yesterday, that these hearings should be confined to the three propositions, namely, amortization, the suspension of the Vinson-Trammell Act, and an excess profits tax.

Of course, we all understand that the proposed legislation is directly related to the question of national defense, a question on which our country is united and determined, and it is therefore exceedingly important that this legislation be enacted as promptly and speedily as is consistent with a matter of such great national magnitude and importance.

We are pleased to have with us this morning, to participate in these hearings, the members of the Finance Committee of the Senate, and we extend to them a cordial welcome and request them to cooperate with us fully and on equal terms in conducting these hearings.

The basis of the hearings will be a report of the Subcommittee on Internal Revenue and Taxation of the Ways and Means Committee. I suppose each member has a copy of this report. A copy will be made a part of these hearings.

Senator Harrison, we will be pleased to have a statement from you at this point, if you desire to make one.

Senator HARRISON. I have no statement to make, Mr. Chairman, except that the Finance Committee are very much pleased that you have extended them the invitation; and they are here.

(The report of the Subcommittee on Proposed Excess-Profits Taxation and Special Amortization is as follows:)

LETTER OF TRANSMITTAL

AUGUST 8, 1940.

Hon. ROBERT L. DOUGHTON,
*Chairman, Committee on Ways and Means,*
*House of Representatives, Washington, D. C.*

MY DEAR MR. CHAIRMAN: As chairman of the Subcommittee on Internal Revenue Taxation, and on behalf of the members thereof, I

am transmitting the report of the subcommittee relating to (1) excess-profits taxation, (2) special allowance for amortization of emergency national-defense facilities, and (3) the suspension of the Vinson-Trammell Act, in accordance with the action taken by the Committee on Ways and Means in referring such proposals to the subcommittee for preliminary study and report.

The report submitted herewith is divided into three parts and makes recommendations unanimously adopted by the subcommittee relative to the subject matters referred to above. The subcommittee has worked diligently and continuously in the consideration of the many complex and difficult problems involved and have had the full cooperation from representatives of the Treasury Department, the members of the staff of the Joint Committee on Internal Revenue Taxation, and the legislative counsel's office, and has had the benefit of advice from the Advisory Commission to the Council of National Defense. It is hoped that this report will be useful to the Committee on Ways and Means and form the basis for public hearings and in the consideration and enactment of subsequent legislation.

Respectfully transmitted.

JERE COOPER,
*Chairman, Subcommittee on Taxation.*

## REPORT OF THE SUBCOMMITTEE ON INTERNAL REVENUE TAXATION OF THE COMMITTEE ON WAYS AND MEANS RELATIVE TO EXCESS-PROFITS TAXATION AND SPECIAL AMORTIZATION

This report sets out the recommendations of the Subcommittee on Internal Revenue Taxation of the Committee on Ways and Means to the full committee with respect to the following correlated and interdependent subjects: (*a*) The suspension of the application of the provisions of the Vinson-Trammell Act, restricting profits upon naval and aircraft construction; (*b*) the provision of special amortization in respect to facilities necessary for national defense; and (*c*) an excess-profits tax.

Your subcommittee feels that it is desirable to consider these three kindred questions in the same bill.

For the sake of clarity, each aspect of this 3-point program will be discussed separately. Furthermore, the recommendations respecting the excess-profits tax are divided into two parts so that the major problems may be discussed first.

### I. SUSPENSION OF THE VINSON-TRAMMELL ACT

Your subcommittee recommends that those provisions of the so-called Vinson-Trammell Act, as amended, which relate to limitation of profit upon the construction or manufacture of naval vessels and Army and Navy aircraft, be suspended as to contracts or subcontracts for such construction or manufacture which are entered into or completed during the taxable years to which the excess-profits tax will be applicable.

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, it is felt that such special provisions should not apply while the excess-profits tax is in force.

Uniformity will thereby be achieved in the treatment for tax purposes of all abnormal profits resulting from the national-defense program. It is not believed that the limited types of businesses affected by the Vinson-Trammell Act should be treated, during the period in which the excess-profits tax applies, differently from the way in which other businesses engaged in production for the national defense are treated.

## II. AMORTIZATION OF EMERGENCY FACILITIES

The extension of existing facilities is a necessary and vital part of the national-defense program. To obtain the needed facilities will require the investment of hundreds of millions of dollars. Your subcommittee has been informed by the Advisory Commission to the Council of National Defense that substantial amounts of private capital will not be invested in the construction of such facilities unless corporations are assured, in view of the fact that such facilities will be of use chiefly only during the period of national emergency, that they will be permitted to amortize the cost thereof over a shorter period than would be permitted under the depreciation provisions of the Internal Revenue Code.

Your subcommittee, therefore, recommends that a corporation be allowed a deduction for income- and excess-profits tax purposes for the amortization of certain facilities which are 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. Such facilities are land, buildings, machinery, and equipment, or parts thereof, constructed, reconstructed, erected, installed or acquired after July 10, 1940, and the construction, reconstruction, erection, installation, or acquisition of which was contracted for prior to the termination of the present emergency. It is recommended that the write-off of the cost (adjusted basis for income-tax purposes) of such facilities be permitted to be spread over a period of 60 months, this deduction to be in lieu of the present deduction for exhaustion, wear and tear, and obsolescence provided for in section 23 (l) of the Internal Revenue Code. The taxpayer should have the option of beginning the 60-month period either with the month following the month in which the facility is completed or with the taxable year following the year in which the facility is completed, by signifying on the appropriate income-tax return its desire to have the benefits of the amortization deduction.

It is further recommended that if, after having elected the amortization deduction, the taxpayer desires to terminate such deduction and use the deduction provided by section 23 (l) of the Internal Revenue Code with respect to the remainder of the adjusted basis of the facility, that it be permitted to do so upon notice to the Commissioner at any time prior to the termination of the 60-month period and that (except as set forth below) it be not permitted thereafter again to elect amortization with respect to the same facility.

Your subcommittee further recommends that if the President has proclaimed the ending of the emergency or the Secretary of War, or the Secretary of the Navy, has certified to the Commissioner of Internal Revenue that the facility ceased to be necessary in the interest of national defense during the emergency, and such proclamation or certificate is made before the end of the 60-month period, the

taxpayer may elect to recompute the amortization deduction on the basis of the period as terminated by the proclamation or certificate in lieu of the 60-month period. The benefits of this election should be accorded regardless of whether the taxpayer has in the past elected the amortization deduction with respect to the facilities involved.

Your subcommittee recommends that a deduction be allowed, in lieu of the amortization deduction above described, equal to the amount of certain payments received from the United States with respect to a facility if such payments are required to be included in the taxpayer's gross income. It is felt that the payments referred to should consist only of amounts certified by either the Secretary of War or the Secretary of the Navy as compensation to the taxpayer for the unamortized cost of the facility, made because further contracts with the United States involving the use of the facility are not forthcoming.

## III. EXCESS-PROFITS TAX

There are two basic types of excess-profits tax distinguished chiefly by difference in concept as to earnings which are to be considered "excessive." One type is based upon the amount of capital being risked by the taxpayer and contemplates a tax on all profits in excess of a stated percentage of return upon the taxpayer's investment. The other type of excess-profits tax involves a comparison of the taxpayer's earnings for the taxable year with those experienced during some fixed previous period.

The plan recommended by your subcommittee combines what your subcommittee believes are the best elements of each of these fundamental excess-profits tax concepts. It is recommended that the tax apply only to corporations, as individual and partnership incomes are subject to heavy surtaxes upon all net income, whether left in the business or not, while corporations and their stockholders are relieved from surtaxes upon earnings which are not distributed. Moreover, as all of the assets of an individual, or of all of the individuals comprising a partnership, are liable in any venture, it is extremely difficult, if not impossible, to determine the capital attributable to any particular undertaking or business in which an individual or partnership is engaged.

### A. General Discussion

#### 1. TAXABLE YEARS AFFECTED

It is recommended that the excess-profits tax be applicable with respect to all taxable years beginning after December 31, 1939.

#### 2. BASE PERIOD

For the purpose of ascertaining the previous earning experience of corporations which is to be used as a comparative measure of their earnings for the taxable year, it is recommended that the years 1936 to 1939, inclusive, constitute the base period.

#### 3. EXCESS-PROFITS CREDIT

In determining the portion of the corporate profits to be considered as "excessive," to which the tax will apply, your subcommittee recommends that in the case where the taxpayer corporation was inexistence

during the whole of the base period it be given an election of either of the following methods of computing the excess-profits credit:

(*a*) It may take as a credit against its net income for the taxable year its average earnings for the base period. The amount so arrived at shall be increased by 8 percent of the additions to capital occurring after the beginning of the taxpayer's first taxable year under the excess profits tax and decreased by 6 percent of reductions in capital during the same period; or

(*b*) It may take as such credit an amount equal to the percentage of its invested capital for the taxable year which its earnings during the base period bears to its invested capital for the base period, but not to exceed 10 percent or be less than 4 percent. With respect to the first $500,000 of invested capital in the taxable year, the minimum is 6 percent instead of 4 percent.

With respect to those corporations which were not in existence during any part of the base period, it is recommended that the excess-profits credit be 10 percent of the first $500,000 of the invested capital for the taxable year and 8 percent of such capital in excess of $500,000.

As to corporations which were in existence during only part of the base period, it is recommended that for any part of the base period during which they were not in existence they be deemed to have had an invested capital equal to their actual invested capital as of the first day of its taxable year 1940 upon which base they are deemed to have received earnings of 10 percent on the first $500,000 and 8 percent on the balance.

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 | *10 and *8 |
| 1937 | *800,000 | 74,000 | *10 and *8 |
| 1938 | 650,000 | 45,500 | 7 |
| 1939 | 700,000 | 63,000 | 9 |
| | 2,950,000 | 256,500 | 8.7 |
| 1940 | 800,000 | | |

Thus those amounts and percentages marked by an asterisk (*) for which the corporation had no actual experience have been supplied by the invested capital for 1940 upon which a yield of 10 percent for the first $500,000 of invested capital and 8 percent on the balance is assumed.

Thus corporations which were in existence during the whole of the base period are allowed an optional method of computing the excess-profits credit, while those corporations which were in existence during only a part of the base period or which came into existence in 1940, or later, may compute their excess-profits credit only on the basis of invested capital.

In the case of corporations which elect to compute their excess-profits credit on the basis of invested capital, a return on additions to the invested capital is allowed at a rate of 10 percent to the extent that the invested capital does not exceed $500,000, and 8 percent on

such new capital in excess of $500,000. For the purpose of distinguishing between old and new capital, all capital in excess of that for the beginning of the taxpayer's first taxable year is considered to be new. Furthermore, should the invested capital of the taxpayer in any subsequent year reach a point lower than any previous experience after the beginning of its first taxable year under the excess-profits tax, such lowest invested capital would then become the measure of new capital.

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 $75,000 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.

#### 4. INVESTED CAPITAL

Your subcommittee recommends that the invested capital of the taxpayer should consist of equity invested capital and borrowed invested capital.

(*a*) *Equity invested capital.*—In computing equity invested capital for any taxable year, the taxpayer would add the sum of the following four items:

(1) Money paid in for stock or as paid-in surplus or as a contribution to capital;

(2) Property likewise paid in.

(3) Taxable stock dividends: Taxable stock dividends are included in invested capital because they represent in effect a reinvestment of earnings in the business.

(4) Accumulated earnings and profits as of the beginning of the taxable year.

The sum so obtained is reduced by the aggregate of the following amounts: (1) distributions out of capital during previous taxable years, plus (2) the deficit in the earnings and profits account as of the beginning of the taxable year, plus (3) distributions previously made during the taxable year out of capital or out of the accumulated earnings and profits as of the beginning of the taxable year. Thus, the fluctuations of earnings and profits for the taxable year have no effect upon the invested capital for such year.

(*b*) *Borrowed invested capital.*—Your subcommittee recommends that to the equity invested capital so arrived at there be added, under a graduated limitation at varying percentages (100, 66⅔, 33⅓), the borrowed capital of the taxpayer which is evidenced by a written promise to pay.

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. Thus, if this corporation has an equity in-

vested capital of $60,000 and borrowed capital of $2,000,000, its invested capital will be increased as follows:

| Borrowed capital | | Borrowed capital included in invested capital |
|---|---|---|
| $40,000 ($100,000 less $60,000 (equity invested capital)), at 100 percent | | $40,000 |
| $900,000, at 66⅔ percent | | 600,000 |
| $1,060,000, at 33⅓ percent | | 353,333 |
| $2,000,000 | Total | 933,333 |

If the equity invested capital is $100,000 or more, say $300,000, and the borrowed capital is the same, that is, $2,000,000, the invested capital would be increased as follows:

| Borrowed capital | Borrowed capital included in invested capital |
|---|---|
| $700,000 ($1,000,000 less $300,000 (equity invested capital)), at 66⅔ percent | $466,667 |
| $1,300,000 ($2,000,000 less $700,000), at 33⅓ percent | 433,333 |
| Total | 900,000 |

### 5. ADMISSIBLE AND INADMISSIBLE ASSETS

The average invested capital as computed above is reduced by a percentage which is the ratio of the inadmissible assets of the corporation for the year to the total of admissible and inadmissible assets for such year.

"Inadmissible assets" are (1) corporate stocks (except stock in a foreign personal holding company), and (2) State and local securities, obligations of corporate agencies, and obligations of the United States or its possessions. All other assets are "admissible assets."

The invested capital is so reduced for the reason that since the income from inadmissible assets is not taxable to the corporation, the assets from which such income arose should be excluded from invested capital.

Inadmissible assets are not deducted directly from the invested capital for the reason that the total of admissible and inadmissible assets is not ordinarily equal to the invested capital.

### 6. EXCESS-PROFITS NET INCOME

*A. Where the invested capital method of computing the excess-profits credit is used.*—In determining the net income for any taxable year, including the years in the base period, for the purposes of the excess-profits tax, it is recommended that there be used the normal tax net income, with the following adjustments:

(1) Dividends received: The credit for dividends received will be 100 percent and will apply to dividends on the stock of all corporations, whether domestic or foreign, except dividends (actual or constructive) on stock of foreign personal holding companies.

(2) Interest: The deduction allowable for interest paid or accrued during the taxable year shall be reduced by an amount which is the same percentage of so much of such interest as represents interest on borrowed capital as the borrowed invested capital is of the total borrowed capital.

(3) A deduction is allowed equal to the normal corporate income tax payable for such year.

(4) Gains or losses from the sale or exchange of assets (depreciable or nondepreciable) held for more than 18 months are disregarded for the purpose of the excess-profits tax.

*B. Where the invested capital method of computing the excess-profits credit is not used.*—In computing the excess-profits tax net income for the taxable year, excess-profits tax net income means the normal tax net income with the following exceptions:

(1) A deduction is allowed equal to the normal income tax payable for such year; and

(2) Gains or losses from the sale or exchange of assets (depreciable or nondepreciable) held over 18 months are disregarded for the purpose of the excess-profits tax.

In computing the excess-profits tax net income for the base period, the same concept is used.

### 7. METHODS OF COMPUTATION OF TAX

*Method No. 1.*—If the taxpayer so elects, it may take as its excess-profits credit its average earnings during the base period. The tax base, in that event, will be the excess of the earnings for the taxable year over the base period average, such excess to be reduced by a specific exemption of $5,000.

For example—

| | |
|---|---|
| Excess-profits net income for the taxable year | $150,000 |
| Less: Average excess-profits net income for the base period (excess-profits credit) | 100,000 |
| Excess of profits for the taxable year over the average profits for the base period | 50,000 |
| Less specific exemption | 5,000 |
| Excess profits subject to tax | 45,000 |

If the corporation acquires new capital after the beginning of its first taxable year under the excess-profits tax, its credit, as arrived at in the above example, will be increased by 8 percent of such new capital. For example, if a corporation on a calendar-year basis acquired $100,000 of new capital on January 1, 1940, its excess-profits credit of $100,000 as shown in the above example would be increased by $8,000 (8 percent of the $100,000 addition to capital).

If the corporation reduces its capital after the beginning of its first taxable year under the excess-profits tax its excess-profits credit will be reduced by 6 percent of the reduction in capital.

Thus, in the above case, if a reduction in capital of $100,000, instead of an increase of such amount, had occurred, the excess-profits credit of $100,000 would be reduced to $94,000.

*Method No. 2.*—If the taxpayer elects to compute its excess-profits credit upon the basis of invested capital instead of under method No. 1, it may take as such credit an amount equal to the percentage which its aggregate excess-profits net income for each of the years in the base period (reduced by the deficit in income for any of such years) bears to the aggregate of the invested capital for each of those years, but not in excess of 10 percent or less than 4 percent—except that with respect to the first $500,000 of invested capital in the taxable year the minimum is 6 percent instead of 4 percent. Thus, if the taxpayer's return on its average invested capital for the base period is, for example, 2 percent, it is given a miniumm of 6 percent upon the first $500,000 of its invested capital plus 4 percent upon the balance

of such invested capital. Likewise, if the taxpayer's base period earnings are in excess of 10 percent upon its average invested capital for the base period, its excess-profits credit, in the case of an election to compute such credit under method No. 2, is limited to a ceiling of 10 percent.

If the percentage of the base-period earnings to the base-period invested capital lies between the extremes indicated, the corporation is allowed an excess-profits credit for the taxable year equal to such percentage of its capital for the taxable year.

For example, a corporation has a base-period percentage of 10. Its excess-profits net income for the taxable year is $150,000 and its average capital for such year is $1,000,000.

Its excess-profits credit is computed as follows:

| | |
|---|---|
| Excess-profits net income | $150,000 |
| Less: Excess-profits credit (10 percent of invested capital) | 100,000 |
| | 50,000 |
| Less specific exemption | 5,000 |
| Excess profits subject to tax | 45,000 |

If a corporation acquires new capital after the beginning of its first taxable year under the excess-profits tax or after a subsequent taxable year for which its invested capital was lower than it was at the beginning of such first taxable year, its credit, computed on the basis of its lowest previous invested capital, is increased by 10 percent of so much of its new capital as does not produce a total invested capital in excess of $500,000, and 8 percent of the remainder of its new invested capital.

In the computation of the excess-profits tax in both the examples given under method No. 1 and that given under method No. 2, the procedure is the same. For example, in both cases, after the deduction of the specific credit of $5,000 and the excess-profits credit of $100,000, there was left $45,000 subject to tax. The tax on this sum in each case is computed as follows:

| | |
|---|---|
| First bracket: 25 percent of so much of the excess-profits net income as does not exceed 10 percent of the excess-profits credit (10 percent of $100,000=$10,000) | $2,500 |
| Second bracket: 30 percent of so much of the remainder of the excess-profits net income as does not exceed 10 percent of the excess-profits credit (10 percent of $100,000=$10,000) | 3,000 |
| Third bracket: 40 percent of so much of the excess-profits net income as is not taxed under the first and second brackets ($45,000 less $20,000=$25,000) | 10,000 |
| Total excess-profits tax | 15,500 |

### 8. TREATMENT OF FOREIGN CORPORATIONS

In the case of a foreign corporation in existence during the entire base period and engaged in trade or business in the United States or having an office or place of business therein, your subcommittee recommends that its excess-profits credit consist of the excess of its excess-profits net income for the taxable year over its average excess-profits net income for the base period, with no adjustments for additions to or reductions in capital. Such corporations will also be entitled to a specific exemption of $5,000. In the case of such foreign corporations, which were not in existence during the entire base period,

the tax shall be computed by reference to the invested capital, which shall be determined as follows:

The daily invested capital for any day of the taxable year shall be the aggregate of the adjusted basis of each United States asset held by the taxpayer in the United States on the beginning of such day. For the purpose of reducing the average invested capital by the ratio of inadmissible assets to total assets, the terms "admissible assets" and "inadmissible assets" shall include only United States assets.

### 9. SPECIAL RELIEF PROVISIONS

Your subcommittee believes that the need for special assessment under the plan formulated by it is much less than it was under the excess-profits tax legislation of the World War period. This is due to the following reasons:

(1) Allowing corporations to compute their excess-profits tax on the basis of the excess of their income for the taxable year over the income of a base period.

(2) The inclusion in invested capital of borrowed capital to a considerable extent.

(3) The omission of any percentage limitation upon the value of intangible property paid in for stock that may be included in invested capital.

(4) The elimination of gains or losses from the sale or exchange of assets (depreciable or nondepreciable) held over 18 months.

(5) The fixing of a minimum credit of 6 percent on the first $500,000 of invested capital, plus 4 percent of the remainder of the invested capital.

(6) Allowing new capital a return (free of excess-profits tax) of 10 percent up to a total of $500,000 invested capital and 8 percent on the balance, and recognizing that the capital of corporations coming into existence after December 31, 1939, is new capital.

(7) Allowing corporations which were in existence during only part of the base period, an invested capital for such part of the period they were not in existence, consisting of the invested capital as of the beginning of the taxable year 1940 upon which they are deemed to have earned 10 percent on the first $500,000 and 8 percent on the balance.

Your subcommittee has granted special relief only in cases where the Commissioner is unable to determine the taxpayer's equity invested capital for the first day of the first taxable year beginning after December 31, 1939. In such a case, such equity invested capital shall be an amount, determined in accordance with rules and regulations prescribed by the Commissioner, with the approval of the Secretary, equal to the cash on hand plus the aggregate of the adjusted bases at such time of the assets of the taxpayer then held minus the indebtedness outstanding at such time. The equity invested capital for each day in the taxpayer's base period and for each day after the beginning of the taxpayer's first taxable year shall be determined using as the basic figure the equity invested capital as of the beginning of such first taxable year.

### 10. PERSONAL SERVICE CORPORATIONS

A corporation whose income is to be 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 corpora-

tion and in which capital is not a material income-producing factor is classed as a personal service corporation. Such a corporation may signify in its return for any taxable year its desire not to be subject to the excess-profits tax and in such case it will be exempt from tax for such year. However, in order to obtain such treatment the shareholders of the corporation are required to include the undistributed income of such a corporation in their gross income, which then is subject to normal tax and surtax.

#### 11. EXEMPT CORPORATIONS

The following corporations are to be exempt from the excess-profits tax:

(*a*) Corporations exempt under section 101 from the tax imposed by chapter 1 of the Internal Revenue Code.

(*b*) Foreign personal holding companies, as defined in section 331.

(*c*) Mutual investment companies, as defined in section 361.

(*d*) Personal holding companies, as defined in section 501.

(*e*) Foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein.

## B. DETAILED DISCUSSION

### TAXPAYERS AND TAXABLE YEARS AFFECTED

Your subcommittee recommends that an excess-profits tax be imposed for taxable years beginning after December 31, 1939, upon all corporations except (1) corporations exempted under section 101 from the tax imposed by chapter 1 of the Internal Revenue Code, (2) foreign personal holding companies, (3) mutual investment companies, (4) personal holding companies, and (5) foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein. It is further recommended that a personal service corporation be permitted to elect to have its income taxed in the hands of its shareholders in lieu of paying the excess-profits tax.

### RATES OF TAX

It is recommended that the excess-profits tax be measured by the taxpayer's adjusted excess-profits net income, defined as so much of the taxpayer's net income (computed with certain adjustments) as exceeds the sum of a specific exemption of $5,000 and an excess-profits credit hereinafter described. The following graduated rates of tax are recommended:

25 percent of so much of the adjusted excess-profits net income as does not exceed 10 percent of the excess-profits credit;

30 percent of so much of the adjusted excess-profits net income as exceeds 10 percent of the excess-profits credit and does not exceed 20 percent of such credit;

40 percent of so much of the adjusted excess-profits net income as exceeds 20 percent of the excess-profits credit.

### EXCESS-PROFITS CREDIT

Your subcommittee recommends that the excess-profits credit be computed under two alternative methods. It is further recom-

mended that a taxpayer in existence during the whole of the base period (the years 1936 to 1939, inclusive) be permitted to elect for each taxable year whichever method it chooses. A taxpayer which was not in existence during the whole of such base period would be required to compute the credit under the second of the following alternative methods:

*Credit based on average base period income.*—Your subcommittee recommends that the credit computed under the first alternative be based upon a comparison of net income for the taxable year with the average net income for the base period. The credit is to consist of the average net income for the base period increased by 8 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. The credit is to be decreased by 6 percent of distributions other than distributions of earnings or profits, made after the beginning of such year.

*Credit based on invested capital.*—Your subcommittee recommends that the credit computed under the second alternative be based upon the relationship of net income to invested capital. In determining this credit there must first be ascertained the base period percentage, defined as the percentage which the aggregate net income for the base period is of the aggregate of the invested capital for each of the taxable years in the base period. In no event, however, shall such percentage be more than 10 percent or less than 4 percent. In the case of corporations which have made no additions to their invested capital following the close of the base period, the excess-profits credit is to be an amount equal to the base period percentage of the invested capital for the year, except that as to so much of the invested capital as does not exceed $500,000 the percentage shall be 6 percent if the base period percentage is lower. Any increase in the invested capital for the taxable year over the invested capital at the close of the base period or the invested capital for any preceding taxable year beginning after December 31, 1939, will increase the credit computed upon such previous invested capital by 10 percent of so much of the new invested capital as does not produce a total invested capital in excess of $500,000, and by 8 percent of the remainder of the new invested capital.

It is recommended that the invested capital for any taxable year (including the years in the base period) be the average invested capital for such year based on the invested capital for each day of the taxable year. Such invested capital is to consist of two component parts:

(*a*) Equity invested capital; and

(*b*) Borrowed invested capital.

Equity invested capital for any day of the taxable year is to be the sum of the following amounts:

(1) Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) The unadjusted basis (for determining loss) of property other than money previously paid in for stock, or as paid-in surplus, or as a contribution to capital. Property so admitted is taken at its unadjusted basis for determining loss upon the sale or exchange. The use of the unadjusted basis is dictated by the fact that adjustments to basis, notably for depreciation,

are reflected in earnings and profits. Where the property so paid in was disposed of before the beginning of the taxable year, the basis is determined just as if the property were still in the taxpayer's hands. The result is uniformity of basis treatment, regardless of the law in effect at the time of the disposition of the property;

(3) Taxable stock dividends to the extent they constituted a distribution of earnings and profits other than earnings and profits of the taxable year. To the extent that distributions in stock have reduced the earnings and profits of the corporation, such distributions are included in invested capital. Conversely, if the dividend was not considered taxable to the distributee under the applicable revenue law, it is not deemed to reduce the earnings and profits account and is, therefore, already reflected in the accumulated earnings and profits; and

(4) Earnings and profits at the beginning of the taxable year, and in computing such earnings and profits, distributions made during the first 60 days of the taxable year are considered, to the extent they do not exceed the accumulated earnings and profits as of the beginning of the taxable year, to have been made on the last day of the preceding taxable year; less the sum of the following amounts:

(1) Distributions in prior taxable years which were not out of accumulated earnings and profits;

(2) Any deficit in accumulated earnings and profits as of the beginning of the taxable year; and

(3) Distributions previously made during the taxable year which were not out of earnings and profits of the taxable year.

Borrowed invested capital for any day of the taxable year is to be based on the borrowed capital at the beginning of such day, consisting of indebtedness of the taxpayer evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, but is not to exceed the following amounts as the case may be:

(1) If the equity invested capital is less than $100,000, 100 percent of that portion of the borrowed capital which does not exceed the difference between $100,000 and the equity invested capital, plus 66⅔ percent of so much of the remainder of the borrowed capital as does not exceed $900,000, plus 33⅓ percent of any remaining borrowed capital.

(2) If the equity invested capital is $100,000 or more and less than $1,000,000, 66⅔ percent of that portion of the borrowed capital which does not exceed the difference between $1,000,000 and the equity invested capital, plus 33⅓ percent of the remainder of the borrowed capital.

(3) If the equity invested capital is $1,000,000 or more, 33⅓ percent of the borrowed capital.

It is recommended that the invested capital be reduced by an amount which is the same percentage of the invested capital as the inadmissible assets of the taxpayer are of its total assets, with an adjustment for short-term capital gains realized upon the sale or other disposition of such inadmissible assets. Inadmissible assets are to consist of stock in other corporations (except foreign personal holding companies) and wholly or partly tax-free obligations.

It is recommended that corporations in existence during part but not all of the base period be treated in the same manner, for the purposes of the credit based on invested capital, as corporations which were in existence during the entire base period. The invested capital of such taxpayers for each taxable year in the base period during the whole of which they were not in existence is to be an amount equal to the invested capital as of the beginning of the first taxable year after December 31, 1939, reduced by the same percentage of reduction on account of inadmissibles as is applicable to invested capital for the preceding taxable year. The invested capital for any portion of a taxable year in the base period during which they were not in existence is to be a proportionate part of such amount. The excess profits net income for each taxable year or portion thereof in the base period during which they were not in existence is to be 10 percent of so much of the invested capital as does not exceed $500,000, plus 8 percent of the remainder.

It is recommended that the credit of corporations which were in existence during no part of the base period be 10 percent of that portion of the invested capital which does not exceed $500,000, and 8 percent of the remainder.

### EXCESS-PROFITS NET INCOME

Your subcommittee recommend that the net income computed for excess-profits tax purposes for any taxable year (including taxable years in the base period) be the normal tax net income computed with the following adjustments:

(1) The deduction for taxes paid or accrued is to be increased by an amount equal to the income tax payable for such taxable year;

(2) The amount of any gain or loss realized upon the sale or exchange of any asset (depreciable or nondepreciable held for more than 18 months) is to be excluded from the computation.

If the excess-profits credit based upon invested capital is used, the following further adjustments are to be made:

(3) The deduction for interest on indebtedness which represents borrowed capital is to be reduced by an amount which is the same percentage of such interest as the amount of borrowed capital included in invested capital is of the total borrowed capital.

(4) Instead of the limited credit for dividends received allowed by section 26 (b), a credit is to be allowed of the full amount of all dividends received from another corporation, whether foreign or domestic (except foreign personal holding companies).

*Personal-service corporations.*—It is recommended that a personal-service corporation be given the privilege of electing whether to be taxed under the excess-profits tax provisions applicable to other corporations or, in lieu of paying such tax, to have its shareholders include their pro rata share of the corporation's net income in their own income as a constructive dividend subject to tax in the same manner as other dividends. For this purpose it is proposed to define a personal-service corporation as any corporation whose income is to be ascribed primarily to the activities of the principal owners or shareholders who are themselves regularly engaged in the active conduct of its affairs and

in which capital, whether invested or borrowed, is not a material income-producing factor, but not including any foreign corporation or any corporation 50 percent or more of the gross income of which consists of gains, profits, or income derived from trading as a principal. Whichever method of taxation is chosen by the corporation, the corporation will, of course, continue to be subject to the normal corporate income tax.

*Rule for cases where equity invested capital cannot be determined under general rule.*—It is recommended that, in cases where the Commissioner determines that the equity invested capital of a corporation as of the beginning of the taxpayer's first taxable year which begins after December 31, 1939, cannot be determined in accordance with the method previously described, such equity invested capital be an amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, equal to the cash on hand plus the aggregate adjusted bases at such time of the assets of the taxpayer then held minus the indebtedness outstanding at such time. The equity invested capital for each day in the base period and for each day after the beginning of the taxpayer's first taxable year which begins after December 31, 1939, shall be computed in accordance with regulations, using as the basic figure the equity invested capital as of the beginning of such taxable year.

*Invested capital of foreign corporations.*—It is recommended that in the case of foreign corporations (in existence during the whole of the base period) in trade or business within the United States, or having an office or place of business therein, the excess-profits credit be computed under the second alternative method. For this purpose the invested capital shall be based only on the assets of the taxpayer held by it in the United States. Such assets shall be taken into account in accordance with their adjusted bases as of the day for which the computation is made. If the Commissioner determines that the amount of the United States assets cannot be determined, invested capital is to be an amount which is the same percentage of all the assets of the corporation as the United States income is of the total income. It is recommended that if such foreign corporation was not in existence during the whole of the base period it be compelled to compute its excess-profits credit in accordance with the first alternative method but with no adjustments for increases or decreases in capital.

*Earnings and profits.*—Your subcommittee recommends that chapter I of the Internal Revenue Code be clarified in order that the unrecognized gain or loss upon the sale or exchange of property by a corporation not be reflected in its earnings or profits account. This rule is in accord with the previous practice adopted by taxpayers and the Bureau of Internal Revenue alike and set forth in the income-tax regulations.

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The CHAIRMAN. It was deemed best to hold the hearings on the report, which was unanimous, and leave the drafting of the bill until the hearings are concluded in order that the committee might have the benefit of any and all facts and information the hearings might disclose.

The first witness to appear this morning is the Honorable Henry Morgenthau, Jr., Secretary of the Treasury, whom we shall be very glad to hear at this time.

## STATEMENT OF HON. HENRY MORGENTHAU, JR., SECRETARY OF THE TREASURY; ACCOMPANIED BY DANIEL W. BELL, THE UNDER SECRETARY; AND JOHN L. SULLIVAN, ASSISTANT SECRETARY

Mr. MORGENTHAU. Mr. Chairman, members of the Ways and Means Committee of the House and of the Finance Committee of the Senate, the national defense program places upon us the duty of reconsidering certain features of the tax structure now, in order to obtain a rapid expansion of production for defense and a better distribution of its cost to the taxpayer.

I should like first to outline the fiscal situation as it has developed since the beginning of June, when the revenue bill of 1940 was under consideration.

According to the Budget estimates, as of June 3, with the revenue laws then in force and the appropriations which had passed or were pending, the expected deficit for the fiscal year 1941 was $4,350,000,000. The balance of the borrowing authority at that time under the limitation of $45,000,000,000 was $1,950,000,000. With the rate of expenditure anticipated at that time this balance would be exhausted and the working balance of the Treasury would be seriously depleted by the end of January 1941.

In view of these circumstances, a provision was placed in the Revenue Act of 1940 authorizing the issuance of not more than $4,000,000,000 of short-term obligations for financing national defense expenditures. At the same time additional taxes were provided, most of which are to be used to retire within 5 years any defense obligations issued under this authority. As I reported to you, these provisions of the bill then pending before your committee were sufficient to meet the situation as it existed at that time.

With the rapid deterioration of world conditions, however, it became necessary to plan for an expansion of the program for national defense, and the President requested the Congress to provide additional funds for this purpose. I have here a statement showing the appropriations and contract authorizations for defense now made or pending before this Congress. The total as of August 5 is $14,702,000,000, to be expended during the next few years as rapidly as circumstances will permit.

The Bureau of the Budget and the Treasury now estimate that the receipts for the current fiscal year will amount to $6,367,000,000, and that the total expenditures will probably exceed $12,000,000,000, leaving a net deficit of about $5,700,000,000. I have a further statement showing the revised Budget estimates as of August 5, compared with those made on June 3 and those included in the President's Budget message of January 3, 1940.

To meet the expected deficit of $5,700,000,000, we had as of July 31, a balance of borrowing power of $965,000,000 under the debt limitation of $45,000,000,000 and the whole of the $4,000,000,000 authorization of the 1940 Revenue Act. In addition, the Treasury had a working balance of $1,504,000,000.

By the end of the calendar year 1940, the borrowing power under the general limitation will be down to about $800,000,000, and that under the $4,000,000,000 authorization will have been reduced to

about $2,460,000,000. On June 30, 1941, according to present estimates, the balance under the general debt limitation will have shrunk to $300,000,000, and the $4,000,000,000 authority will have been exhausted. In addition, it will have been necessary to draw upon the working balance of the Treasury, reducing that balance to about $1,275,000,000.

On the basis of these estimates it is obvious that in view of the requirements of the defense program, the present combined debt limitation of $49,000,000,000 will sooner or later need to be increased. Whether an increase will be required before the end of the present fiscal year must depend in the first instance upon the speed at which the defense program progresses. Naturally we all hope that present estimates of the rate of defense expenditure can be greatly exceeded, and certain changes in the tax law that we are now discussing are for this very purpose.

At the same time, I want to point out that in addition to readjusting the tax structure in a way to speed the production of defense material, the proposed tax legislation should also aim at an increase in revenues which will help to strengthen the fiscal position of the Treasury. Accordingly, it is desirable not only to provide for changes in the period of amortization on war facilities, and for the suspension of the present profit limitation on certain Army and Navy contracts, but also to enact an excess profits tax that will provide additional revenue without restricting the productive activity necessary for defense.

I am in hearty accord with the statement made by this committee in its report on the last revenue bill, in which you called attention to the need for providing special amortization, and for preventing the creation of new war millionaires.

Since those statements of policy were made, however, there has arisen in the minds of contractors who desire to do business with the Government a barrier of uncertainty as to the conditions under which they will operate. In some cases, on this account, contractors have been hesitant to accept Government contracts. To remove this hesitancy, it has been my opinion that immediate steps should be taken to obtain adequate remedial legislation.

The Treasury Department accordingly presented to the subcommittee a plan for an excess profits tax, with corresponding changes in the amortization rules and the Vinson-Trammell Act. The subcommittee has adopted many features of this plan and has added other provisions which alter the excess profits tax in certain respects. I think we all agree, however, that the present need is for immediate action, so that those businessmen who have hesitated to participate in the national defense program because of tax uncertainties may proceed without further delay. It is therefore essential that differences as to details of the bill be not allowed to stand in the way of early passage of this urgently needed legislation.

Members of the Treasury staff will of course be glad to give any assistance which the committee may desire.

(The statements referred to above by Secretary Morgenthau are as follows:)

*Appropriations and contract authorizations for national defense* [1]

[Figures in millions of dollars]

| | Army | Navy | Total |
|---|---|---|---|
| Appropriations made | 2,330 | 1,567 | 4,187 |
| Appropriations pending | 1,672 | 691 | 2,263 |
| Contract authorizations approved | 377 | 512 | 889 |
| Contract authorizations pending | 2,250 | 498 | 2,748 |
| | 6,809 | 3,278 | 10,087 |
| 2-ocean navy and other construction previously authorized | | 4,615 | 4,615 |
| Total | 6,809 | 7,893 | 14,702 |

[1] As of Aug. 5, 1940.

NOTE.—Does not include any estimate of costs of bill to authorize selective compulsory military training and service or bill to authorize the President to order the National Guard into active military service.

*Revised budget summary*

[In millions of dollars]

| | 1941 | | |
|---|---|---|---|
| | Revised Aug. 5, 1940 | Revised June 3, 1940 | In budget |
| I. Receipts: | | | |
| Internal revenue | 6,448 | 5,732.8 | 5,649.6 |
| Railroad Unemployment Insurance Act | 7 | 6.8 | 6.8 |
| Customs | 300 | 300 | 273 |
| Miscellaneous receipts | 221 | 221.4 | 221.4 |
| Total | 6,976 | 6,261 | 6,150.8 |
| Deduct net appropriation to Federal Old-Age and Survivors Insurance Trust Fund | 609 | 608.7 | 602.8 |
| Net receipts | 6,367 | 5,652.3 | 5,548 |
| II. Expenditures: | | | |
| Legislative, judicial, executive | 37 | 37 | 37.6 |
| Civil departments and agencies | 1,060 | 940 | 952.2 |
| General Public Works [1] | 556 | 556 | 541.3 |
| National defense [2] | 5,000 | 3,250 | 1,939.7 |
| Veterans' pensions and benefits | 562 | 560 | 560.7 |
| Aids to Agriculture (including Farm Security Administration, 1941) | 1,090 | 950 | 1,028.8 |
| Aids to youth | 375 | 375 | 308 |
| Social Security | 427 | 417 | 434.9 |
| Work relief (including W. P. A., 1941) | 1,400 | 1,400 | 1,122.8 |
| Refunds | 70 | 71 | 71 |
| Interest on public debt | 1,100 | 1,100 | 1,100 |
| Transfers to trust accounts | 226 | 225 | 225.2 |
| Supplemental items (regular) | 125 | 100 | 100 |
| Total expenditures (excluding debt retirement) | 12,058 | 10,001 | 8,426.2 |
| III. Net deficit | 5,691 | 4,348.7 | 2,878.2 |
| IV. Debt retirement | 100 | 100 | 100 |
| V. Gross deficit | 5,791 | 4,448.7 | 2,978.2 |

[1] Excludes Army and Navy.

[2] Includes public works.

AUG. 5, 1940.

The CHAIRMAN. Does that complete your main statement, Mr. Secretary?

Secretary MORGENTHAU. Yes.

The CHAIRMAN. Does any member of the Finance Committee of the Senate desire to ask any questions of the Secretary?

Senator VANDENBERG. Mr. Chairman, may I ask the Secretary just one question? On page 2, you estimate the net deficit as $5,700,000,000 at the end of the present fiscal year. Can you tell me how much of that deficit is represented by what might be called extra-national defense expenditures?

Secretary MORGENTHAU. Would it be agreeable to you, Senator, if I asked Mr. Bell to answer that question?

Senator VANDENBERG. Yes.

Mr. BELL. It is a little difficult, Senator Vandenberg, to differentiate between the supplemental estimates for national defense and the original estimates; they have been so integrated. But the estimates in the budget for national defense were $1,939,000,000 for 1941. The estimate today is $5,000,000,000. Now, a part of that $1,939,000 represented emergency national defense as compared with expenditures a year ago; probably $400,000,000. That is as nearly as I can separate it.

Senator VANDENBERG. May I put the question differently? How much of the $5,700,000,000 deficit would have existed without the national defense appropriations?

Mr. BELL. You are talking about the emergency matters that have been sent up in the last 2 months?

Senator VANDENBERG. Yes.

Mr. BELL. I think that is the same question put another way. I think you would have to deduct from the deficit of $5,691,000,000, approximately $3,100,000,000.

Senator VANDENBERG. You do the arithmetic and give me the answer.

Mr. BELL. That will give you $2,600,000,000.

Senator VANDENBERG. Thank you.

The CHAIRMAN. Are there any further questions by members of the Finance Committee? If not, are there any questions by members of the House committee?

Mr. MCCORMACK. I would like to ask one question, Mr. Chairman. On page 4 of your statement, Mr. Secretary, on line 3, referring to the suggestion in the report that it is desirable not only to provide for changes in the period of amortization on war facilities and for the suspension of the present profit limitation on certain Army and Navy contracts, you also say:

> * * * but also to enact an excess profits tax that will provide additional revenue without restricting the productive activity necessary for defense.

I assume you also mean to include, without unnecessarily curtailing business in other respects?

Secretary MORGENTHAU. Yes.

Mr. TREADWAY. Mr. Secretary, on page 4 of your statement, you make reference to the difficulty of securing the cooperation of contractors, awaiting this legislation. Would you be kind enough to tell us to what extent this hesitancy has appeared?

Secretary MORGENTHAU. Well, Mr. Treadway, I would be giving it to you second-hand. I think either Secretary Stimson or Mr. Knudsen could answer that. They could give it to you first-hand.

Mr. TREADWAY. That would be entirely satisfactory, but perhaps we had better wait until these gentlemen make their statements later.

Secretary MORGENTHAU. Very well.

Mr. KNUTSON. Mr. Secretary, on page 3 of your statement, you say that sooner or later it will be necessary to increase the debt limit.

Using the present defense program as a basis, how much do you think it will be necessary to increase the limit? Has the Treasury Department given consideration to that?

Secretary MORGENTHAU. We have just made the estimates through the balance of this fiscal year and from these figures which I submitted we can get through to the end of this fiscal year.

Do you want us to say when we will reach the debt limit if the bill now pending passes Congress?

Mr. KNUTSON. Yes.

Secretary MORGENTHAU. Mr. Bell, would you answer that question?

Mr. BELL. We will have about $300,000,000 of borrowing power at the end of this fiscal year. There is a statement attached to the Secretary's prepared statement, showing that you already have on the books a national-defense program of $14,700,000,000. We are going to exhaust about $5,000,000,000 of that this year. So that you will still have a program, if you enact no more legislation except that contained in the President's message of July 10, of $9,000,000,000. And to the extent that such balance is not offset by additional revenue that may be collected under existing tax laws as a result of improving business conditions, you will either have to have a debt increase or additional taxes to finance that.

Mr. KNUTSON. In the event taxes were not increased, we would have to increase the debt limit by $7,000,000,000?

Mr. BELL. $9,000,000,000 if you do not get additional revenue under present tax laws or from other sources.

Mr. KNUTSON. That would be $57,000,000,000, would it not?

Mr. BELL. $58,000,000,000; yes, sir.

Mr. KNUTSON. That is all.

The CHAIRMAN. Are there any further questions?

Senator KING. Mr. Chairman, I would like to ask one question. You mentioned the figure of $14,000,000,000 a moment ago as representing the national-defense program. Does that include any of the ordinary expenses of running the Government, or is that exclusively national defense?

Mr. BELL. That includes all national-defense expenditures of every character, but it does not include expenses that are outside of the national defense.

Senator KING. Where do you draw the line between national-defense expenditures and the ordinary expenses of the Government?

Mr. BELL. We call national-defense expenditures those expenditures made by the War and Navy Departments for military purposes. We do not include the nonmilitary activities of the War Department.

Senator KING. Then you anticipate that the War Department and the Navy Department will expend approximately $14,000,000,000 for national defense?

Mr. BELL. That is your present program; yes, sir.

Senator TOWNSEND. Included in that estimate is the $4,500,000,000 that is before the Senate Appropriations Committee at the present time?

Mr. BELL. Yes, sir; everything is included in this estimate except the two bills pending before Congress which authorize the selective compulsory military training and calling of the National Guard. I have no estimates on that.

Senator TOWNSEND. You have no estimates on that?

Mr. BELL. No, sir.

Senator KING. Would those costs be included in the figure of $14,000,000,000?

Mr. BELL. No, sir.

Senator KING. Then the total military expenditures might be $20,000,000,000 or in excess of that?

Mr. BELL. That I cannot answer. I have no estimates on those two bills.

Senator LA FOLLETTE. Are you preparing any estimates on the cost of those bills?

Mr. BELL. There will be estimates prepared later; yes, sir.

The CHAIRMAN. Are there any further questions?

If not, we thank you, Mr. Secretary and Mr. Bell, for your appearance and the testimony you have given the committee. I suppose later Assistant Secretary Sullivan and Mr. Stam will be called upon to make some detailed explanation of the bill. They had a large part in the preparation of the bill. Before that, however, we will hear the next witness on our calendar, who is the Secretary of War, the Honorable Henry L. Stimson.

Mr. Secretary, we shall be very glad to hear you at this time.

## STATEMENT OF HON. HENRY L. STIMSON, SECRETARY OF WAR

The CHAIRMAN. Mr. Secretary, do you prefer to make your main statement without interruption and then answer questions after you have concluded?

Secretary STIMSON. I have a very brief statement, Mr. Chairman. I should prefer to go through it, and then if you think any questions are necessary, I shall do my best to answer them.

Gentlemen of the Ways and Means Committee and of the Finance Committee, I am not here to enter into the details of this legislation at all, nor even to discuss the philosophy or the fairness or justice of the taxes which I understand you are considering. I am here simply to point out, in a few sentences, that insofar as your present deliberations relate to making provision for quick amortization of defense facilities and to removing the present uncertainties as to future tax legislation affecting the manufacture of munitions, their prompt conclusion is a matter of vital importance to the national defense. And I am happy to say that during the few days of this week in which your subcommittee has been making such progress in its work, as shown by the statements which the chairman has made and by the completion of its report, there have been favorable repercussions in the fields of our work.

Let me take the problems confronting the aviation industry as an outstanding illustration of the difficulties which I have in mind.

Air power today has decided the fate of nations. Germany, with her powerful air armada, has vanquished one people after another. On the ground, large armies have been mobilized to resist her but each time it was that additional power in the air that decided the fate of each individual nation.

When Germany invaded Holland she faced an army of 560,000 ground troops. Yet because the Dutch had but 100 first-line planes and a grand total of less than 200 planes, Germany was able to win decisively in less than 4 days; and all the help of the British and French planes was insufficient to frustrate the German attack from the air.

Again, in Belgium, in 18 days, the results were similar. A Belgian Army of 650,000 ground troops with but 70 first-line airplanes and about 350 obsolescent planes could not cope with the modern German attackers; and the British Expeditionary Forces and the French Armies, decidedly inferior to Germany in the air, suffered a similar series of disasters in Flanders.

With slight variations, the same story was repeated in France. French territory was invaded on May 14. The break-through at Sedan took place on May 16. On June 22 the fighting was over. The French Army, despite its 3,500,000 men, proved inadequate. French deficiency in air power to a large extent explained the subsequent disaster.

On May 16, 2 days after the Dutch surrender, the President of the United States sent a message to Congress calling attention to our national defense needs. In response to this message, Congress passed the military Appropriation Act for 1941, approved June 13, 1940, which provided for the addition of 200 heavy bombers and 1,700 training planes at a cost of approximately $100,000,000. In addition, Congress provided $13,000,000 to modernize existing airplanes.

Thereafter, as reports from overseas multiplied, emphasizing again and again the vital role of the airplane and what it portended for our own security, the President on May 31, 1940, sent another message to Congress requesting further increase of our air forces. As a result of his recommendations there was passed and approved on June 26, 1940, the first supplemental National Defense Appropriation Act of 1941, providing for 1,635 additional combat planes and for 546 others at a total cost of approximately $300,000,000.

In other words, and to sum up, Congress made available to the Army during the month of June approximately $400,000,000 for airplanes, engines, and accessories. Yet today, almost 7 weeks later, we have been able to sign contracts for the construction of but 33 planes of the over 4,000 for which these appropriations that I have mentioned were made.

I might say that some of the newspapers in their articles this morning carried an inaccurate summary of the information given out yesterday by Mr. Knudsen. These papers reported Mr. Knudsen as having stated that some 45 percent of the airplane contracts had been awarded. As a matter of fact, Mr. Knudsen's statement was to the effect that contracts for some 45 percent of the entire War Department program, including a vast number of items other than airplanes, had been awarded. The true figures as to airplanes are those which I have just stated to you.

Now, gentlemen, the fault is not with the Army. So far as I am aware, there has been no undue delay in the preparation of Army specifications and designs for the contracts. The fault has certainly not been with the Defense Advisory Commission. The members of that body have brought to bear on the solution of this problem their great experience, good judgment, and wholehearted efforts. Nor has it been the fault of industry.. The representatives of industry have been earnest; they have shown every desire to cooperate with the Army and with the Defense Commission in the difficult negotiations which have been carried on during these 7 weeks. So far as I have been informed, there has been no evidence that at any time there has been any tendency on the part of industry to hold back on the Army in these negotiations.

The fact is that we have all been facing a difficult problem, and we have been facing it with earnest efforts to cooperate. That problem arises in a large part from the fact that the entire program of airplane construction is so large that it necessarily involves a great expansion of existing plant facilities and the construction of new plants to meet the requirements of our Army in the present emergency.

Risks are inherent in any business enterprise. Industry may be expected to undertake normal risks. But the risk to industry of undertaking at the request of the Government to expand plant capacity at industry's own expense and of then being left, upon a sudden cessation of the emergency, with these expanded facilities useless, is one that is entitled, in my opinion, to special consideration. Under those circumstances, the uncertainty of future taxation as affected by this expanded construction not only, it seems to me, fails to give the special consideration which I have just mentioned, but it rather tends to penalize the situation which the manufacturers confront. It is this element of uncertainty in respect to the industry's right quickly to amortize its investments in an expanded construction program, and also the uncertainty, or I may say the delay, as to the amount and character of taxation which will be levied during the period of the contract, which according to our observations chiefly have prevented the execution of these contracts.

The War Department of the United States does not manufacture airplanes. It must depend upon private industry for the production of the planes that it needs today and tomorrow. Consequently it must attend to the legitimate needs of that industry in this matter of construction.

I have singled out the aviation industry as an example. The problem, however, is much wider. Those who manufacture guns for use in our planes are faced with the same problems as those who are manufacturing the planes. Those who must build our tanks, our artillery, and our ammunition are faced with the same problem as to plant expansion and uncertainties of taxation. Definite tax legislation upon which the calculations of the future may be more safely made will benefit every factory that may be called upon for extensive plant expansion to meet our needs.

We are in the midst of a grave crisis. The time factor is our principal obstacle. I am confident that the War Department and the Defense Advisory Commission, each in its respective sphere, will do their best to protect the true interests of the United States in this vital matter.

As I said when I opened my statement, I have been greatly encouraged by what has happened this week and by the attitude which I have met in my discussion with the chairmen of these committees and the subcommittees.

That is the situation as far as I, in the limited time that I have been here, have been able to diagnose the reasons why there has been delay in the execution of these contracts.

Now as you gentlemen well know, the details of the execution of these contracts are in other hands. The various heads and various bureaus of the War Department negotiate them, and they, with the advice of Mr. Knudsen of the Defense Commission, conduct these negotiations and carry through the details. As to such details they can give you full information. I can only give you the broad outline that comes to me in my official capacity of supervising their tasks.

That is all I have.

The CHAIRMAN. That completes your statement?

Mr. STIMSON. That is my complete statement.

The CHAIRMAN. Senator Vandenberg.

Senator VANDENBERG. If I may, Mr. Secretary, I would like to ask this question: Does your testimony carry the implication that if this bill is to be effective it must carry the assurance that this is the final word in a tax bill?

Secretary STIMSON. No; I do not think that is necessary. But at the present time, there has been vacillation back and forth in suggestions that have been made and in the various bills introduced and statements made on the floor of Congress which has left the entire matter indefinite. An amendment to the Vinson-Trammell Act on the subject of excess profits was made on nearly the very day that the airplane appropriation became available. While the contracts had not been signed, much work had been done on them in anticipation of their being signed as soon as possible after the appropriation became law; yet at that very moment an element of immediate uncertainty was introduced, which made these businessmen unwilling to sign and commit themselves under the changed conditions. They now hesitate to do so until they know what conditions, at least in the beginning they are likely to confront.

Now of course, every businessman knows that Congress has the right to change legislation while it is in effect, but any changes occurring during the very moments of negotiation and of such wide character as those presently being discussed, make it very difficult to proceed to execute contracts until the businessman knows at least what he is starting off with.

Senator VANDENBERG. I completely sympathize with the immediate necessity of trying to serve them, and I want to be helpful to them.

Secretary STIMSON. I appreciate that. In fact, I have been before similar bodies too many times over too many years to not know that that feature rests in your hands and not in anybody elses.

Senator VANDENBERG. The only thought in my mind was that in contemplating a deficit so utterly staggering it is perfectly obvious that the American people have to pay infinitely more taxes than they have ever contemplated and I do not want to have the implication left that we are through with war taxation when we pass this bill.

Secretary STIMSON. I think I understand you.

Senator VANDENBURG. May I ask you one further question: Has your Department made any tentative estimate of the cost of the National Guard organization bill and of the contemplated conscription bill for the next fiscal year?

Secretary STIMSON. If so that has not passed through my hands, and I do not think they have.

Senator VANDENBURG. Those figures would have to be added to the deficit which the Secretary of the Treasury reported for the next year.

Secretary STIMSON. Yes; I believe they would. I have not seen such an estimate, and I do not think it has been made up.

The CHAIRMAN. Any further questions?

Senator VANDENBURG. No.

The CHAIRMAN. Senator Harrison do you have any questions?

Senator HARRISON. I do not think so.

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. Mr. Secretary, with reference to the item of taxation, in your statement, you referred to favorable impressions in your recent contacts with contractors. Would you go into that in a little more detail?

Secretary STIMSON. I referred particularly to statements which I think have been given out by Mr. Cooper in the last few days.

Mr. TREADWAY. There has been, Mr. Secretary, considerable uncertainty as to the relation between these three items constituting the proposed bill. There was, of course, a speech made on the floor of the House day before yesterday by a prominent Member of the House wherein he referred to some criticism of the fact that this committee has not reported an amortization bill and perhaps the repeal of the Vinson-Trammel Act.

Now is it your opinion that criticism of that kind is perhaps in error in that there is close relationship between these three purposes and that one cannot be effected satisfactorily without the other two?

Secretary STIMSON. That is the class of question, Mr. Treadway, which I prefer to leave entirely to the discussion of the Congress. But I can say that there might be an argument made that there is a connection between them. I had no intention in the remarks, which I have made here, to make such a criticism as you mention, and I trust that my remarks will not be so interpreted. I merely sought to state that there is uncertainty today as to the conditions with which the manufacturer is to be confronted.

Businessmen, as you know, Mr. Treadway, are human beings, and they can be affected by changes that come while they are engaged in negotiations, and they can be made timid by that fact, and that is what happened, as I understand it.

Mr. TREADWAY. Have you had contact with manufacturers, Mr. Secretary, to get that impression from them?

Secretary STIMSON. I have not personally. I have not contacted them personally, but I have kept in very close touch with the gentlemen who have met them.

Mr. TREADWAY. Yes; you now refer to Mr. Knudsen?

Secretary STIMSON. I am referring to Mr. Knudsen on the one side and referring to the staff of the War Department on the other, particularly those who have had charge on the other side, Colonel Burns and General Arnold of the Air Corps, who have charge of the basis upon which the negotiations of these contracts rest.

Mr. TREADWAY. Is it fair to assume that any views that Mr. Knudsen may express would be in accord with your experience, insofar as it gives the attitude of the contractors?

Secretary STIMSON. I have great confidence in Mr. Knudsen's experience with contractors, and I have great confidence in his very long, earnest, and laborious work in this case to iron out the problems with the contractors.

Mr. TREADWAY. I would like to clear up, if I can, by the various witnesses, this thought: That we could, perhaps, have hurried the work of Congress by separating these three items, and I refer now——

Secretary STIMSON (interposing). I would rather not give an opinion on that myself. That is a matter over which I have no control.

Mr. TREADWAY. Well, I think you did refer to the timidity of possible contractors.

Secretary STIMSON. Yes.

Mr. TREADWAY. In not entering into contracts.

Secretary STIMSON. I have mentioned some of the factors that enter into it. There may also be the matter of the excess profits taxation.

The CHAIRMAN. Mr. McCormack.

Mr. MCCORMACK. Mr. Secretary, in your statement you said the fault is not with the Army.

Secretary STIMSON. That is true so far as I know.

Mr. MCCORMACK. And you also said that the fault was not with the Advisory Commission, nor has the fault been with industry. From that I might draw the inference, at least, that the fault is with the Congress?

Secretary STIMSON. I tried to clarify that in the next statement.

Mr. MCCORMACK. You did not intend to express that view?

Secretary STIMSON. No; I did not have that intention, and in the sentence that followed, I was careful to point out that we have, for example, in the aviation program, the basic and fundamental problem of asking the manufacturers to make a tremendous enlargement in their industry.

I suppose you gentlemen have already learned that American manufacturers make a very good plane. But the industry has never made them in what we call mass production. It has made them, as I have heard it stated, the way Swiss manufacturers make watches; they have made very good planes, very carefully, but they have never made them on such a large scale as the problem now before the United States demands.

Now under those circumstances we find we have this tremendous problem of getting the plants, of getting skilled employees in sufficient numbers to enable them to increase their production beyond anything the industry has ever had, and it was that basic problem, which I mentioned when I was speaking on that point, which the producers are facing in reference to these tax problems.

Mr. MCCORMACK. What amortization really is, is accelerated depreciation.

Secretary STIMSON. Accelerated depreciation; yes.

Mr. MCCORMACK. Because we have a basic policy in tax matters of allowing reasonable depreciation, except to cover emergencies where you have a program such as this, where expansion is necessary and that reasonable depreciation would have to be accelerated over what ordinary business activities would justify in normal times.

Secretary STIMSON. If a man is obliged to build a factory which he can only use in the emergency, such as we are now in, and is only allowed the amortization over a period, we will say, of 20 years, then if the emergency ceases in 3 or 4 or 5 years he is in trouble.

Mr. MCCORMACK. The situation with which we are faced at present is one of the conditions which arise making necessary legislation because I do not believe anyone could criticise the businessman, who under present conditions is trustee of other peoples money, if he is trying to be careful in its expenditure. But it is also fair to say, from your knowledge, that from the time this matter has been called to the attention of the Congress, which, so far as I am concerned was really last week, the acute situation, that this legislation was definitely connected with the national defense program, and that the legislative committees of the Congress, both the Ways and Means Committee in

the House and the Finance Committee in the Senate, have been doing everything they could to expedite action.

Secretary STIMSON. My personal contacts with the Representatives of the Congress in this matter, in this particular matter, began on Monday, last, when I had the honor to be invited to a meeting in which this Committee of Ways and Means, and its chairman, and the Finance Committee, its chairman and other members were present. From my personal knowledge I should say that there has been the utmost zeal shown by the gentlemen whom I met to accelerate this matter as quickly as possible, and I would like to state that as a matter of record.

Mr. MCCORMACK. And that meeting was really an informal meeting to try and adjust some differences.

Secretary STIMSON. Yes.

Mr. MCCORMACK. Between the Treasury Department and the technical staff of the Ways and Means Committee and at that time Secretary Morgenthau said they would be ironed out by 10 o'clock the next morning, did he not?

Secretary STIMSON. Well, the Secretary is here and can speak of that.

Mr. MCCORMACK. There is just one more question, Mr. Secretary: In the enactment of legislation, whatever it might be, whether it comes from this committee or any other committee, when it is enacted into law, particularly in this emergency, do you not think that the Congress should give to those administering the legislation, which is so vital to the national-defense program, that is, that the legislation should be as broad and as flexible administratively as is possible to meet the existing problems that will arise, and cannot be otherwise handled in an emergency.

Secretary STIMSON. You raise in that a question of constitutional government, and particularly of democratic constitutional government, of long standing. It has many complexities and there is much to be said on it.

Mr. MCCORMACK. The Congress can enact broad legislative standards, but in the standards the administrative power should be flexible.

Secretary STIMSON. I was about to say that my opinion for many years has been that a government which is based upon the proposition that you cannot trust anyone does not get very far.

Mr. MCCORMACK. I agree with you.

Senator TOWNSEND. I would like to ask one question.

The CHAIRMAN. Yes, Senator.

Senator TOWNSEND. Has not the amortization question been worked out by rules and regulations of the Department?

Secretary STIMSON. Not the one that I have reference to.

The CHAIRMAN. Any further questions?

Senator VANDENBERG. May I just supplement my previous inquiry, Mr. Secretary.

As I understand the purpose, we are not asked to amortize defense construction against future taxation, but that the contractors start even and on the same basis as everybody else if additional taxes have to be assessed.

Secretary STIMSON. That would express my view exactly.

The CHAIRMAN. Mr. Knutson.

Mr. KNUTSON. Mr. Secretary, during the last 7 years Congress has appropriated for national defense some seven thousand millions of dollars. Will you kindly put in the record a statement showing how the Army has shared in that vast sum?

Secretary STIMSON. If you will give me the time to have it prepared.

Mr. KNUTSON. Yes; you will have time to prepare the statement for the record, before it is printed. I would appreciate that very much.

Secretary STIMSON. Is that all, gentlemen?

The CHAIRMAN. Yes; Mr. Secretary; we thank you, for your very splendid statement.

Secretary STIMSON. Thank you.

## STATEMENT OF LEWIS COMPTON, ASSISTANT SECRETARY OF THE NAVY

The CHAIRMAN. The next witness on the calendar is Hon. Lewis Compton, Assistant Secretary of the Navy. We will be glad to hear you, Mr. Compton.

Mr. COMPTON. Mr. Chairman and gentlemen of the committee, and gentlemen of the Senate Committee on Finance, I want to explain first that I am here representing Colonel Knox, the Secretary of the Navy, who presents his compliments to you, Mr. Chairman and to the members of the committee of the House and of the Senate and sends his sincere regrets at his inability personally to appear before you this morning to express his views and those of the Navy Department on this important subject.

Colonel Knox has been unavoidably detained in Chicago and it is impossible for him to be here, therefore, I am here to represent him.

The statement which I have prepared is one which I have read to the Secretary of the Navy this morning over the telephone and I have his authority to say that I am expressing his views in the expression of opinion contained in this statement. If you will bear with me, I will stick closely to my notes in order that I may present to you the views of the Navy Department and of the Secretary.

The early enactment of excess-profits tax legislation now being considered by your committee is of paramount importance to the Navy in the speedy and orderly execution of the tremendous task now confronting the Department. Although the Navy Department wholeheartedly subscribes to the principle of profit-limitation legislation, we have felt for some time that the present method of attaining this worth-while objective was wrong. In the first place, the profit-limiting features of the Vinson-Trammell Act and amendments thereto have been and are discriminatory in that they only affect purchases made by the Navy Department, with the exception of aircraft, which, under the Army Aircraft Procurement Act, is also subjected to a similar method of profit limitation. This, of course, places the Navy in a very unfavorable buying position when compared with domestic and foreign business and nonmilitary departments and when compared with the Army, except in the case of aircraft.

After 6 years of experience operating under the profit-limiting clause of the Vinson-Trammell Act, the Navy has found that competition has been restricted. We have also found that administrative difficulties caused considerable delay and some expense due to the rather

cumbersome administrative procedures necessary in the enforcement of the present act. The Navy has experienced considerable difficulty in gaining and retaining the interest of smaller business and manufacturing concerns in bidding on the Navy's requirements. These smaller concerns do not have and cannot afford the legal and accounting staffs necessary to insure compliance with the law and the administrative regulations. Our prime contractors have also experienced considerable difficulty in spreading some of the Navy's business to small subcontractors for this same reason.

The recent enactment by Congress of a measure which raised the limit of exemption to $25,000 from $10,000 has helped the situation somewhat, although it has not cured it.

In many of the industrial concerns with whom the Navy has been doing business difficulty has also been experienced in segregating the Navy's business on which the profit is limited from the normal commercial business of the concern.

May I cite one or two concrete examples of the effect that the present profit-limiting clause in the Vinson-Trammel Act is having upon current Navy business. A contract has recently been under negotiation and practically consummated with a firm to manufacture $10,000,000 worth of 5-inch naval guns needed for 6 of our naval vessels now under construction. Six subcontractors were involved in supplying to the prime contractor gears, castings, and so forth, for these guns. These subcontractors absolutely refused to accept the business on the 8-percent basis now invoked insofar as shipbuilding and ordnance is concerned. There is another case of an aircraft firm who bid on the 12-percent profit basis and before the award was made, the legal profit was reduced to 8 percent. The result was that the subcontractors refused the business on the basis that it was not attractive to them under those conditions. This was a case where the rules of the game were changed while the game was in progress.

That is an example of the condition mentioned by Secretary Stimson in his remarks.

For the above reasons the Navy Department feels that the best interests of the national defense would be by repeal rather than a suspension of the present profit-limiting clause of the Vinson-Trammell Act and by the recapture of excess profits through the medium of taxation.

The Navy Department is also very vitally interested in the clause in the tax bill under consideration which definitely stipulates in advance the amortization period which will be allowed for depreciation of plant and facilities. Industry and business must know the rules of the game before the game is played rather than when the game is over. The inability of the manufacturers to predetermine the rate of depreciation presents a very serious problem to the Navy Department particularly in respect to our aircraft program.

May I state here that the same serious situation exists in the Navy Department in connection with our aircraft program as was so ably presented by the Secretary of War.

I might cite as an example, one firm increased its production capacity from 100 motors per month to 700 per month by plant and facility expansion financed through loans and foreign orders. It is now called upon by the Navy to develop a 1,400-motors-per-month production. To accomplish this it would need about $18,000,000. This firm on top of its existing expansion does not feel justified in

undertaking this large expenditure without knowing in advance the rate of amortization for tax purposes that it will be permitted to use. There is another case now pending where a firm is called upon to provide 60,000 tons of special-treatment steel, sometimes known as class B armor. In order to meet this added production of 60,000 tons it is necessary for this firm to construct a new plant. For the past month this plant has been delayed because the manufacturer is unwilling to proceed until he definitely knows what rate of amortization can be applied.

The Navy has under contract approximately $1,250,000,000, involving ships, ordnance, aircraft, and public works. It has only been possible to do this volume of business under the existing law, because of the fact that industry in some instances has been willing, to the limit of its economic ability, to finance its own plant expansion and take a chance on what amortization will be allowed.

In some instances, it has been necessary for the Navy to finance plant expansion on a 100-percent basis. In these instances, of course, the Government owns the plant and facilities so financed.

The splendid cooperation of the Treasury Department and the Advisory Commission to the Council of National Defense has contributed materially to the early placement of these contracts.

In view of the fact that some contractors have been willing to proceed with the acquisition of the additional facilities without delaying until the question of amortization of such facilities has been settled by the enactment of the necessary legislation, the Navy Department feels that ordinary fairness indicates that the law should be so worded that existing contracts be covered under the provisions of the new law. It is the considered opinion of the Navy Department that no single act would be more beneficial in expediting our program than the clarification of the present situation through the early enactment of an excess-profits tax.

Mr. BOEHNE. Do I understand that the last few words of your statement mean that existing contracts should be covered under the new amortization schedule provided for in the proposed legislation?

Mr. COMPTON. Yes, sir. In other words, some industries have gone ahead, financing their own plant expansion and acquisition of additional facilities and have put up their own money under the present law and present regulations. They have been willing to take a chance on just what the rate of amortization allowed will be.

The contention of the Navy Department is that if this new law fixes a more favorable rate of amortization then it ought to be applicable to those cases where industry has been willing to gamble and to put up their own money. It seems to me that is the only fair thing to do.

Mr. BOEHNE. However, the report of the subcommittee proposed that this not be done further back than July 10, 1940.

Mr. COMPTON. I did not know that.

Mr. BOEHNE. Do you propose, even though new buildings have been built and equipment placed therein before that, that that should be covered under the schedule proposed?

Mr. COMPTON. If that can be done without seriously impairing the tax features of the bill. I merely suggest this because it seems to me the fair thing to do, if it can be done consistently with the revenue features of the act.

Mr. BOEHNE. Would you venture to figure how far back you would go?

Mr. COMPTON. It seems to me it only ought to cover those plants and those firms who have actually put up their own money for plant expansion that they did not need for their own commercial activities, but constructed specifically to assist in national defense.

The earliest one I recall—and I will have to correct this figure if it is not correct—was about 2 years ago when the steel industry built some plant facilities, putting up about six or seven million dollars of their own money to accommodate our requirements for heavy armor, which is not a commercial product.

Mr. BOEHNE. I believe I can speak for the subcommittee to this extent, that this is a program based on the President's message which was addressed to the Congress on July 10, and that that was the reason that date was put in there.

Mr. COMPTON. Of course, it may not have been generally known that this condition existed—that some industries have already put up some money of their own to finance plants and facilities expansions specifically to meet the needs of national defense.

Mr. MCCORMACK. Following the line of questions asked by Mr. Boehne, are there some companies that have, since January 1, expanded their plants, or made contracts for Navy planes, as the result of negotiations with the Navy Department, which the Navy Department believes are essential in relation to the national defense program?

Mr. COMPTON. Yes; there are many of them. I can give you a complete list of those, with the amounts.

Mr. MCCORMACK. Can you give us a list of those, where that has occurred since January 1 of this year?

Mr. COMPTON. Yes; but there are some that go back prior to January 1.

Mr. MCCORMACK. The difficulty is that whatever date you put in is more or less of an arbitrary date, and there are always some cases that have occurred prior to that date.

Mr. COMPTON. We could give you such a list.

(The statement above referred to is as follows:)

STATEMENT INDICATING THE PLANT EXPANSION AND FACILITY ADDITIONS WHICH HAVE BEEN FINANCED BY PRIVATE CAPITAL UPON THE SOLICITATION OF THE NAVY DEPARTMENT, IN ORDER THAT PRIVATE MANUFACTURING AND SHIPBUILDING CONCERNS COULD MEET THE NAVY'S REQUIREMENTS

SHIPS

As of August 9, the following table indicates the amount of plant expansion made by private shipbuilders on solicitation of the Navy Department for the periods shown. These were occasioned by the contracts for BB57, 58, and 59. The costs were included in the cost of the respective ships.

| | New York Shipbuilding Corporation BB57 | Newport News Shipbuilding & Dry Dock Corporation BB58 | Bethlehem Steel Co. Shipbuilding Division BB59 | Total |
|---|---|---|---|---|
| Dec. 15, 1938, to Sept. 1, 1939 | $556,541 | $508,023 | $1,064,447 | $2,429,014 |
| Sept. 1, 1939, to Dec. 31, 1939 | 453,952 | 361,661 | 365,688 | 1,191,301 |
| Jan. 1, 1940, to July 10, 1940 | 253,719 | 30,106 | [1] 74,836 | 360,651 |
| July 10, 1940, to date | None | None | None | |
| Total | 1,576,213 | 899,790 | 1,504,961 | 3,980,966 |

[1] To Mar. 30, 1940.

In the event of repeal of the Vinson-Trammell Act, consideration should also be given to the following item representing additional facilities to be paid for by the contractors and to which the contractor will retain title. These are in connection with the 11-percent program, contracts for which were let July 1, 1940, and July 3, 1940.

| | |
|---|---|
| Bath Iron Works Corporation | $203, 671 |
| Newport News Shipbuilding & Drydock Co | 200, 000 |
| Electric Boat Co | 27, 000 |
| Federal Shipbuilding Co | 227, 250 |
| Total | 657, 921 |

In addition to the above, facilities in the amounts shown below will be required for the companies indicated on account of the vessels of the 11-percent increase program awarded on July 1, 1940, and July 3, 1940. The contractors have indicated that they desire the Government to pay 100 percent of the cost.

| | |
|---|---|
| New York Shipbuilding Corporation | $3, 000, 000 |
| Bath Iron Works Corporation | 1, 500, 000 |
| Bethlehem Steel Co.: | |
| Quincy Plant | 3, 400, 000 |
| Staten Island Plant | 1, 250, 000 |
| Union Iron Works | 1, 450, 000 |
| Electric Boat Co | 1, 500, 000 |
| Federal Shipbuilding Co | 2, 000, 000 |
| Newport News Shipbuilding & Drydock Co | 6, 000, 000 |
| Total | 20, 100, 000 |

ORDNANCE MATERIAL

The following table gives a list of private manufacturing concerns that within the past 2 years have, at the earnest solicitation of the Bureau of Ordnance in order to meet urgent requirements for ordnance material, substantially expanded their plant facilities with private capital. With regard to these expansions it is pointed out that in at least three cases the plant capacity was increased by at least 75 percent. Inasmuch as a considerable part of this expansion was for the purpose of armor production which is limited to Government purchase, and the rest was to meet Government requirements for national defense along other lines, since no prospective demand from trade called for the increased facilities, it appears that means for reasonable amortization of these facilities should be provided.

| Company | Nature of expansion | Expansion initiated | Cost of expansion |
|---|---|---|---|
| | ARMOR FACILITIES | | |
| Midvale Steel Co | New machine equipment | Dec. 1, 1938 | $300, 000 |
| Do | New equipment, furnaces, and facilities. | Feb. 21, 1939 | 875, 000 |
| Carnegie-Illinois Steel Corporation | New machine equipment, enlargement of furnaces, extension of building. | do | 1, 225, 000 |
| Bethlehem Steel Co | Enlargement of furnaces, rearrangement of facilities. | do | 700, 000 |
| | FIRE CONTROL FACILITIES | | |
| Bausch & Lomb | New range finder test tower | Mar. 1, 1939 | 67, 571 |
| Do | New assembly building, tools, and equipment. | Sept. 1, 1939 | 58, 353 |
| | | During calendar year 1939. | 612, 429 |
| General Electric Co. (Schenectady Plant) | New building and tools | Sept. 1, 1939 | 1, 200, 000 |
| Spencer Lens Co | do | do | 291, 000 |
| | ARMOR FACILITIES | | |
| Midvale Steel Co | Extension of building, erection of press | Nov. 24, 1939 | 725, 000 |
| | FIRE CONTROL FACILITIES | | |
| Ford Instrument Co | Extension of building and new equipment. | Dec. 1, 1939 | 900, 000 |
| General Electric Co. (Erie Plant) | New equipment | do | 200, 000 |
| Bausch & Lomb | Tools and equipment | Jan. 1, 1940 | 274, 293 |
| Arma Corporation | do | Apr. 1, 1940 | 700, 000 |
| Total | | | 8, 028, 646 |

AIRCRAFT

The matter of plant expansions in the aircraft industry is extremely complex and involves considerations of foreign orders and Army orders as well as Navy requirements. In the past 18 months, a number of plant expansions have been carried through, but these have, in general, been made to meet the requirements of foreigh orders and have been financed out of payments made by foreign purchasers.

So far as relates to plant expansions and facility additions which have been financed by private capital upon solicitation of the Navy Department, there are only a few cases that are of such size as to warrant mention, and in some of these the expansion has not come about solely through Navy Department solicitation. Various other factors are known to have played their part in influencing the contractors to arrange for expanded facilities.

LIST OF KNOWN PRIVATELY FINANCED PLANT EXPANSIONS

Edo Aircraft Corporation (in July 1940): Entirely to take care of Navy work.

Grumman Aircraft Engineering Corporation (in December 1939): Largely on account of Navy work.

Curtiss Propeller Division: Not believed to be mainly due to Navy work. Expansion of the facilities of this concern has taken place within the last 12 months.

Brewster Aeronautical Corporation: Within the last 3 months and probably partly due to Navy work.

Eclipse Aviation: Within the last 6 months and probably partly due to Navy work.

Walter Kidde & Co., Inc.: Expansion started about May 1940 and due mainly to Navy work.

Mr. McCORMACK. The thought in my mind was that in most of those cases the Treasury Department has pretty broad powers to determine what is reasonable depreciation, and while I recognize that they probably would not want to go to 20 percent in statutory legislation, I make the suggestion that in the case of companies as to which it can be definitely shown that a company made such an expansion of its plant or facilities, prior to July 10, in connection with national defense, and they get the necessary certificate from the proper governmental agency, the Treasury Department, through the Internal Revenue Bureau might well consider that with relation to such deductions with reference to reasonable depreciation, or with reference to expanded plant facilities that might be larger than ordinarily would be allowed under normal conditions. That might, in a sense, be a way to meet your problem.

Mr. COMPTON. That might very well be, and I do not doubt that they would receive fair treatment at the hands of the Treasury.

Mr. BOEHNE. I want to read into the record a statement that is found on page 2 of the report of the subcommittee on proposed excess-profits taxation, as follows:

> Such facilities are land, buildings, machinery, and equipment, or parts thereof, constructed, reconstructed, erected, installed or acquired after July 10, 1940—

and so on.

That is a part of the report.

Mr. TREADWAY. Mr. Secretary, would you mind reading again the last paragraph of your statement, having to do with excess profits?

Mr. COMPTON. My closing sentence was:

> It is the considered opinion of the Navy Department that no single act would be more beneficial in expediting our program than the clarification of the present situation through the early enactment of an excess-profits tax.

Mr. TREADWAY. I assume, then, that the attitude of the Navy Department is that the amortization feature and the proposed suspension

of the Vinson-Trammell Act should not be separated from the excess-profits tax?

Mr. COMPTON. That is a matter of legislative policy, I think, Mr. Treadway. I have not any opinion on that.

Mr. TREADWAY. We are going to be charged with the enactment of the legislation, so I think it is fair to have an expression of opinion as to whether or not the three should be in unison.

Mr. COMPTON. I can only say this in answer to that question: The Navy Department, as a matter of policy, subscribes wholeheartedly to the absolute necessity of profit limitation. If you enact a law which repeals profit limitation and do not replace that with some other medium, then the field is wide open, and from that standpoint, perhaps, it is well that they may be considered together.

Senator KING. I would like to ask whether those with whom your department has had contacts with respect to contracts had any objection to the excess-profits tax, or were they rather concerned in determining what the amortization should be. They would prefer to know just what the amortization rather than the excess-profits tax would be, would they not?

Mr. COMPTON. It is my considered opinion, from my contacts with industry, that they accept as sound national policy a profit limitation, but it is necessary for them to know in advance what the rules of the game are before the game is played.

Senator KING. Their principal concern is with respect to amortization.

Mr. COMPTON. Yes, sir.

Mr. JENKINS. I do not understand that your department, in connection with any of these contracts let before July 10, gave anybody any assurance that they would have any benefit by reason of this legislation.

Mr. COMPTON. No, sir; all of those contracts were let before the legislation was considered, and there were no commitments.

Mr. DISNEY. Are there any instances, Mr. Compton, where firms entered into contracts with the Navy Department prior to July 10, where it would be an injustice to permit amortization on contracts entered into since July 10 and not consider it in connection with contracts entered into prior to July 10?

Mr. COMPTON. There might be some injustices if the proposed law permitted a more favorable amortization for contracts entered into subsequent to July 10. It might be unfair to the men who took a chance under the old law. They have put up their money and built their plants and were willing to take that chance, upon the request of the Navy Department that they do it so we could get along with our program. It seems to me that the proposed new law puts in a more favorable position the people who entered into contracts and put up plants subsequent to July 10. We ought to consider spreading those benefits to the people who have taken the chance and put up their money to help the defense program during its earlier stages.

Mr. DISNEY. I think those details will be of interest to the committee, and that they ought to be furnished to us.

Senator GERRY. Mr. Secretary, have you not in mind that in the future it would be beneficial to the Navy to have acted in the way proposed? In other words, when you had a contract that was entered into after July 10, and the contractor was given that advantage,

would it not be fair to give the same advantage to a contractor who enters into such a contract before July 10, and then in the future the Navy could say that they have always treated everybody fairly?

Mr. COMPTON. That would be desirable only if it does not affect the tax features of the bill with which I am not familiar.

Senator GERRY. Certainly; that would be for you to pass on.

Senator BROWN. Mr. Secretary, you have spoken in your statement about the Vinson-Trammel Act and the limitation upon profits contained in it, and said there was not a similar limitation in regard to other divisions of the Government. It seems to me there is some sound reason for that discrimination.

When you enter into a contract for building a $70,000,000 battleship, it is well known that that contract will be carried out. When the War Department enters into a contract for the construction of a thousand airplanes at a price of $10,000, $15,000, or $50,000 per plane, that contract may be canceled. Such contracts are usually subject to cancelation.

Therefore it seems to me that in the matter of limitation, the limitation is sound in one case but not in the other. I submit that for your consideration.

Mr. COMPTON. Of course, ship contracts have been canceled in the past.

Senator BROWN. It is not very likely that a $70,000,000 contract will be canceled, like a lot of these smaller contracts are.

Mr. COMPTON. They were at one time.

Senator BROWN. I may say in that respect that that problem is not settled by this legislation before us. As to many of those instances of which Senator Gerry speaks, I, as a member of the Claims Committee of the Senate have some knowledge. We have any number of claims based on that situation, asking for compensation on account of cancelation.

It seems to me the situation is one where you cannot lay down a general rule.

For instance, I note in the report of the subcommittee that a 5-year's amortization period is recommended. It seems to me that perhaps there ought to be a little more flexiblity than that. It may be that this demand for a lot of war material will cease in 2 years, and that therefore you would have a very unfair situation.

Mr. COOPER. Will the Senator yield?

Senator BROWN. Certainly.

Mr. COOPER. I think upon a more detailed analysis of the report you will find that this situation is taken care of.

Senator BROWN. I am very glad to hear that.

Senator KING. Your theory is that the question of morality should be considered when questions arise as to compensation, and that you should not depend exclusively upon a technical, legal construction?

Mr. COMPTON. You have expressed it very well.

Senator GERRY. In order to clarify what I had in mind, let me say this. My question led to the point that where the Navy Department had been able to obtain contracts that they considered beneficial to the Department, and then when subsequent legislation was enacted that was beneficial to the contractor who had not been required to take the same risks which the Department had asked the other con-

tractors to take, that that was a bad precedent to establish for the future?

Mr. COMPTON. Yes, it is.

Senator GERRY. That is what I had in mind, and I think that is what you had in mind.

Mr. COMPTON. Yes, sir; it is.

Mr. MCCORMACK. Your testimony has been very interesting, and I am sure will be very carefully studied and considered by members of both committees. Of course, we realize that any date fixed is more or less arbitrary.

Assuming that the committee should go back to last January 1, or last September, would that help the situation, so far as amortization is concerned?

Mr. COMPTON. It would help on everything except the armor contracts, which were let prior to the advent of the emergency in September. It seems to me if we go back at all we should take in all of them rather than part of them—include the whole situation, or leave it, to be settled at the end of the contract.

Mr. MCCORMACK. I am not saying that I am in disagreement with your view, but assuming that what you would like to see accomplished could not be accomplished, but that some date in between could be agreed upon, the further back we could go the more equitable you think it would be, and the better, from the standpoint of the Navy Department in contacts with those with whom they have negotiated contracts in the past.

Mr. COMPTON. Yes, sir.

Mr. MCCORMACK. And it will have a future effect.

Mr. COMPTON. Yes, sir. I would like to say that everything I have said on this subject is predicated entirely on the proposition that nothing be done that would impair in any way the tax features of the bill. The Navy Department would not want anything done that would impair that in any way.

Mr. TREADWAY. Did I understand you to say, in answer to Mr. McCormack, that aside from the armor-plate contract, which is of about 2 years' duration, you think the date of the first of last January would care for most of the contracts of the Navy?

Mr. COMPTON. Probably about 75 percent of them. But that is a guess. My detailed statement which I will file with the committee will show that more definitely.

Mr. TREADWAY. How much, in dollars and cents, would it run into that would be left out if you went back to that date?

Mr. COMPTON. I would rather not give you a curbstone opinion on that. I would like to submit a complete statement showing what the contracts are and the amounts involved in them, and the dates. I do not have the figures offhand.

Mr. TREADWAY. If that has not been already requested, I think it would be very desirable to have it.

Mr. COMPTON. That has been asked for, and I am prepared to submit it.

Mr. TREADWAY. In other words, unless we do go back to an earlier date than was agreed upon, July 10, those contractors who have shown a disposition to aid the Navy in accepting contracts would be more or less penalized, would they not?

Mr. COMPTON. That is the point exactly.

Mr. KNUTSON. Mr. Secretary, from some letters that Members have received recently there is an impression that Congress has been "niggardly" in the matter of national defense, or that it is largely responsible for our unpreparedness.

It may be well to have the record show that in the last 7 years we have appropriated an amount equal to $18 for every minute since the dawn of the Christian era for national defense. I would like to have you submit for the record a statement showing how the Navy's part of this huge appropriation has been spent, how much for airplanes, how much for battleships, how much for maintenance, and so forth.

Mr. COMPTON. I will be very happy to submit such a statement, and I will give it to you in detail.

Mr. KNUTSON. For the last 7 years.

Mr. COMPTON. Yes, sir.

(The statement above referred to is as follows:)

*Statement of the expenditures made by the Navy during the past 7 years, for each year, subdivided into normal operating costs and replacement of naval vessels*

| Year | Replacement of naval vessels, including allocation of emergency funds | Other capital expenditures including allocation of emergency funds | Maintenance and operation, including allocation of emergency funds | Total expenditures |
|---|---|---|---|---|
| 1933 | $18,231,178 | $36,657,258 | $257,237,940 | $342,176,417 |
| 1934 | 66,730,537 | 23,823,242 | 213,063,324 | 303,632,404 |
| 1935 | 132,312,739 | 24,975,302 | 291,316,628 | 448,604,669 |
| 1936 | 182,679,054 | 23,564,089 | 312,332,077 | 518,625,222 |
| 1937 | 181,522,074 | 27,168,145 | 330,340,790 | 539,030,790 |
| 1938 | 191,083,298 | 34,708,847 | 362,091,345 | 587,945,491 |
| 1939 | 226,709,305 | 58,630,926 | 374,865,881 | 660,206,184 |
| 1940 [1] | 325,839,934 | 98,704,530 | 457,907,310 | [1] 882,451,764 |

[1] Estimated. These figures are as of June 29, 1940. Delayed charges will increase figures by an estimated $4,200,000.

The following data indicate the amount of contracts awarded and obligations incurred, chargeable to 1941 appropriations:

| | To June 30, 1940 | July 1940 | Total, July 31, 1940 |
|---|---|---|---|
| Gun forgings, projectiles, armor, and other ordnance materials | $5,696,123.78 | $1,375,402.94 | $7,271,526.72 |
| Public-works construction, engineering, and architectural services | 176,432,962.00 | 34,908,259.00 | 211,341,221.00 |
| Airplanes, engines, and accessories thereto | 13,356,730.00 | 29,127,604.12 | 42,484,334.12 |
| Auxiliary vessels, patrol, district, and yard craft, and equipment for vessels | 3,945,962.29 | 21,556,205.22 | 25,502,167.51 |
| Construction of combatant vessels at privately owned shipyards and propulsion machinery | 73,749,287.00 | 600,605,821.00 | 674,355,108.00 |
| Construction of vessels at navy yards | 274,977,000.00 | 2,060,000.00 | 277,037,000.00 |
| Miscellaneous supplies, equipment, etc | 1,054,289.90 | 3,040,100.51 | 4,094,390.41 |
| U. S. Marine Corps | 2,328,499.53 | 92,186.98 | 2,420,686.48 |
| Total | 551,740,854.50 | 692,765,579.74 | 1,244,506,434.24 |

The CHAIRMAN. Has all of the amount appropriated been expended?

Mr. COMPTON. No. Congress has been very generous to the Navy. We are obligating the funds made available as rapidly as we possibly can, consistent, of course, with sound judgment.

Mr. BOEHNE. I suggest you might also show how much money has been expended since 1921 for national defense.

Mr. KNUTSON. But the gentleman must realize that we were then operating under an international agreement among five or six big powers, and I well remember how the Democrats criticized us for spending so much.

The CHAIRMAN. The Chair hoped that this hearing would be entirely immune from any political controversy. The deliberations of the subcommittee were entirely free from partisanship. There was no intimation of partisanship in the deliberations of the subcommittee, and the Chair expresses the hope that we shall confine our discussion during these hearings to the particular matter we have for consideration.

Mr. CARLSON. Mr. Chairman, I would like to ask some questions.

Mr. Secretary, are you doing construction work on a cost-plus basis at the present time, similar to the type you used in the prior war?

Mr. COMPTON. Definitely not. In fact, I doubt if the Department has authority in law to do so. All of the contracts are on the basis of negotiation and a fixed fee. Under the old cost-plus-percentage form of contract, the more the cost, the more the percentage of profit. Under the present type of contract, where the fee is fixed, the emphasis is the reverse of that. In other words, the sooner and the cheaper the contractor completes the job, the more his fee represents compensation to him for his efforts.

Mr. CARLSON. Do you have charge of the construction of all barracks at Navy posts?

Mr. COMPTON. The Bureau of Yards and Docks of the Navy Department has direct charge of all public works or construction of this character.

Mr. CARLSON. Does that come under you?

Mr. COMPTON. It comes under the general direction of the Secretary's office.

Mr. CARLSON. Did you not let a contract last week of approximately $2,000,000 for the construction of a barracks at Annapolis, based on a cost-plus basis?

Mr. COMPTON. No; that is not a cost-plus-a-percentage-of-profit contract; that is cost-plus-a-fixed-fee contract, and the fee is fixed definitely in advance.

Mr. CARLSON. That is a very interesting thought, because I want to develop that a little. I want to know how far you are going in this particular contract on a cost-plus basis. The article I read said "cost plus," and I associated that with the type of contract used in the World War.

Mr. COMPTON. No, sir; we have avoided the World War type of contract entirely, and the Bureau of Yards and Docks can give you the complete details concerning contracts so awarded.

Mr. CARLSON. I would like to have all the details on that. How do you determine the fee in a case like that?

Mr. COMPTON. The law puts a ceiling on the fee of 6 percent. To my best knowledge, however, as to the contracts that have been negotiated up to the present time by the Bureau of Yards and Docks, the fees are something under 6 percent—4 percent, or 5 percent, or five and a half. The fees have varied of course, but all are under the legal limit.

Mr. CARLSON. Is that 6 percent of the gross expenditures?

Mr. COMPTON. No, sir; it is not a percentage of the cost; it is a fixed fee which cannot exceed 6 percent of the estimated cost less the fee.

Mr. CARLSON. How generally are you using that form of contract?

Mr. COMPTON. Quite generally in connection with ships and public works.

Mr. CARLSON. In other words, the contractor comes in and you agree on the cost of this particular project, or ship, and enter into an agreement that he is to construct it on a cost-plus basis?

Mr. COMPTON. No; he is to construct the project on a fixed-fee basis. His fee is predetermined; it is not a percentage of the cost of the job. On the old wartime form of contract, which was cost plus a percentage, the emphasis or tendency there might be, for the contractor, to make the job cost more to increase his percentage of profit. Under this form of contract, with the fee fixed, no matter how long the job takes or how much it costs, he gets a predetermined fixed fee and he cannot get more.

Mr. CARLSON. I would like to know how you arrive at that fixed fee.

Mr. COMPTON. That is negotiated; it is a matter of negotiation between the Bureau and the contractor concerned.

Senator KING. Is that fee and cost predetermined before the contract is entered into?

Mr. COMPTON. The cost of the contract is predetermined by estimate as accurately as possible. The law requires that the fee be predetermined prior to the execution of the contract.

Senator KING. It is a matter of predetermination?

Mr. COMPTON. Yes.

Mr. CARLSON. I just want to develop some points I had on that. The subcontractors write to me that is unfair to them, that it is gradually going into the World War cost-plus contract program.

Mr. COMPTON. No, sir; definitely not.

Mr. CARLSON. And I want to be positive we are not going into that. Another thing: The subcommittee has recommended to this full committee that we suspend the Vinson-Trammell Act. Of course, that act was passed in 1932 when we thought conditions were normal and there was a reason for placing a limit on the contractors' profits. If we remove that, I think the country and the citizens are entitled to have some assurance that we do not get into a repetition of excessive profits.

Mr. COMPTON. As I understand it, the excess-profits tax will take care of that.

Mr. CARLSON. I would like you to submit to the committee the amount of contracts you are constructing on a cost-plus-fixed-fee basis.

The CHAIRMAN. To be incorporated in the record?

Mr. COMPTON. Yes, sir.

*The amount of money involved under the headings of ships, propulsion machinery, ordnance, aircraft, and public works awarded on a negotiated price basis*

| | Number of ships | Total price |
|---|---|---|
| New ship construction | 69 | $591,911,808 |
| Acquisition and conversion of ships | 15 | 8,634,001 |
| Propulsion machinery, ships | 27 | 19,033,371 |
| Miscellaneous machinery and equipment, ships | 4 | 79,232 |
| Total | | 619,660,412 |
| ORDNANCE MATERIAL | | |
| Contract July 10, 1940 [1] | | 458,458 |
| PUBLIC WORKS | | |
| Under authorized acts | | 260,000,000 |
| Second Supplemental National Defense Act now being considered by the Congress | | 50,000,000 |
| AIRCRAFT | | |
| The money value of contracts already let on a negotiated basis is very small. For the future, the amount will probably be large, and will include some contracts let on a cost plus a fixed fee basis. | | |

[1] Negotiation of contracts for ordnance material totaling approximately $30,000,000 is now in process but contracts have not yet been signed.

Senator LODGE. Mr. Secretary, has the Navy purchased any commercial vessels lately?

Mr. COMPTON. Yes.

Senator LODGE. What were they?

Mr. COMPTON. They are mostly trawlers to be converted into mine sweepers, mine layers, net tenders, and vessels of a noncombatant type such as tankers and transports.

Senator LODGE. The Navy did not purchase any passenger steamers?

Mr. COMPTON. We purchased some of those, too.

Senator LODGE. Why is it necessary to purchase an article like that which is readily available in case of an emergency?

Mr. COMPTON. Because a considerable amount of time has to be spent in the conversion of these ships. We can convert them quicker than we can build them, and do it cheaper. We have to have them.

Senator LODGE. How long would it take to convert a passenger liner into a troop carrier? Is not that what they are to be used for?

Mr. COMPTON. Admiral Robinson, Chief of the Bureau of Ships, is here with me this morning, and he can give you a more accurate estimate on the time to convert a passenger liner into a troop transport. I do not know.

Senator LODGE. Was not that done very rapidly during the World War?

Mr. COMPTON. I was not connected with the building of transports then; I was just on one. I do not know.

Senator LODGE. I think a great many people have a feeling that this money should be put into articles and equipment that are not readily available, and that things like passenger steamers, boots, shoes, and all kinds of commercial available equipment can be acquired later in an emergency, and I wish you would have a statement prepared as to why it was necessary to acquire these passenger vessels now, when the Navy, of course, could commandeer them or take them over during an emergency. Will you have that done?

Mr. COMPTON. Yes; I will be very glad to, and I will mail it to this committee.

The CHAIRMAN. To be incorporated in the record.

STATEMENT OF THE REASON THE NAVY IS PURCHASING AND CONVERTING COMMERCIAL VESSELS, INCLUDING DISTRICT CRAFT, TRANSPORTS, TANKERS, ETC.

The Navy has bought several merchant vessels for conversion to naval uses and plans to acquire several more in the near future.

While ships so acquired are not as fully satisfactory as those specially built by the Navy, they can be commissioned in a very much shorter time and incidentally at less cost. The reasons for this procedure may briefly be summarized as follows:

(a) The recommissioning of practically all of the old destroyers and submarines has increased the immediate need for auxiliaries, which will be accentuated as the newly authorized ships and airplanes are completed.

(b) The wider dispersion of the United States Fleet and the increase in air and other bases in outlying areas requires increased facilities for servicing these stations and the airplanes based thereon.

(c) The critical international situation renders it imperative that we train, at the earliest practicable date, a proper nucleus of Reserve personnel in the techniques of mine sweeping, mine laying, boom and net defense operations and patrol against hostile submarines and aircraft. For this purpose trawlers, yachts, and other small craft are satisfactory.

(d) Another factor to be considered is that we must have transports immediately available to transport the marines or the Army to critical areas at short notice and to train these troops in embarkation, disembarkation, combat loading and landings.

The following table shows the ships acquired to date and those which it is hoped can be acquired in the near future.

| Type | Number acquired | Number to be acquired in near future | Type | Number acquired | Number to be acquired in near future |
|---|---|---|---|---|---|
| Transports | [1] 6 | 0 | Seagoing tug | 0 | 1 |
| Survey ships | [2] 1 | 0 | Hospital ships | 1 | 0 |
| Oilers | [2] 3 | 2 | Large mine sweepers | 12 | 0 |
| Cargo ships | 0 | 3 | Coastal mine sweepers | | 19 |
| Provision ships | 0 | 1 | Patrol vessels | 4 | 12 |
| Ammunition ships | 0 | 2 | Tugs for nets and booms | 3 | 0 |
| Stores issue ships | 0 | 2 | Gate vessels | 0 | 8 |
| Submarine tenders | 1 | 1 | Coastal mine layers | 1 | 1 |
| Seaplane tenders | 1 | 1 | District patrol vessels | 2 | 0 |

[1] 2 of these were acquired last fiscal year.
[2] Acquired last fiscal year.
[3] These were acquired in 1939.

NOTE.—Depending upon the international situation and the funds available for further acquisition the above list may be augmented during the present fiscal year.

Mr. MCCORMACK. Mr. Secretary, the cost-plus-fixed-fee, of course, was authorized by act of Congress?

Mr. COMPTON. Yes.

Mr. MCCORMACK. And the Department was simply carrying out what Congress told them to do?

Mr. COMPTON. Definitely so. All of our contracts are negotiated within the terms of existing law.

Mr. MCCORMACK. In view of the fact that question has been raised, might I suggest that you incorporate in the record the procedure that is employed by the Navy Department in negotiating with contractors, and the wording of the contract?

Mr. COMPTON. Yes, sir; I will be very glad to do so.

(A) A statement concerning negotiated contracts, including—

1. The law under which we have negotiated contracts for ships, aircraft, public works and ordnance;

2. Procedures being followed by the various bureaus concerned, in following out the provisions of the law.

With reference to item (A) 1 above, section 2 (a) of the act approved June 28, 1940 (Public, No. 671, 76th Cong., 3d sess.), authorizes the negotiation of contracts, during the national emergency declared by the President on September 8, 1939, to exist, "for the acquisition, construction, repair, or alteration of complete naval vessels or aircraft, or any portion thereof, including plans, spare parts, and equipment therefor, that have been or may be authorized, and also for machine tools and other similar equipment with or without advertising or competitive bidding, upon determination that the price is fair and reasonable."

This includes ordnance material.

Negotiation of contracts for public works (Yards and Docks projects) is covered in section 4 (b) of the act of April 25, 1939 (53 Stat. 590–592), and has been repeated in the First Supplemental National Defense Appropriation Act, 1941, approved June 25, 1940 (Public, No. 667, 76th Cong.), and the Naval Appropriation Act approved June 11, 1940 (Public, No. 588, 76th Cong.), page 33, under "Bureau of Yards and Docks, Public Works."

With reference to item (A) 2, in each case after the preliminary negotiations are concluded, the recommendation of the board of naval officers or group of officers within the Bureau conducting such negotiations is submitted to the Chief of the Bureau for his action. The approval of the Secretary of the Navy of each negotiated price is required before the award is made. Records of all such negotiations are being maintained for future reference. There is generally available to the Navy Department, through audits of work undertaken in private and Government plants, cost data for use in arriving at a fair and reasonable price.

With reference to this authority, it is the continued policy of the Navy Department to submit to competition, wherever practicable, prospective construction and procurement schedules. However, in many cases, owing to the necessity of preparing detailed plans and specifications where bids are to be invited, the limited competition possible and the opportunity for securing better prices and terms, it is definitely in the interests of the national defense to negotiate such contracts.

Mr. McCORMACK. I understand the larger ones are initiated here and presented to a board of three contractors, and then there is a policy of decentralization in the case of smaller contracts of $1,000,000 and down, to the local public works boards.

Mr. COMPTON. That is right. The board, however, is composed of naval civil engineers.

Mr. McCORMACK. And the local public works board of the yard in question determines whether to do it by contract or by day labor?

Mr. COMPTON. Yes; that is right.

Mr. McCORMACK. In view of that question being raised, I think it would be a good thing, from the Department's angle, to give the whole procedure so that there can be no possibility of any mystic idea that something strange is being done.

Mr. COMPTON. Thank you. I will take care of that.

The CHAIRMAN. Put it in as part of your remarks.

Mr. COMPTON. Yes, sir.

NAVY DEPARTMENT,
*Washington, August 12, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Ways and Means Committee,*
*House of Representatives, Washington, D. C.*

MY DEAR MR. CHAIRMAN: With reference to my testimony given before your committee on August 9, 1940, the following additional information is furnished as requested:

(A) A STATEMENT CONCERNING NEGOTIATED CONTRACTS—

1. The law under which we have negotiated contracts for ships, aircraft, public works and ordnance.

2. Procedures being followed by the various bureaus concerned, in following out the provisions of the law.

With reference to item (A) 1 above, section 2 (a) of the act approved June 28, 1940 (Public, No. 671, 76th Cong., 3d sess.) authorizes the negotiation of contracts, during the national emergency declared by the President on September 8, 1939 to exist, "for the acquisition, construction, repair or alteration of complete naval vessels or aircraft, or any portion thereof, including plans, spare parts, and equipment therefor, that have been or may be authorized, and also for machine tools and other similar equipment with or without advertising or competitive bidding upon determination that the price is fair and reasonable."

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*3. The amount of money involved under the headings of ships, propulsion machinery, ordnance, aircraft, and public works awarded on a negotiated-price basis*

| | Number of ships | Total price |
|---|---|---|
| New ship construction | 69 | $591,911,508 |
| Acquisition and conversion of ships | 15 | 8,634,001 |
| Propulsion machinery, ships | 27 | 19,035,371 |
| Miscellaneous machinery and equipment, ships | 4 | 79,232 |
| | | 619,660,412 |

ORDNANCE MATERIAL

Contract July 10, 1940, $458,458. Negotiation of contracts for ordnance material totaling approximately $30,000,000 is now in process but contracts have not yet been signed.

PUBLIC WORKS

Under authorized acts, $260,000,000. Second Supplemental National Defense Act now being considered by the Congress, $50,000 000.

AIRCRAFT

The money value of contracts already let on a negotiated basis is very small. For the future, the amount will probably be large, and will include some contracts let on a cost plus a fixed fee basis.

(B) A STATEMENT INDICATING THE PLANT EXPANSION AND FACILITY ADDITIONS WHICH HAVE BEEN FINANCED BY PRIVATE CAPITAL UPON THE SOLICITATION OF THE NAVY DEPARTMENT, IN ORDER THAT PRIVATE MANUFACTURING AND SHIPBUILDING CONCERNS COULD MEET THE NAVY'S REQUIREMENTS

SHIPS

As of August 9, the following table indicates the amount of plant expansion made by private shipbuilders on solicitation of the Navy Department for the periods shown. These were occasioned by the contracts for BB57, 58, and 59. The costs were included in the cost of the respective ships.

| | New York Shipbuilding Corporation, BB57 | Newport News Shipbuilding & Dry Dock Corporation, BB58 | Bethlehem Steel Co. Shipbuilding division, BB59 | Total |
|---|---|---|---|---|
| Dec. 15, 1938-Sept. 1, 1939 | $856,544 | $508,023 | $1,064,447 | $2,429,014 |
| Sept. 1, 1939-Dec. 31, 1939 | 463,952 | 361,661 | 365,688 | 1,191,301 |
| Jan. 1, 1940-July 10, 1940 | 255,719 | 30,106 | [1] 74,826 | 360,651 |
| July 10, 1940-date | None | None | None | ..... |
| Total | 1,576,215 | 899,790 | 1,504,961 | 3,980,966 |

[1] To Mar. 30, 1940.

In the event of repeal of the Vinson-Trammell Act, consideration should also be given to the following item representing additional facilities to be paid for by the contractors and to which the contractor will retain title. These are in connection with the "11-percent program," contracts for which were let July 1, 1940 and July 3, 1940.

| | |
|---|---|
| Bath Iron Works Corporation | $203,671 |
| Newport News Shipbuilding and Dry Dock Co | 200,000 |
| Electric Boat Co | 27,000 |
| Federal Shipbuilding Co | 227,250 |
| Total | 657,921 |

In addition to the above, facilities in the amounts shown below will be required for the companies indicated on account of the vessels of 11-percent-increase program awarded on July 1, 1940, and July 3, 1940. The contractors have indicated that they desire the Government to pay 100 percent of the cost.

| | |
|---|---|
| New York Shipbuilding Corporation | $3,000,000 |
| Bath Iron Works Corporation | 1,500,000 |
| Bethlehem Steel Co.: | |
| Quincy plant | 3,400,000 |
| Staten Island plant | 1,250,000 |
| Union Iron Works | 1,450,000 |
| Electric Boat Co | 1,500,000 |
| Federal Shipbuilding Co | 2,000,000 |
| Newport News Shipbuilding and Dry Dock Co | 6,000,000 |
| Total | 20,100,000 |

ORDNANCE MATERIAL

The following table gives a list of private manufacturing concerns that within the past 2 years have, at the earnest solicitation of the Bureau of Ordnance in order to meet urgent requirements for ordnance material, substantially expanded their plant facilities with private capital. With regard to these expansions it is pointed out that in at least three cases the plant capacity was increased by at least 75 percent. Inasmuch as a considerable part of this expansion was for the purpose of armor production which is limited to Government purchase, and the rest was to meet Government requirements for national defense along other lines, since no prospective demand from trade called for the increased facilities, it appears that means for reasonable amortization of these facilities should be provided.

| Company | Nature of expansion | Expansion initiated | Cost of expansion |
|---|---|---|---|
| Midvale Steel Co | Armor facilities: New machine equipment. | Dec. 1, 1938 | $200,000 |
| Do | Armor facilities: New equipment, furnaces, and facilities. | Feb. 21, 1939 | 875,000 |
| Carnegie-Illinois Steel Corporation | Armor facilities: New machine equipment, enlargement of furnaces, extension of building. | ....do.... | 1,225,000 |
| Bethlehem Steel Co | Armor facilities: Enlargement of furnaces, rearrangement of facilities. | Feb. 21, 1939 | 700,000 |
| Bausch & Lomb | Fire control facilities: New R. F. test tower. | Mar. 1, 1939 | 67,571 |
| Do | Fire control facilities: New assembly building, tools, and equipment. | Sept. 1, 1939<br>During calendar year 1939. | 58,333<br>612,129 |
| General Electric Co. (Schenectady plant). | Fire control facilities: New building and tools. | ....do.... | 1,200,000 |
| Spencer Lens Co | Fire control facilities: New building and tools. | ....do.... | 291,000 |
| Midvale Steel Co | Armor facilities: Extension of building, erection of press. | Nov. 24, 1939 | 725,000 |
| Ford Instrument Co | Fire control facilities: Extension of building and new equipment. | Dec. 1, 1939 | 900,000 |
| General Electric Co. (Erie plant) | Fire control facilities: New equipment | ....do.... | 200,000 |
| Bausch & Lomb | Fire control facilities: Tools and equipment. | Jan. 1, 1940 | 274,293 |
| Arma Corporation | ....do.... | Apr. 1, 1940 | 700,000 |
| Total | | | 8,028,646 |

AIRCRAFT

The matter of plant expansions in the aircraft industry is extremely complex and involves considerations of foreign orders and Army orders as well as Navy requirements. In the past 18 months, a number of plant expansions have been carried through, but these have, in general, been made to meet the requirements of foreign orders and have been financed out of payments made by foreign purchasers.

So far as relates to plant expansions and facility additions which have been financed by private capital upon solicitation of the Navy Department, there are only a few cases that are of such size as to warrant mention, and in some of these the expansion has not come about solely through Navy Department solicitation. Various other factors are known to have played their part in influencing the contractors to arrange for expanded facilities.

LIST OF KNOWN PRIVATELY FINANCED PLANT EXPANSIONS

Edo Aircraft Corporation: In July 1940, entirely to take care of Navy work.

Grumman Aircraft Engineering Corporation: In December 1939, largely on account of Navy work.

Curtiss Propeller Division: Not believed to be mainly due to Navy work. Expansion of the facilities of this concern has taken place within the last 12 months.

Brewster Aeronautical Corporation: Within the last 3 months and probably partly due to Navy work.

Eclipse Aviation: Within the last 6 months and probably partly due to Navy work.

Walter Kidde & Co., Inc.: Expansion started about May 1940, and due mainly to Navy work.

(C) A STATEMENT OF THE REASON THE NAVY IS PURCHASING AND CONVERTING COMMERCIAL VESSELS, INCLUDING DISTRICT CRAFT, TRANSPORTS, TANKERS, ETC.

The Navy has bought several merchant vessels for conversion to naval uses and plans to acquire several more in the near future.

While ships so acquired are not as fully satisfactory as those specially built by the Navy, they can be commissioned in a very much shorter time and incidentally at less cost. The reasons for this procedure may briefly be summarized as follows:

(a) The recommissioning of practically all of the old destroyers and submarines has increased the immediate need for auxiliaries, which will be accentuated as the newly authorized ships and airplanes are completed.

(b) The wider dispersion of the United States fleet and the increase in air and other bases in outlying areas requires increased facilities for servicing these stations and the airplanes based thereon.

(c) The critical international situation renders it imperative that we train, at the earliest practicable date, a proper nucleus of reserve personnel in the techniques of mine sweeping, mine laying, boom and net defense operations and patrol against hostile submarines and aircraft. For this purpose trawlers, yachts, and other small craft are satisfactory.

(d) Another factor to be considered is that we must have transports immediately available to transport the Marines or the Army to critical areas at short notice and to train these troops in embarkation, disembarkation, combat loading, and landings.

The following table shows the ships acquired to date and those which it is hoped can be acquired in the near future.

| Type | Number acquired | Number to be acquired in near future | Type | Number acquired | Number to be acquired in near future |
|---|---|---|---|---|---|
| Transports | [1] 6 | | Seagoing tug | | 1 |
| Survey ships | [2] 1 | | Hospital ships | 1 | |
| Others | [3] 3 | 2 | Large mine sweepers | 12 | |
| Cargo ships | | 3 | Coastal mine sweepers | | 19 |
| Provision ships | | 1 | Patrol vessels | 4 | 12 |
| Ammunition ships | | 2 | Tugs for nets and booms | 3 | |
| Stores issue ships | | 2 | Gate vessels | | 8 |
| Submarine tenders | 1 | 1 | Coastal mine layers | 1 | 1 |
| Seaplane tenders | 1 | 1 | District patrol vessels | 2 | |

[1] 2 of these were acquired last fiscal year.
[2] Acquired last fiscal year.
[3] These were acquired in 1939.

NOTE.—Depending upon the international situation and the funds available for further acquisition the above list may be augmented during the present fiscal year.

(D) *A statement of the expenditures made by the Navy during the past seven years, for each year, sub-divided into normal operating costs and replacement of naval vessels*

| Year | Replacement of naval vessels, including allocation of emergency funds | Other capital expenditures including allocation of emergency funds | Maintenance and operation, including allocation of emergency funds | Total expenditures |
|---|---|---|---|---|
| 1933 | $48, 251, 178 | $36, 687, 296 | $257, 237, 940 | $342, 176, 417 |
| 1934 | 68, 730, 837 | 21, 823, 242 | 213, 085, 324 | 303, 639, 404 |
| 1935 | 132, 312, 749 | 26, 975, 302 | 281, 316, 628 | 440, 604, 660 |
| 1936 | 182, 979, 054 | 23, 564, 089 | 312, 382, 077 | 518, 625, 222 |
| 1937 | 181, 522, 074 | 27, 168, 145 | 330, 340, 700 | 539, 030, 700 |
| 1938 | 191, 093, 298 | 34, 768, 847 | 362, 091, 345 | 587, 945, 491 |
| 1939 | 226, 709, 306 | 58, 630, 996 | 374, 865, 851 | 660, 206, 154 |
| 1940 | [1] 325, 849, 934 | 98, 204, 520 | 457, 907, 310 | [1] 882, 451, 764 |

[1] Estimated.

NOTE.—These figures are as of June 29, 1940. Delayed charges will increase figures by an estimated $4,200,000.

Sincerely yours,

LOUIS COMPTON,
*Acting Secretary of the Navy.*

The CHAIRMAN. Are there any further questions of the Secretary? If not, Mr. Secretary, we thank you for your appearance.

The next witness on the calendar is Hon. William S. Knudsen, chairman of the National Defense Advisory Council, Washington, D. C.

## STATEMENT OF WILLIAM S. KNUDSEN, CHAIRMAN, NATIONAL DEFENSE ADVISORY COMMISSION

Mr. KNUDSEN. I have to apologize to the committee. I have no prepared statement. It is purely due to my ignorance of the procedure. I have no prepared statement to read, but I am quite anxious you should direct any question to me that you would like me to explain. I did not know it was customary to bring a prepared statement, otherwise I should have brought one.

Senator VANDENBERG. We all love your type of ignorance.

Mr. COOPER. Mr. Knudsen, having had the privilege of hearing your brief statement made to the subcommittee when they were considering this matter, I think it would be helpful to the full committees present on this occasion if you would be kind enough to give us about the same information that you very kindly gave to the subcommittee.

Mr. KNUDSEN. You mean with regard to our negotiations?

Mr. COOPER. Yes; with respect to your experience and connection with the contracts and the work you are now carrying on.

Mr. KNUDSEN. Well, the Advisory Commission of which I am a member started to work down here about the 1st of June. We naturally went to the Army and Navy to get a list of the requirements and they were split into two parts at that time—the immediate requirements for which there was legislation pending, and the further requirements which were going to be asked for after the first section had been handled by Congress.

The first section was before Congress and by the end of June or about the 1st of July we were told to go ahead with the money then allowed. Naturally, we knew after the smaller quantity was coming along there would be a larger quantity which had to follow and, in negotiating for the smaller section of it, we tried to impress upon the contractors the necessity of preparing plant expansion for the second section, as it would not seem prudent to start one small one and then start another big one afterward. So, in talking to them, we were able to tell them, pending approval by Congress of the second expenditure, how much plant would be needed.

We immediately ran up against the question of amortization and, being wholly ignorant of the procedure, I consulted the Treasury and was told what could be done. That, of course, under the circumstances, was rather difficult to sell to anybody. The rates had been established over a number of years, but not with any situation like this in mind. And right in the middle of the plane negotiations, as Secretary Stimson stated, the Vinson-Trammell Act rate was cut from 12 to 8 percent, and that created a lot of uneasiness on the part of the manufacturers. I think, in justice to the manufacturers, we should say this, that they have operated on a very small volume during the past 2 or 3 years. There has not been the requirement for airplanes that has suddenly sprung up, and some of their plant expansions have been financed by the Allied Powers and, of course, must be used for that work unless we step in and order differently. So that there was quite a bit of uneasiness in their minds as to how they could proceed and we finally got the principal manufacturers of planes together and agreed tentatively that, pending the passage of this bill, or whatever bill might come up in the future, we would go over to the fixed-fee basis. But we could not give them any assurance on the amortization until,

finally, I was called before the subcommittee and was told what the plans were.

I think I should add something more to Mr. Compton's statement. The subcontractor out in the field who has other business and is offered a $25,000 contract under the Vinson-Trammel Act is naturally hesitant to carry the records which are necessary to prove his profit in that particular line, especially if he has other work for other people who do not require those records. So that, so far as the subcontractors are concerned, the repeal of the Vinson-Trammel Act will clear up that question entirely, and he will not have to worry about the bookkeeping part, which is the most important part; because nobody ever got any money back from them. But the way we are now, since the statement by Mr. Cooper, from the contractors we have talked to, we feel we are going to have fairly clear sailing from now on.

You have, of course, to remember that the appropriation of the larger amount has not passed yet and we are not permitted to contract until the bill is actually signed; but I think our negotiations can proceed in an orderly way so that, when we get the larger appropriation, there will not be the delay there was in the small ones, due to the uncertainty.

And I want to say we have had marvelous cooperation from everyone. I was able to report last night that, of the total amount available in the first bill, 45 percent of the Army appropriations have been placed and 74 percent of the Navy appropriations have been placed; this, of course, being due to the fact that the Navy have larger unit costs and less units, as against the Army. I do not think the manufacturers will hold back; I think, in justice to themselves and their stockholders, they ought to know where they are going and with the provisions of the bill, as I understand them to be, I do not think we will have any trouble.

Senator LODGE. Mr. Knudsen, could you give a guess as to how soon we would actually have the equipment for an army of 750,000 men?

Mr. KNUDSEN. Well, it depends somewhat on what you are talking about. Are you talking about the total?

Senator LODGE. Yes.

Mr. KNUDSEN. Or merely the infantry equipment?

Senator LODGE. No; I mean the artillery, tanks, and everything.

Mr. KNUDSEN. Of course, the tank item, as you probably know, is a slow item. The medium tank had to be redesigned; the design we found here had to be changed in the light of the battle experience in France, and the drawings for the medium tank will be finished about August 26 or 27. Now, the tooling of a job like that will take somewhere around between 8 and 10 months and, after that, we get a tank.

On guns, only the new gun, the last gun, the 105 mm. is behind; the others are pretty well taken care of.

On planes, I do not know how many planes are required for 700,000 men.

Senator LODGE. I saw a statement of yours in the press about a week ago that we would be able to supply an army of 2,000,000 men. Is not that true?

Mr. KNUDSEN. That is the sum total of the two appropriations.

Senator LODGE. Yes; and the question arose in my mind right away—how soon?

Mr. KNUDSEN. Well, it looks to me, Senator, as if the entire amount that we have allotted us in both bills could be handled by the middle of 1944.

Senator LODGE. By the middle of 1944?

Mr. KNUDSEN. Yes; everything.

Senator LODGE. Thank you.

Mr. DINGELL. Mr. Chairman, I would like to ask my distinguished Michigander a question or two and I would like to assure him that, while he is in Washington, if he finds himself in difficulty or in need of a guide, he will find many of his friends right here in Washington to help guide him straight. But, thus far, I do not think Mr. Knudsen has had any difficulty in Washington of getting around and finding his way.

What I am interested in knowing, Mr. Knudsen, is in regard to your attitude on the amortization provisions of the bill. At the outset, when the tax bill was proposed, my interest centered very largely upon a fair and equitable provision being inserted in that bill to provide proper protection by way of amortization to the manufacturers and industrialists who had expanded their facilities in order to make real your program of national defense.

I would like to ask whether you are convinced that the amortization features contained in this bill are ample to fully protect any manufacturers and industrialists in connection with the national-defense program?

Mr. KNUDSEN. In the over-all, yes, I think so. Some small contractor might feel he should have a better rate, but it is impossible to make a rate that fits every situation. I think, by and large, this rate is fair. I have advocated it.

Mr. DINGELL. You have no further suggestion to make for the benefit of the committee at this time, with regard to any amendments?

Mr. KNUDSEN. No, sir.

Mr. DINGELL. Or any amendments at all?

Mr. KNUDSEN. No, sir.

Mr. DINGELL. Well, let me say to you if at any time during the consideration of this bill you should have any suggestion you considered worthy, I am sure the committee would welcome any suggestion.

Mr. KNUDSEN. Thank you very much.

Mr. DINGELL. Let me ask you just this one further question: I am interested in the bottlenecks which I have been reading about. Can you tell me whether the present situation has been affected by the lack of some assurance to the manufacturers, and has it affected the airplane motor contract with any manufacturing concern, particularly Packard Motors? Has the fact we had no amortization provision in the law to date cramped your negotiation with the Packard Motor Car Co.?

Mr. KNUDSEN. No, sir.

Mr. DINGELL. It has not; the Packard contract has not been held up by that at all?

Mr. KNUDSEN. It just takes so long to negotiate a contract and in this case it happened to be a large contract.

Mr. DINGELL. I appreciate that, but I just wondered whether the lack of proper amortization provisions in the present law had anything to do with any delay insofar as the Packard contract was concerned.

Mr. KNUDSEN. It did not happen to be that kind of a contract, sir.

Mr. ROBERTSON. Mr. Knudsen, Congress in effect has declared a national emergency exists and the Congress has appropriated, according to the statement this morning by the Secretary of the Treasury, an aggregate of $14,700,000,000 for national defense, which it is proposed by the Government to expend as rapidly as possible consistent with sound business principles. In the light of that situation, have you heard of any inclination on the part of American businessmen to criticize the theory of an excess-profits tax being levied at this time?

Mr. KNUDSEN. Will you say that again, a little shorter? I beg your pardon, but do I understand you to say you want me to express an opinion as to what American business thinks of the excess-profits tax?

Mr. ROBERTSON. Have you heard any opposition?

Mr. KNUDSEN. No.

Mr. ROBERTSON. From the businessmen, to the imposition, under the circumstances, of an excess-profits tax?

Mr. KNUDSEN. Frankly, I have not been talking to businessmen about the excess-profits tax. I have confined myself to the business at hand, which was the Vinson-Trammell Act and the amortization provisions, which were uppermost in everybody's mind. I am frank to say I have not discussed the tax. In fact, I only got the bill this morning.

Mr. ROBERTSON. Well, as one of the outstanding business leaders of America, do you endorse the theory at this time of an excess-profits tax, in the light of the emergency I have mentioned?

Mr. KNUDSEN. Yes; I think so. It has got to be paid.

Mr. ROBERTSON. That is all.

Mr. KNUDSEN. I would like to add to that, however, that the provisions of the tax bill itself I am not familiar with, but the principle of the tax has to be met; the principle has to be involved when we are making emergency expenditures for national defense.

Senator CLARK. Mr. Knudsen, I would like to ask you whether there is any inherent ineligibility in the States west of the Mississippi and east of the Rocky Mountains as a location for these various munitions plants and other facilities.

Mr. KNUDSEN. No, sir.

Senator CLARK. I ask that question because I understand the contracts let and the placements decided on are something less, for instance, than 1 percent in the 22 States between the Mississippi River and the Rocky Mountains, and it occurs to me if you create by Government, in awarding these contracts, subsidies, and one thing and another, the establishment of these industries, and then couple that with an amortization plan for 5 years, it means a permanent transfer of a great many industries out of the Middle West and the concentration of practically the whole industry of the country on the eastern seaboard and on the Pacific coast, which appears to me to be an extremely bad thing from a national defense standpoint and economic standpoint, or anything else, for the country.

Mr. KNUDSEN. Well, Senator, the plants we are talking about on the Pacific coast and the eastern seaboard have happened to be there.

Senator CLARK. Well, you are locating a good many plants around this country, are you not, like your powder plants, and I understand from the newspaper men that they said the other day one plant was located at Hamilton, Ohio, with the intimation that they were going very far west. Now, of course, anybody who lives in the center of the country, or throughout that section of the country, regards Hamilton, Ohio, as very near East and it does seem to me from a strategic and tactical standpoint, and from every other standpoint, that those placements should be spread around over the country.

Mr. KNUDSEN. Well, sir, I have heard a lot about that the last 2 weeks, or 3 weeks, and I fully subscribe to your idea. A general study was made by the General Staff showing the boundary lines within which these new plants should be located. We have surveyed about half that area. It keeps away from the seaboard about 300 miles all around. Of course, some of the plants are there now, and we cannot tear them down——

Senator CLARK. Nobody wants to tear them down, but I want to advocate, when a lot of new plants are built, that they be spread around. That is what I am talking about.

Mr. KNUDSEN. Let me finish. This is a very large territory to survey.

Mr. MCCORMACK. Speak a little louder. You are getting into a very practical question, now. [Laughter.]

Mr. KNUDSEN. This is a very large territory to survey and about half of the States up to nearly the Mississippi River have been surveyed. The Army and Navy Munitions Board, who are charged with finding the location for these plants, are now at work on west of the Mississippi, but you will realize it will take a lot of time to cover all that territory out there, because there does not seem to be any part of that territory that is unsuited in anybody's mind, regardless of whether there has been any industry there before, or not.

Now, in dealing with the plant question, we start with what is there and try to make it bigger. We had to consider, to a certain extent, the time we have to do this job, but when we have the complete plants to place, where no industry of that sort exists, they will be next.

Senator CLARK. Let me say that nobody wants to interfere with the most expeditious prosecution of this program; nevertheless, there is a large section of the country out there that is going to have to pay the taxes for this program, and that I am sure can take part in this program, and we would like to have it remembered that we are still a part of the United States.

Mr. KNUDSEN. Well, I feel it is quite safe to assure you that we will never forget it. [Laughter.] I am sorry I did not bring the map, but I will send it to you, and show you how far we have gone.

Senator VANDENBERG. I just want to ask this one general question, Mr. Knudsen: If this bill is passed, as I assume it will be, is there anything left which handicaps you in a maximum speed-up for national defense?

Mr. KNUDSEN. I do not know of anything.

Senator KING. Coming to the question Senator Clark developed, may I ask one question: "Has any plan been devised, formulated, or agreed upon that would prohibit the construction of plants which are needed for the national defense in any part of the United States?"

Mr. KNUDSEN. No, sir.

Senator KING. Particularly in the Intermountain region and the Mississippi Valley, to which the Senator referred?

Mr. KNUDSEN. No, sir.

Senator KING. You do not contemplate confining all of your new construction to the Atlantic seaboard or the Pacific seaboard, but you contemplate spreading plants around wherever they will do the most good and where the work can be most speedily accomplished and where the national defense will be promoted?

Mr. KNUDSEN. Yes, sir—where we can find a reasonable amount of skill and maybe some raw material, or a good class of labor. That will be considered in every instance.

Senator CAPPER. Have you any information as to the extent of the movement of labor from the interior part of the United States to the coast States?

Mr. KNUDSEN. I do not think it amounts to much. I do not think it is important. There will be a certain amount due to higher wages.

Mr. TREADWAY. I dislike to bore you with questions that may have been previously asked, but when you appeared before the Ways and Means Subcommittee you made the very definite statement that many contractors were hesitating to close contracts because of not knowing what the law would be.

Mr. KNUDSEN. Yes, sir.

Mr. TREADWAY. Does not that condition still apply?

Mr. KNUDSEN. No, sir; we have had a little better reaction since the statement by Mr. Cooper. We have had a very favorable reaction to that.

Mr. TREADWAY. I understood you to say earlier in your testimony that you were finding better cooperation than you had previously to the last meeting with you a few days ago. Is that correct?

Mr. KNUDSEN. Yes, sir.

Mr. TREADWAY. Would that change your viewpoint at all as to the need for these three big coordinated questions being included in one bill? In other words, going back to the same point of whether we should write an excess-profits tax at a later date, and include the two other propositions in this bill for prompt and speedy action.

Mr. KNUDSEN. I think it would be much better to have the thing over with now, and have it settled.

Mr. TREADWAY. You would prefer, despite the delay that might be incurred in writing the excess-profits tax feature into the bill now, including it with the other two items?

Mr. KNUDSEN. Yes, sir; I think it should be settled.

Mr. TREADWAY. There was some criticism that we were delaying the work of providing for the national defense by endeavoring to include at the same time the excess-profits tax feature with the amortization feature and repeal of the Vinson-Trammell Act, but, as I understand it, you would prefer some slight delay in order to include all three propositions together in the bill at this time.

Mr. KNUDSEN. Yes.

The CHAIRMAN. You realize that frequently those who know least about a subject are loudest in their criticisms.

Mr. MCKEOUGH. I would like to make one observation in connection with Senator Clark's suggestion: As I understood your reply to

the Senator, the Army and Navy are now at work with a view to using available places between the Rocky Mountains and the Alleghany Mountains, and were giving consideration to the Mississippi River Valley, in relation to facilities, sites, labor, and so forth, for the production of necessary material for the national defense, and I trust that the members of the committee, as well as the Army, and the other members of the Advisory Council will bear in mind that Chicago has all of the things necessary for your purposes, manufacturing and transportation facilities, a fine labor market, and a very fine city administration.

Mr. KNUDSEN. Yes, sir.

Mr. WOODRUFF. Mr. Knudsen, I understood you to say a few moments ago, in response to an interrogation, that the present program would be completed by the middle of 1944.

Mr. KNUDSEN. Yes, sir.

Mr. WOODRUFF. Does that contemplate the fullfilment of all the contracts you have in mind which can be carried out with the present appropriations and contract authorizations?

Mr. KNUDSEN. Yes, sir. I will have to think a little bit there, because the question was rather quick, and I was trying to get it in mind, as to what was meant by it—that is, whether it was for 2,000,000 men with maintenance or 2,000,000 men without maintenance. I had in mind the whole program, and if you will permit me, I would rather submit a brief in answer to that question.

Mr. WOODRUFF. Suppose you put in the record a statement showing exactly what the situation is, and how much you expect to accomplish from your present appropriations and contract authorizations.

Mr. KNUDSEN. That, of course, is intended to arm 1,200,000 men with the necessary maintenance and critical noncommercial items for 800,000 more.

Mr. WOODRUFF. Then you expect the whole of the contracts to be closed and finished. You will include in your statement when you expect contracts to be closed and finished.

Mr. KNUDSEN. Yes, sir; I will include that.

Mr. WOODRUFF. Showing when the work will be completed?

Mr. KNUDSEN. Yes, sir.

Mr. WOODRUFF. And, also, include in your brief any further program that you may have, or that your organization may have in mind looking to the necessity of further appropriations or contract authorizations at this time. I ask you to give that information for the reason that we have been given to understand that there will be further requests for appropriations for the national defense and further requests for contract authorizations. In view of the fact that it is your opinion the present program cannot be completed before 1944, it seems to some of us, at least, that we have already appropriated sufficient funds and provided sufficient contract authorizations to last until, at least, the meeting of the next Congress. So if you will put a statement of that in your brief, I will appreciate it.

Mr. KNUDSEN. I will do so.

The CHAIRMAN. The Chair would like to express the hope that Mr. Knudsen will furnish that information as soon as possible so that it may be included in our hearings and will not delay the printing of the hearings.

Mr. KNUDSEN. Yes, sir. I beg your pardon, but I gathered from Mr. Woodruff's question that it was a forecast of a further expansion beyond the amounts in these bills.

Mr. WOODRUFF. Yes.

Mr. KNUDSEN. Of course, that is not within my province. That is up to the General Staff.

Mr. WOODRUFF. I understand that perfectly, but what I am wondering is whether, or not, any information has been given to your Council that would indicate that such further appropriations would be necessary before the meeting of the next Congress, because, certainly, if we are to have other estimates of appropriations and contract authorizations, it seems to me that Congress should have the information on which to base intelligent action.

Mr. KNUDSEN. The next Congress meets in January, does it not?

Mr. WOODRUFF. Yes; it meets in January.

Senator HARRISON. This request is for information relative to the Navy as well as the Army, as I understand it.

Mr. WOODRUFF. Yes, for both.

Mr. MCCORMACK. Of course, if that is something not within your province, you cannot forecast it, and I assume that the request that is made is based on the theory that the information so given is compatible with the public interest.

I would like to suggest, also, that it might be well for the Advisory Commission to present a picture of its difficulties and the practical situation that confronts the Commission, so the American people may know what are the difficulties and responsibilities faced by the Commission.

Mr. KNUDSEN. I will do that.

Mr. MCCORMACK. There is one question I would like to ask: The Assistant Secretary of the Navy, Mr. Compton, referred to the amortization going back beyond July 10. He said if it went back to January 1, or if that date was agreed upon, it would take care of 75 percent of the plant expansion due to the Navy Department's negotiated contracts, or as a result of which the plant expansions had been made. Do you have any views to express on that suggestion?

Mr. KNUDSEN. No, sir; I have no data on which to base any suggestions.

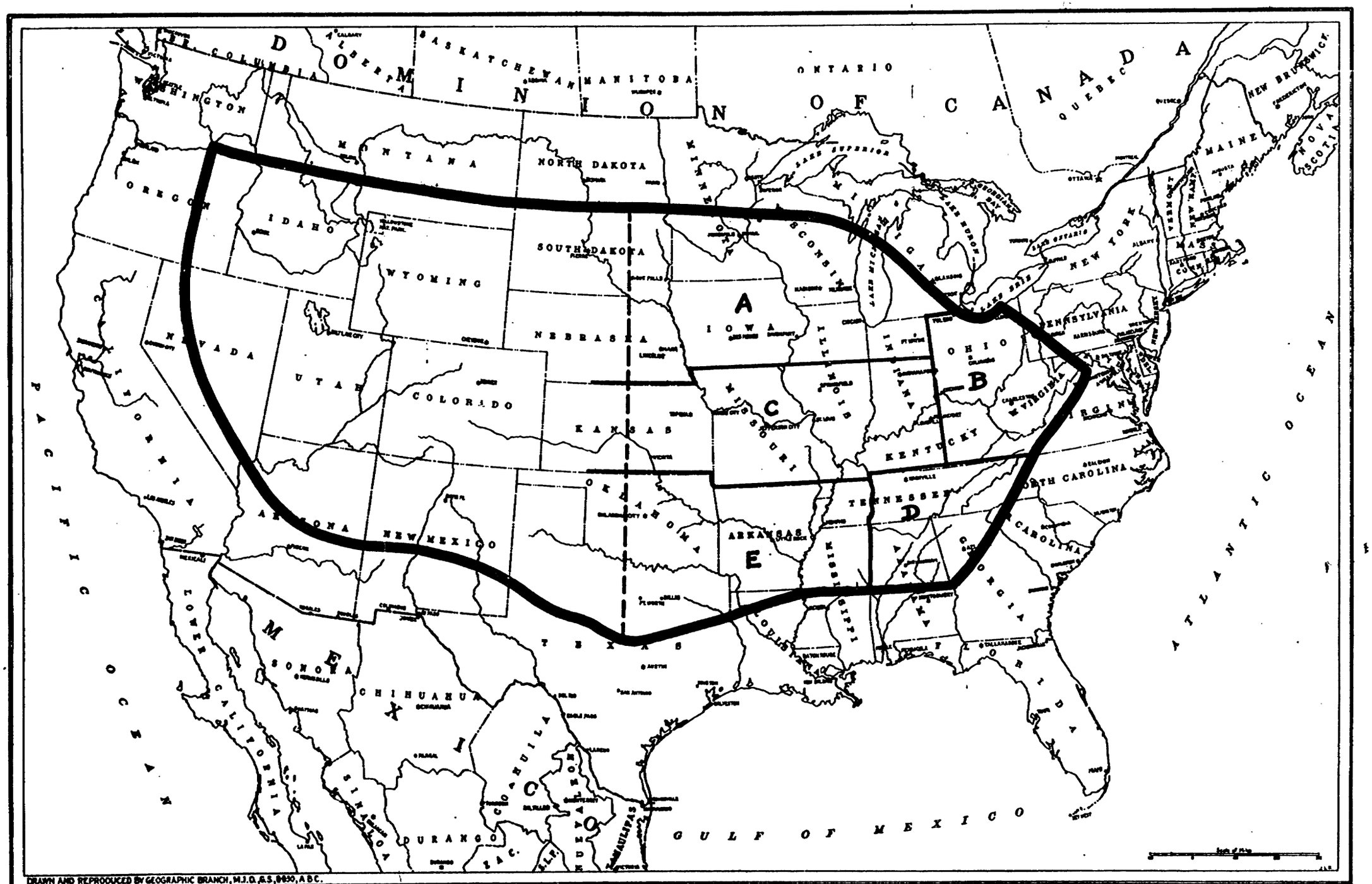
Mr. MCCORMACK. You have no objection to going back beyond July 10, if the committee deems it necessary, have you?

Mr. KNUDSEN. No, sir; I have no opinion in the matter at all.

Mr. DISNEY. I want to refer to Senator Clark's statement made awhile ago about the alleged discrimination as between the Central States and some other States, and to Mr. McCormack's suggestion that it was a very practical question. I want to inquire if you know about any so-called protest meeting at Kansas City, on August 30, going to the question of business interests in that section being discriminated against in the matter of the locations of plants?

Mr. KNUDSEN. Yes, sir; they had that question up here. I have not had time enough yet to go into it.

Mr. MCCORMACK. That would be the same situation where some city would demand that its Congressman go down and get some money. Of course, I do not believe that the American public would want to support a defense program on that basis, and I think that my colleague from Oklahoma would not want anybody to approach him from that point of view.

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Mr. DINGELL. I would like to interpose a question at this point: Is it the practice, policy, and the best judgment of the Defense Commission that there probably should be, and is it planned that there shall be, some essential decentralization of industry for the sake of a sound and rounded-out program?

Mr. KNUDSEN. Yes, sir.

Mr. DINGELL. In other words, from what I have heard and read, I thought it was the policy of the Commission to create small plants in widely scattered areas for further production, but, of course, they are not available now for immediate production. That is the reason, I presume, why a considerable part of the program is being concentrated at places where industry is already established.

Mr. KNUDSEN. The territory has not been surveyed. If you had traveled over it for the last 2 months, you would not have covered it. It takes a long time to decide on the relative advantages of particular sites. While we do not have the personnel, I am sure that the Army and Navy are working on it right along.

Mr. COOPER. Mr. Knudsen, when you referred to the year 1944, I assume that you meant that both the Army and Navy programs would be completed by that time.

Mr. KNUDSEN. No, sir; I was thinking about the maintenance of 2,000,000 men, plus the equipment for 2,000,000 men. I asked permission to prepare a statement on that, because the question confused me at the moment.

Mr. REED. Mr. Knudsen, regardless of the zeal that may be displayed by various localities wishing industries to be located in their midst, you still have to be governed by other considerations, the facilities, amount of skilled labor, climate, and various other factors, as well as the map laid down by the General Staff?

Mr. KNUDSEN. Yes, sir.

The CHAIRMAN. If there is nothing further, we thank you, Mr. Knudsen, for your appearance and the splendid statement you have given the committee.

(Mr. Knudsen subsequently submitted the following statement:)

THE ADVISORY COMMISSION TO THE
COUNCIL OF NATIONAL DEFENSE,
*Washington, D. C., August 10, 1940.*

I wish to submit herewith brief covering questions given to me at the hearing Friday, August 9, by the honorable members of your committee and their guests from the Senate.

Taking up the questions in order, I begin with Senator Lodge's query as to when 2,000,000 men could take the field fully equipped. The correct answer is that we have no program for the entire equipment and maintenance of 2,000,000 men. Our program is for the complete equipment of 1,200,000 men with critical noncommercial items for 800,000 more. This program will be finished by the end of 1942. I was unable to figure quickly how much additional material would be required and therefore allowed myself sufficient time on delivery to make it conservative, but safe. With the proper additional funds allotted when the time comes, and depending upon circumstances which will warrant extreme pressure on the program, I am quite sure that the date I gave of July 1, 1944, can be shortened by 9 months.

The second question, by Senator Clark, as to the map we are working with for the location of new plants away from seaboard, I enclose the map herewith and you will see by the red lines that the territory is being surveyed up to a line slightly west of the Mississippi River. This does not mean that the area west of this red line and bounded by the heavy black line is excluded; it simply means that this territory has not been surveyed as yet by the Army and Navy Munitions Board

As to Mr. Woodrum's and Senator Harrison's question about the present bill before Congress, this bill calls for $3,986,995,417 of which $1,814,398,625 is cash and $2,172,596,792 is contract authorizations. This covers two-thirds of the cost of fully equipping and maintaining 1,200,000 men in the field and obtains in addition all noncommercial items for 800,000 more. The contracts should all be placed within 60 days after the passage of this bill and the excess-profits tax bill, and the work should be done by the end of 1942.

On the Navy part of the bill, the amount is $1,099,017,540 of which $600,712,540 is cash and $498,305,000 is contract authorizations. The general description of the project is on statements A and B attached. If you will examine items 1 and 2 on statement A, and item 2 on statement B, you will find that a total of $435,000,000 of cash and $444,000,000 of contract authorizations are all that is allotted to new construction and the balance can be classified as operating and maintenance expense.

The contracts involved in this expenditure can be placed within 60 days after the passage of this bill and the excess profit tax bill. The work on the ships will not be finished until 1945 at the earliest. The work on planes and ammunition can be finished by July 1, 1942.

Respectfully submitted.

WILLIAM S. KNUDSEN.

*Appropriation summary*

| Title | Project | Cash | Contractual authority |
|---|---|---|---|
| Replacement of naval vessels: | | | |
| Construction and machinery | 1 | $93,000,000 | |
| Armor, armaments, and ammunition | 1 | 90,000,000 | $17,000,000 |
| Alterations to naval vessels | 1 | 75,000,000 | |
| Aviation, Navy | 2 | 170,000,000 | 375,000,000 |
| Public works | 3 | 37,750,000 | 31,000,000 |
| Naval Reserve | 4 | 3,189,780 | |
| Bureau of ships | 5 | 35,000,000 | 26,230,000 |
| | 6 | | |
| General expenses, Marine Corps | 6 | 7,000,000 | |
| Ordnance and ordnance stores: | | | |
| Marine items, $16,700,000 | 6 | 60,293,000 | |
| Naval items, $43,593,000 | 7 | | |
| Contingent expenses Navy Department | 8 | 50,000 | |
| Salaries, Director, Naval Communications | 8 | 10,080 | |
| Salaries, Secretary's Office | 8 | 13,680 | |
| Salaries, Chief of Naval Operations | 8 | 24,000 | |
| Miscellaneous expenses | 8 | 50,000 | |
| Maintenance, supplies and accounts | 8 | 500,000 | |
| Printing and binding | 8 | 50,000 | |
| Total | | 571,926,540 | 479,230,000 |

PROJECT 1. H. R. 10100—SHIPBUILDING AND SHIP ACQUISITIONS AND CONVERSIONS

| | Construction and machinery | Armor, armaments, and ammunition | Cash total | Contract |
|---|---|---|---|---|
| Replacement of naval vessels: | | | | |
| (a) Commence 200 combatant ships | $25,000,000 | $12,000,000 | $37,000,000 | |
| (b) Plant expansions—Shipbuilding for (c) | 30,000,000 | | 30,000,000 | |
| (c) Construct patrol craft, etc | 20,000,000 | 5,000,000 | 25,000,000 | |
| (d) Lay down 52 auxiliaries (against prior authorizations and H. R. 8926, 75,000 tons; H. R. 10100, 100,000 tons) | 18,000,000 | 5,000,000 | 23,000,000 | |
| (e) Ordnance facilities (gun factory, etc.) | | 28,000,000 | 28,000,000 | $12,000,000 |
| (f) Armor facilities (South Charleston, W. Va., and private) | | 25,000,000 | 25,000,000 | 35,000,000 |
| (g) Powder facilities, public (Indian Head—100,000 pounds a day additional) | | 15,000,000 | 15,000,000 | |
| Total | 93,000,000 | 90,000,000 | 183,000,000 | 47,000,000 |
| Alterations to naval vessels: Acquisition and conversion of auxiliaries (22 ships) from Maritime Commission and private sources | | | 75,000,000 | |
| Total project 1 | | | 258,000,000 | |

*Appropriation summary*—Continued

PROJECT 2. AVIATION

| | Cash | Contract |
|---|---|---|
| Aviation, Navy: | | |
| Plant expansions | $45,000,000 | |
| Cash to finance contract advance payments | 125,000,000 | $375,000,000 |
| Total | 170,000,000 | 375,000,000 |

The $125,000,000 contract authorization of $375,000,000 here requested (together with the contract authority of $125,000,000 in titles I and II of the 1941 act) provides for contracting for 4,025 planes (to avail 10,000 plane total authorized in H. R. 9848). The additional $45,000,000 cash is for Government-owned plant expansions to expedite the program.

PROJECT 3. PUBLIC WORKS

| | Obligation total | Cash |
|---|---|---|
| 1. Navy yards | $8,319,000 | |
| 2. Naval stations and fleet facilities | 13,606,000 | |
| 3. Bureau of navigation | 1,025,000 | |
| 4. Ammunition depots and ordnance | 10,115,500 | |
| 5. Air stations and bases | 14,731,000 | |
| 6. Medical facilities | 2,085,000 | |
| 7. Radio stations | 1,543,500 | |
| 8. Naval Research Laboratory, Bellevue | 250,000 | |
| 9. Marine Corps items | 4,565,000 | |
| 10. Supply depots and storage | 5,330,000 | |
| 11. Naval district facilities, including drydocks | 7,227,000 | |
| Total project 3 | 68,750,000 | $37,750,000 |

PROJECT 4. PERSONNEL TRAINING

| | | |
|---|---|---|
| (a) Naval Reserve: 5,000 Reserve militiamen (12-day training course including equipment) | | $3,189,780 |

PROJECT 5. BUREAU OF SHIPS

| | Required | Cash | Contract |
|---|---|---|---|
| (1) Commissioning of ships (1 storeship, *Boreas*; 1 cargo ship, *Regulus*; 2 fleet tugs, *Iuka*, and *Sciota*; 1 submarine rescue vessel, *Chanticleer*; 2 submarine chasers, *PC 475, 477*; 2 gate vessels, *Eider* and *Dreadnaught*, 6 patrol boats, eagles, being recommissioned and converted for use as naval district defense training vessels) | $3,380,000 | | |
| (2) Installing guns on 2 seaplane tenders, *Langley* and *Wright*; 1 transport, *Henderson*; 4 submarine tenders, *Canopus, Holland, Argonne, Bushnell*, 5 destroyer tenders, *Altair, Black Hawk, Melville, Dobbin, Whitney*, 2 repair ships, *Medusa* and *Vestal*; 2 ammunition ships, *Pyro* and *Nitro*, 1 provision ship, *Artic*, 4 cargo ships, *Capella, Sirius, Vega, Regulus*; 8 colliers, *Brazos, Cuyama, Kanawha, Necches, Pecos, Romulus, Salinas, Trinity*; 26 minesweepers; 9 small seaplane tenders; 12 ocean tugs; 5 submarine rescue vessels, 1 storeship, *Boreas*; 9 miscellaneous auxiliaries | 2,500,000 | | |
| (3) Miscellaneous equipment (small boats, transmitters, direction finders and chemical warfare equipment for patrol plane squadrons; life rafts; and magnetic minesweeping equipment) | 1,500,000 | | |
| (4) Experiments and development | 2,000,000 | | |
| (5) Deficiencies in radio, sound and signaling equipment | 23,000,000 | | |
| (a) Shore radio stations | $7,508,913 | | |
| (b) Existing air stations and air bases | 2,764,200 | | |
| (c) Hepburn Board air stations | 616,000 | | |
| (d) Horn Board air stations | 780,200 | | |
| (e) Marine Corps | 208,500 | | |
| (f) Ships | 10,416,700 | | |
| (g) Cipher devices and material | 731,000 | | |
| (h) Research and development | 1,500,000 | | |
| (6) Additional for protection of ships against magnetic mines | 4,000,000 | | |
| (7) Overhauls | 3,000,000 | | |
| (8) High priority alterations of vessels | 2,000,000 | | |
| (9) Material to expedite 1942 overhauls | 3,000,000 | | |
| (10) Maintenance of additional vessels acquired | 4,000,000 | | |
| Total | 55,380,000 | $29,150,000 | $26,230,000 |

*Appropriation summary*—Continued

PROJECT 6. MARINE CORPS

| | | Cash |
|---|---|---|
| General expenses, Marine Corps: | | |
| Clothing—29,500 outfits at $84.75 | | $2,500,000 |
| Semiautomatic rifles—13,000 rifles at $78.46 | | 1,020,000 |
| Small arms ammunition—35,238,000 rounds at $42 per thousand | | 1,480,000 |
| Combat transportation | | 750,000 |
| 459 carts, hand drawn | $73,956 | |
| 28 carts, artillery | 15,400 | |
| 82 tractors | 139,200 | |
| 110 trailers | 31,400 | |
| 180 trucks, including ambulances | 410,700 | |
| 49 motorcycles | 25,725 | |
| Communication equipment | | 500,000 |
| Wire-laying equipment | $20,875 | |
| Visual signaling equipment | 24,060 | |
| Telephones, telegraph sets, mikrophones, etc. | 41,306 | |
| Switchboards | 11,100 | |
| Field telephone wire | 376,263 | |
| Hand carts | 17,500 | |
| Miscellaneous | 8,896 | |
| Equipment and commodities | | 750,000 |
| Organizational equipment (protective clothing, mess equipment, bedding rolls, cots, tents, etc.) | $260,567 | |
| Individual equipment, such as field glasses, compasses, shelter tents, entrenching tools, steel helmets, web carrying equipment, etc.) | 300,417 | |
| Landing rations (for 3 forces, as follows: 3 complete rations, field rations, type C, consisting of canned meat, canned crackers, soluble coffee and sugar; one-third ration, U. S. Army field ration, type D (concentrated chocolate bars | 61,270 | |
| Engineering equipment, miscellaneous equipment for Third Engineer Battalion | 127,746 | |
| | | 7,000,000 |

| | | | Cash |
|---|---|---|---|
| Bureau of Ships: | *Number* | *Unit* | |
| Landing boats | 271 | 10,800 | $2,926,800 |
| Lighters (self-propelled) | 55 | 45,000 | 2,475,000 |
| Rigs, boat | 40 | 1,000 | 40,000 |
| Ramps, boat | 20 | 1,000 | 20,000 |
| Rubber boats | 41 | 940 | 38,200 |
| Radio equipment | | | 350,000 |
| Total | | | 5,850,000 |
| Bureau of Ordnance: | | | |
| Ammunition for— | *Rounds* | *Unit* | |
| 48 3-inch antiaircraft guns | 136,531 | 21.00 | 2,867,151 |
| 16 37-mm. antiaircraft guns | 108,000 | 9.00 | 972,000 |
| 62 37-mm. antitank guns: | | | |
| High-explosive shell | 360,000 | 4.00 | 1,440,000 |
| Armor-piercing shell | 160,000 | 6.00 | 960,000 |
| 48 75-mm. pack howitzers | 266,208 | 18.50 | 4,924,848 |
| 48 81-mm. mortars | 135,021 | 12.70 | 1,714,766 |
| 12 4.2-inch chemical mortars | 16,200 | 29.45 | 477,090 |
| 108 60-mm. mortars | 193,834 | 9.00 | 1,742,706 |
| Grenades, VB, rifle | 65,410 | 2.74 | 179,771 |
| Grenades, hand, fragmentation | 140,400 | 1.92 | 269,568 |
| | | | 15,550,000 |
| 37 combat tanks | | | 1,150,000 |
| Total | | | 16,700,000 |
| Total project 6 | | | 29,550,000 |

*Appropriation summary*—Continued

PROJECT 7. ORDNANCE

| | | Requirements | Cash | Contract |
|---|---|---|---|---|
| Ordnance and ordnance stores: | | | | |
| (a) Projectile deficiencies | | $24,000,000 | $0 | |
| (b) Ammunition deficiencies | | 29,993,000 | $15,033,000 | |
| Fuses | $1,400,000 | | | |
| Powders | 400,000 | | | |
| Bombs | 800,000 | | | |
| Pyrotechnics | 700,000 | | | |
| Ammunition details | 1,033,000 | | | |
| Small arms ammunition | 3,700,000 | | | |
| Projectiles | 7,000,000 | | | |
| Total | 15,033,000 | | | |
| (c) 173 1. 1-inch guns ($165,000 unit—gun and mount $88,000, fire control $25,000; ammunition $62,000) | | 28,560,000 | 28,560,000 | |
| (d) Fire control and power equipment (increased cost $34,000 unit for 400 1 1-inch guns) | | 13,600,000 | | (1) |
| Total project 7 | | 96,153,000 | 143,593,000 | |

PROJECT 8. MISCELLANEOUS

| | Cash |
|---|---|
| Miscellaneous expenses | $50,000 |
| Salaries, Secretary's office | 13,680 |
| Salaries, Office of Chief of Naval Operations | 20,000 |
| Salaries, Office of Director of Naval Communications | 10,080 |
| Contingent expenses, Navy Department | 50,000 |
| Maintenance, Supplies and Accounts (collateral and maintenance of supply depots) | 500,000 |
| Printing and binding | 50,000 |
| Total project 8 | 693,760 |

[1] $28,560,000 in Title III.
[2] $16,700,000 under Marine Corps, project 6.

Miscellaneous expenses ..... $86,000

This estimate provides for opening 7 new naval attaché offices at Montevideo, Uruguay; Capetown, South Africa; Canberra, Australia; Delhi, India; Aukland, New Zealand; Managua, Nicaragua; and Tegucigalpa, Honduras; and for 22 clerks for these new offices and 8 additional clerks for attaché offices in Central and South America, including expenses for the operation of the offices. These new offices have been selected after consultation with the State Department to cover areas in which it is believed desirable to have naval attachés.

Ordnance and ordnance stores:
Cash ..... $7,000,000
Contract ..... 15,000,000

The 4,028 aircraft being procured under the "aviation" estimate will require for their ordnance, ammunition, bombs, and torpedoes $28,536,269. This request covers $7,000,000 cash and $15,000,000 contract authorization. Since these planes will not be delivered until 1941 or early 1942, it is believed that the contract authorization should be raised $6,500,000. Admiral Towers will cover the subject of plane deliveries.

Medical Department ..... $1,450,000

Due to the expansion of the Navy, a total of $1,450,000 is required for miscellaneous items of equipment, furniture and furnishings, medical outfits for auxiliary ships, and incidental expenses in connection with the organization and maintenance of a 500-bed hospital in the Caribbean area.

Maintenance, Yards and Docks ..... $2, 000, 000

The $2,000,000 is requested to cover expenses in connection with naval stations on account of the expanison of the Navy for personal services and routine upkeep, including transportation equipment, machine tools, and furnishings.

Public works, Bureau of Yards and Docks:

| | |
|---|---|
| Cash | $8, 250, 000 |
| Contract | 4, 075, 000 |

The cash requested, $8,250,000, plus the contract authorization of $4,075,000 covers expansions at the Naval Academy and training stations and the purchase of a developed site at Bayonne, N. J., for additional supply facilities in connection with the two-ocean Navy.

At the Naval Academy, the increased facilities will provide for five appointments. The construction has been set out as temporary, but the construction at the Naval Academy should be made permanent in character so as not to disfigure this national institution. Permanent facilities will be required by the two-ocean Navy. It might be possible to crowd the midshipmen into the existing space under the five appointments, but it is not believed to be desirable, sanitary, or healthy, nor will such crowding facilitate their concentration on their studies.

Aviation, Navy ..... $10, 000, 000

The $10,000,000 of increased maintenance has been requested for aviation, most of which will be expended for outfits for new squadrons, advanced base equipment, machine tools and shop equipment, and public works equipment for new buildings. This money is designed primarily to provide for equipping of the air bases, construction of which is well under way.

In my letter of August 5, 1940, I requested two changes of language, one designed to enable us to place a commandant separate from the navy yard commandant in such areas as Boston, New York, and Puget Sound, due to the very great increase in district activities, and the other a provision to enable us to use enlisted men in the Navy Department on confidential work during the existing emergency. In the same letter, I mentioned the fact that in addition to the sums which had been sent to the committee to provide for the Naval Academy and training stations, a real necessity exists for increased receiving ship facilities at Philadelphia, New York, Boston, and Charleston, S. C., to assemble and train the crews for ships under construction in those areas.

At this point, I might commennt that the Budget office will furnish you with an estimate of the clerical assistance needed to staff the office of the newly appointed Under Secretary of the Navy. I also beileve that the estimate for "Contingent expenses, Navy Department" in this submittal, totaling $50,000, should be doubled to care for the expansions which are taking place in the Navy Department.

*Supplemental items forwarded by the President on Aug. 3, 1940, to the President of the Senate*

The additional items transmitted to the Senate under date of August 3, 1940, by the President total:

| | |
|---|---|
| Cash | $28, 786, 000 |
| Contracts | 19, 075, 000 |
| Total | 47, 861, 000 |

This supplemental request is for the following purposes:

| Appropriation title | Item | Amount | |
|---|---|---|---|
| | | Cash | Contract |
| Miscellaneous expenses | 7 new attaché offices and 22 clerks | $86, 000 | |
| Ordnance and ordnance stores | Aviation ordnance for 4,028 planes | 7, 000, 000 | $15, 000, 000 |
| Medical Department | Collateral, and stores and equipment for expanded Navy. | 1, 450, 000 | |
| Maintenance, yards and docks | Maintenance, repairs, equipment | 2, 000, 000 | |
| Public works | Naval Academy and training stations | 5, 000, 000 | 2, 325, 000 |
| | Bayonne supply base | 3, 250, 000 | 1, 750, 000 |
| Total public works | | 8, 250, 000 | 4, 075, 000 |
| Aviation, Navy | Maintenance | 10, 000, 000 | |
| Total | | 28, 786 000 | 19, 075, 000 |

*Second Supplemental National Defense Appropriation Act (title IV) 1941*

| | Cash | Contract | Totals |
|---|---|---|---|
| House bill (H. R. 10263) | $571,926,540 | $479,230,000 | $1,051,156,540 |
| Budget, Aug. 3, 1940, to Senate | 28,786,000 | 19,073,000 | 47,861,000 |
| Total | 600,712,540 | 498,303,000 | 1,099,017,540 |

Mr. TREADWAY. I have a letter here from Mr. Millard D. Brown, president of Continental Mills, Inc., of Philadelphia. He compliments the subcommittee on its recommendation allowing corporations the choice of two alternatives as a basis on which to figure the excess-profits tax. I suggest that this letter be made a part of the record.

The CHAIRMAN. It will be inserted at this point.

(The letter referred to is as follows:)

CONTINENTAL MILLS, INC.,
*Philadelphia, August 8, 1940.*

Congressman ALLEN T. TREADWAY,
*House Office Building, Washington, D. C.*

DEAR CONGRESSMAN TREADWAY: Through you may I compliment the subcommittee on their recommendation allowing corporations a choice of two alternatives as a basis on which to figure the excess-profits tax? In fairness to the efficient corporations and for the best interest of the country as a whole, I hope the Ways and Means Committee will concur in this recommendation.

All of us realize that more taxes must be raised to support our preparedness program, that we may continue to be a free and independent Nation. Most of us are willing to make whatever sacrifices are necessary to achieve that end.

We can all remember the excess-profits tax of World War No. 1, which was unfair to the conservatively capitalized and efficient corporations and favored the overcapitalized and inefficient ones. The option provided in your suggestions obviates that objection.

During my 41 years in industry I have found that those organizations that make fair profits are always the most efficient; that they invariably pay the highest wages; that their employees have more steady employment; that their personnel relations are the most advanced and liberal. They are the first to adopt new and better methods; are quicker to throw out obsolete machinery and buy new, thus giving orders to our heavy industries; and are continually employing more people in their own institutions.

Too much of our legislation and too many of our tax laws have handicapped the efficient. I am not asking that our legislation should handicap the inefficient but I am hoping that our future legislation can at least give to the efficient encouragement to become more efficient, and to the inefficient encouragement to become efficient. In that way only can we again succeed in becoming a prosperous Nation and thus absorb our unemployed in useful endeavor.

Sincerely yours,

MILLARD D. BROWN.

The CHAIRMAN. The next witness is Mr. John V. Lawrence, representing the American Trucking Association, Washington, D. C. Is Mr. Lawrence present?

(There was no response.)

The CHAIRMAN. The next witness is Mr. Eugene A. Conniff, representing the National Electric Coil Co., of Columbus, Ohio.

## STATEMENT OF EUGENE A. CONNIFF, REPRESENTING THE NATIONAL ELECTRIC COIL CO., COLUMBUS, OHIO

Mr. CONNIFF. Mr. Chairman and members of the committee, my name is Eugene A. Conniff, certified public accountant of Pennsylvania, with office at 917 Park Building, Pittsburgh, Pa.

I represent the National Electric Coil Co. It operates two small plants, one at Columbus, Ohio, the other at Bluefield, W. Va. This company manufactures only electric coils, large and small, designed to be installed in an immense dynamo, an electric locomotive, a mining machine, or a small motor.

The history of American business has generally been one of small beginnings with steady growth made possible by plowing back a substantial part of earnings into the business. Any tax legislative action which would oppose such precedent would, in our opinion, be harmful since it would tend to prevent the birth and growth of small companies. Perpetuation of this tradition is, we think, all-important for the continuation of the typical American way of business.

Should your committee propose an excess-profits tax bill which would unduly penalize smaller companies with fundamentally sound financing and with relatively high ratio of earnings to net worth, as opposed to companies heavily over-capitalized because of unused plants and obsolete equipment, it would, in our judgment, obviously be unfair to the smaller companies. Of course, it is of prime interest to us all to not only maintain present employment levels, but to continue to expand business, thus providing for additional employees. This obviously will require retention of a substantial share of annual earnings which you appreciate will not be in cash, but will be in accounts receivable, inventories, and other deferred assets, plus normal plant expansion charges in case of newer and smaller companies such as our own.

The tax collector, as you know, demands that taxes be paid in cash; hence, it is necessary for the taxpayer to carry his own increased inventories and accounts receivable required in keeping with the tendency towards longer terms of payment. After the defense emergency is past and the cancelation of the excess-profits tax, the taxpayer will have to absorb losses incidental to larger inventories and increased accounts receivable, which represent the taxpayers' share of the net profit on which was paid the so-called excess-profits tax as well as normal income tax. You, of course, know the manufacturer's books are kept on an accrual basis and his profits are not held in cash but in fixed assets, notes and accounts receivable—bad as well as good.

There are thousands of manufacturers in this country other than my client who will likely not share in direct governmental purchases in connection with the preparedness program, yet will find it necessary to provide plant expansion because of increased business from essential industries such as steel, mining, transportation, electric power generating, and so forth. We fear this situation will not be recognized by our Government in amortization plans now being considered for the relief of essential industries which have provided special facilities for the benefit of the defense program. In our case, better than 99 percent of our production is furnished to industries

which are very essential to the execution of the preparedness program.

The Excess and War Profits Tax Law of 1917 and 1918 with its peculiar invested capital provisions which neither the Treasury Department nor the taxpayer could interpret without long years of legal contests in the courts and which caused undue hardship and expense on the taxpayer and finally caused unjust apportionment of taxes against corporations of the size of my client and thousands of other corporations with a result that in some cases the taxpayer went out of existence and in other cases where the taxpayer had large resources to carry their claims into court, many millions of the excess-profits taxes were refunded to the taxpayers through the courts, in subsequent years at exorbitant legal costs to the Government and the taxpayer. It, therefore, seems logical to write a tax law that will be simple of interpretation of the questions:

First. What is net income for the normal basic period?

Second. What is allowable invested capital?

Your subcommittee has made excellent recommendations and the following suggestions are offered to supplement them:

First. That the fiscal or calendar years ending in 1936 to 1939, inclusive, be the base period for computation of the normal taxable income.

Mr. McCORMACK. What period would that be?

Mr. CONNIFF. A 4-year period, from 1936 to 1939, inclusive.

Mr. McCORMACK. Will you repeat that statement?

Mr. CONNIFF. It is that the fiscal or calendar years ending in 1936 to 1939, inclusive, be the base period for computation of the normal taxable income. I do not think the committee's first report includes that. It says from 1936 to 1939, without saying whether it is the fiscal year or the calendar year. It does not show whether you are taking the fiscal year basis or taking the calendar-year basis.

Mr. McCORMACK. Does not a corporation that is operating on a fiscal-year basis return its income on that basis? If it is operating on a calendar-year basis, the return would be made accordingly.

Mr. CONNIFF. Yes, sir.

Mr. McCORMACK. In other words, to let the excess-profits tax-base period be computed in accordance with the way the books are kept or the affairs are conducted, of the company involved.

Mr. CONNIFF. That is the point.

Second. That alternative to other recommendations of the subcommittee, there be allowed on profits credit of 10 percent of the average adjusted declared value in its Federal capital-stock-tax return filed on July 1, 1936, 1937, 1938, 1939, and 1940; or 1936, 1937, 1938, and 1939, giving them the average of the declared adjusted value which showed in the capital stock reports of previous years, instead of having to go through the long and tedious and impossible computation of invested capital.

Mr. McCORMACK. These are alternative plans, you know. One is on the theory of invested capital as the base and the other is on the theory of average earnings, if a corporation has a 4-year base experience.

Mr. CONNIFF. That is right.

Mr. McCORMACK. And that observation would apply to the first one, is that right?

Mr. CONNIFF. To the first one. The second one is entirely new to what the subcommittee said in its recommendations; that is, that an excess-profits-tax credit of 10 percent or some percentage be allowed as a credit based on the amount of the declared invested capital in the capital stock tax law.

The CHAIRMAN. May I ask if you have studied the report of the subcommittee? If so, will you state with what part you are in accord and with what part you disagree?

Mr. CONNIFF. I do not disagree with it, Mr. Chairman.

The CHAIRMAN. You do not disagree with the recommendation of the subcommittee?

Mr. CONNIFF. I just ask that these things be added or these alternatives put in.

Mr. COOPER. Mr. Chairman, the very first recommendation you make, Mr. Coniff, is taken care of in the subcommittee report. You understand that, do you not?

Mr. CONNIFF. That is right, with the exception of the question whether it is a fiscal year or a calendar year.

Mr. COOPER. No; that is taken care of. The purpose is to take the corporation's own basis, the one that they use for ordinary income-tax purposes which, of course, embraces fiscal year and calendar year, both.

Mr. CONNIFF. Then that is taken care of.

Mr. COOPER. So your first recommendation is certainly covered in the recommendations included in the report.

Mr. MCCORMACK. Will the gentleman yield?

Mr. COOPER. Yes.

Mr. MCCORMACK. You said that if your company was furnishing its product—that is, electrical machines, is it not?

Mr. CONNIFF. Coils for electrical machinery.

Mr. MCCORMACK. The point is this: Certain other companies have contracts and you have to expand your plant as a result of that. You can go down and if you satisfy the Advisory Commission or the War or Navy Department, whichever gives out that contract, and get a certificate, your company, as I understand it, comes under this special amortization plan.

Mr. CONNIFF. But our company will not have a Government contract.

Mr. MCCORMACK. That is not necessary, as I understand it. My understanding is that any company, whether they have a direct Government contract or not, that has to expand its plant and can get a certificate, may come within the purview of this recommendation; is not that your understanding, Mr. Chairman?

Mr. CONNIFF. If that is true, that covers my recommendation No. 3. I thought you had to have a Government contract to get the benefit of that amortization plan.

Mr. COOPER. The amortization plan applies to contractors or subcontractors, all the way down the line.

Mr. CONNIFF. We may not be a subcontractor. We just sell our product to somebody who has a contract or a subcontract.

Mr. COOPER. If you sell your product, you make some kind of a contract to sell it, do you not?

Mr. CONNIFF. Not with the Government.

Mr. COOPER. You make a contract with somebody to sell your product.

Mr. CONNIFF. That is right.

Mr. COOPER. If that is used for national defense and so certified, it is included under the recommendations.

Mr. CONNIFF. Very good. That takes care of No. 3.

No. 3 is that some amortization of an abnormal increase in plant facilities be granted corporations which are forced to construct new facilities to meet the defense program of its customers who have Government contracts.

In our opinion a graduated excess-profits tax exceeding 5 percent, 10 percent, and 20 percent, with 25 percent as top bracket, in addition to normal income tax and capital-stock tax would be exceedingly burdensome to my client and similarly situated corporations and may jeopardize their present credit in the trade because a higher tax would tend to:

1. Permit no receipts for business expansion in accounts and notes receivable and credit to its customers.

2. Permit no earned profits for expansion of plant facilities so necessary to the defense program in supplying other companies which have or will have Government war-defense contracts.

3. Force the borrowing of money to pay for taxes and customer credit extension.

My client is heartily in favor of a reasonable excess-profits tax for defense and asks that your committee consider well these suggestions made in the interest of all small and medium-sized corporations.

The CHAIRMAN. Are there any further questions? If not, we thank you for your appearance and the information you have given the committee.

Is there anyone else present who would like to be heard? If so, we will try to make arrangements to hear you at this time or later in the day.

There seems to be no one present who desires to be heard today.

Mr. MCCORMACK. Mr. Chairman, I ask that this letter addressed to me by the treasurer of the Shepard Steamship Co. be inserted in the record following the testimony of the witnesses this morning.

(The letter referred to is as follows:)

SHEPARD STEAMSHIP CO.,
*Boston, Mass., August 6, 1940.*

Hon. JOHN W. MCCORMACK,
*House Office Building, Washington, D. C.*

DEAR SIR: There is something particular to be said in regard to excess-profits taxes on steamship companies. Take our own steamship company, for instance: We did business for quite a number of years, either at a loss or at an extremely modest profit, and averaging some loss, I believe. If we suddenly have a chance to make some little money, we should be allowed to preserve it to use in the steamship business and to some extent make up the past losses. A heavy excess-profits tax would be likely to have the result of putting ourselves, and perhaps others, out of the steamship business, as new ships can only be had at quite high prices. If the Government wants steamship services continued, they will certainly have to be lenient in regard to excess-profits taxes with the steamship companies, as many of them are in the same position as we are; quite a number having been driven out of the intercoastal business during the last 10 years through being unable to make any profit and having made large losses.

American steamship wages are far above any foreign, and conditions generally are unfavorable in regard to union activity. Special attention should certainly be given to the steamship case, and be thoroughly examined before any severe excess-profits tax is put on.

Yours very truly,

SHEPARD STEAMSHIP CO.,
T. H. SHEPARD, *Treasurer.*

Mr. COOPER. Mr. Chairman, I move we adjourn until 10 o'clock in the morning.

The CHAIRMAN. Without objection, it is so ordered.

(Whereupon the committee adjourned to meet on Saturday, August 10, 1940, at 10 a. m.)

# EXCESS PROFITS TAXATION, 1940

**SATURDAY, AUGUST 10, 1940**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, D. C.*

The committee met at 10 o'clock, Hon. Robert L. Doughton (chairman) presiding.

The CHAIRMAN. The committee will come to order.

The chairman has received a letter this morning from Mr. Stimson, Secretary of War, transmitting a paper which was called for yesterday showing the appropriations that had been made for the military service, broken down by objects, from 1932 to 1941, inclusive.

Without objection this will be included in the record.

(The statement referred to follows:)

WAR DEPARTMENT,
*Washington, August 9, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Committee on Ways and Means,*
*House of Representatives, Washington, D. C.*

DEAR MR. DOUGHTON: As requested this morning while I was testifying before your committee and the Senate Finance Committee, I enclose herewith for the record a statement prepared by the War Department showing the expenditures of defense funds from the year 1933 to date.

If there is any further information which your committee desires to have for its records I shall be glad to furnish it.

Sincerely yours,

HENRY L. STIMSON,
*Secretary of War.*

*Appropriations for the Military Establishment showing approximate break-down into major functions, fiscal years 1933–41, inclusive*

| Fiscal year | Recurring charges and improvement of plant | | Augmentation, modernization, and replacement of arms and equipment | | Total appropriation; Military Establishment |
|---|---|---|---|---|---|
| | Pay, rations, clothing, repairs, research and development, planning, construction, training, operations, maneuvers, schools, etc. | | This includes new aircraft, spare engines, spare parts, bombs, new tanks, anti-aircraft, and antitank guns, semiautomatic rifles, trucks, tractors, field guns, machine guns, ammunition, etc. | | |
| | Entire Army (less Air Corps) | Air Corps | Entire Army (less Air Corps) | Air Corps | |
| (1) | (2) | (3) | (4) | (5) | (6) |
| 1933 | $238,003,000 | $47,217,000 | $6,617,000 | $12,163,000 | $304,000,000 |
| 1934 | 222,625,000 | 45,472,000 | 590,000 | 8,313,000 | 277,000,000 |
| [1] | 53,150,000 | [1] 18,050,000 | [1] 18,000,000 | [1] 7,500,000 | [1] 93,700,000 |
| 1935 | 205,219,000 | 54,375,000 | 8,373,000 | 13,033,000 | 281,000,000 |
| [1] | 6,300,000 | [1] 2,100,000 | [1] 500,000 | | [1] 8,900,000 |
| 1936 | 243,335,000 | 57,284,000 | 24,121,000 | 30,057,000 | 355,000,000 |
| [1] | 13,950,000 | [1] 4,650,000 | | | [1] 18,600,000 |
| 1937 | 258,834,000 | 65,951,000 | 19,538,000 | 43,677,000 | 388,000,000 |
| [1] | 23,700,000 | [1] 7,900,000 | | | [1] 31,600,000 |
| 1938 | 282,790,000 | 75,303,000 | 15,636,000 | 43,291,000 | 417,000,000 |
| [1] | 37,950,000 | [1] 12,650,000 | | | [1] 50,600,000 |
| 1939 | 294,010,000 | 81,431,000 | 30,151,000 | 54,408,000 | 460,000,000 |
| [1] | 91,425,000 | [1] 31,475,000 | | | [1] 125,900,000 |
| 1940 | 380,038,000 | 222,533,000 | 118,633,000 | 202,396,000 | 923,000,000 |
| [2] | 29,250,000 | [2] 9,750,000 | | | [2] 39,000,000 |

For fiscal year 1941: Total appropriated to date, $2,323,000,000; contractual authorization to date, $577,400,000.

[1] A total of approximately $36,500,000 was impounded and refunded in 1934. This was taken more or less proportionately from all activities.
[2] Allotments from Federal emergency funds.

## STATEMENT OF HON. JOHN L. SULLIVAN, ASSISTANT SECRETARY OF THE TREASURY, ACCOMPANIED BY ROY BLOUGH, DIRECTOR OF TAX RESEARCH, TREASURY DEPARTMENT

The CHAIRMAN. The first witness on the calendar is Hon. John L. Sullivan, Assistant Secretary of the Treasury, Washington, D. C.

We will be glad to hear you, Mr. Sullivan.

Mr. SULLIVAN. Mr. Chairman and gentlemen of the committee, the committee, during its consideration of the Revenue Act of 1940, adopted the following resolution which was incorporated in the committee report:

During the executive sessions, there have been discussed proposals to provide special amortization for national defense industries and to provide for the imposition of excess-profits taxes. These two measures—each in itself requiring a complicated and exhaustive legislative project—must be considered together. 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. Accordingly we have instructed our technical assistants and the appropriate Treasury officials to accelerate their work in these two fields so that bills will be prepared for submission not later than the opening of the next session of Congress which, if passed by the Congress, may become retroactive and apply to income earned during the calendar year of 1940, or may become effective upon any other date which Congress, in the light of information it then possesses, may deem advisable.

Subsequently the committee of conference on the same bill adopted a somewhat similar resolution on June 21, 1940. This resolution, advancing the date for action and definitely anticipating the application of this tax to 1940 income, was as follows:

*Resolved by the committee of conferees on H. R. 10039,* That the committee is firmly of the opinion that an excess-profits tax should be enacted as soon as possible and should be made applicable to the calendar year 1940, and all taxable years beginning in 1940 and to all subsequent years. In pursuance of this policy the Treasury Department is urgently requested to submit to the Ways and Means Committee of the House and to the Finance Committee of the Senate not later than October 1, 1940, a plan for such tax, together with supporting data and drafts for proposed legislation.

Pursuant to the instructions contained in these resolutions the Treasury Department speeded to a conclusion the study of the problem which it had begun some time ago and, on the basis of this and other studies made over a period of years, formulated a plan for the taxation of excess profits and the amortization of the cost of plant facilities necessary to national defense.

Subsequent to the committee resolutions which I previously read, the President in his message to Congress of July 1, 1940, urged the prompt enactment of an excess-profits tax law. Accordingly the Ways and Means Committee delegated to its subcommittee on internal revenue taxation the task of preparing recommendations to your committee. The Treasury has presented the results of its studies to the subcommittee in frequent sessions over the last 2 weeks. The subcommittee is to be congratulated on its performance of an extremely difficult and complicated task with great diligence and care.

During this time the staff of the Joint Committee on Internal Revenue Taxation was also formulating a plan of excess-profits taxation. This plan differed from the Treasury plan in certain important respects, notably in allowing in full the taxpayer's average earnings in the base period as a credit in determining what profits were deemed to be excessive. In its recommendation the subcommittee combined certain aspects of the plan submitted by the Treasury and certain aspects of the plan submitted by the joint committee staff by providing that most taxpayers might elect between alternative methods of computing excess profits subject to tax. As stated by Secretary Morgenthau yesterday, in view of the need for immediate action, the Treasury does not wish to delay the passage of a bill dealing with the problems before you and accordingly interposes no objection to the joint plan recommended by the subcommittee.

As I have just indicated, the plan which the Treasury suggested to the subcommittee has in large measure been adopted by it as one of the alternative methods for computing excess profits subject to tax. It may be conveniently designated as the invested capital method. I shall confine my discussion principally to that method, leaving to Mr. Stam of the staff of the Joint Committee on Internal Revenue Taxation the discussion of the alternative plan.

Under both methods the excess-profits tax applies only to corporations and not to individuals or partnerships. This conclusion was reached because individuals are already subject to graduated surtaxes which reach 75 percent in the top bracket. Individuals and partnerships also differ from corporations in that they cannot accumulate any surpluses tax-free, but are taxed on their profits whether distributed or not.

The subcommittee recommended that the excess profits tax under both methods should apply to taxable years beginning after December 31, 1939.

Under either alternative of the plan proposed by the subcommittee, all corporations having net incomes of less than $5,000 are exempt from excess profits taxation. In addition the following corporations are exempt: Corporations exempt from income tax under section 101 of the Internal Revenue Code, domestic and foreign personal holding companies, mutual investment companies, and foreign corporations not engaged in trade or business in the United States and not having an office or place of business therein.

The subcommittee report recommends an excess-profits tax on incomes in excess of an excess-profits credit at the following rates:

Twenty-five percent of so much of the adjusted excess-profits net income as does not exceed 10 percent of the excess-profits credit.

Thirty percent of so much of the adjusted excess-profits net income as exceeds 10 percent of the excess-profits credit and does not exceed 20 percent of such credit.

Forty percent of so much of the adjusted excess-profits net income as exceeds 20 percent of the excess-profits credit.

The invested capital method must be used, under the subcommittee recommendations, by all corporations organized after 1936.

The invested-capital method is designed to measure the excessiveness of profit by a comparison between the ratio of earnings to invested capital in the taxable year with such ratio computed for a base period consisting of the years 1936, 1937, 1938, and 1939. In other words, if the corporation earned 7 percent upon its invested capital in the base period it is permitted to earn 7 percent on its invested capital for the taxable year before the application of the excess-profits tax. Corporations having deficits or very low earnings during the base period are relieved by allowing them to earn free of excess profits 6 percent on the first $500,000 of their invested capital for the taxable year, and 4 percent on the remainder of such capital. In the case of corporations which earned more than 10 percent on their invested capital in the base period only 10 percent of their 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 and additional capital is to be 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 further additional new capital.

The net income to be used for excess-profits tax purposes is to be the net income computed for income tax purposes with an additional deduction for dividends received and for income taxes payable. Such income is to be increased by the disallowance of a portion of the interest deduction otherwise allowable equal to the percentage of borrowed capital included in invested capital.

Senator BROWN. Would you mind being interrupted for a question, Mr. Sullivan.

Mr. SULLIVAN. No.

Senator BROWN. I want to know why the committee in its recommendations, and I am referring particularly to page 5 of the committee's report on the same subject matter which is now under discussion, made a distinction between borrowed capital and invested capital as the basis for determining the exemptions.

Mr. SULLIVAN. There are two schools of thought on that, Senator Brown. Previous acts have not provided for borrowed capital being included at all. It is considered to be advisable to encourage expansion. We think that if all borrowings were to be admitted 100 percent to the invested capital base that perhaps might encourage an overexpansion that was not entirely desirable. The smaller corporation encounters more difficulty in borrowing money than a large corporation, and for that reason it is recommended that under this alternative plan any borrowings that do not bring the total invested capital—that is, borrowed and equity capital—above $100,000, shall be admitted in full, 100 percent.

We recommend that borrowings that bring the total loan and equity capital above $100,000 but below $1,000,000 should be admitted to the base at a rate of 66⅔ percent; and borrowings which bring the total investment above $1,000,000 would be admitted at 33⅓ percent.

Senator BROWN. I can see there exist pretty good reasons for it, but it would seem to me the practical situation is one where large and powerful corporations, take General Motors, for example, have very little, if any invested capital based on borrowings; their capital is all in the form of common stock, and I guess a little bit of preferred stock; whereas a small corporation that wants to expand, generally, it has to borrow that money, and as a result, the big stock outfit, with all its capital in the form of common stock, is greatly benefited by this arrangement while the small corporation that has to borrow its money to make up the invested capital is injured by it.

Mr. SULLIVAN. Not at all.

Senator BROWN. In comparison with the large corporation.

Mr. SULLIVAN. No; I think it works the other way, Senator Brown.

Senator BROWN. That is the way it looks to me.

Mr. SULLIVAN. Well, let us take the company that has equity capital of $50,000 and wishes to double its capacity; it has to borrow an additional $50,000. This additional $50,000 will be admitted completely to the base, and companies under that illustration will be allowed to earn, free of excess-profits tax, 10 percent on that additional $50,000.

Now in the case of the company you just spoke of, the big company, which also may have to expand—that company will probably not have to pay 10 percent——

Senator BROWN (interposing). My point is that it will expand by selling more common stock rather than by borrowing money.

Mr. SULLIVAN. It may.

Senator BROWN. In that event it would escape a portion of the excess-profits tax in comparison with the small corporation that must borrow and which does not have the security it can sell, or because of conditions in the market, it cannot sell common stock.

Mr. SULLIVAN. That is true.

Senator BROWN. That is the point I was making.

Mr. SULLIVAN. That is why for small companies we are allowing up to $100,000 in borrowings to be admitted in full just as though they had floated a stock issue for that $50,000.

Mr. COOPER. May I interpose a question, if you are through, Senator?

Senator BROWN. Certainly.

Mr. COOPER. It is true, is it not, that the main reason for this provision, as has been so well outlined by you, is to help the small concern.

Mr. SULLIVAN. That is correct, Mr. Cooper.

Mr. COOPER. The small businesses of the country, and of course, if they increase the capital of their business by selling more stock and increase their equity capital they may soon reach the point where they are no longer small corporations but large companies and large corporations, whereas if they have to continue as a co-called small-business institution and resort to borrowing capital, why this provision is designed to help them.

Senator BROWN. May I interpose another question, Mr. Cooper?

Mr. COOPER. Certainly.

Senator BROWN. That means all of the equity capital is taken into consideration in the exemption.

Mr. SULLIVAN. Yes; that is correct.

Senator BROWN. And only a portion of what the large company borrows is taken into consideration.

Mr. SULLIVAN. That is correct.

Senator BROWN. The additional part.

Senator BARKLEY. Up to $100,000 at 100 percent.

Mr. SULLIVAN. At 100 percent; yes.

Senator BARKLEY. So if a $50,000 corporation borrows $50,000 more the entire $50,000 would be credited as invested capital.

Mr. SULLIVAN. That is correct.

Senator BROWN. Then it begins to slide down.

Mr. SULLIVAN. From $100,000 to $1,000,000 it goes down to 60⅔ percent.

Senator BROWN. I have not studied this matter like the members of the committee and subcommittee have, but it seems to me that there should not be this distinction between the two classes of capital.

Mr. SULLIVAN. You have to Senator, in order to effectuate the purpose you just outlined, to enable the small concern that cannot float equity capital to enjoy some of the benefits that are enjoyed by the large corporation.

Mr. COOPER. I think it would be fair to state that we have labored with this question days and days and days and that this is the best method we could get to accomplish the very purpose that Senator Brown has referred to.

Mr. SULLIVAN. That is correct, Mr. Cooper.

Mr. MCCORMACK. May I ask a question?

Mr. SULLIVAN. Yes.

Mr. MCCORMACK. I would like to have for the record what your idea of a small corporation is, or a small business in the United States.

Mr. SULLIVAN. I do not think that would be at all helpful to you, Mr. McCormack, but for the purpose of this bill the graduation in the rate of borrowings that will be permitted are $100,000——

Mr. MCCORMACK (interposing). I understand that.

Mr. SULLIVAN (continuing). $1,000,000 and above. And, we have further recommended to the subcommittee and I think in their report they have recommended to the full committee, that the earnings to be allowed on increased capital up to $500,000 ought to be 10 percent, and above that 8 percent; so, in answer to that question, I believe under the proposal of the subcommittee the dividing line would be deemed to be $500,000.

Mr. McCORMACK. That is a rather small business; that is not so large, is it?

Mr. SULLIVAN. Well, everything is relative.

Mr. McCORMACK. That is true. I think you have made a very clear recommendation. Whether the $100,000 should be the dividing line at 100 percent inclusion of all borrowed money in invested capital I am not prepared to say, but I think the Treasury's recommendation on this question has been very considerate of all aspects, particularly business; and I think it is only fair to them to have the record show, as coming from one member of the subcommittee at least, that the Treasury Department, through Assistant Secretary Sullivan, has been very considerate in the plan to recommend a bill that would be as equitable as is possible with the knowledge that whatever such legislation may be it is difficult.

Mr. SULLIVAN. We have tried to be.

Mr. McCORMACK. I know you have. I was wondering if you could give us some idea of what is considered a small business, not to embarrass you, because I would not do that to any witness, but this question may come up in executive session and there may be some who would feel that the $100,000 should be stepped up at least as to the 100 percent inclusion of borrowed money in invested capital.

Mr. SULLIVAN. Well I think it would be very difficult to determine that, Mr. McCormack, because what would be a very small corporation in one type of business, say the heavy industries, might be a very large corporation in another industry.

Mr. McCORMACK. Yes.

Mr. SULLIVAN. We will be very happy to give you a break-down as to the size of corporations, by industries, or by any other type of classification you wish, but to look over the 478,000 active corporations in America today and to say that below a certain figure they are small corporations and above that they are large corporations would imply the selection of a figure that I am not prepared to give.

Mr. McCORMACK. I think that answer comes from the mind of a statesman. What you say is absolutely correct and I realize it is difficult to draw a dividing line. Some people might consider one corporation large and other people might consider it small. It is pretty much like the witness who says that an automobile is going fast. A judge could not reach a conclusion from that evidence.

In these four-hundred-seventy-odd-thousand corporations I understand some 240,000 have invested capital of less than $50,000.

Mr. SULLIVAN. We can give those figures to you.

Mr. BLOUGH. That is substantially correct. The number of active corporations filing income tax returns in 1937 was 478,857, of which number 416,902 filed balance sheets. Of the corporations which filed balance sheets, 228,721 reported total assets of less than $50,000.

Mr. McCORMACK. They paid an income tax of how much; what was the total income tax of those corporations?

Mr. BLOUGH. The total income tax, undistributed profits tax and so-called "excess profits" tax for the 416,902 corporations which filed balance sheets in 1937 was $1,245,562,000.

Mr. McCORMACK. Does your report show the net earnings of those corporations?

Mr. BLOUGH. The net earnings of the 417,000?

Mr. McCORMACK. Yes; about seven billion?

Mr. BLOUGH. Their total net income less deficits, was $7,306,115,000

Mr. MCCORMACK. What will the net earnings reported by the 226,000 or 229,000 corporations having invested capital of less than $50,000?

Mr. BLOUGH. Some reported income and some deficit. All together, Mr. McCormack, they lost money, $131,673,000. They paid altogether $20,465,000 worth of taxes.

Mr. MCCORMACK. That is for the two hundred and twenty-odd-thousand?

Mr. BLOUGH. That is for the 228,721.

Mr. MCCORMACK. They paid $20,000,000 out of a total of how much?

Mr. BLOUGH. $1,246,000,000.

Mr. MCCORMACK. They must be very small.

The CHAIRMAN. You may proceed, Mr. Sullivan.

Mr. SULLIVAN. The net income for the base period, as well as for the taxable year, is to be computed without regard to long-term capital gains or losses, whether they be of depreciable or nondepreciable property.

Under the invested-capital method, invested capital is defined as the money paid into the corporation for stock or as paid-in surplus or as a contribution to capital, plus the basis for income-tax purposes of property so paid in, plus a portion of borrowed capital. The portion of borrowed capital to be included in invested capital is to decrease as the size of the corporation increases, since in general the smaller the corporation the less its ability to secure equity capital in the capital market. Invested capital is to be reduced by the percentage of the taxpayer's total assets which consists of assets the income from which is received wholly or partly tax free, such as tax-exempt obligations and stock in domestic corporations.

The subcommittee report recommends special treatment for personal-service corporations. A personal-service corporation is defined as one whose income is to be 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 return for any taxable year its desire not to be subject to the excess-profits tax and in such case it will be exempt from tax for such year. However, in order to obtain such treatment the shareholders of the corporation are required to include the undistributed income of such corporation in their gross income, which then is subject to normal tax and surtax.

In addition to excess profits, the proposed legislation deals with two other problems: Amortization and suspension of the profit limitations of the Vinson-Trammell Act.

The agencies of the Government charged with the duty of letting contracts for national defense orders have brought to the attention of the Treasury an aspect of the present income tax law on which they have requested revision. I refer to the provisions for depreciation—which, incidentally, are as generous to taxpayers in America as in any other country in the world. Under existing law the taxpayer is permitted to spread the cost of his depreciable assets over their expected useful life. This arrangement is fair to the taxpayer and fair to the Government since this cost is allowed in the form of deductions from

income during the years when the asset is contributing to the taxpayers income.

In the case of the expansion of plant and 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. 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. Because of this situation, the Treasury recommended to the subcommittee 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.

The Vinson-Trammell Act limits profits on contracts with the United States Government for the construction of naval vessels and contracts for airplanes or parts thereof for the Army and the Navy. The Treasury Department has been informed by the Advisory Commission to the Council on National Defense and by the War and Navy Departments that the restrictions of the Vinson-Trammell Act have discouraged many manufacturers from making contracts or subcontracts. It has been stated to us that the extensive special bookeeping requirements necessary to determine the actual profit on the contracts has served to discourage manufacturers from proceeding with national-defense work. In the light of the information that had been given to us, the Treasury Department recommended to the subcommittee the suspension of the Vinson-Trammell Act for the period in which an excess-profits tax is in effect.

The Vinson-Trammell Act, as I have pointed out, deals with only a limited kind of contract, namely, contracts for the construction of naval vessels and for 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 does not seem necessary or desirable to have what are in effect two profit-limiting provisions outstanding at the same time. For this further reason the subcommittee seems to be well justified in providing for suspension of the Vinson-Trammell Act during the period that an excess-profits tax is in effect.

Mr. CROWTHER. On page 7 of your statement you make reference to the agencies of the Government charged with the duty of letting contracts for national defense orders having brought to the attention of the Treasury an aspect of the present income tax law, and you say that you refer to the provisions for depreciation.

Mr. SULLIVAN. That is correct.

Mr. CROWTHER. That is in the income tax law.

Mr. SULLIVAN. I think it is contemplated in the report of your subcommittee that the amortization will apply for income tax purposes and for excess-profits tax purposes, Dr. Crowther.

Mr. CROWTHER. It seems to me that in 1932 and 1934 the Treasury Department voluntarily agreed to tighten up very considerably on depreciation.

Mr. SULLIVAN. I believe that is true, and I think they have.

Mr. COOPER. That is true. The subcommittee which was appointed in 1933, and which is the same subcommittee that has continued from that time down to now, made a report which resulted in the 1934 Revenue Act. They made a very careful study of the question of depreciation. The subcommittee was unanimous in their view that depreciation allowances were too liberal. We found that this country had the most liberal provisions for depreciation of any country in all the world.

We had many cases brought to our attention where we were thoroughly convinced that it was too liberal.

As a result of that study the subcommittee made a recommendation to take care of that situation.

When the full committee worked the matter out with the Treasury Department officials—and Dr. Magill was the then Treasury Department representative working with us—they agreed to adopt certain regulations that would accomplish the purpose which the subcommittee had in mind.

We were told that we would gain about $85,000,000 in revenue as a result of the treatment which was provided with respect to depreciation.

Mr. CROWTHER. That is my idea of it, and I refer particularly to the fact that the Treasury representatives themselves suggested or stated that they might gain about $85,000,000 by tightening up the depreciation sections of the regulations.

I wondered if they had done so; if there has been a general attitude on the part of the Treasury Department over the 6 years to tighten up a little on the depreciation allowances.

Mr. SULLIVAN. That has been done, sir, and I think it may be proper, since there seems to be some misunderstanding as to how the Treasury arrives at depreciation rates, if I may state how that is done.

There seems to be a feeling in some quarters that we pull a number out of a hat. That is not so.

The rate of depreciation that we allow 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. We have those rates for all different types of machinery and construction, and in the light of new information we are continually revising those figures.

For instance, when radio became popular and receiving sets were being manufactured for the first time the figures we had on the anticipated life of the machinery in those receivers proved to be wrong, and, naturally, we had to revise them. We have been constantly revising those figures all the time.

We intend those figures to represent what is the anticipated life of a certain plant or equipment.

A suggestion was made yesterday that perhaps the Treasury Department had it within its discretion to increase depreciation for certain purposes. That is a power which we do not believe the Treasury Department possesses. That would be a power that we would not welcome.

We think that depreciation should be just what I have said it to be, and if Congress wishes to make exceptions, or extend those figures, we think that should be done by Congress. We think it would be very unfortunate if we were given powers of discretion to extend it in certain cases and not to extend it in others.

Senator VANDENBERG. Has it been stated for the record how much this bill is supposed to produce?

Mr. SULLIVAN. No; I do not think it has, Senator.

Senator VANDENBERG. What is the estimate?

Mr. SULLIVAN. The bill combines two alternative plans, and the taxpayer has the power to elect under which plan he will file.

The expected yield of tax on 1940 excess profits under this plan recommended by the subcommittee is about $225,000,000. If we are talking in terms of net increase in revenue, I would think it should be reduced by $35,000,000 which is the amount which we anticipate individual income taxes would be reduced. So that there would be an anticipated net increase of $190,000,000.

Senator VANDENBERG. Is it worth subjecting American businessmen to this additional headache, aside from the necessity for doing something about preventing the building up of war profits?

Mr. SULLIVAN. I think we are all agreed that the latter is the major consideration in this measure.

Senator VANDENBERG. I think it would probably cost American business another $190,000,000 to hire experts who understand what it is all about.

Mr. SULLIVAN. I think they understand it.

Senator VANDENBERG. Let me ask you this question about the amortization plan, to see if I understand it.

At the top of page 8 of your statement you refer to a provision for shortening the period if the emergency should last for a shorter period than 5 years.

In other words, the expectation is that these plant expansions for national defense purposes are to be completely amortized within the period of the emergency, whatever the length of the emergency is set.

Mr. SULLIVAN. That is right, Senator. The proposal of the subcommittee contemplates this situation, that the owner of the increased or expanded facilities shall have the right to adopt amortization which would mean depreciation of 20 percent, and of course all of this amortization is applicable only to those new facilities which the Advisory Commission and either the War or Navy Department have jointly certified are necessary for national defense.

If the emergency ends, or if the War or Navy Department and the Advisory Commission decide they no longer need the additional facilities and they are no longer going to use the products of those facilities, then, at the end of the third year, that taxpayer may reopen his returns and take amortization at the rate of 33⅓ percent.

Senator VANDENBERG. That is on the theory that the new-plant expansion will not be utilized after the emergency is over.

Mr. SULLIVAN. That is correct.

Senator VANDENBERG. Suppose the operator finds a means to continue, through that plant expansion, in some other activity as profitable. Should not there be some recapture of these credits?

Mr. SULLIVAN. No; I think that in that event that situation is automatically taken care of because the manufacturer would not then come in and ask to have his returns reopened. He would much prefer to be allowed to continue his regular depreciation from that point on on whatever part of the building had not been amortized. In other words, at the end of 3 years 60 percent has been amortized and he would have 40 percent left to depreciate.

Senator BROWN. He would not have any further amortization in future years?

Mr. SULLIVAN. No, sir; he would prefer to have 40 percent left in the property, out of which he could take depreciation from that point on.

Senator VANDENBERG. Suppose he goes along for 5 years.

Mr. SULLIVAN. Then he can no longer take any depreciation on that property.

Senator VANDENBERG. But he can use it profitably for his own purposes.

Mr. SULLIVAN. That is right. He will pay an income tax, without the benefit of depreciation.

Senator VANDENBERG. You feel that that is an equitable situation?

Mr. SULLIVAN. I do. I do want to state to the Senator and the other members of the committees that there is another provision in the proposal recommended by the subcommittees, and it is this. A manufacturer is not obliged to take 20 percent. As a matter of fact, he is allowed to go ahead for some time on the regular depreciation and then go on to amortization.

We have also given him a further option, Senator Vandenberg, and that is after he has deducted amortization he may then return to depreciation and have that advantage.

The reason for that provision is that we think many of these people who elect to take amortization, after a year or two may decide they are dissipating that advantage too fast for their own good.

Senator BARKLEY. Under one plan suggested, based on earnings, it was estimated that more than $300,000,000 would be produced in revenue. Under another plan tentatively suggested, based on invested capital, it was stated that $700,000,000 would be raised. I am wondering whether combining those two propositions with a maximum and a minimum you would not arrive at something that would be an average between the two, and, if so, how you would get it down to $190,000,000.

Mr. SULLIVAN. I think this is a case where you do not arrive at an average, because——

Senator BARKLEY. If every corporation in the United States should elect to take the earnings basis and none took the invested capital basis, with the amount previously stated, based on earnings over a period of years, that would be a criterion, but does that operate to reduce the amount from more than 300 million to less than 200 million?

Mr. SULLIVAN. The $300,000,000 figure given you, I think, was described as a guess rather than an estimate.

Senator BARKLEY. Was that true of the Treasury's $700,000,000 estimate?

Mr. SULLIVAN. No; that Treasury estimate was a rough guess and was so described, and we told you we thought it would run between five hundred and seven hundred million. We have a figure, a more careful computation, leading us to expect that we should have told you between four hundred and four hundred and eighty million, because under that plan we would expect to lose between one hundred and one hundred and twenty million out of the personal-income tax.

Mr. COOPER. Mr. Chairman, in order to try to clarify this matter a little bit further, I think I am correct in my recollection that under the two plans recently presented, the one presented by the Treasury Department, based upon the principle of invested capital, and the other on earnings, or rather a combination, a guess was given that it would yield between five hundred and seven hundred and fifty million dollars in revenue.

Mr. Stam, the Chief of Staff of the Joint Committee on Internal Revenue Taxation stated that the plan based alone on average earnings over the base period of the 4 years, 1936, 1937, 1938, and 1939 would produce, according to his estimate, $300,000,000 of revenue the first year and about $500,000,000 after that.

It, of course, will be remembered that as these contracts are made and this business goes into operation, there will be some increase.

Now, then, I think it is also fair to state that the latest estimate we have received from the staff of the Joint Committee on Internal Revenue Taxation is that the plan embraced in the report of the subcommittee will yield about $300,000,000 in 1940 and around $500,000,000 thereafter.

The fact is there is not an entire agreement between the estimates presented by the staff of the Joint Committee on Internal Revenue Taxation and the representatives of the Treasury Department. That is a fact, is it not?

Mr. SULLIVAN. I do not think, on as complicated a piece of legislation as this, where the estimate depends on so many different factors, that a person, unless he was quite egotistical, could feel that only his estimate was correct. As I told Mr. Treadway the other day, any estimate would be fairly rough.

Mr. COOPER. I think we readily agree with you on that, but have I not made a fair statement about the whole situation?

Mr. SULLIVAN. Yes; you have.

Mr. COOPER. In reply to Senator Barkley's observation that a combination of the two suggested plans should, in the ordinary course of events, produce about an average of the revenue estimated for the two different plans, I think it should be borne in mind that when we allow the taxpayer to take an alternate plan, with the element of human nature being always present, it will result in his taking the plan that will cost him the least and will result in a loss of revenue.

Mr. SULLIVAN. And the yield would be less than under either of the alternative plans.

Mr. COOPER. The result would be less than under either of the alternative plans.

Mr. SULLIVAN. That is correct, sir.

Mr. COOPER. In other words, if you take the invested capital plan it would work to the advantage of some corporations and against the

advantage of other corporations. The result would be that we would get some more revenue than if you allow them to take either that or the alternative plan, or average earnings over a base period.

The natural result is that having the option to exercise, and knowing the taxpayer will take the one that will cost him the least, the result naturally follows that the revene will be somewhat less than if either one of the plans were adopted without any option.

Mr. SULLIVAN. I think that is true.

Mr. CROWTHER. May I ask Mr. Sullivan this question: Is it not a fact, and I think our experience demonstrates that it is a fact, that whenever they attempt to make these estimates the Treasury Department, naturally, is inclined to be rather conservative, because they are the ones who will get the money and pay the bills. They are rather conservative in their estimates to the production of revenue.

Mr. SULLIVAN. If we are, we are not conscious of it. When Congress asks us for an estimate we try to give the Congress the benefit of our best opinion.

Mr. CROWTHER. I do not doubt that you attempt to be fair, but I think you are always inclined to be rather conservative.

Mr. SULLIVAN. I will say this, that if we had to choose, I think it is a good direction in which to go.

Mr. CROWTHER. That is the side you lean to.

Mr. SULLIVAN. No; I do not think we lean consciously either one way or the other, Doctor.

Mr. TREADWAY. There was one matter called to my attention yesterday about which I want to get your viewpoint, and then I want to ask you some other questions, if I may.

On page 4 of your statement you speak of the invested capital method as being designed to measure the excessiveness of profit by a comparison between the ratio of earnings to invested capital in the taxable year with such ratio computed for a base period consisting of the years 1936, 1937, 1938, and 1939.

Assuming that a corporation had not made any profit during that period, how would any estimate be made in order to reach this matter of excess profits, and how would you make an adjustment?

Mr. SULLIVAN. It would not be necessary to make any estimate because where there is a deficit or earnings of less than 6 percent, that company is allowed to earn 6 percent on its present invested capital up to $500,000, and on capital in excess of $500,000 is permitted to earn 4 percent on its present invested capital regardless of whether it has made losses during the base period.

Mr. TREADWAY. I understand that feature of it, but if the invested capital is very high in proportion to their earning power, they would suffer then from this method?

Mr. SULLIVAN. No; on the contrary, they would enjoy an advantage.

Mr. TREADWAY. They would be favored rather than injured?

Mr. SULLIVAN. I think that is true, sir.

Mr. TREADWAY. Now, Mr. Sullivan, the members of the subcommittee have had the benefit of your views and the views of your associates in the Treasury, and the rest of the committee have not been so favored although some of them have been in session with us.

Of course, the general public has had no knowledge of the proceedings of the executive sessions of our subcommittee.

I think it is proper that certain general questions might be asked you, possibly duplicating what you have told us in the executive sessions, but which are nevertheless pertinent to the subject in hand.

So I would like to ask if you can tell us how much money has been actually expended by the Treasury on national defense since the President's message of May 16?

Mr. SULLIVAN. I do not have those figures available, but I will be glad to have Mr. Bell or his assistants here at any time you would like to hear from them.

(Mr. Sullivan subsequently submitted the following for the record:)

The Treasury's records of cash expenditures are not susceptible of segregation between expenditures on account of obligations incurred prior to May 16, 1940, and those incurred subsequent to that date.

Total national-defense expenditures (on basis of Treasury Daily Statement) since May 16, 1940, are as follows:

| | War | Navy | President's defense fund | Total |
|---|---|---|---|---|
| May 17 to 31, 1940 | $26,425,524.80 | $44,428,031.41 | | $72,853,556.21 |
| June 1940 | 64,404,392.50 | 88,510,199.86 | | 152,914,592.36 |
| July 1940 | 79,146,255.35 | 98,145,526.08 | $33,097.75 | 177,325,479.18 |
| Aug. 1 to 8, 1940 | 28,933,061.25 | 22,380,527.98 | 222,137.20 | 51,535,726.43 |
| Total | 198,909,233.90 | 255,464,285.33 | 255,834.95 | 454,629,354.18 |

Mr. TREADWAY. In that same connection, I would like to know how much has actually been contracted for.

Mr. SULLIVAN. We will try to get that for you.

Mr. TREADWAY. As a part of your answer.

Mr. SULLIVAN. I wonder if I might be duplicating some information that Mr. Woodruff asked for yesterday.

Mr. TREADWAY. I think possibly some of this line of inquiry I am pursuing may have appeared piecemeal in either Mr. Morgenthau's testimony or elsewhere, but as you are here as the representative of the Treasury Department, I think it would be valuable if we can concentrate this information into one general statement coming from you.

Mr. SULLIVAN. We will be glad to get it for you.

(Mr. Sullivan furnished the following for the record:)

This data is not reflected in records maintained by the Treasury, but the Treasury has been informally advised by the Advisory Commission of the Council of National Defense that national defense contracts let during June and July, 1940, are as follows:

| | War Department | Navy Department | Total |
|---|---|---|---|
| June 1940 | $121,600,000 | $703,400,000 | $825,000,000 |
| July 1940 | 442,300,000 | 694,600,000 | 1,136,900,000 |
| Total | 563,900,000 | 1,398,000,000 | 1,961,900,000 |

Mr. TREADWAY. If I ask you any questions that in a sense duplicate what you may have gone into with other members of the committee, I trust you will bear with me in my repetition.

Mr. SULLIVAN. Gladly.

Mr. TREADWAY. It is so complicated and deep a subject we cannot get too much information about it.

Mr. SULLIVAN. Correct.

Mr. TREADWAY. Has the Treasury made any estimate of how much will be spent on national defense in the fiscal year 1941?

Mr. SULLIVAN. Other than what was presented in the Secretary's statement yesterday, I do not believe so.

Mr. TREADWAY. I am not sure whether it was or not.

Mr. SULLIVAN. You mean if we have made any estimate that was not presented to you in the Secretary's statement you would like to have it made available to the committee.

Mr. TREADWAY. I personally would like to get whatever information you have, and I am asking for that, not with the idea of putting you on the spot.

Mr. SULLIVAN. I understand.

Mr. TREADWAY. But for our own information. And I would like to ask you the same question applicable to 1942.

Mr. SULLIVAN. Very well, sir.

(Mr. Sullivan supplied the following for the record:)

The estimate of the Treasury and the Bureau of the Budget as of August 5, 1940, of national defense expenditures for the fiscal year 1941 is $5,000,000,000.

It is not possible at this time to make any dependable estimate of national defense expenditures for the fiscal year 1942. Work on the 1942 Budget is just getting under way and it will not be completed until the submission of the President's budget at the beginning of the next regular session of Congress.

Mr. TREADWAY. I do not suppose you or any other official at the present time has made any estimate of the total cost of the national-defense program.

Mr. SULLIVAN. I cannot answer that, sir.

Mr. TREADWAY. Well, so far as the Treasury is concerned?

Mr. SULLIVAN. So far as I am concerned?

Mr. TREADWAY. Yes.

Mr. SULLIVAN. No; I have not.

Mr. TREADWAY. And, as representing the Treasury, you do not consider the Treasury has made any estimate of the ultimate cost of national defense?

Mr. SULLIVAN. I do not think any of us know what future events will require us to spend for national defense, Mr. Treadway.

Mr. TREADWAY. That is one difficulty. We have had so many messages come in, each one we think is going to be the last one, and they have followed one another rather rapidly in the last few months.

Mr. SULLIVAN. That is right, sir; and several kingdoms have fallen in the last few months.

Mr. TREADWAY. I hope—we all hope—there will be an end in the making of those requests, but there has been no guaranty we have reached the end yet, has there?

Mr. SULLIVAN. No; and I do not think there can be any such guaranty.

Mr. TREADWAY. Well, does not that in a way allow Congress a little more latitude than has been given them in the public mind, in the matter of developing a sound program of financing? Unless we can see some end to the picture of need, how can we provide an adequate tax program for meeting national-defense needs, if we do not know what is coming to us?

Mr. SULLIVAN. I think for that, sir, we have to rely upon the advice of those gentlemen who are entrusted with the duty of giving this country an adequate national defense.

Mr. TREADWAY. Yes; but I am looking at the picture from the standpoint of our own needs, that is, of what we must do, what Congress must do. Unless we can get a more definite idea of the ultimate call for funds for national defense, how can we set up a sound financial program in Congress?

Mr. SULLIVAN. I think we will have to go on the basis that we will need additional funds for further expansion of the national defense until the situation in foreign affairs indicates that need has ceased.

Mr. TREADWAY. In other words, you think it is a temporary program; that whatever we adopt here now is temporary and will be based on further requests; that is, any adjustments of it will be based on further requests?

Mr. SULLIVAN. I should assume so, sir.

Mr. TREADWAY. And you feel that Congress should place implicit confidence in those who are entrusted with the duty of prescribing what the actual needs are for national defense?

Mr. SULLIVAN. Yes; assuming Congress has the confidence in the ability of those gentlemen that is implicit in their being confirmed in their appointments.

Mr. TREADWAY. I think we have shown very great confidence in them.

Mr. SULLIVAN. I do, sir, and I hope that continues.

Mr. TREADWAY. Of course, there is a limitation on that trust. In a sense there must be some limitation. However, I won't press that, Mr. Sullivan.

Now I would like your opinion as to what proportion of the $14,500,000,000 now appropriated or authorized for defense purposes should be met by taxation and what proportion by borrowing.

Mr. SULLIVAN. I think that is a question that Mr. Bell, in charge of the fiscal affairs of the Treasury, should answer.

Mr. TREADWAY. I beg pardon.

Mr. SULLIVAN. I think that is a question that Mr. Bell, the Under Secretary, who has charge of the fiscal affairs of the Treasury, should answer, rather than I. I shall be very glad to get his answer and put it into the record for you.

Mr. TREADWAY. I should like to have the answer come from you, as I say, for a concentration of answers to these various questions.

Mr. SULLIVAN. All right, sir.

Mr. TREADWAY. We did not interrogate Mr. Bell to any extent yesterday.

Mr. SULLIVAN. No; I recall.

Mr. TREADWAY. Mr. Knutson furnishes one of his characteristic remarks by saying he pinch hit occasionally yesterday for the Secretary.

Now, what is your expectation of any request for a further increase of the debt limit during 1941?

Mr. SULLIVAN. I will get that information for you.

Mr. TREADWAY. Do you think there is some definite viewpoint in the minds of the officials as to what the increase is likely to be?

Mr. SULLIVAN. Oh, I do not know, sir; but I will find out for you.

Mr. TREADWAY. Did not Mr. Bell say yesterday we were going to be $9,000,000,000 short? There was some reference to the amount; I am not quite certain; it was so big that I could not quite comprehend it.

Mr. SULLIVAN. I think Mr. Bell remarked that with further increases for the requirements of national defense there would have to be an increase; but I do not recall exactly, sir; but I will get that information for you.

Mr. TREADWAY. Nine billion, I think, was the figure.

Mr. SULLIVAN. I do not recall exactly.

Mr. TREADWAY. We will be glad to have that incorporated in the record, Mr. Sullivan.

Mr. SULLIVAN. I will see that you get it, sir.

Mr. TREADWAY. Now, perhaps this is another question with respect to which you would prefer to have the answer come from Mr. Bell or others: How much should the debt limit be raised for defense purposes?

Mr. SULLIVAN. Yes; I will see that you get that. You mean the opinion of the Treasury?

Mr. TREADWAY. Yes, sir.

Mr. SULLIVAN. Yes; I will be glad to get that for you. I anticipate, of course, it will be based upon future requirements in the development of the defense program.

Mr. TREADWAY. Along the line of my previous inquiry, because this has been a piecemeal proposition, in January the Treasury said it required no increase; in June it said three billions, then it changed the amount to $4,000,000,000, and in August it now appears $14,000,000,000 is the amount that is really required. Of course that all tends toward a lack of a sound financial policy when those figures vary so from time to time.

Mr. SULLIVAN. I beg your pardon, sir; I am afraid I did not get that last remark.

Mr. TREADWAY. I asked how much the debt limit should be increased for defense purposes, and then I made a comment on that.

Mr. SULLIVAN. I imagine events that are happening abroad even now will largely affect that situation; but we will give you the benefit of whatever opinion we are able to get.

(Mr. Sullivan submitted the following material requested in Mr. Treadway's questions:)

Secretary Morgenthau in commenting on the fiscal situation before this committee on August 9 said:

"On June 30, 1941, according to present estimates, the balance under the general debt limit will have shrunk to $300,000,000, and the $4,000,000,000 authority will have been exhausted. In addition, it will have been necessary to draw upon the working balance of the Treasury, reducing that balance to about $1,275,000,000.

"On the basis of these estimates it is obvious that in view of the requirements of the defense program, the present combined debt limitation of $19,000,000,000 will sooner or later need to be increased. Whether an increase will be required before the end of the present fiscal year must depend in the first instance upon the speed at which the defense program progresses."

In determining the extent to which the debt limitation should be increased, it will be necessary for the Congress not only to consider the expenditures arising out of the national-defense program, but also expenditures of the Government for other purposes as related to the revenues which the Treasury will receive. The most practicable method of treating the debt limitation is for the Congress to fix such limitation as is determined to be necessary to cover the requirements of the Treasury for a reasonable time and to reexamine the situation whenever such limitation is about to be reached.

Secretary Morgenthau in his statement before the Senate Finance Committee on June 12, 1940, said, in part, as follows:

"The financing of the increase of Federal expenditures for national preparedness requires provision for additional taxes, or a decrease in other expenditures, or an increase in the national debt beyond the present statutory limit. In my judgment all three steps are required."

In enacting the Revenue Act of 1940 the Congress has indicated that it proposes to finance the increased expenditures for national defense by borrowing and by levying additional taxes. In the present circumstances it is difficult to give a categorical opinion as to the proportion of the $14,700,000,000 defense program that should be met by taxation and by borrowing. There are numerous factors which influence this determination, such as the rapidity with which the defense program is carried forward, the additional revenues that will be collected under existing tax laws as a result of improvements which may materialize in general business conditions, etc.

Mr. TREADWAY. I think you answered Senator Vandenburg as to the amount you expected would be raised by this new bill.

Mr. SULLIVAN. Yes, sir.

Mr. TREADWAY. Something around $200,000,000?

Mr. SULLIVAN. $225,000,000.

Mr. TREADWAY. But you made a deduction of $35,000,000 from that?

Mr. SULLIVAN. That is right; that is correct, because if out of the earnings of the corporations you take $225,000,000 in excess-profits taxes, there is that much less to distribute to the stockholders and there is that much less that will be reported by individuals in their income-tax returns that will be subject to both the normal and surtax rates.

Mr. TREADWAY. In that deduction, you anticipate there will be about $35,000,000 involved?

Mr. SULLIVAN. That is correct, sir.

Mr. TREADWAY. Now, the $190,000,000 that will be net to the Treasury in your estimate—will this be segregated in a sinking fund for defense expenditures, as was done in the 1940 act?

Mr. SULLIVAN. I have heard no proposal that that should be done, and it was not in the report of your subcommittee.

Mr. TREADWAY. So that it would go in the general funds of the Treasury?

Mr. SULLIVAN. That is correct.

Mr. TREADWAY. Would you see any reason why it should not; so long as we are working under a defense program, do you see any reason why it should not be earmarked for defense purposes?

Mr. SULLIVAN. I think there are others in the Treasury who are better prepared or qualified to debate that question with you, but I think the general consensus of the Treasury on earmarking is that it is not generally wise or desirable.

Mr. TREADWAY. Then why did we do it in the last revenue act?

Mr. SULLIVAN. Because in the last revenue act I do not believe we anticipated there would be such further calls for expanding our national defense.

Mr. TREADWAY. I would be glad to have that subject included in your statement.

Mr. SULLIVAN. We will be very glad to include it, sir.

Senator BARKLEY. There is one thing that might be suggested there—that is, that tax was a definite tax for defense purposes.

Mr. SULLIVAN. That is correct.

Senator BARKLEY. Whereas this tax is a tax growing out of the program for defense, possibly, but not definitely levied for defense purposes.

Mr. SULLIVAN. It is not levied to defray the expenses of national defense.

Mr. KNUTSON. Well, is this or is it not a defense program?

Mr. SULLIVAN. Oh, I think all three parts of this bill are directly required because of our need for expanding our national defense.

Mr. KNUTSON. They are definitely defense measures?

Mr. SULLIVAN. Yes.

Mr. KNUTSON. Then why should not the money raised be earmarked for defense purposes?

Mr. SULLIVAN. Well, I think the thought implicit in Senator Barkley's remark was that the excess-profits tax was not exclusively a revenue-raising measure, but was rather intended to prevent undue enrichment of certain people during this period. Was not that the thought you had in mind, Senator Barkley?

Senator BARKLEY. Yes.

Mr. KNUTSON. But it will raise revenue, will it not?

Mr. SULLIVAN. Yes, sir; it will.

Mr. KNUTSON. And it is part of the defense program?

Mr. SULLIVAN. Yes, sir; correct, sir.

Mr. KNUTSON. Then why would it not be desirable to earmark the receipts from that tax?

Mr. SULLIVAN. I do not see any benefit that comes from earmarking, Mr. Knutson. It merely requires a great deal more bookkeeping, and all of the money eventually gets into the same pocket, and all of it——

Senator CLARK. You scarcely raise enough money to pay for the bookkeeping anyhow, under this bill; do you?

Mr. SULLIVAN. Well, I do not think the bookkeeping will be that expensive, Senator Clark.

Mr. TREADWAY. We hope not.

Mr. KNUTSON. Is it not always desirable to take steps to assure the money being spent as Congress intended it should be?

Mr. SULLIVAN. I do not recall that the subcommittee has recommended that the particular dollars that come in from this particular tax shall be set aside to be spent for a particular purpose.

Mr. KNUTSON. I understand that, but would there be any objection?

Mr. SULLIVAN. I beg your pardon, sir?

Mr. KNUTSON. Would there be any objection to the entire committee taking the action of earmarking the money connected with it?

Mr. SULLIVAN. Yes; we recommend you do not do it.

Mr. KNUTSON. I understand that.

Senator BARKLEY. But that earmarking, in the final analysis, would not affect the situation in any way so far as the solvency of the Treasury is concerned?

Mr. SULLIVAN. It would not affect it so far as the solvency of the Treasury is concerned, no.

Mr. TREADWAY. Mr. Secretary, with all due respect, I do not think I could quite go along with you and with Senator Barkley, that this money is not definitely intended for defense purposes. We would not be proposing any such bill as this if it was not for national defense.

Mr. SULLIVAN. In the one you passed a few months ago, you said:

> This is a special defense tax and we are going to earmark these funds and the money we get here, since it is being raised exclusively for the purpose of contributing to the national defense, must be earmarked.

Now I understand there is a dual purpose of the excess-profits tax—to raise some money, but also to prevent undue enrichment on the part of a few.

Mr. TREADWAY. That latter, of course, is true; we want to avoid the millionaire class that was created in the previous war; but, nevertheless, there is no need of arguing that. I do not see where this differs from the previous law in the matter of actually being brought about and caused by the national defense program.

Mr. SULLIVAN. Neither do I; I agree with you.

Mr. TREADWAY. We agree on that point?

Mr. SULLIVAN. Yes.

Mr. TREADWAY. Therefore, there is just as much reason to earmark these funds as to earmark the other.

Now, does the Treasury contemplate that the excess-profits tax shall be a temporary tax, like the 10-percent super tax was, or do you intend it to be permanent?

Mr. SULLIVAN. I beg pardon?

Mr. TREADWAY. Does the excess-profits tax end with the emergency?

Mr. SULLIVAN. I would assume Congress——

Mr. TREADWAY. Is not that the way it appears in the report?

Mr. SULLIVAN. Yes.

Mr. TREADWAY. Do you consider the total yield of this bill for 1940, assuming it is retroactive, will reach the $200,000,000 figure?

Mr. SULLIVAN. Yes, sir. The gross yield, I think, of this particular tax will be $225,000,000.

Mr. TREADWAY. And if it stays in the law, it will increase somewhat after 1940?

Mr. SULLIVAN. I would anticipate it would increase substantially, sir.

Mr. TREADWAY. So far as you know, is there anything in the mind of the responsible people in the Treasury of further taxes to amortize this defense expenditure?

Mr. SULLIVAN. I do not recall any that are under consideration at the present time.

Mr. TREADWAY. Nothing of that kind is contemplated?

Mr. SULLIVAN. No, sir.

Mr. TREADWAY. Just one more question——

Mr. SULLIVAN. But nothing of that kind is precluded, sir.

Mr. TREADWAY. I beg pardon?

Mr. SULLIVAN. Nothing of that kind is contemplated, but nothing of that kind is precluded. We will have to shape our course upon the events of the future.

Mr. TREADWAY. That is why I think we should let these things be generally known, in order if people have suggestions to make to the committee they can be made during the progress of these public hearings.

Now I think I can answer this question myself, but I would like to have your view on it. Has any reduction in nondefense expenditures been effected to date?

Mr. SULLIVAN. I do not know. I will get that for you.

Mr. TREADWAY. Were there any contemplated in the 1941 Budget?

Mr. SULLIVAN. I will get that for you.

Mr. TREADWAY. And are there reductions of nondefense expenditures contemplated beyond 1941?

Mr. SULLIVAN. I will try to get you what we can on that, sir. After all, it is Congress and not the Treasury Department that reduces the Budget.

Mr. TREADWAY. Well, we have been very liberal in making appropriations and I, personally, have been anxious to see some reductions in nondefense appropriations, but that has not been realized very extensively. But if there are any you know of or any in contemplation, I would be glad to have you include that in the statement you furnish the committee.

Mr. SULLIVAN. I will do that.

Mr. TREADWAY. I thank the chairman and Mr. Sullivan.

(Mr. Sullivan supplied the following for the record:)

Responsibility, as far as the executive end of the Government is concerned, as to possible economies, rests with the Director of the Budget, under the immediate jurisdiction of the President. The Treasury, therefore, is not informed as to the details of any contemplated economy program involving other than national defense expenditures for the fiscal years 1941 or 1942. However, actual expenditures seperated as to defense and nondefense purposes for the fiscal years 1939 and 1940, and estimated expenditures for 1941, are as follows:

| | Fiscal years | | |
|---|---|---|---|
| | Actual, 1939 | Actual, 1940 | Estimated, 1941 |
| National defense expenditures | $1,163,000,000 | $1,559,000,000 | $5,000,000,000 |
| Nondefense expenditures | 7,544,000,000 | 7,439,000,000 | 7,058,000,000 |
| Total expenditures, excluding debt retirements [1] | 8,707,000,000 | 8,998,000,000 | 12,058,000,000 |

[1] On basis of present classification which excludes transactions in Federal old-age and survivors insurance trust fund.

Mr. MCCORMACK. In connection with Mr. Treadway's question about reduced expenditures beyond 1941, that naturally presupposes, if I may make the observation, the theory or the implied admission that the Democratic Party, of course, is going to be in power—which we are. [Laughter.]

(After several remarks by members of the committee which the reporter could not hear:)

Mr. CROWTHER. I suggest the gentleman from Massachusetts (Mr. McCormack) should have that stricken from the record to save himself future embarrassment.

Mr. MCCORMACK. Mr. Sullivan, you have been asked something about additional taxes to meet increased expenditures. Is not that also a duty of Congress; has not Congress some responsibility along that line?

Mr. SULLIVAN. Not only some responsibility, but the entire responsibility. I understand ours is giving you the benefit of what information and experience we have.

Mr. MCCORMACK. Now, the question has been asked you about your idea of what additional funds are needed: Is not that dependent upon what happens in other parts of the world; to a great extent, is not that dependent upon other events over which this country has no control?

Mr. SULLIVAN. That and the degree to which we care to protect ourselves against eventualities.

Mr. McCORMACK. In other words, we do not want to bring in the names of any country or individual, but that is in the main predicated upon happenings outside of the United States, which happenings have a bearing, one way or another, on the defense program for our own country?

Mr. SULLIVAN. Over which we have no control.

Mr. McCORMACK. Exactly. Now, I have one or two questions to ask.

Take the case of a corporation 6 percent of the income exempt under the Treasury's plan up to the first $500,000 of invested capital, and 4 percent after that; that is on corporations that have not had that average of earnings during the base period? That is correct, is it not?

Mr. SULLIVAN. Or having had less, or having had losses.

Mr. McCORMACK. Or having had deficits?

Mr. SULLIVAN. That is correct.

Mr. McCORMACK. Or have not had earnings of that amount on the average?

Mr. SULLIVAN. That is correct.

Mr. McCORMACK. And the limit on the corporation of over $500,000 means an exemption of 4 percent plus?

Mr. SULLIVAN. Well, up to $500,000, it is 6 percent.

Mr. McCORMACK. I mean taking a corporation of $50,000,000, it would be a little bit above 4 percent?

Mr. SULLIVAN. That is right.

Mr. McCORMACK. But you do not have to go into that. It would be 4 percent plus, anyway?

Mr. SULLIVAN. That is correct.

Mr. McCORMACK. Where the corporation has in excess of $500,000 invested capital?

Mr. SULLIVAN. That is correct.

Mr. McCORMACK. We will assume this law is in operation and those are the provisions of the law, as recommended by the Treasury and the subcommittee—tentatively recommended by the subcommittee—as a basis for these hearings, and we will assume a corporation, after the first year of operation under this law, earns 2 percent, and we will say they have $500,000 of invested capital, or less: with that exemption of 6 percent from the imposition of the excess-profits tax, what do you think of the idea of giving that corporation a carry-over for the next year as against the excess-profits tax of the difference between the 2 percent they earn and the 6 percent they were exempted?

Mr. SULLIVAN. You mean to say if they earned 10 percent the next year, they would not have to pay any tax?

Mr. McCORMACK. That is it. It is a carry-over of 1 or 2 years of the excess-profits tax alone.

Mr. SULLIVAN. Yes.

Mr. McCORMACK. Have you considered that, Mr. Sullivan?

Mr. SULLIVAN. Yes; it is a close question and we have resolved it in the negative.

Mr. McCORMACK. In other words, it is a close question?

Mr. SULLIVAN. It is.

Mr. McCORMACK. That is a very frank answer and I appreciate it, because that is just what I know would come from you; but there is something to it, Mr. Secretary?

Mr. SULLIVAN. Oh, yes; a very good case can be made out for it. It is a further relief provision for the company that has not been doing at all well in the past.

Mr. McCORMACK. Because in the outset, of course less than 5 percent of the corporations are going directly to benefit from the speed-up in consequence of our national-defense program.

Mr. SULLIVAN. I do not think I would want to agree with that—or did you say benefit "directly"?

Mr. McCORMACK. "Directly."

Mr. SULLIVAN. Well, I do not know. I should imagine your figure is not too high.

Mr. McCORMACK. Well, in any event, the great majority of the corporations. It is going to be some time before the money gets out into circulation and it goes from hand to hand in the purchase or exchange of goods or services before a lot of the corporations are going to benefit from it.

Mr. SULLIVAN. There will be a lag.

Mr. McCORMACK. And we do not want to do anything that would discourage corporations who are not directly connected with the national-defense program from reasonably expanding in response to increased business, if that situation arose?

Mr. SULLIVAN. We definitely do not.

Mr. McCORMACK. And such a carry-over might in part meet that situation, or enable a corporation to proceed with more confidence and, in part, to meet that situation, if they had a 1- or 2-year carry-over—not of losses, but of earnings, under the exempted percentage?

Mr. SULLIVAN. You mean a carry-over of deficiency of exemptions?

Mr. McCORMACK. As against the excess profits.

Mr. SULLIVAN. That is right.

Mr. McCORMACK. Now, take the case of an American corporation doing business in Canada. It has made money in Canada and it pays its tax there. Under the normal tax, of course, that corporation is entitled to a certain credit, is it not?

Mr. SULLIVAN. That is correct—on the tax paid in Canada.

Mr. McCORMACK. Not to exceed the amount paid in Canada?

Mr. SULLIVAN. Right.

Mr. McCORMACK. Or, if they are not entitled to that exemption benefit, its proportionate share of the earnings in Canada in relation to total earnings?

Mr. SULLIVAN. That is right.

Mr. McCORMACK. Now, assuming such a corporation—and there are many of them, and I use Canada as an illustration of a neighbor country, but it would apply to any other country in the world where an American corporation has business—assuming they are not entitled to an exemption of the amount of the tax paid in another country and they take the proportionate amount, as they are entitled to do, what would you say about allowing a tax credit against the excess-profits tax paid on the proportionate part of the earnings of the corporation in a foreign country to the total amount of earnings subject to excess-profits tax?

Mr. SULLIVAN. That is a long question and a longer problem, and I think I would prefer to answer that at the next session of your committee, if I may.

Mr. MCCORMACK. What?

Mr. SULLIVAN. I would prefer to answer that at the next meeting of the committee.

Mr. MCCORMACK. You understand what I have in mind?

Mr. SULLIVAN. I do.

Mr. MCCORMACK. I was bringing it up to bring it to the attention of you and your associates for study.

Mr. SULLIVAN. I will go into that and bring you an answer Monday morning.

Mr. MCCORMACK. It is not a matter of my own thought; it was called to my attention and I felt there was such merit to it that it should be brought out in the public hearings and looked into by the Treasury Department.

Now, take the case of personal-service corporations. Of course, that is a very difficult problem. I had breakfast this morning with a gentleman, for example, who represents an association of one hundred-and-some-odd personal service corporations that go out and deal with newspapers in negotiating for advertisements. They represent clients. Now, they have very little invested capital. Most of it is in the ability of the men and the corporation and their personality, and the invested capital in dollars is usually rather small.

Mr. SULLIVAN. We think we have treated them very kindly, Mr. McCormack. Those hundred personal-service corporations, if they come under the regular definition of a corporation whose income is attributable primarily to activities of the principal owners and stockholders, and if those stockholders themselves are regularly engaged in the active conduct of the affairs of the corporation, and if the capital is not a material income-producing factor in the income of that corporation, then they do not have to be subject to the excess-profits tax. But whatever profit has been made by that company is taxable in the hands of the stockholders whether or not it has been distributed.

Now, when we say "principal owners or stockholders," according to the definition, that means the holders of 80 percent of the stock in that company must be personally active in the affairs of the corporation.

Mr. MCCORMACK. I am acquainted with that. The thought was conveyed to me and I am just passing it to you to give consideration to, as to whether or not some type of personal-service corporations—their percentage of income, before being subject to the excess-profits tax, should not be connected with earnings based upon volume, because of the fact that the invested capital is usually low, although the actual success of the business is mainly based upon the ability of the individuals who comprise it.

Mr. SULLIVAN. That is right. But they do not have to pay any tax upon invested capital if they elect not to be subject to the excess-profits tax.

Mr. MCCORMACK. They can go on the partnership theory?

Mr. SULLIVAN. That is correct—after payment of the corporation income tax.

Mr. MCCORMACK. Now I notice "mutual investment companies" here on page 4 (of course, we know about their situation) are exempt

and that includes, of course, those corporations like up in Boston, Mass., and elsewhere, where a person goes in and buys an interest in an investment company that deals in stocks and bonds and they can sell on 24 hours' notice, and where the corporation declares over 90 percent of its earnings out in dividends.

Mr. SULLIVAN. The reason they are exempt, Mr. McCormack, and the reason the subcommittee recommended it, is because they have distributed 90 percent of their income.

Mr. MCCORMACK. But that particular matter you are acquainted with, and my interest in it, is included in that?

Mr. SULLIVAN. Yes, sir.

Mr. DISNEY. Mr. Sullivan, did you read an article in last night's Star by David Lawrence, suggesting that rather than an excess-profits tax we increase the rate on corporations?

Mr. SULLIVAN. No, sir; I did not.

Mr. DISNEY. He thought it would be more desirable than an excess-profits tax.

Mr. SULLIVAN. I did not see it.

Mr. DISNEY. I would like to have your views on that subject after you have read the article. I think that, coming from the source it does, it deserves consideration.

Mr. SULLIVAN. Yes, sir.

Senator CLARK. Mr. Sullivan, I understand that the excess-profits tax portion of this bill is only estimated to raise $190,000,000.

Mr. SULLIVAN. Yes, sir.

Senator CLARK. With the situation we are in, and with the President recommending an additional four or five billion dollars every time he comes back from a week-end trip, $190,000,000 is simply a drop in the bucket.

Mr. SULLIVAN. Yes, sir.

Senator CLARK. Is not this excess-profits tax included in the bill as a sort of a sugar coating for the American people to swallow the amortization plan? It does not represent enough revenue to be of any considerable moment. Of course, $190,000,000 is a lot of money, but in proportion to the amount of money that we are spending, it is but a drop in the bucket.

Mr. SULLIVAN. Yes, sir.

Senator CLARK. So it is included in this bill really to convey the impression to the American people that we are soaking somebody for the expense of the national-defense program, but is not the real purpose to induce the American people to swallow this amortization feature in the interest of the munitions makers?

Mr. SULLIVAN. That inquiry involves a question of motive. The Treasury started with the excess-profits tax features, the amortization plan, and suspension of the Vinson-Trammell Act; so I do not think the Treasury did have that motive.

Senator CLARK (interposing). The Treasury is not responsible for that, or for coupling them up.

Mr. SULLIVAN. The Treasury approved coupling them together.

Senator CLARK. Is not $190,000,000 of tax, which is merely a drop in the bucket, merely to make the amortization feature more palatable?

Mr. SULLIVAN. I do not think so. We started with the excess-profits tax before amortization was considered.

Senator CLARK. The excess-profits tax, however, will be of considerable moment in questions involving the Budget, but, in view of the tremendous appropriations and authorizations they are going ahead with, it is really a very small item in the annual program of expenditure.

Mr. SULLIVAN. For 1940 it will be a very small item.

Senator LA FOLLETTE. Mr. Sullivan, in your opinion, is there any essential conflict in the proposal of the subcommittee in theory, or have you not got here a proposition which tries to combine the theory of excess-profits taxation as a permanent or quasi-permanent feature of the tax structure and unjust enrichment taxation?

Mr. SULLIVAN. Do you mean war-profits taxes?

Senator LA FOLLETTE. Yes.

Mr. SULLIVAN. They are two different ideas.

Senator LA FOLLETTE. Will not that combination, or the attempt to combine those features, by which you give the taxpayer or tax paying corporation an election as to which basis he shall use in the payment of taxes, result in a reduction of revenue?

Mr. SULLIVAN. Yes, sir; to a great extent.

Senator LA FOLLETTE. Have you made any study of the incidence of the tax under this theory of permitting the tax paying corporation to elect the basis of the tax?

Mr. SULLIVAN. Yes, sir; our conclusion was that the yield would be reduced. I think Mr. Stam's estimate was $300,000,000 under the average earnings plan alone, and our figures were $500,000,000 based on the invested capital feature alone. By combining them, and giving the taxpayer an election as to which plan to follow, we estimate it would yield a gross revenue of $225,000,000.

Senator CLARK. Under the Treasury's plan, or original plan, the estimates were higher, or $750,000,000?

Mr. SULLIVAN. Our original estimate, that we gave the subcommittee, was from $500,000,000 to $750,000,000.

Senator LAFOLLETTE. Perhaps I did not make my question clear. What I am anxious to ascertain is whether or not the Treasury has made any study of this plan that is now proposed to indicate what the effect of it will be, so far as corporations are concerned, in relation to the capacity to pay excess-profits taxes.

Mr. SULLIVAN. Do you mean a particular corporation?

Senator LA FOLLETTE. I have no particular corporation in mind, but it seems to me that it would be important in the consideration of this legislation to know what the effect would be, so far as corporation earnings are concerned, under the alternative or optional plan that is proposed here upon a specimen corporation. Has the Treasury made any study of that which could be made available to the committee?

Mr. SULLIVAN. Do you mean the degree to which a corporation should pay or be excused from paying, and the extent to which this alternative plan gives a corporation with higher earnings an opportunity, in relation to its ability to pay taxes, to be relieved of them under this combined proposal?

Senator LA FOLLETTE. Yes. Have you made a study of its application to any specimen corporation that could be made available to the committee?

Mr. SULLIVAN. No, sir; but we will be glad to do that.

Senator LA FOLLETTE. Will you please do that, because I think it is very important and essential that we have such information.

Mr. SULLIVAN. Would you like that for any particular corporation?

Senator LA FOLLETTE. I do not expect you to disclose for the public record any information of a particular corporation, but I would like to have the study made. As I understand it, sometimes a study made of a specimen corporation will give us the effect on certain situations, and I would like to have such a study made which would give the committees in their consideration of this legislation some specific information as to the incidence of this particular proposal.

Mr. SULLIVAN. We will have that for you at the next session.

Senator LA FOLLETTE. I have no further questions; thank you.

Mr. REED. Mr. Sullivan, I understand that the Treasury has prepared a memorandum covering the elimination of undesirable features of the 1918 excess-profits tax, and I would like to have it put in the record. I think it should be furnished for the record. I have received a great many letters before these hearings on the subject, in reference to the undesirable features of the 1918 act.

Mr. SULLIVAN. You are now referring to the memorandum you were given earlier this week?

Mr. REED. Yes.

Mr. SULLIVAN. I do not have a copy here today, but I will have one here Monday.

(The memorandum referred to follows:)

ADVANTAGES OF THE INVESTED CAPITAL CONCEPT CONTAINED IN THE CURRENT EXCESS-PROFITS TAX PROPOSAL OVER THE INVESTED CAPITAL CONCEPT CONTAINED IN THE REVENUE ACT OF 1918

(1) *Valuation problems.*—The 1918 act provided in substance that invested capital was to be computed as the actual cash value at the time paid in to the corporation of cash or property paid in for stock, or as paid-in surplus, or as a contribution to capital. The current proposal provides that equity invested capital shall be computed as the cash paid in plus the aggregate of the basis (adjusted up to the time paid in) of property paid in for stock or as paid-in surplus or as a contribution to capital. The necessity under the wartime acts of determining the value of property as of a fixed date, possibly far in the past, was productive of much litigation and many administrative complications. These difficulties are avoided under the current proposal by the use of basis rather than value, since the records of the Bureau and the income-tax returns filed by the taxpayers can reasonably be expected to reveal the data necessary for the determination of the basis of property paid in to the great majority of corporations.

(2) *Intangibles.*—The 1918 act provided that the cash value of intangible property paid in and taken into account in the computation of invested capital should not exceed 25 percent of the par value of the corporation's capital stock. The wartime differentiation between intangibles and tangibles resulted in much confusion and many administrative problems, particularly where stock was issued for an aggregate of assets, both tangible and intangible, without segregation. These difficulties, together with the enormous burden of valuing items such as patents and good will, are avoided under the current proposal, which makes no distinction between tangible and intangible property.

(3) *Par value problems.*—The 1918 act provided that the value of property paid in for stock should not exceed the par value of the stock issued therefor, unless it could be shown to the satisfaction of the Commissioner that the value of the property was clearly and substantially in excess of such par value. It was also provided that the par value of no-par stock should be deemed to be the fair market value of the stock as of the date of issue. None of these limitations appears in the current proposal, and the determination of the basis of property paid in to the corporation need not be complicated by determinations of par value or of actual value of no-par stock, nor by questions concerning the distinction between par value and no-par stock.

(4) *Earned surplus.*—The 1918 act provided for the inclusion of earned surplus in invested capital. Much litigation arose concerning the propriety of including various items in determining earned surplus. The current proposal uses the concept of "earnings and profits" rather than earned surplus. "Earnings and profits" is a term which has been used for many years in the income-tax law and which has received lengthy judicial interpretation. The Bureau records are adequate to reveal the accumulated earnings and profits of corporations.

(5) *Reorganizations.*—The 1918 act provided that, for the puprose of determining invested capital in the case of a reorganization, no asset should be asigned a greater value in the hands of the transferee corporation than it had in the hands of the transferor corporation if a 50 percent or more interest or control remained in the same persons after the reorganization. This provision was necessary to prevent corporations from stepping up their invested capital, represented by property which had appreciated in value, through realization of the appreciation by means of a purely formal reorganization. This provision was productive of much litigation. No such provision is necessary under the current proposal, because invested capital is computed upon the adjusted basis of property, and section 113 of the Internal Revenue Code prevents such basis from being increased in the case of tax-free reorganizations.

(6) *Special assessments.*—The provision of the 1918 act which occasioned the greatest difficulty and which stimulated the greatest amount of criticism of the administration of the act was the provision relating to special assessment. The 1918 act provided in substance that where the Commissioner found that, owing to abnormal conditions affecting the capital or income of the corporation, the tax computed in the ordinary manner would produce exceptional hardship upon the taxpayer, the tax should instead be an amount bearing the same ratio to the net income of the taxpayer as the average tax of representative corporations engaged in a like or similar trade or business bore to their average net income. Not only was there opportunity for abuse of administrative discretion in applying this provision, but the comparison with representative corporations in a similar trade or business was impossible to determine accurately and could not be determined in any manner without much dispute and endless delay. The class of cases for which this provision was most necessary and beneficial involved situations in which the tax became unduly high because of the exclusion of borrowed capital from invested capital, or because of the exclusion of a large part of the value of intangible property from invested capital. No provision for special assessment is made in the current proposal because, under the proposal, intangible property is treated like other property and because a large portion of borrowed capital is permitted to be included in invested capital.

Mr. CROWTHER. Is it the opinion of the Treasury that the rates, or the excess-profits rates, carried in this report are high enough? I realize, of course, that there is a vast difference between the general tax rates now and the tax rates that were in force in 1917 and 1918. Corporations then were taxed only 14 percent, and now the rates have jumped to 75 or 78 percent, and if more is to be raised by an excess-profits tax, the rates should be higher than those submitted in the report.

Mr. SULLIVAN. That may be true. I would, however, make this suggestion, that if the proposal of the subcommittee is to be accepted and that is to be the law, in entering upon what is acknowledged to be a complicated bill, or a new complicated piece of legislation with these alternative plans, it might be just as well to sacrifice some additional revenue until we find how this will work out.

Senator HARRISON. Mr. Sullivan, I want to bring to your attention this letter which was written by Mr. McReynolds, secretary to the Advisory Commission to the Council of National Defense, addressed to Chairman Doughton, and I want to get your reaction to it. The letter is as follows:

After most careful consideration, the Advisory Commission to the Council of National Defense unanimously and urgently recommends to your committee that there not be included in the proposed amortization or accelerated depreciation bill

any provision limiting or restricting the use which a taxpayer may make of facilities against which amortization or accelerated depreciation has been charged pursuant to the terms of this bill.

The Commission is in full accord with the Treasury Department and your subcommittee in 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. They are being submitted today to the Secretaries of War and the Navy and to the office of the Comptroller, for their approval, and 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 protection of the Government's interest through contract provisions is logical and proer, 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 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.

What do you say to that?

Mr. SULLIVAN. This is a matter that has been discussed in the subcommittee, and I might say that the Advisory Commission and the Treasury are in entire accord on amortization except in one regard. The Treasury Department expressed its opinion to the subcommittee that where the United States Government paid 100 percent for a factory, or for the equipment for a contractor, or where they allowed the contractor to write off 100 percent through special amortization, they do so because those facilities are not for any purposes except the national defense. If they are so needed, then it is the position of the Treasury, after that emergency period has expired, that the contractor will not be allowed to tear down the building without getting permission from the Secretary of War or the Secretary of the Navy. The National Defense Council is in accord with our proposal. The difference is that we have recommended that the restriction be placed in the law, and they say that that is not flexible enough. They say that there are different situations which must be met by different clauses in the contracts. The difference of opinion between the Treasury and the Advisory Commission is simply whether, or not, the restriction shall be made by a provision of the law or by a provision in the contract.

Senator HARRISON. In view of that difference, it seems to me to be a most important question, and may I suggest that at some time during the hearings some member of the National Defense Council be requested to appear before the committee?

The CHAIRMAN. The request will be complied with.

Mr. SULLIVAN. I think that concludes the testimony of the Department, except that Mr. Biggers and Mr. Eaton can give some further information.

Mr. MCCORMACK. In connection with that matter, the Treasury and the Defense Council are in full agreement on that point, whether the Government directly or indirectly furnishes the money.

Mr. SULLIVAN. Yes, sir. The Advisory Council believes that it should be covered by a flexible provision in the contract, and the Treasury would cover it in the law.

The CHAIRMAN. The next witness is Mr. Colin F. Stam, Chief of Staff of the Joint Committee on Internal Revenue Taxation.

## STATEMENT OF COLIN F. STAM, CHIEF OF STAFF, JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, WASHINGTON, D. C.

Mr. STAM. Mr. Chairman and gentlemen of the committee, Mr. Sullivan has discussed all the aspects of the subcommittee's plan, with the exception of the average earnings plan, and I will, therefore, confine my remarks to that plan.

Three approaches seem fundamental in considering the imposition of an excess-profits tax.

First, it should be examined in the light of our own World War experience and that of other countries.

Second, in the light of conditions as they exist today. The recent business experience, business structure, and requirements of the Government present an entirely different background for the imposition of this tax than existed in 1918.

Third, in the light of the need for acceleration of the defense program—the acceleration of the manufacture of the facilities needed by the country for defense.

The history of excess-profits taxation in this country and other countries shows its proper place in a tax system. In a period of emergency, such as the one recognized by our defense program, the people, through their Government, spend huge sums. This results in large private profits. Economics authorities, business and tax authorities are unanimous in considering these profits a legitimate field of taxation; as these profits arise from Government expenditures, part of them should be returned to the Government in the form of taxes. It is a reasonable assumption that such profits result not only to those directly contracting with the Government but also affect other persons indirectly. It is recognized that inordinate profits should not result from huge expenditures made for the defense of the country. On the other hand, private enterprise must operate with the greatest efficiency and speed.

In designing this form of tax, the need of the Government for revenue and the need of the greatest efficiency on the part of the industrial arm of defense must be kept in mind.

A tax of this character, therefore, should be imposed with reference to the existing income-tax system. We first imposed it during the World War. The normal tax then imposed on corporations was 10 percent for 1919 and 1920 and 12 percent for 1918. The tax on individuals then consisted of surtaxes graduated to 65 percent and normal tax of 12 percent for 1918 and 8 percent for 1919 and 1920. Our present system has a normal tax of 4 percent and a surtax max-

imum of 75 percent, the total tax being increased by 10 percent under the defense program. This is shown by the following table:

INDIVIDUALS

| | 1917 | 1918 | 1919-20 | Present law [1] |
|---|---|---|---|---|
| | Percent | Percent | Percent | Percent |
| Normal tax | 4 | 12 | 8 | 4 |
| Surtax | 63 | 65 | 65 | 75 |

CORPORATIONS

| | | | | |
|---|---|---|---|---|
| Normal tax | 4 | 12 | 10 | 20.9 |
| Excess-profits tax | 60 | 65 | 40 | ..... |
| War profits tax | ..... | 80 | ..... | ..... |

[1] In addition, the normal and surtax rates under existing law have been increased by 10 percent of the tax payable.

Since our normal income-tax system is designed to tax income in normal times fairly and effectually, it is believed that an excess-profits tax should be laid with reference to the conditions of the abnormal period of the defense emergency when unusual profits should result by reason of large Government expenditures for defense.

For this reason, the tax recommended in the subcommittee report, takes into consideration the earnings of business in an assumed normal period, called the "base period," which will be the years 1936, 1937, 1938, and 1939, and compares with those earnings made in the defense program years, or the taxable period.

The subcommittee has recommended as one of the methods for determining excess profits, a plan under which the earnings for the taxable year are compared with the average earnings for a prior base period. If the earnings for the taxable year exceed the average earnings for the base period, such excess, if in excess of a specific exemption of $5,000, is subject to the excess-profits-tax rates.

The following example will indicate how the plan operates:

| | |
|---|---|
| Earnings for 1940 | $150,000 |
| Less average earnings for the base period | 100,000 |
| Excess of profits for the taxable year over the average profits for the base period | 50,000 |
| Less specific exemption | 5,000 |
| Excess profits subject to tax | 45,000 |
| First 10 percent of base period credit (10 percent of $100,000) $10,000 taxable, at 25 percent | 2,500 |
| Next 10 percent of base period credit (10 percent of $100,000) $10,000 taxable, at 30 percent | 3,000 |
| Balance of excess profits subject to tax ($45,000 less $20,000) $25,000 taxable, at 40 percent | 10,000 |
| Total excess profits tax | 15,500 |

The average earnings for the base period constitute the excess-profits credit where the taxpayer elects to compute his excess-profits tax according to the average-earnings method. Thus, in the example given above, this credit would be $100,000. The first bracket to which a rate of 25 percent applies is 10 percent of this credit or $10,000. The

second bracket to which a rate of 30 percent applies is also 10 percent of this credit or $10,000. Since $20,000 of the excess profits have been absorbed by the first two brackets, the balance or $25,000 is taxable under the third bracket at a rate of 40 percent. The total tax is, therefore, $15,500.

The reason for applying the rates by reference to a percentage of the excess-profits tax credit instead of merely to the taxable excess is that it effects greater relief to the lower brackets than if the rates were applied to a percentage of the taxable excess.

If the corporation acquires new capital after the beginning of its first taxable year under the excess-profits tax, its excess-profits credit will be decreased by 6 percent of the reduction in capital.

This plan 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:

(1) The normal tax payable for the taxable year is allowed as a deduction.

(2) Gains or losses from the sale of exchange of assets (depreciable or nondepreciable) are eliminated from income for the purpose of the excess-profits tax.

The base period under this method is the same as the base period under the method already explained. That is the years 1936, 1937, 1938, and 1939.

The average earnings method is followed in Great Britain and Canada. However, it is recognized that taxpayers with very low base earnings will be unjustly treated by a tax based entirely on average earnings. In those countries, this situation is met by giving broad discretionary powers to a Board of Referees to apply relief in the hard cases. It is difficult under a system such as ours to vest such broad powers in a governmental agency. Accordingly, the subcommittee report provides for this situation by allowing the corporation to elect to compute its excess-profits tax on the basis of the invested-capital method. This method has already been explained. It might be pointed out that it provides a minimum credit of 6 percent with respect to the first $500,000 of invested capital in the taxable year and 4 percent with respect to the invested capital in excess of that amount. Corporations which were not in existence during the entire base period are required to compute their tax on the bases of the invested capital method.

That part of the report dealing with the Vinson-Trammell Act and the amortization allowances has already been explained.

It is believed that these methods will meet the requirements of an excess-profits tax.

That concludes my statement, Mr. Chairman, except that I would like to point out that both in Great Britain and in Canada the system operates almost on a basis of a war-profits tax and an excess-profits tax. In other words, in both of those countries, you have the base earnings method and the invested capital method.

In Canada, the invested capital method is used by a board of referees in applying it to hard cases. In England, the invested capital method is used as to new corporations organized after July 1, 1936. So that in both of those countries, you really have this combination system, and the only difference is that in one instance

the application of the system is imposed by a discretionary board, which is given very broad powers, while in the subcommittee plan, they put the provision right into the plan itself and do not give the discretion to any board.

That is all I have to say, Mr. Chairman.

The CHAIRMAN. Are there any questions?

Senator HARRISON. What do you say about this estimate of $190,000,000 the first year under this plan?

Mr. STAM. We estimated about $300,000,000 for the first year. Of course, that did not take into account the reduction in surtaxes in the hands of the individuals. If you increase your corporate rates any amount, naturally you are going to cut down the dividends that the shareholders are going to receive. We did not take that factor into consideration. But if that factor is taken into consideration, we do not feel that the tax for the first year will yield less than $270,000,000. It should be remembered that over half the dividend year has already elapsed for 1940.

Of course, after this program gets under way, and all of these contracts are let, and the money comes in, we feel that the program should yield approximately $450,000,000, and may well exceed $500,000,000.

Mr. MCCORMACK. Mr. Stam, under your plan, the question of invested capital is based on the general theory of looking at the earnings in terms of dollars made during the base period, instead of in terms of percentages. So that a corporation, having a 4-year base-period experience, will not have the complicated questions of invested capital arise. That was a very difficult question in the 1918 act, was it not?

Mr. STAM. That is true.

Mr. MCCORMACK. Out of which arose many thousands of court cases.

Mr. STAM. That is true. Over 10,000 cases were litigated, some of which have not yet been disposed of.

Mr. MCCORMACK. You look to the earnings in terms of dollars?

Mr. STAM. That is right.

Mr. MCCORMACK. Without regard to capitalization or anything else; you take the base period average earnings and then, under the excess-profits tax act, whatever kind it might be, if your proposal is included therein, the excess shall be considered as subject to the excess-profits tax in terms of dollars.

Mr. STAM. That is right.

Mr. MCCORMACK. And under your plan, the annoying and complicated and controversial question in relation to a corporation having a 4-year base period expereince, with respect to invested capital, is eliminated.

Mr. STAM. We will not have the enormous refunds under this plan that we had under the 1918 act, in my opinion.

Mr. MCCORMACK. That is a new contribution. I had not heard that. Will you dwell a little on that? Why is that?

Mr. STAM. Because those corporations which elect to take the base-earnings method will know exactly what their tax is. They can determine it and pay it promptly, and there will not be all of these adjustments and all of this litigation with the Bureau later on.

Mr. MCCORMACK. What were the refunds?

Mr. STAM. We do not have any break-down on the refunds.

Mr. MCCORMACK. Will you put in the record a statement as to what the refunds were to corporations under the 1918 act?

Mr. STAM. I shall be glad to do that.

Mr. MCCORMACK. You think your plan will meet that situation so that it will not justify future refunds?

Mr. STAM. There will be some refunds, but nothing like the number under the World War tax.

Mr. MCCORMACK. When you revise your remarks, will you elaborate your ideas on that, for the record?

Mr. STAM. I shall be very glad to.

The data which I am submitting is taken from our refund reports relating to refunds and credits in excess of $75,000. This is far from a complete picture of the situation, since it embraces only years after 1927, and does not include refunds below $75,000. In addition to the refunds and credits made on account of the excess profit, it should also be remembered that a large part of the taxes which were assessed for those years were abated prior to payment of the tax.

EXCERPTS FROM REPORTS OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION ON REFUNDS AND CREDITS OF INTERNAL REVENUE TAXES

1928 REPORT

"In concluding this part of the report it seems proper to sum up the principal conclusions which can be drawn from the analysis made, as follows:

"1. Eighty-three percent of all refunds reported to the joint committee in a 21-month period involve the excess-profits tax years prior to 1922.

"2. Forty-two percent of all refunds are due to provisions no longer found in our revenue act.

"3. The present provisions which seem to be most troublesome from the standpoint of refunds are those which involve valuations of tangible and intangible property."

1931 REPORT

The most important factor in connection with overassessments are the old excess-profits tax cases. When these cases are finally settled, overassessments should be substantially less. The following table shows to what large extent these excess-profits tax cases have affected the overassessment total.

*Percent of total overassessments for the excess-profits tax years*

| | Percent |
|---|---|
| 14-month period, Feb. 28, 1927, to Apr. 24, 1928 | 88 |
| 7-month period, May 29 to Dec. 31, 1928 | 77 |
| 12-month period, Jan. 1 to Dec. 31, 1929 | 71 |
| 12-month period, Jan. 1 to Dec. 31, 1930 | 59 |
| 12-month period, Jan. 1 to Dec. 31, 1931 | 53 |

Over one-half of the total overassessment still result from adjustments for the years 1917 to 1921, inclusive. These tax cases are over 12 years old. Moreover, the interest attributable to the excess-profits tax years represents 73 percent of the total interest paid on all overassessments reported to the committee during the calendar year 1931. It is true that the table shows considerable progress in settling these old cases, but it is evident that the work is far from concluded.

1932 REPORT

Analysis of all overassessments reported to the committee during 1932 shows that allowances of $14,138,590.30, or 51 percent were made on account of taxes for the excess-profits tax years up to and including 1921, and that the remaining 46 percent of the allowances were for years subsequent to 1921. Further analysis shows that the interest paid on overassessments prior to 1922 totaled $4,005,856.62, i. e., the interest charges attributable to the excess-profits tax year represent 64

percent of the interest paid on all overassessment reported to the committee during the calendar year 1932. The following table shows to what extent these old cases have affected the overassessment allowances which have been reported to the committee:

*Percent of total overassessments attributable to the excess-profits tax years*

| | Percent |
|---|---|
| 14-month period, Feb. 28, 1927, to Apr. 24, 1928 | 88 |
| 7-month period, May 29 to Dec. 31, 1928 | 77 |
| 12-month period, Jan. 1 to Dec. 31, 1929 | 71 |
| 12-month period, Jan. 1 to Dec. 31, 1930 | 59 |
| 12-month period, Jan. 1 to Dec. 31, 1931 | 53 |
| 12-month period, Jan. 1 to Dec. 31, 1932 | 54 |

These figures in respect to refunds and credits show that a decline in the amounts of such allowances may be expected coincident with the extent to which the old excess-profits tax years are eliminated from the picture. Certain provisions contained in the laws governing the excess-profits tax years dealing with special assessment, invested capital, and amortization have contributed largely to the overassessments found.

1935 REPORT

*Overassessments attributable to excess-profits tax years.*—Analysis of all overassessments reported to the committee during the period covered by this report shows that allowances of $8,860,697.52, or 78 percent, were made on account of taxes for the excess-profits tax years up to and including 1921, and the remaining 22 percent of the allowances were for years subsequent to 1921. Further analysis discloses that the interest paid on overassessments prior to 1922 totaled $2,375,178.01; that is, the interest charges attributable to the excess-profits tax years represent 72 percent of the interest paid on all overassessments submitted to the committee during the calendar year 1935. Adjustments relating to excess-profits tax years comprised about 88 percent of all overassessments allowed in 1927 and gradually decreased to 35 percent in 1934.

Senator GERRY. Another advantage in your proposition, Mr. Stam, is that the corporation that wishes to expand will have the knowledge of exactly how much it will have to pay.

Mr. STAM. That is right.

Senator GERRY. There will not be the doubt which might prevent the corporation's undertaking to go into some of these enterprises, which condition will accelerate the defense program; and with that acceleration there ought to be more revenue from income taxes, is that right?

Mr. STAM. It makes the tax definite and certain. Under the 1918 act, some of these old cases were not settled for 10 or 15 years; some are not yet settled. The trouble was in the determination, mainly, of the invested capital of the corporation. Of course, this method will entirely eliminate that complication.

Senator GERRY. I know that during our hearings in the Naval Affairs Committee, the question was continually raised by the naval officers concerning the difficulty that they met because a contractor could not tell exactly what his liabilities were going to be.

Mr. STAM. That is true.

Senator GERRY. And therefore he hesitated. Now, under your plan, he has a very sound way of ascertaining what his liabilities are going to be. The result is we will probably get an acceleration of the defense program which means, in turn, that your income taxes will be coming in more promptly.

Mr. STAM. I think that is true.

Senator GERRY. Apart from other benefits that it will bring about in the matter of the national defense.

Mr. STAM. I think that is true, Senator.

Mr. CARLSON. Mr. Stam, on page 2 of your statement, you say this:

A tax of this character, therefore, should be imposed with reference to the existing income tax system.

Then you proceed to outline the rates and the exemptions in the 1917 and 1918 acts. Of course, we should bear in mind also the amount of income received in the 1917 and 1918 acts. Therefore, I think it ought to be made a part of the record at this point the fact that in 1917 we collected from war and excess profits tax, $1,638,748,000; in 1918, we collected $2,505,586,000; in 1919, $1,439,806,000; in 1920, $988,725,000; in 1921, $325,122,000.

It seems to me that we should keep that in mind in view of the fact now that the present bill is only contemplated to raise $190,000,000 to $225,000,000.

Mr. STAM. Your figures do not take into consideration the refunds made. I might say in answer to that, Congressman, that Great Britain, which had a base earnings tax during the war years of 40 percent, in 1919 collected about $1,419,000,000, as compared with $1,439,806 in the United States.

What I mean to say is, if the particular tax we are talking about were imposed today, under the conditions existing in 1918, we would certainly collect a lot more than our estimate as to the tax yield today. We are not in a war today. We have not gotten the industries of the country geared up to a war program. I think if you just took this particular plan and applied it to 1918 conditions you would get considerably more revenue than we have estimated this is going to yield today.

Mr. CARLSON. I did not want to take issue with your statement, but I did not want to leave the impression in the record that we were collecting on the basis of those previous rates. To me this is a serious situation; we are only going to raise approximately $200,000,000 under this excess-profits tax, when Secretary Morgenthau testified yesterday that for the fiscal year we will have a deficit of $5,700,000,000. With this tax that will be reduced to $5,500,000,000. I just wanted to bring that point out.

Mr. STAM. Of course, we have got to look to other sources to get our revenues.

That is all, Mr. Chairman.

The CHAIRMAN. Mr. Stam, you are a tax expert, and from your long and comprehensive study of this question, in your judgment could an equitable excess tax law be imposed based entirely on invested capital.

Mr. STAM. In my judgment, it could not. That question has been debated ever since the old tax was imposed, and everybody who seemed to have any experience with the tax—Dr. Adams and Mr. Ballantine, and a number of others—all seemed to be of the opinion that a tax based on invested capital alone would work very severe hardships on a great number of corporations, in addition to adding complications to the administration of the law. That is one reason why I feel that this combination system offers the best possible solution.

In the hardship cases, where a taxpayer has low base earnings or losses in the base period—he can get some relief under the invested capital method, whereas the ordinary corporation is going along making earnings. Of course, in the case of the ordinary corporation, as a general rule—in cases of small corporations, the earnings are greater in percentage to the invested capital than in the case of large

corporations. And it would afford some relief to the small corporations and the new corporations to permit them to base their tax upon the record of past earnings.

The CHAIRMAN. As a practical matter, is it not almost impossible to determine, on a basis of equality among taxpayers, just what is invested capital?

Mr. STAM. It is a very difficult problem. There are cases still pending in the courts today dealing with the invested capital provisions of the 1918 law.

The CHAIRMAN. And if there were any possible way of actually determining among taxpayers just what is invested capital, it would be easier to impose an excess profits tax based on invested capital?

Mr. STAM. I think that is right, Mr. Chairman.

Mr. KNUTSON. Mr. Stam, I called your attention to a letter that I received from a large milling concern in Minneapolis. I have the letter here. I would like to have your comments on how this legislation will affect such companies that collected processing taxes up to the time that the triple A was held unconstitutional.

Mr. STAM. I remember reading the letter. In that particular case, that corporation had to make a reimbursement of a heavy tax collected from the consumer in an excess price of certain products. When that tax was repaid or refunded to these consumers, it was allowed as a business expense to the corporation. Naturally, that reduced their base period income. I think it was in the year 1937 when they had to make this large reimbursement to the consumers. That would result in rather a hard situation in that particular case. I looked into that and that would result in a hard situation unless that corporation had a very large invested capital. If they had a large invested capital they could elect to come in under the invested-capital method. I have not been able to get the facts yet on the invested capital of that particular corporation. I would like to look into that a little further before I give you my final conclusion.

Mr. KNUTSON. I would appreciate getting it so that their legitimate interest might be protected in this legislation. Undoubtedly, a large number of concerns are similarly situated, those who came in under the processing-tax provision of the triple A. They are in the same boat, I presume, whether they be flour millers or meat packers.

Mr. STAM. Every time you reduce the income in the base period by an extraordinary reduction of that type, naturally you are going to have some hardship, and I think we ought to look into that and see if we can do something about it.

The CHAIRMAN. If there is nothing further, we thank you for your appearance and the information you have given to the committee, Mr. Stam.

Mr. MCCORMACK. Mr. Chairman, I should like to ask Mr. Sullivan, if it can be done without too much delay, to have the Treasury put into the record a statement of all excess-profits taxes paid under the 1918 act, together with all refunds paid, and the years they were paid in, as well as the interest on the refunds.

Mr. SULLIVAN. You mean during the time they were in force, 1917, 1918, and 1919 and 1920.

Mr. MCCORMACK. A statement of all refunds made of excess-profits taxes, together with the interest paid if that can be done without too much delay.

Mr. SULLIVAN. Very well.

Mr. McKeogh. Mr. Chairman, I would like to have from Mr. Sullivan and Mr. Stam, somewhat in detail, an explanation as to how the increased profits which this bill is proposed to care for, either by the capitalization tax or the earnings base tax, will mean a reduction brought about by reason of an anticipated reduction to stockholders through the dividend process. Obviously, if there is increased earning power, which apparently we all agree must be the situation due to the heavy expenditures, I cannot reconcile how it is that the dividends to the individual income-tax payer are going to be reduced, so that they will represent an offset against the corporation's excess tax. If that can be developed somewhere in the hearings, I would like to have it developed, because that is difficult for me to reconcile.

Mr. Sullivan. We shall be very glad to do that for you.

(Mr. Sullivan subsequently furnished the following for the record:)

In estimating the revenue yields of present taxes, account is taken of expected increases in the level of business which may result from the defense program and other causes. Accordingly, to arrive at the net effect on revenue of a proposed new tax, the estimated yield of such tax should be adjusted by deducting the probable amount of decrease in the yields of existing taxes which would follow from the imposition of the new tax.

The collections from the proposed excess-profits tax will not represent a complete gain to the Federal Government because there are diminutions in the income-tax collections which partially offset these increases in revenue. In any given year, whether a year of good business or poor business, some corporations will have a net profit after paying all expenses of the business with the exception of Federal income and excess-profits taxes. It is from this profit that the corporations must pay the income and excess-profits taxes, after which the balance may be split up into two portions, (1) the amount deemed necessary to be kept in the business which will be allocated to surplus, and (2) the amount which is to be distributed as dividends to the stockholders. The larger the amount of the income and excess-profits taxes which the corporations must pay in any given year, the smaller the amount which is left to be allocated to surplus and as dividend payments to stockholders. It seems reasonable to assume that although the directors of corporations might allocate somewhat less to surplus under such conditions, they would also make smaller distributions of dividends to their stockholders.

That action causes the partial offset to the revenue from the excess-profits tax. Dividend payments by corporations to stockholders are subject to both the corporation normal tax and to the individual normal tax and surtax. Therefore, any diminution in dividends as compared with what they would otherwise have been tends to decrease the individual income-tax collections and to a very minor extent to diminish the corporation income tax collections. This reduction in income-tax collections because of the collection of excess-profits taxes therefore reduces the increase in revenues to the Federal Government from the imposition of an excess-profits tax.

Mr. Cooper. Mr. Chairman, I move that we recess until 2 o'clock.

The Chairman. Without objection, the committee will recess until 2 o'clock.

(Whereupon, a recess was taken until 2 p. m.)

AFTERNOON SESSION

The hearing was resumed at 2 p. m., Hon. Robert L. Doughton (chairman).

The Chairman. The committee will please be in order.

The next witness on the calendar is Mr. John W. Hooper, representing the Chamber of Commerce of Brooklyn, N. Y.

## STATEMENT OF JOHN W. HOOPER, CHAIRMAN, COMMITTEE ON FEDERAL TAXATION, BROOKLYN CHAMBER OF COMMERCE

Mr. HOOPER. Mr. Chairman and gentlemen of the committee; the Federal taxation committee of the Brooklyn Chamber of Commerce, of the city of New York, wishes to express certain observations regarding proposals now under consideration by the Ways and Means Committee to recover for the Government excess profits accruing to industry from present and planned-for emergency expenditures. Obviously, with no printed bill available, these observations are necessarily influenced largely by newspaper reports of proposed legislation.

As one of the first five manufacturing communities of the country, Brooklyn is vitally concerned in the enactment of any such legislation. A very sizable number of our 5,000 factories are now or will be participating, directly or indirectly, in the defense program, and the borough is therefore deeply cognizant of the great responsibility which rests in the Ways and Means Committee in its present endeavors. The chamber speaks directly for some eighteen hundred of the more representative industries of the borough employing some 120,000 persons. In this presentation it has also had the active assistance of the Brooklyn chapter of the National Association of Cost Accountants.

We recognize that the Congress must raise the necessary financial revenues required for financing present and contemplated expenditures involved in the defense program.

It is regrettable, however, that the question of amortizing the cost of defense facilities has been joined with the tax enactment in such a way as to force speedy action at the expense of thoroughness and thoughtful deliberation. This artificial creation of an expediency in these serious days is certainly subject to severe criticism. The Nation's welfare would be far better served by a separation of these two matters, enabling the Congress to give adequate and proper consideration to a tax law without delaying a prompt solution of the amortization problem.

Mr. COOPER. On that point you would simply take a flat rate and let everybody take all the amortization they wanted?

Mr. HOOPER. That is not our view, Congressman. Our view is that it is necessary that the amortization feature be enacted promptly and let the excess-profits tax feature go over until later.

Mr. COOPER. And you are not specially anxious to have that anyway?

Mr. HOOPER. Yes; if it is needed.

Mr. COOPER. The excess-profits tax?

Mr. HOOPER. That is entirely up to the committee because you are familiar with the needs of the country.

Mr. COOPER. Very well.

The CHAIRMAN. Suppose we enact the amortization feature and Congress fails to enact the excess profits tax?

Mr. HOOPER. I do not think Congress would fail to do so.

The CHAIRMAN. But suppose that is done; it is possible.

Mr. HOOPER. There is the possibility.

The CHAIRMAN. We would have the amortization but would not have the excess profits tax feature.

Mr. HOOPER. Well, I do not think that is what would happen. I certainly think that you ought to separate the amortization feature and enact that feature and then give careful consideration to the excess-profits-tax feature.

The reported conception of the proposed tax is that corporations whose incomes are substantially increased, directly or indirectly, through the national-defense program, should contribute to the cost of that program from their earnings over and above either normal earnings or a reasonable return upon the capital invested in their enterprises. However sound or unsound this conception may be, its application is not simple nor can the formula be rigid or arbitrary, if we are not to repeat the experiences with similar taxes finally repealed by the Revenue Act of 1921. The reports of former Secretaries of the Treasury McAdoo, Glass, and Houston for the fiscal years ended June 30, 1918, 1919, and 1920, as well as the report of the Senate Committee on Finance on the internal revenue bill of 1921, bear adequate testimony to the inequities and distressing hardships of those taxes.

An arbitrary or inelastic formula cannot conceivably result in a just, or even workable, application of the tax to the ramified condition of American business, many of which will be called upon for rapid expansion or adjustment to the needs of the armament program.

It seems generally accepted that the legislation under consideration contemplates a determination of the excess profits tax on alternate bases of actual profits or invested capital. Exemption of a fair percentage of capital subsequently added and of the investment in new companies should be made to equalize conditions and promote the flow of capital into enterprises sharing the emergency load. A minimum fair return on invested capital should be set at not less than 8 percent where invested capital is required to determine the taxable excess profits.

Acceptance of the two bases proposed as being sufficiently flexible for just application of the tax should not be prematurely conceded by the Ways and Means Committee. For many companies the new tax would be predicated upon earnings which, while not more than normal, would be in excess of those in years when the depression was still very real. Others would be deprived of their optional relief because of rearrangement of their capital structures to meet the exigencies of depression years. For such situations and for new businesses, provision, through a board or otherwise, for determination of a fair standard of profits in the industry would be a necessary safeguard. The findings of such a board as to the fair earnings on the invested capital of many industries might be of vital importance to the solvency of business with unusual capital structures or without normal earning histories in the preemergency period. The preemergency period should include the years 1936 to 1939 inclusive. This board or commission should be independent of the Treasury Department but should have available to it the advice and information of that Government division.

The two definite bases referred to should in their application be optional with the taxpayer from year to year. If any limitation or tie-up with invested capital is imposed upon the use of the preemergency earnings, as has been reported by the press, then the conception of the tax to recover profits for the Government accruing from its emergency activities will not be borne out in reality.

Any required additional income to supplement the revenue from the proposed excess-profits tax should be raised by means other than the assessment of corporation income.

The problems of the management of incorporated business in their capacities as trustees have become increasingly serious owing to the imposition on its operating income of levies not contributing thereto.

No consideration of additional burdens upon the business corporations of this country can overlook the present taxes, many of comparatively recent origin, and care must be taken to avoid as far as possible any pyramiding of taxation through the failure to provide for appropriate exemptions.

It must be remembered that an excess-profits tax will be superimposed upon corporate income taxes alone averaging close to 21 percent compared with a normal corporation tax of 2 percent at the time of our entry into the previous World War. Figures recently published show that for the fiscal year 1939 the Federal Government looked to business for 75 percent of its tax revenues, while for the same year business contributed approximately 74 percent of all State taxes.

Retroactive application of such a tax, referring to the excess-profits tax, to the earnings of 1940 as now proposed would be grossly unjust to business and to all forms of enterprise, which are entitled to know in advance the taxation to which their activities will be subjected. Irrevocable financial commitments would, for many corporations, prohibit the adjustment to anticipated taxes, which is their normal privilege and practice. Further, the excess profits sought to be taxed will not, it is felt, tangibly accrue until after 1940. Hence an unnecessary and illogical administrative burden would be imposed upon business and the Government.

While the present trend in this country is toward simplification of corporate interrelationships, there remain many business enterprises devoted to the accomplishment of single or allied purposes, comprising numerous affiliated or subsidiary corporations. The contemplated legislation should recognize the common purpose of such related groups and require consolidated returns. It is submitted that in the existing emergency no closer relationship than the ownership of a majority of the outstanding stock or obligations be required for eligibility to classification as a subsidiary for this purpose.

By similar reasoning, intercompany dividends should be exempted from the normal income tax and the proposed excess-profits tax. Inadequate safeguards against the possible multiplication or pyramiding of a just excess-profits tax would bring about stultification of its true purposes and permit an indefensible, possibly unforeseeable, impost upon many businesses.

The enactment of the excess-profits tax should, in accordance with the experience of this and other countries with such taxes, embody specific provisions safeguarding taxpayers against arbitrary regulations. These should include a definition of invested capital sufficiently broad to permit the inclusion therein of the sound value of tangible and intangible investments whether or not the true value of such assets is presently reflected on the records of the corporation.

The amortization of investments in additional facilities to meet the requirements of the emergency has been widely discussed in connection with the defense program. It seems generally recognized that amor-

tization allowances should be based on not more than a 5-year life with provisions for adjustment in the event of prior termination of the emergency, to permit reconcilliation of the amortization charges with the period of taxable profits. The taxpayer should be privileged so to arrange his amortization charges during the allotted 5-year life of the improvements, that they shall be ratably adjusted to the accrual of taxable earnings during the period, as such earnings vary from year to year.

Determination of the tax should not be made a closed matter for at least 5 years so that the tax may be justly determined and not be turned into a capital levy through taxation of profits offset by prior or subsequent losses. It will be recognized by business generally that extension of the period of limitation will involve the possibility of assessments as well as refunds. The adjustments of this nature necessary after the last war as a result of cancelation of contracts and of inventory losses bear ample testimony to the necessity of this safeguard. Similar reasoning indicates that abatement claims properly limited should be included in the program in order that the injustices resulting from incorrect regulations or bureau decisions might be minimized pending their consideration by the Board of Tax Appeals or the courts.

If the normal or base profits are to be determined as an average for a period of years or to be based on a fair rate of return, then provision should be made for an average of earnings for the period of years to which the excess-profits tax applies. Otherwise serious injustice will be done, in years of high profits, to the corporations whose earnings fluctuate materially from year to year.

The reported proposed specific flat exemption of $5,000 seems entirely inadequate as a safeguard which would encourage small business to participate in the armament program to the fullest extent. It would seem reasonable to promote this participation through raising of this exemption to $25,000, of taxable net income.

The excess-profits tax should be limited to a period of 2 years. The emergency nature of this contemplated legislation should be so fully recognized as to discourage any possibility of its retention as a permanent deterrent to our business progress.

We endorse the reported proposal to eliminate the limitation of profits provided for in the Vinson-Trammell Act pertaining to naval vessels and airplane work as a natural concomitant to the enactment of the proposed excess-profits tax. Likewise, the present excess-profits and capital-stock taxes should be repealed.

Corporations now exempt from income tax and personal service corporations should be exempted from the proposed excess-profits tax. Personal holding corporations, in view of the heavy taxes to which they are now subjected, should also be exempted.

We are not in a position to make specific recommendations respecting rates of taxation for this purpose since these must in fairness be predicated upon data available from the Treasury.

We are appreciative of this opportunity to present the views of that section of business represented by the Brooklyn Chamber of Commerce.

The CHAIRMAN. Have you as a tax expert made an estimate about what taxes, based on your professional experience, would be collected?

Mr. HOOPER. No.

The CHAIRMAN. You have not?

Mr. HOOPER. No.

Mr. TREADWAY. You are against the consolidated return?

Mr. HOOPER. We have come out for it, in favor of the consolidated return.

Mr. TREADWAY. You are in favor of the consolidated return; you think it should be mandatory?

Mr. HOOPER. Yes.

Mr. TREADWAY. The information that we have received would indicate that in view of the haste of securing legislation it would be very difficult to prepare a consolidated return section. Do you think the legislation should be delayed in order to properly write such a clause?

Mr. HOOPER. I think, Congressman Treadway, that the excess profits tax should be delayed in order that a proper clause could be drafted.

I went personally into this whole act in my capacity as an accountant and I know what the headaches were and I feel very serious about it. I am very earnest, Mr. Chairman, that careful consideration should be given to drafting this excess-profits section, and that is why we are here urging the separation of the two proposals, amortization and excess-profits tax.

Mr. TREADWAY. To what extent have you studied the two suggestions, one offered by Mr. Stam and the other offered by the Treasury?

Mr. HOOPER. I have not been able to study them because I have only seen what was reported in the press.

The CHAIRMAN. Any questions by the Senators?

Senator KING. I did not have the privilege of hearing all the testimony of the witness. Apparently he is familiar with taxation and with revenue legislation. I was wondering if the criticisms—and I do not use the word offensively—against certain provisions of the proposed legislation have been embodied in any suggestions that you will make to the committee, or, have you already done that?

Mr. HOOPER. Yes; they are in this proposal, Senator King.

Senator KING. Have you offered such an amendment?

Mr. HOOPER. No; we have not, because we have not seen the bill.

Senator KING. From your study of the question of excess-profits tax, and I assume from your statement that you have studied the situation, do you think there ought to be any protracted delay in working out a formula that would meet the situation?

Mr. HOOPER. I do not think there should be any protracted delay, Senator King; however, I do think adequate time should be taken in writing the legislation.

Senator KING. With your long experience in regard to taxation do you think you could sit down and in 2 or 3 days do that?

Mr. HOOPER. No; I do not, but I think if you got groups of individuals who knew their stuff, if I could speak in the vernacular, I think they could do it in about 2 weeks' time. There is an awful lot of history available for that purpose.

Senator KING. In view of the fact that we have had an excess-profits tax and that we have the experience of other nations, particularly Great Britain, do you believe that there is need for protracted delay in order to draft a revenue bill that would enable us to levy an excess-profits tax to meet the situation?

Mr. HOOPER. As I have said, Senator, I do not think there is need for protracted delay, but I do think that serious study should be be given to the proposal.

Senator KING. Speaking for myself, I cannot understand why, with the large experience which you have had, the historical facts presented by other nations, as well as the United States, with our ability and with the experts at command, the experts of the Treasury Department as well as the Joint Committee on Taxation, there should be any delay on the excess-profits tax draft.

Mr. HOOPER. I agree with you.

Mr. COOPER. Mr. Chairman, I understood Mr. Hooper to state that he thought a group of experts could assemble and draft the act in 2 weeks.

Mr. HOOPER. Yes.

Mr. COOPER. I can give you the assurance that this bill will require far more time than that and will be given far more time by the experts, as well as those who are considering the legislation.

Mr. HOOPER. I am glad to know that will be done.

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. Was the answer you just made applicable to the consolidated returns?

Mr. HOOPER. That is, with reference to the short period?

Mr. TREADWAY. In response to Mr. Cooper's question about 2 weeks. Well, let me put it this way, how long do you think that it would delay the preparation of this bill to secure a proper formula for consolidated returns?

Mr. HOOPER. Three hours.

Mr. TREADWAY. Three hours?

Mr. HOOPER. Yes.

Mr. TREADWAY. That is contrary to the suggestions we have had from the experts.

Mr. HOOPER. Yes.

Mr. TREADWAY. Then if it can be prepared in 3 hours why could it not be submitted to us Monday morning? We are here to receive suggestions. Now, the attitude of both the Department and of Mr. Stam has been that too much time is required, in view of the desirability to report the legislation, to consider it separately.

If you have got a definite program in mind for consolidated returns I think it is a duty that you owe to this committee to offer it to us, because we are here to receive suggestions from men just like yourself.

Mr. HOOPER. Congressman Treadway, we have no definite program in definite language to submit along that line, because there is so much expert talent, and that is why we were at a loss to understand the answer of the Treasury on the question of consolidated returns, that is why the Department experts cannot do it in a week.

I can readily understand that, however, because the consolidated return feature is only one part of the excess-profits tax.

Mr. TREADWAY. Now if it were found that more time than 3 hours was required, or 3 weeks, would you then prefer to delay the enactment of this bill in order to secure a consolidated returns provision or to take the question of consolidated returns up when the next Congress assembles in January?

Mr. HOOPER. I would prefer to delay the enactment of this bill.

Mr. TREADWAY. Well, that is directly contrary to the attitude of the administration. Were you here yesterday?

Mr. HOOPER. No. I read the press report.

Mr. TREADWAY. Well, gentlemen testified from the various Departments, the Secretary of War and the Secretary of the Treasury and the Secretary of the Navy; they are all anxious for as rapid enactment as possible.

Mr. HOOPER. Congressman Treadway, my statement was this, that I do not see why they are so anxious for rapid enactment of the excess-tax provision. I can understand the need for the enactment of the amortization provision, but insofar as the excess-profits tax provision is concerned, there is plenty of time to consider that.

Mr. TREADWAY. That is at variance with the testimony of others.

Mr. HOOPER. Of course, I am speaking entirely as a businessman and not as an accountant.

Mr. TREADWAY. I really feel that if you have a definite suggestion which you think would be a practical addition to this bill, along the lines of consolidated returns, it would be very helpful if you would submit it before the hearings close.

Mr. HOOPER. I will see what can be done. I would like to say, however, that I feel like it would be carrying coals to Newcastle because you have the advantage of so much brains here anyway.

Mr. TREADWAY. That does not agree with the conclusion of how quickly it could be done.

Mr. CROWTHER. Do you not think it is necessary for the people who are actively engaged in this industrial operation for them to have laid before them the entire picture of what their obligations are going to be?

Mr. HOOPER. It would.

Mr. CROWTHER. Then why give it to them piecemeal, in amortization, repeal of the Vinson-Trammel Act and then a few months afterwards let them know what they are going to have to pay in the way of excess-profits taxes?

Mr. HOOPER. Except this, Dr. Crowther: So far as the amortization is concerned, it is a very important thing in order that the concerns that will engage in war work, or defense work, will know what their capital obligations are going to be with respect to such work and how they are going to be able to work out their obsolescence. That is entirely separate and apart from the question of raising revenue out of the profits that will result from this work.

Mr. CROWTHER. Well I do not agree with you on that. If I were going into this I would want to have the whole picture before me.

Mr. HOOPER. Yes.

Mr. CROWTHER. I think Mr. Cooper, chairman of the subcommittee on taxation, put it this way, that amortization was something that was really going to be given to them.

Mr. HOOPER. Well I do not agree with that.

Mr. CROWTHER. Well, it is in a sense true; and that the excess-profits tax is something you are going to take away from them and the balance in between is the advantage that he is going to get from the amortization and what is going to be taken out as excess-profits taxes.

Mr. HOOPER. Well, I can see that.

Mr. DISNEY. Mr. Hooper, Mr. Knudsen, a very good businessman, appeared before the committee and it was he who suggested that we ought to have the amortization feature, the excess-profits tax, and the suspension, and he is dealing with the firms who are making contracts with the Government. That was his view as a businessman, that we ought to have the amortization, the Vinson-Trammell Act and the excess-profits tax section all in one act so they could deal with the businessman and he would know what they were going to do.

Mr. HOOPER. Congressman Disney, as I pointed out, I have not questioned that they ought to have the act now; there is no question about it, but I say this, that if a proper excess-profits tax act is to be drawn then adequate time must be given to it, and as I suggested to Chairman Doughton, it may take a little more time to draft that section, and that is why we ask you to separate the two features.

Mr. DISNEY. We have already put in 2 weeks with the best experts we can find on it.

Mr. HOOPER. And you have done a good job.

Mr. DISNEY. And we are having hearings to get the expression and get the reaction from business and the people of the Nation after that work has been done.

Mr. HOOPER. Yes, Mr. Disney; but we only learned of it, I have only learned this morning, not officially, but what was in the press, what has been proposed by the committee, and we have not learned up to this moment what is going to be proposed or what has been done by your committee.

Mr. DISNEY. One other question. Our experts, and we think we have had before us those who have had experience with consolidated returns, say that it would take 2 or 3 weeks to draw a consolidated return provision. Now we are rather inclined to accept their judgment.

Mr. HOOPER. Certainly.

Mr. DISNEY. That it would take 3 weeks, result in that much delay, and we have already had more delay than we ought to have.

Mr. HOOPER. Well, if they say 3 weeks I would follow their judgment, but I, as a businessman have had experience with this before and I think it could be drawn pretty quickly.

Mr. COOPER. I believe you said that you could draw a consolidated return provision in 3 hours.

Mr. HOOPER. Yes.

Mr. COOPER. You refer of course to taking a group of corporations. Now some of them have been affiliated during a part of the base period.

Mr. HOOPER. Yes.

Mr. COOPER. Some of them may not have been affiliated during a part of the base period; and some of them that were affiliated during the early part of the base period may not be affiliated during the taxable year.

Now how would you handle that?

Mr. HOOPER. Well, I would handle it by appropriate language and indicate the percentages that should be allotted to the situation. It would require a little thought, certainly, but it could be done in a short time. We had a consolidated returns act before, up until prior to 1934, I think it was, and it worked very well.

Mr. COOPER. You did not have the base period to contend with then.

Mr. HOOPER. I beg your pardon.

Mr. COOPER. You did not have the base period that consisted of 4 different years to contend with.

Mr. HOOPER. That is very true.

The CHAIRMAN. You said, Mr. Hooper, that you could draft such a provision, or that it could be drafted in 3 hours. Suppose you draft it and submit it to us by Monday morning. Now, suppose, following the opinion of our legislative council and the experts we find that it cannot be drafted in that time and it is found that the plan which you submit is not satisfactory, but that it would take longer to work it out, would you advise the Congress to go ahead and disregard what you say and to adopt the suggestions and the advice of those whom we had relied on in the past, and in whom we have confidence, and be guided by the experts?

Mr. HOOPER. I would be guided by what I think was the most competent advice.

The CHAIRMAN. Well, that is what we are doing.

Mr. MCCORMACK. Will you draft such a proposal?

Mr. HOOPER. I did not say that I could, but I think it could be done, and I will try to have it done.

Mr. MCCORMACK. Would you undertake to assist us? It is well known that the Treasury has recommended and would like to see a mandatory consolidated return on excess profits. You are referring to the 1928 act?

Mr. HOOPER. We had it up until 1934, I think.

Mr. MCCORMACK. And in the years following, of course.

Mr. HOOPER. Yes, and there were changes in between.

Mr. MCCORMACK. Will you try to draft something that will confine itself to the excess-profits tax?

Mr. HOOPER. If you will amend that and include the income tax also.

Mr. MCCORMACK. You and I see eye to eye, but I do not know how many others do.

Will you draft and submit to the committee on Monday a proposition confining itself, in the alternative, either to the mandatory consolidated return of excess profits, or to the optional excess-profits tax; will you do that?

Mr. HOOPER. No, sir; because I cannot do that unless it includes the income tax.

Mr. MCCORMACK. In other words, you will agree that unless it does include the normal tax then the position of the Treasury and our staff is correct in the findings they have given?

Mr. HOOPER. I would not say they are correct, because I do not know the policy or premise on which they have operated.

Mr. JENKINS. I presume you appreciate the fact, in connection with your statement, that it would be possible and may be feasible to separate these two classes of taxes. I presume you appreciate the fact that probably the principal reason for enacting the excess-profits tax now is that it will be of help to those who are trying to pass the bill to conscript men as soldiers. In other words, it would not look right to provide conscription of men now, if you do not conscript money, that it looks better to have both together.

Mr. HOOPER. I did not come here to discuss a matter of policy; I came to consider taxes from a business angle.

The CHAIRMAN. We thank you for your presence and the statement you have given to the committee.

## STATEMENT OF PAUL E. SHORB, ATTORNEY FOR AMINO PRODUCTS CO., WASHINGTON, D. C.

The CHAIRMAN. The next witness is Mr. Paul Shorb. Will you give your full name, your address, and state the capacity in which you appear?

Mr. SHORB. Mr. Chairman, my name is Paul E. Shorb; I am attorney for the Amino Products Co., and I want to speak on the special relief provisions in the bill, if you please.

Amino Products Co., of Detroit, Mich., was organized in June 1935. On that date it acquired from James E. Larrowe the assets relating to the production of monosodium glutamate, a food seasoning compound. Prior to its organization in 1935 much research work had been done in the production of monosodium glutamate by the Larrowe Suzuki Co. This work was costly. In excess of $600,000 had been spent in such research for development work and necessary machinery. The Larrowe Suzuki Co. was adjudicated bankrupt on July 27, 1934. At the sale of the trustee in bankruptcy on November 17, 1934, all its assets (except cash) were acquired for $5,000 in cash, and these assets were subsequently acquired by the Amino Products Co. for 50 shares of its no-par common stock, which were issued to James E. Larrowe. A research chemist who was familiar with the prior work done relative to the process of manufacturing monosodium glutamate was retained.

He wanted to get the process correct, and it was also necessary to have certain machinery, which was subject to a very heavy rate of depreciation.

He pursued that work up through 1936 and 1937 and had a staff of about seven employees. Also, in 1938 he made a profit, due largely to the fact that out of some of the assets of the company acquired in 1935, for which $5,000 cash had been paid, there was certain raw material from which this compound was extracted. In 1938 and 1939 they made some profit, and this year they are really in production on a good-sized scale.

The Amino Products Co. also retained the well-known consulting chemist, A. E. Marshall, of New York City. Research and experimental work on the process, and for the machinery needed, to manufacture mono-sodium glutamate was continued. About September 30, 1938, Mr. Marshall became a stockholder in the company with Mr. Larrowe. At that time the capital of the company was increased to $37,500. On its books the company, on January 1, 1940, showed as capital structure:

| | |
|---|---|
| 1,000 shares no-par $6 preferred stock | $37,495.00 |
| 500 shares no-par common stock | 5.00 |
| Total | 37,500.00 |
| Surplus Jan. 1, 1940 | 28,049.32 |
| Total capital stock and surplus | 65,549.32 |

From time to time, and for its development work, it became necessary for the stockholders to loan the company substantial amounts. On May 1, 1940, the company had "notes payable" representing money borrowed from its stockholders in the amount of $203,750.

The net income or loss of the company for the 1935 period and calendar years ending December 31, 1936 to 1939, was as follows:

| | Loss | Profit | | Loss | Profit |
|---|---|---|---|---|---|
| 1935 | $1,518.26 | | 1938 | | $36,761.95 |
| 1936 | 8,587.33 | | 1939 | | 16,003.82 |
| 1937 | 8,610.81 | | | | |

Obviously, during this period from 1935 to 1939 when the company was continuing research and development work and its manufacturing process was being perfected, its earnings were not normal. Monosodium glutamate is a compound which intensifies flavor in various foods. Prior to 1939 the company sold very little of its product in the United States. At that time its chief customer was a company in China. The business with the Chinese customer has been lost on account of the Japanese-Chinese conflict. In the present year the company has secured a large use for its product in the United States. Its foreign business has been hindered by the war, and it can be truly said that it has no excess profits due to the emergency here.

This year our estimate is that we will make probably $250,000. We have borrowed money, as I have said, from the stockholders, from time to time.

Our computation shows that we would pay on $250,000, $52,250, and our excess-profits tax, according to our computation would be $72,000. The $52,250 would be our corporate, normal, and defense tax. In other words, our normal corporation income tax, plus 10 percent defense tax would make a total effective rate of 20.9 percent taking altogether practically 50 percent of our total available income.

I think we have abnormalities of capital and income and we get no effective credit from either the invested capital method or the average income method, on the method of computing our credits.

As stated, the company has small invested capital and the base period of 1936–39 does not represent its normal earnings because during those years it was in development work. Had its stockholders been less stout-hearted and persistent, work on the process would have ended, and one less miracle of science would have been unsolved. In 1940 the work on this process, and the design and manufacture of the machinery necessary to the production of mono-sodium glutamate has been perfected and has succeeded. A new business of possible substantial volume is under way.

The facts in the instant case establish abnormalities of both income and invested capital in the base period consisting of the taxable years 1936–39 inclusive, and also the year 1940. This case illustrates the need for additional relief provisions in the present excess-profits tax bill. The options or privileges given taxpayers under the act which are operative in many cases, do not operate in the instant case to afford the taxpayer any relief whatever from the heavy impact or burden of the excess-profits tax. In this case the taxpayer had not reached, during the base period, the place where its earnings were normal, hence, the

excess-profits credit based on its average income in that period affords it no real exemption.

The same is true of the excess-profits credit based upon taxpayer's invested capital during the base period. Similarly the other comments or explanations given in the report of the subcommittee under item 9, "Special relief provisions," are not operative or effective to give any relief in the instant case.

Therefore, Congress is respectfully urged to include in the excess-profits tax bill a specific provision for "relief" or a special method of determining the excess-profits tax applicable to this and other "hard" cases. A draft of such a provision is submitted with this statement.

Such a provision would carve out or segregate from the excess-profits tax a group of cases like the present which require relief.

If a specific provision cannot be written to cover this and other harsh cases which warrant "special relief," the committee is urged to include in the bill a relief provision similar to that contained in sections 327 and 328, Revenue Acts of 1918 and 1921.

A computation shows that this taxpayer would on an estimated net income of $250,000 pay for 1940 an excess-profits tax of about $72,000. Its corporate normal and defense tax would be $52,250, making a total tax payment of $124,250, or a total effective tax rate of about 50 percent of its 1940 net income.

On page 5 of my statement which I have submitted to the committee, and also on page 6, I have made some specific suggestions.

Let me say this in reference to our total effective tax rate. I find that it is about 50 percent, as I have stated. I think that is about as high a rate as you can write as a total effective tax rate, under such conditions.

In a situation of that kind we think that none of the suggested methods would apply in such a case, and there are seven reasons in the subcommittee report which explain why special relief has not been given to any companies. None of those seven methods, as near as I can tell, and I have tried honestly to study them, would apply to this company and give it any relief, because we cannot do anything about our base earnings or about our invested capital.

We have put in a substantial amount of money since 1935, but it is largely borrowed money, borrowed from the stockholders, but the percentage limitation of borrowed money excludes a substantial part of that.

So we have suggested and ask your committee to consider the possibility of a special relief provision. One method of doing it, as we suggest on page 5 of our statement, is to provide that in any case where the excess profits net income for any taxable year exceeds the invested capital of the taxpayer for such year as computed hereunder, such excess profits net income shall be taxed at the rate of 15 percent in lieu of the graduated rates provided for in the bill. We believe that would give you an effective rate of 35 percent, and I think if your experts will take the normal income tax as estimated for 1940 and make a comparison of the excess profits for 1940 you will find that the average is not as much as 15 or 20 percent. I think the effective over-all rate would be 35 percent, whereas we would get up to 50 percent plus on our taxable net income.

If that method would not meet with your approval you can write a graduated excess-profits rate, such as I have suggested on page 5 of

my statement. A net income equal to 50 percent of invested capital could be taxed 10 percent; net income in excess of 50 percent and not more than 100 percent of invested capital could be taxed 15 percent, and a net income in excess of 100 percent of invested capital could be taxed at 20 percent. You could work it out that way and it would be easy to relieve a group like this company, where there has been a patented process. It would relieve similar struggling new companies from the impact of the higher bracket tax rates where they would be paying an effective over-all rate as compared with the larger corporations.

If those suggestions are not thought desirable, you could, as suggested on page 6 of my statement, include a ceiling provision. To the section which imposes 25, 30, or 40 percent tax rate you could add a provision reading as follows:

*Provided, however,* That in no case shall the total of the normal corporation income and defense tax and the excess-profits tax hereunder exceed 35 per centum—

or some such figure—

of the taxable net income.

That would relieve a group of these companies that have these abnormalities in connection with invested capital and income that I think require some relief.

Senator KING. Are there many corporations or companies, so far as your observation permits you to make a statement, that fall in the same category?

Mr. SHORB. In numbers, I would not know how many there are, but I know that half a dozen people have talked to me about it, and I suppose that over the United States you might find very readily in each State half a dozen such companies. There might be as many as a thousand altogether.

Senator KING. We have before the Senate committee of which I am a member the question of patents, and the question arises as to whether or not many of those corporations, the capital of which is a patent, would come within the terms of your suggestion.

Mr. SHORB. I think they would, particularly if the ceiling method were used. You would have to put restrictions on it, so that every company only earning 20 or 25 percent might not get relief, but when they get to 100 percent earnings on invested capital I think it is obvious that there are abnormalities which should be corrected.

Mr. MCCORMACK. Does your company expect to make $250,000 this year?

Mr. SHORB. Up to May 31 it had made $100,000 this year, and that is our best estimate.

Mr. MCCORMACK. You have a capital investment now of about $65,000.

Mr. SHORB. That is right.

Mr. MCCORMACK. How much have you borrowed?

Mr. SHORB. We have $200,000 in notes payable.

Mr. MCCORMACK. From the practical angle, why could you not change that $200,000 in notes outstanding into capital stock?

Mr. SHORB. We could, but it would only be for part of the year. I think a computation would show that we would not get as much of an excess-profits tax credit as we could with our average earnings in the base period.

Mr. McCORMACK. As to your average earnings in the base period, you have had two deficits and two good years?

Mr. SHORB. Yes.

Mr. McCORMACK. And the good years totaled about $53,000?

Mr. SHORB. Yes.

Mr. McCORMACK. And you divide that and you will have average earnings of about $13,000?

Mr. SHORB. We find we have to take the deficits off and take the $53,000 and reduce it by $17,000. We had about $8,900 for our income credit, and our invested capital would have to be over $250,000 to give us that.

The CHAIRMAN. We thank you for your appearance and the statement you have given the committee.

## STATEMENT OF CLINTON DAVIDSON, REPRESENTING FIDUCIARY COUNSEL, INC., 40 WALL STREET, NEW YORK, N. Y.

The CHAIRMAN. The next witness is Mr. Clinton Davidson. Will you give your full name to the reporter and state your residence and the capacity in which you appear?

Mr. DAVIDSON. Mr. Chairman, my name is Clinton Davidson. I am representing Fiduciary Counsel, Inc., 40 Wall Street, New York, N. Y., an advisory organization which is engaged in supervising approximately four hundred million dollars for investors residing in all sections of this country. The majority of these investments will be materially affected by an excess profits tax as planned in the report of your subcommittee.

If these plans are enacted two groups of corporations will be penalized heavily in 1940 and future years even though they have no income in excess of normal income.

Unfortunately, one of these groups consists of thousands of small business men located in the medium sized cities in every State, businessmen who have greater difficulty in securing needed capital than any other group, and who will find it almost impossible to secure any capital in the future if this new tax plan is not revised. The Department of Commerce, the R. F. C., and other agencies have expressed real concern regarding their capital difficulties and have tried without much success to enable them to secure needed capital.

I know that it is not your intention to penalize them unfairly and I shall try to explain these inequities and show how they can be corrected without violating any of the principles that underlie your committee's report.

### REAL PERSONAL SERVICE COMPANIES

The first group of companies, I refer to are the real personal-service companies. It is your intention, I believe, to permit personal service companies to be taxed for excess profits tax purposes as partnerships. That is, the corporation would pay no excess-profits tax, if all of the stockholders paid surtax and normal tax on all of the net income.

Unfortunately, the great majority of the personal-service companies cannot qualify as such under the definition proposed in your report, merely because in most personal-service corporations, approximately 50 percent of the stockholders are not "regularly engaged in the active conduct of the affairs of the corporation." The definition of personal-

service corporations on page 9 of your report defines, we believe, the exceptional or the minority group of such companies and, therefore, it puts the average or the great majority of such companies, in an unfair and unfavorable position.

All of you gentlemen know how the average personal-service company is formed. One or more men have special experience and ability but lack capital. They wish to form an advertising agency, an automobile sales and repairs agency, a company to publish service reports, an investment-counsel company, and so forth.

This morning Mr. McCormack asked something about personal-service corporations, and I think Mr. Sullivan said he thought those that came under that definition in this report were being treated very favorably. That is correct, but our study has led us to believe that 90 percent of the personal service companies will not come under that definition, because of the technicalities of the definition.

They start out trying to get others to put up the capital. They usually have to give 50 percent or more of the stock to those who put up the capital because the risk is so great.

Mr. McCORMACK. To make the patents workable they have to put up the capital.

Mr. DAVIDSON. Quite so. The man who invests in such enterprises is properly called an "angel" and he must make large profits on one such investment, to make up for the complete loss on the other four as less than one in five of such companies prove profitable.

I believe that every member of your two committees knows some such company where the man with the experience and ability sweated blood before he found people who were willing to put up the capital and you know that those who put up the capital got at least 50 percent of the stock. Did not Henry Ford and George Eastman have to give this much for their first capital?

We believe, gentlemen, that if there is a need for the personal service corporation classification in the act (and there certainly is) it should include the companies just described because such companies represent the great majority of personal service companies in such cities as Worcester, Springfield, Nashville, Memphis, Chattanooga, Indianapolis, Tulsa, San Francisco, Kansas City, Detroit, Richmond, Pittsburgh, Dallas, Cleveland, Minneapolis, Buffalo, Newark, and so forth.

The proposed definition on page 9 discriminates against the great majority merely because it provides that:

1. The principal owners or stockholders must be regularly engaged in the active conduct of the affairs of the corporation, and

2. The income of the corporation must be attributed primarily to the activities of the principal owners or stockholders.

A great many people who put up capital do not quit their work and become actively engaged in the business; they merely furnish the capital.

Mr. TREADWAY. Do they not look after their capital to the extent of knowing what is going on in the company, and would not that bring them within that definition?

Mr. DAVIDSON. I would hate to try to convince the Treasury Department of that myself.

Mr. TREADWAY. You are looking after their interests.

Mr. DAVIDSON. I do not think I could convince them of it.

As I said, the third proposition is that the income of the corporation must be attributed primarily to the activities of the principal owners or stockholders.

So as to the people who put in the money and put up 50 percent of the money in the corporation, you could not say that the income of the corporation is contributed primarily because of their activities.

Under the 1921 act it was ruled that 80 percent of the stockholders must be regularly engaged in the active conduct of the affairs of the corporation if it is to be classified as a personal service company, but no intelligent investor is going to furnish all of the capital for a personal service corporation and receive only 20 percent of the stock. Such legislation would not only treat the great majority of such small businesses unfairly, but it would result in the men in your communities who have the experience and ability, never being able to find people who are willing to put up all of the capital for 20 percent of the stock.

The advertising agencies in New York and Chicago would not be affected. They have and can secure, at low rates, ample capital. It is the little fellow with ambition, ability, and tireless energy who will find the door to his needed capital closed by such legislation, although the President, the Department of Commerce, and the R. F. C. have all expressed a desire to help him secure capital on a more reasonable basis than has existed heretofore.

I am glad to say that the remedy is very simple.

About 90 percent of the corporations to which I have referred have only a small number of stockholders. If the law which you are preparing expands the definition found on page 9 of your report so as to include "A corporation in which capital is not a material income-producing factor and one having not more than —— (a designated number) of stockholders," this inequity will be satisfactorily remedied.

In defining holding corporations in the present act, one important factor is the number of individuals or families who own stock. I believe that if you used this same formula in designating the number of stockholders or if not more than 20 was used as the number, the definition would be fair to the great majority of personal service companies.

Let me give you a few examples. A fair example of the company I have in mind is an agency with capital of $25,000, having no net income for several years but finally reaching net earnings of $25,000 to $50,000, with those who put up the capital and are not actively engaged in business, owning at least 50 percent of the stock.

Your alternate plan—the average earnings basis—would be unfair because their average earnings for the past 4 years is not their normal earnings. This "average earnings" basis is never fair where earnings have been increasing from year to year. Your "percent of invested capital" basis is unfair because earnings are not based upon capital. They are based upon:

A. Special experience and unusual ability, and

B. Capital which cannot be secured on a 6-percent basis.

This capital requires large earnings because four out of five ventures fail.

The only fair treatment for such companies—that is the great majority of the real personal services companies—is to give them also, the option to make returns as personal service companies.

EFFECT ON SUCH SERVICE CORPORATION

Organized in 1931. Capital required only $100,000. The President had previously earned over $50,000 per year. He was given 50 percent of the stock in lieu of salary. The earnings were:

| | | | |
|---|---|---|---|
| 1931 | Red | 1936 | 60,000 |
| 1932 | Red | 1937 | 100,000 |
| 1933 | 10,000 | 1938 | 140,000 |
| 1934 | 20,000 | 1939 | 185,000 |
| 1935 | 35,000 | 1940 | 240,000 |

This $240,000 will probably be its normal net income; that is, it has just about reached its normal stride.

Ten percent of capital, $10,000, would leave $225,000 subject to this large excess-profits tax merely because those who provided the capital had to have more than 20 percent of the stock.

The average earnings for 1936 to 1939 were $101,000. This would leave $134,000 subject to the excess-profits tax even though its 1940 income does not exceed its normal income.

Now the people who ventured this capital where four out of five prove failures, and the men who furnished management, have built a business which now has many employees. They were persuaded to do it during depression years. Although men of proven ability, they received nothing during the earlier years. I know that you want such companies treated fairly; I know that you do not want the Fords, Edisons, and George Eastmans of the future to find that the mere definition of a personal-service company has closed the door to their kind of capital.

Now, the interesting thing about this suggestion I am making is that we definitely believe, after a lot of investigation, it will not produce less tax; that it will bring in as much or more money. We believe that this will not produce less tax, because the income will be taxed at surtax and normal tax rates to the stockholders. Ever since the *DeMille Corporation case*, you have been seeking means to have net income taxed to the stockholders instead of being retained in the corporation. This proposed change will be an additional incentive and will produce such results; that is, this proposed change for these corporations would force the income to be taxed at normal and surtax rates of the stockholders; therefore we believe it will not produce less total tax.

Gentlemen, the big corporations will be represented here by eminent counsel and great trade associations who are capable of effectively pleading their causes. May I urge you not to forget the tremendous number of little personal-service companies who will probably not even know how seriously this legislation will affect their businesses until 6 months after it has been enacted, and it is for them that I make this reasonable plea.

Now, the second group—and it will not take as long to cover the second group, because it covers some of the first group: there is another group of corporations that will be drastically affected even though their 1940 net income does not exceed their normal income. I refer to companies whose earnings do not depend essentially upon capital and whose earnings have not been regular during the last 4 years. These companies will be hit hard and the sad part about it is that they include so many of the companies formed since 1933—companies

whose stockholders were encouraged to start these businesses to give employment to the unemployed.

Now, let me ask this question: I wonder if you have ever analyzed the list of corporations to determine who would be favored and who would be hurt by the proposed legislation? Well, the suggestions in the report you are now considering will not hurt a large list of corporations I have listed here, some of the largest in the country, if 1940 is no better than 1939, because their net earnings have not exceeded 10 percent of their invested capital. I give a large list of the companies here. They include—

| | 1939 earnings as a percent of invested capital | 1939 earnings as a percent of 3-year average out of last 4 years |
|---|---|---|
| American Shipbuilding | [1] 3.3 | (2) |
| Ohio Oil Co | 1.3 | (2) |
| Pennsylvania R. R | 2.9 | 98 |
| United States Steel Corporation | 3.1 | 43 |
| Standard Oil Co. of California | 3.2 | 58 |
| Union Pacific R. R. Co | 3.3 | 94 |
| Youngstown Sheet & Tube | 3.5 | 46 |
| Spencer Kellogg | [4] 3.6 | 58 |
| Louisville & Nashville | 3.8 | 92 |
| International Harvester | [3] 3.9 | 26 |
| American Steel Foundries | 4.4 | 50 |
| Gulf Oil Corporation | 4.5 | 63 |
| Mathieson Alkali Works, Inc | 4.5 | 72 |
| Newmont Mining Co | 4.8 | 89 |
| Crane Co | 5.2 | 64 |
| General American Transportation Corporation | 5.3 | 89 |
| Allis Chalmers Manufacturing Co | 5.4 | 71 |
| Phillips Petroleum Co | 5.7 | 87 |
| Westinghouse Air Brake Co | 5.7 | 56 |
| New York Air Brake Co | 5.7 | 92 |
| Yale & Towne Mfg. Co | 6.0 | 86 |
| Lone Star Gas Corporation | 6.1 | 94 |
| National Lead Co | [4] 6.2 | 95 |
| Cerro de Pasco Copper Corporation | 6.6 | 63 |
| Continental Oil (Del.) | 6.6 | 66 |
| Chesapeake & Ohio Ry | 6.7 | 77 |
| Sun Oil Co | 6.7 | 83 |
| Amerada Corporation | 6.8 | 61 |
| Standard Oil Co. of New Jersey | 7.0 | 78 |
| Texas Corporation | 7.0 | 75 |
| Pacific Telephone & Telegraph | 7.1 | 98 |
| Norfolk & Western R. R | 7.2 | 93 |
| American Brake Shoe & Foundry | 7.2 | 77 |
| Westinghouse Electric & Manufacturing Co | 7.3 | 85 |
| Otis Elevator | 7.4 | 98 |
| Burroughs Adding Machine | 7.4 | 37 |
| United Biscuit Co | 7.7 | 100 |
| American Telephone & Telegraph | 7.9 | 98 |
| Congoleum-Nairn, Inc | 8.0 | 88 |
| Swift & Co | [4] 8.5 | 106 |
| Bethlehem Steel Corporation | 8.2 | 111 |
| Boston Edison Co | 8.2 | 101 |
| Southern California Edison Co., Ltd | 6.9 | 102 |
| Pacific Gas & Electric Co | 7.5 | 105 |
| Phelps Dodge Corporation | 7.8 | 101 |
| Commonwealth Edison Co | 7.7 | 106 |
| Underwood Elliott Fisher Co | 8.5 | 53 |
| Johns-Manville Corporation | 8.6 | 86 |
| North American Co | 8.6 | 100 |
| Link Belt Co | 8.8 | 69 |
| Armstrong Cork Co | 8.8 | 82 |
| Sherwin Williams Co | 8.8 | 78 |
| Cannon Mills | 9.0 | 106 |
| May Department Stores | 9.1 | 92 |

[1] Deficit.
[2] Deficits in 1939.
[3] Deficit on common stock in 1939.
[4] Fiscal year ended Sept. 2, 1939.
[5] Fiscal year ended on or about October 31.
[6] After nonrecurring loss.

| | 1939 earnings as a percent of invested capital | 1939 earnings as a percent of 3-year average out of last 4 years |
|---|---|---|
| Niles-Bement-Pond Co. | 9.3 | 83 |
| Consolidated Gas, Electric Light & Power of Baltimore | 9.3 | 105 |
| Kresge (S. S.) Co | 9.4 | 98 |
| National Steel Corporation | 9.6 | 87 |
| Corn Products Refining Co | 9.7 | 96 |
| Bullard Co | 9.7 | 46 |
| Humble Oil & Refining Co | 9.7 | 77 |
| United Carbon Co | 10.0 | 75 |
| Pacific Lighting | 10.0 | 89 |
| Kennecott Copper Corporation | 10.0 | 93 |

I doubt if those companies, unless their income this year is much larger than it was last year—I doubt if they will pay 1 cent of tax under this bill you are proposing.

Now, here is another group——

Mr. McKeough. May I make an observation at that point: I assume you are quite familiar with the first 6 months' returns already made by the big industrial companies of the United States, showing an average net income of 11.4 percent earned after all charges and depreciation for the first 6 months of 1940. Have you seen the National City Bank's office bulletin?

Mr. Davidson. No, sir; I have not seen the National City Bank's bulletin.

Mr. McKeough. Then how can you be certain that the average in 1940, based upon the first 6 months already reported, won't show better earnings than in 1939?

Mr. Davidson. I am awfully glad you brought that up, because I am afraid I have given the wrong impression. 1940 unquestionably will bring a larger percent of return than 1939. Now we ourselves believe and I think the average patriotic citizen, the average citizen of the United States believes companies that are going to profit from the expenditure of the $14,000,000,000 should pay their fair share of taxes. The only point I make is this, and I think the report you prepared shows here is what you want—you want these companies to pay a percentage of the excess over something. Now, the point I am making is—what I am suggesting and what I believe you really want, is that, to treat all fairly, it should be excess over normal; not just excess over an arbitrary amount. And if you have three alternatives, you can have 95 percent of the corporations of this country pay excess over normal. Now, I just mention here that unless we have much larger earnings in 1940 than in 1939, you won't get a cent of tax out of all those companies.

I come now to another group, and these companies would pay a considerable tax on the "percent of invested capital" basis, if that was the only basis; but if you bring in the alternative basis of average income, they won't pay any tax unless their earnings in 1940 are higher than in 1939. These companies are:

| | |
|---|---|
| American Chain & Cable. | Liggett & Myers. |
| Chrysler Corporation. | F. W. Woolworth. |
| General Electric. | United States Tobacco. |
| General Motors. | Hamel, Atlas Glass. |
| Inland Steel. | National Distillers. |
| Penney (J. C.). | Caterpillar Tractor. |
| Monsanto Chemical. | Ingersoll Rand. |
| Commercial Investment Trust. | Reynolds Tobacco. |
| Union Carbide & Carbon. | Timken Roller Bearing. |
| Beechnut Packing. | Minneapolis Honeywell Regulator. |
| Air Reduction. | Dow Chemical. |

All great big companies.

Mr. McKEOUGH. Incidentally, right there, I might say that General Motors, for the first 6 months, show 21.6 percent—for the first 6 months reported. Not bad?

Mr. DAVIDSON. No, sir.

Mr. McCORMACK. Do you think the committee should eliminate the alternative plan?

Mr. DAVIDSON. No, sir.

Mr. McCORMACK. I was wondering if you were advocating that, by inference?

Mr. DAVIDSON. No, sir. I am just going to suggest a third alternative plan for the purpose of treating all fairly. If that is done, then we will collect the excess tax on the excess over normal income. If you only had one of those two plans, for a large group of companies, it would not have been excess over normal; it would have been excess over an arbitrary figure; but, by having both of those, you make the excess tax excess over normal. And I believe the average man on the street, as well as the large corporations, is in favor of the companies paying an excess-profits tax on excess over normal.

Now, I come to one other group of companies that are not likely to be hurt by the suggestions in your report—those companies either earning 16 percent or more on invested capital, or whose 1939 earnings were more than 20 percent above the average for prior years. They would not pay a large tax; that is, it would not be excessive; it would not be unfair. Certain of these companies would be taxed heavily if one proposal alone were to be adopted, while the remainder would be likewise heavily taxed under the other proposal. Many, however, would be wholly or largely exempt if an alternative were permitted, while none of them would be severely taxed under the circumstances. They are such companies as—

| | 1939 earnings as a percent of invested capital | 1939 earnings as a percent of 3-year average or 4 of last 4 years |
|---|---|---|
| American Car & Foundry | (1?) 3.001 | (?) |
| Baldwin Locomotive | 1.4 | (?) |
| United Airlines | 2.0 | (?) |
| Industrial Rayon Corporation | 6.5 | 121 |
| Kimberly-Clark Corporation | 6.8 | 121 |
| Eagle-Picher Lead Co | 9.0 | 153 |
| Marshall Field & Co | 9.1 | 135 |
| Pan-American Airways | 10.3 | 171 |
| Vanadium Corporation | 10.7 | 161 |
| U. S. Gypsum Co | 12.3 | 124 |
| Montgomery Ward & Co | 1 12.9 | 122 |
| Celanese Corporation | 13.6 | 125 |
| Thompson Products | 13.8 | 125 |

See footnotes at end of table.

| | 1939 earnings as a percent of invested capital | 1939 earnings as a percent of 3-year average out of last 4 years |
|---|---|---|
| Bendix Aviation | 15.5 | 138 |
| International Business Machines | 16.1 | 101 |
| General Motors Corporation | 17.3 | 88 |
| Reynolds (R. J.) Tobacco Co | 17.7 | 92 |
| Timken Roller Bearing Co | 17.8 | 80 |
| General Foods Corporation | 19.0 | 104 |
| Eaton Manufacturing Co | 19.3 | 105 |
| Minneapolis Honeywell Regulator Co | 19.5 | 78 |
| Procter & Gamble Co | [4] 19.6 | 109 |
| St. Joseph Lead Co | [7] 19.9 | 107 |
| Masonite Corporation | 20.7 | 80 |
| Penney (J. C.) Co | 20.9 | 95 |
| Dow Chemical Co | [1] [2] 22.7 | 90 |
| Mead Johnson | 23.0 | 110 |
| Sterling Products | 23.5 | 101 |
| Chrysler Corporation | 23.7 | 74 |
| Parke Davis & Co | 24.2 | 101 |
| Philip Morris & Co., Ltd | [12] 25.1 | 114 |
| Vick Chemical Co | [9] 26.5 | 99 |
| Life Savers, Inc | 26.8 | 102 |
| Bristol-Myers | 30.6 | 104 |
| Homestake Mining Co | 31.2 | 97 |
| Square D Co | 36.3 | 101 |
| American Chicle Co | 37.4 | 107 |

[1] Fiscal year ended Apr. 30, 1940.
[2] Deficit.
[3] Deficit in 1939.
[4] Deficit, 3-year average.
[5] Fiscal year ended Jan. 31, 1940.
[6] Fiscal year ended June 30.
[7] Before depletion.
[8] Fiscal year ended May 31, 1940.
[9] Estimated.
[10] Fiscal year ended Mar. 31, 1940.

Now, if it were not for the point that was brought up about 1940 income being larger than 1939, the question could well be asked, I think, Mr. McCormack, which had something to do with what you had in your mind—the question could well be asked "If we are not going to collect the tax from these corporations, then where is it going to come from?" I firmly believe the tax under this new bill as it stands today is going to come from two sources; first, from the large companies and the great mass of the old large companies, and is going to come from the excess of 1940 over 1939 and the other years; but, from the newer companies, the ones that were encouraged to go in business over the past 8 years to give employment to the unemployed—from those companies, it is not going to come from the excess over fair and normal income, but is going to come right out of their regular earnings, and which we are not taking out of the earnings of the big corporations. I want to explain why.

Mr. McKEOUGH. Pardon me for interrupting you again, and I apologize, but this is the second time you have made reference to new corporations going into business on the premise of giving work to the unemployed. I am just wondering whether or not that was the major consideration for the investment of new capital in any industry of the country in the last several years. It was not the major consideration, was it?

Mr. DAVIDSON. The answer to your question is it is not the major consideration; but, if you would revise your question a little bit and include companies not based on capital——

Mr. MCKEOUGH. Please do not misunderstand me; I am not for discouraging that activity, but I must on the record at least question the observation that capital did not seek a return in the last 7 or the last 700 years only for any such high purpose as caring for the unemployed. That might have been present in the last 7 years and I hope so, but I have some serious doubts about it.

Mr. DAVIDSON. I think you are correct. I do say, however, they were encouraged to go into business for that effect, and I think there has been a tremendous amount of encouraging to persuade them to do that sort of thing.

Mr. MCKEOUGH. I assume from that observation you mean the national administration in power for the last 7 years has aided and abetted that consideration and sought to bring it about?

Mr. DAVIDSON. I mean there have been public-spirited statements by bankers and the heads of corporations, the administration and by people in all lines, over the past 10 years, to encourage people to do that, and the newspapers have been full of it, I think.

Mr. MCKEOUGH. Not out in Chicago. The fact of the matter is, do not you think it more proper to say that, as the result of that type of investment, an increase in employment resulted?

Mr. DAVIDSON. That is very much better, Mr. McKeough

I believe that your intention to tax only the excess over normal is shown by your providing the two alternative methods and by the fact that your plan will not collect much income unless the $14,000,000,000 defense expenditures increase future net income over 1939 net income. Your purpose, however, is defeated as regards those companies whose income in the past 4 years has not been regular, largely the companies organized during the past 8 years and companies not directly affected by defense expenditures.

As some examples of this—an aviation manufacturing company is largely dependent upon capital, but an aviation transportation company is not. The "percent of invested capital" basis is unfair to such companies. Their business is new; they just began having decent earnings in 1939, so the average earnings' percentage basis is also unfair.

Similar companies would include the following, together with a host of closely held companies, such as the Sperry Co. and companies based upon inventions and other lines which, after years of development losses, are now becoming quite profitable. Now, I list here companies that would not be treated fairly by the two alternative provisions you have, and that would require still another alternative to tax the excess of those companies over normal income:

American Airlines, Inc.
Fruehauf Trailer Co.
Coca Cola Bottling Co. of New York, Inc.
Hershey Chocolate Corporation.
Cluett, Peabody & Co., Inc.
Dayton Rubber Manufacturing Co.
Coty, Inc.
Bourjois, Inc.
Electric Boat Co.
Bayuk Cigars, Inc.
Aluminum Company of America.
Douglas Aircraft Co.
Martin (Glenn L.) Co.
Eastern Air Lines.
Electric Auto Lite.
United Aircraft Corporation.
Lockheed Aircraft.
Sperry Corporation.
American Home Products.

Now, here is one remedy, and I think a very simple remedy and fair remedy. In general, the years 1936 and 1937 were better years than 1938 and 1939. Now, if you have a company whose income in 1938 and 1939, on the average, was higher than its income in 1936 and 1937, it is one of those companies that is in the growing period; it had to be one of those companies in the growing period, or it could not have overcome that handicap of having the poorer years 1938 and 1939 being better than the good years 1936 and 1937. Now, we suggest if you would add a third alternative, if you would direct those companies to take an average of their 1936 and 1937 income, take an average of their 1938 and 1939 income, and subtract the first average from the second and then divide by two, you will have in dollars their rate increasing on a fairly high average.

Mr. McCORMACK. Give an illustration.

The CHAIRMAN. The gentleman's time has already expired.

Mr. McCORMACK. I will withhold my question, then, until he concludes.

Mr. DAVIDSON. I would like to state that again: If the companies in the poor years 1938 and 1939 have an average higher than in the better years of 1936 and 1937, then that is pretty good proof that the company is in the growing period. Then if you will take the average for 1936 and 1937 and deduct it from 1938 and 1939 and, because you are taking 2 years, divide it by two, that would give, in dollars, the normal average rate of increase.

Mr. McCORMACK. What about any 3 out of 4 years?

Mr. DAVIDSON. That would be terrible.

Mr. McCORMACK. You mean to have them take any 3—would not that be better than the 4 base years?

Mr. DAVIDSON. Nothing like as well; because when you take 4 years and take 3 out of the 4, your company is growing all of the time and, instead of making some allowance for its growth period, you are merely taking the lower period. That is true even of your company that has regular earnings.

Mr. McCORMACK. I am referring to that in the light of the recommendation of the subcommittee. For instance, suppose a corporation made $50 in 1936, lost $50 in 1937, made $50 in 1938 and $50 in 1939, the average earnings would be $25—$100 divided by four over that period; but if they could take 3 out of 4 years, it would be $150.

Mr. DAVIDSON. I misunderstood you. Three out of 4 is better than all 4; yes, sir. I did not understand you. But even 3 out of 4 would not anywhere near show the normal earnings of such a company, because it has not struck its normal stride.

Mr. McCORMACK. I am not arguing it with you; I want to get your reaction.

Mr. DAVIDSON. Now, to determine the normal net income of corporations whose earnings do not depend essentially upon capital and whose earnings have been increasing from year to year, it is necessary to recognize some "rate of progress" to be added to previous years. If you do not do that, if you do not have any other alternative and just have those two alternatives, I ask the question—Who will be hurt in these companies? Well, it will be the innocent stockholders, the average people—the butcher, the baker, and the candlestick maker—that will be severely penalized. And I ask "Who owns these corporations that will be unfairly penalized merely because their

earnings are not regular—the multimillionaires?" No; just average people.

Take, for example, one of the best known corporations in the South, one whose name is known to everyone in this room. Its stock sells at about $104 per share, but the assets behind each share are only about $4. The present stockholders receive about 5 percent on their investment, but the company earns a large percent on its invested capital. If the "percent of invested capital" basis alone was permitted, the company would be greatly penalized. And who would it hurt—the big corporation? It would hurt the small individual stockholders who are receiving only 5 percent on their investment. Their dividends would be reduced and the market value of their stock (their capital) would also be greatly diminished. I mean by that if any of you gentlemen last year bought a share of stock of that company, you are getting about 5 percent on your capital. Now, the company, may be earning 50 percent on the invested capital, because it is one of those that does not require much invested capital, and if you come along and say "Here, that is terrible for this big company to be earning 50 percent on its capital; we ought to take half of that." If that is done, it is the present stockholder who has to bear the burden; the little fellow who just bought the stock is going to have his dividends cut in half, and if you cut the dividends in half, then you cut the value of his stock in half.

Mr. KNUTSON. The company you have reference to has at least had one split of a melon, have they not, of four for one?

Mr. DAVIDSON. I imagine they have had several splits; I do not know.

Mr. KNUTSON. I think I know the company you have reference to—down in the deep South?

Mr. DAVIDSON. Yes, sir; now, I have just this one further thing and I am through. If corporations, other than personal-service corporations, were given three alternative methods—and I do think the definition of "personal-service corporation" should be revised so that it will really include personal-service corporations, but if other corporations were given three alternative methods, namely (1) the average earnings' basis; (2) the percent of invested capital basis and (3) the progressive earnings rate base that I have just suggested, most of the inequities would be eliminated. In other words, you would be taxing excess over normal income of the great majority of the corporations of the country.

So, in conclusion, I want to ask you—do not let the lean cows swallow all of the fat cows. Several thousand years ago the Lord instructed Joseph to tell Pharoah that unless a fair portion of the grain from the excess years was saved, they would be liquidated during the lean years, just as the lean cows swallowed the fat cows in his dream. Now, if we do not recognize the difficulties and losses during development years, if instead of recognizing real normal net income we use formulas that are not normal for these younger companies, if when they just become to have some fat years we take most of their profits through some formula that is not normal for them, they will be liquidated during the lean years just as the lean cattle in Pharoah's dream swallowed the fat cattle.

The CHAIRMAN. Do you contend that this type of corporation, for whom you are pleading so earnestly, will have most of its earnings taken away under this bill or just an unfair share?

Mr. DAVIDSON. I beg pardon?

The CHAIRMAN. I say you are claiming under this proposal that the most of their earnings will be taken away from them. Do you think that is possible?

Mr. DAVIDSON. I think I know many of them that will, Mr. Doughton—surprisingly so; that is, taking the Federal tax and including them both together, it will be more than 50 percent.

The CHAIRMAN. I do not see how, under this proposal, it will be possible for any corporation to have the most of its earnings taken away, as you say.

Mr. DAVIDSON. Most of them would not have most of their earnings taken away.

The CHAIRMAN. I am asking you if any of them will have most of their earnings taken away by this proposal.

Mr. DAVIDSON. Not by the excess-profits tax alone, but by the Federal tax, the normal tax, and the excess-profits tax both together.

The CHAIRMAN. Well, it is not germane to get off on the other tax at all; it is this excess-profits tax that we are discussing, and we want to confine it to this tax.

Mr. DAVIDSON. If I may answer you, Mr. Doughton, if I said that the excess-profits tax would take more than 50 percent of any corporation's earnings, that is not correct; but it is the excess-profits tax added on to another tax already collected, and there are cases where the two together would take more than 50 percent. That is what I mean.

The CHAIRMAN. You did not mean to say under this proposal that most of the earnings of any corporation could be taken away?

Mr. DAVIDSON. That is right—they cannot.

Mr. KNUTSON. The two are related, however?

Mr. DAVIDSON. It hurts just as bad and they have just as much difficulty in building up to protect them over the lean years.

The CHAIRMAN. If that should be true and yet those corporations have reasonable returns on their investments, do not you think that in this great emergency in making these great provisions for national defense, they should be willing to make a liberal contribution without complaint? If we should levy only such taxes as the taxpayers are willing to pay, how much taxes do you think we would get for the national defense?

Mr. DAVIDSON. I think that all corporations should be perfectly willing to pay a very large part of the increase in their earnings due to the expenditure of the $14,000,000,000, even if it was all of that increase that they got from it; but when you ask me if they should complain, and when the younger companies are going to strike a heavy tax just because their earnings have not been regular, and here are the big corporations that have big earnings and have regular earnings, and they do not have to pay the tax, I think the younger corporations are justified in complaining.

The CHAIRMAN. Suppose the younger corporations, referring to the multimillionaires—and God knows I have no brief for multimillionaires—but suppose even a multimillionaire is in business and he does not make an excess profit, do you think he should be penalized and should be taxed just because he has a big investment, if he does not make an excess profit? How could you get it under the excess-profits tax? You might get it under the general income tax, but if

he doesn't make an excess profit, how could you properly get it under the excess-profits tax?

Mr. DAVIDSON. That is just the point I was making. It all depends on what you call "excess profits." We want what will be fair; instead of having something that is favorable to the large established ones and unfair to the new ones, we want something that is fair. It is just a matter of the definition of "excess profits." That is just the point I was making.

Mr. TREADWAY. I want to make two inquiries of you, Mr. Davidson. I was very much interested in your statement.

If the suggestions you are offering in your brief and your remarks were carried into effect, what would be the effect on the revenue that appears to be produced by this bill?

Mr. DAVIDSON. The first suggestion about personal-service companies might, as Mr. Stam explained in his report—he did not explain about this, but he brought in the same thing that explains it—it might this year mean slightly less revenue collected, very slightly, and larger next year; the point being that—well; no, I doubt that, even. I believe it would not decrease hardly any; it might decrease some. The reason for that, Mr. Treadway, is that we are not asking, in personal-service companies, that the income should not be taxed, but simply raising the question as to who pays the tax, and if you expanded the definition so that it would include the great majority of them, you would have the great majority of those included electing the device of letting the stockholders pay the tax. And that is the thing—and I have sat in here in years past and have listened to this committee—that is the thing they have always been working toward and what you have a special section in there for is to try to get the companies to pay dividends, so that they would be subject to the normal tax and the surtax through the stockholders, instead of having the money accumulate in the corporation. And if you expand that definition so that it will really include the great majority of personal-service companies, then you will have the tax paid by the stockholders, both the normal tax and the surtax, and it would not reduce it.

Mr. COOPER. Now, Mr. Davidson, it would depend entirely, with all deference, on what brackets those stockholders were in as individual taxpayers, would it not, as to what effect it would have on the revenue?

Mr. DAVIDSON. Of course, it would in some cases.

Mr. COOPER. In all cases.

Mr. DAVIDSON. I do not think so, in all cases.

Mr. COOPER. It is bound to; it depends on what bracket the individual taxpayer was in, as to what effect it would have on the revenue.

Mr. DAVIDSON. I think, Mr. Cooper, I can give you and Mr. Treadway an absolutely correct answer to that question. I am not the one to answer as to the effect it will have on the revenue, but I think unquestionably the staff of the joint committee can give you that information, and I would like to see the thing considered and I hope you get it considered and find out what the effect is. I personally believe the expanding of that definition so as really to include personal-service companies would not reduce the revenue, but I request you to get that from your staff experts.

Mr. TREADWAY. Then, as I understand, your effort is more along the line of obtaining equality and equity to all types of personal-service companies, than any effect on the revenue?

Mr. DAVIDSON. Certainly.

Mr. TREADWAY. Now, just one other question.

Mr. DAVIDSON. May I answer that further?

Mr. TREADWAY. Certainly.

Mr. DAVIDSON. I do hope that all of you men will take this into consideration, that you are passing retroactive tax legislation and, if there is ever a time when you have to be awfully careful to see that you are fair to all, it is when you are passing retroactive tax legislation.

Now, in our own company, we pay out our dividends just as fast as they are earned—every month, and we come along, because our company is new and does not require capital, and find if we continued on that basis we would be paying out more in dividends than we earned if this plan goes into effect. I think, as you are passing retroactive tax legislation, that is why it is so unusually important to consider it.

Mr. TREADWAY. There is just one other thought that comes to me. On page 2 you refer to numerous cities, medium-size cities, throughout the country: Was that list just picked at random, or did you select it from the list of committee members?

Mr. DAVIDSON. They are very carefully selected, Mr. Treadway. What I have been anixous to do here is to get a clear and accurate picture in the minds of you men of the conditions in those homes, because the thing I am talking about is national; it is all over the country.

Mr. TREADWAY. That is what I am coming at. You selected representative cities from which the members on this committee come?

Mr. DAVIDSON. That you are familiar with; that is right. I wanted you to have the picture of John Smith, Bill Jones, and somebody back home, so you gentlemen would understand.

The CHAIRMAN. If there are no further questions, we thank you, Mr. Davidson.

Mr. DAVIDSON. Thank you.

The CHAIRMAN. The next witness is Mr. M. L. Seidman, representing the New York Board of Trade. How much time do you want, Mr. Seidman?

Mr. SEIDMAN. I can conclude in 15 minutes.

The CHAIRMAN. Very well; you may proceed.

## STATEMENT OF M. L. SEIDMAN, REPRESENTING THE NEW YORK BOARD OF TRADE, NEW YORK, N. Y.

Mr. SEIDMAN. Mr. Chairman, you have under consideration the imposition of an "excess profits" tax on the net income of corporations. When, in 1921, an earlier model of such a tax was about to be interred, a Senate report (September 26, 1921) had this to say about it:

> The time for discussion (of the excess-profits tax) is past; and the time to repeal the tax has arrived. It may be mentioned, however, that further investigation has only accentuated the conviction that the inequalities of this tax make necessary its early repeal. Whatever may be its theoretical merits, in practice it exempts the overcapitalized corporations, falls more heavily upon corporations of small or moderate size than upon the larger corporations, penalizes business conservatism, and places upon the Bureau of Internal Revenue tasks which are beyond its strength.

I want to say a word for the small corporation. I have seen references to the New York Board of Trade as being a spokesman for big business. That happens to be true only to a very limited extent. For our membership is a real cross section of our local commerce, industry, and finance.

The President of the United States, in his recent message to Congress, proposed "a steeply graduated excess-profits tax to be applied to all individuals and corporate organizations without discrimination."

In these recommendations which you have before you, an excess-profits tax is proposed only against corporations, not against individuals or partnerships. The reason that no such tax is proposed against individuals or partnerships is, I think, very obvious and must have been so to your subcommittee as it deliberated on this subject. For the imposition of an excess-profits tax against the individual—or the partnership by way of the individual—would constitute the very tax discrimination which the President evidently sought to avoid.

Individuals—especially those whose income falls in the higher brackets—are already paying substantial tax rates. So that to impose a further severe tax on the same individual income would only aggravate the disproportion that already exists between personal and corporate income taxes.

It is with this in mind that I respectfully call your attention to the state of the small corporation under this proposed tax. There are about 400,000 of these small and medium-sized corporations. In fact, about 95 percent of all our corporations are probably in that class. They are really individual or partnership businesses in corporate form. Most of them are so small, that they will be exempt from the excess-profits tax even under this bill since it provides for a $5,000 specific exemption. But if the net income is over $5,000, an excess-profits tax return will have to be filed and an excess-profits tax may have to be paid.

Each of these corporations is privately owned, usually by no more than two or three persons, who have adopted that form of doing business, instead of the individual or partnership form, for whatever minor advantages the corporate form offers. But in essence, these companies are really individual or partnership businesses; and, my point is that they ought to be treated as such in this bill.

If there were good and sufficient reasons for omitting the individual and the partnership from the excess-profits tax, then I submit that the same reasons apply at least with equal force to the small, privately owned corporation. I say "at least" advisedly for, already, these businesses, in corporate form, frequently pay much higher taxes on their income than would be the case if they were conducted in individual or partnership form.

Now, there is a very simple way, I think, of accomplishing this result. The subcommittee report touches on it for personal-service corporations. It is through the medium of having all the stockholders of a company pick up their respective shares of corporate income in their personal returns as if it were the income from a partnership. The mechanism needed is already embodied in the present law. It now applies to certain corporations who, under section 102 of the Revenue Code, are called upon to pay a tax for failing to currently

distribute income. These corporations are told that the tax will not be imposed against them if their stockholders pick up their pro rata share of the corporate income in their individual returns. Exactly the same procedure can be followed for excess-profits tax purposes.

I would accordingly suggest that these privately owned companies be taxed in every respect as heretofore, and that no excess profits tax be imposed upon them in cases where their stockholders similarly report the corporate income as their own. I would make this arrangement optional with the owners of the corporation and would make it apply only to cases where the owners are no more than, say, five in number. In such cases, if all the stockholders agree, in writing, to pick up their pro rata shares of the corporate income in their personal returns, the corporation would be exempt from the excess profits tax.

The principle of singling out a particular class of corporation for special treatment because they are owned by a small number of individuals is already today part and parcel of our revenue laws, as for example, the treatment for personal holding company purposes embodied in section 501 of the code.

There is machinery also set up under the present law for the optional agreement procedure. This is embodied in section 27 of the code in connection with the so-called consent dividend credit.

Under the 1917–19 excess-profits tax law we have had some experience with its application to small corporations. The preparation of the excess-profits tax return is alone a disproportionate burden upon them, and the determination of invested capital proved in many of these cases to be an impossible job. To be fair to these corporations, it was necessary to permit each of them to deduct from net income a reasonable amount for so-called officers' salaries before subjecting their net income to the tax. This, in turn, called upon the Government to pass judgment on the value of the services rendered by each of the officers to their corporations, in every conceivable sort of a business under every conceivable set of circumstances.

This single item of determining a fair deduction as compensation for services in each of the hundreds of thousands of case created an enormous amount of controversy between the taxpayer and the Government in the administration of the law. That was to be expected in the very nature of things.

Obviously, no Government bureau of Government official is qualified to pass judgment on the fair value of an individual's services to a particular business under every conceivable kind of circumstances. Nor, on the other hand, can an interested individual officer or stockholder be expected to uniformly apply an impartial and disinterested point of view in such a matter. Endless haggling and bitter controversy are the result. Such controversies mean additional cost to the Government and to the taxpayer. They mean also the impairment of good will on the part of each toward the other.

I am convinced that these sore spots can be avoided and equity can be done to the small corporation without the loss of revenue to the Government—if these recommendations are given effect. I respectfully urge them upon you for your careful consideration.

And now, a general observation about this proposed tax. Never, more than now, has an enlightened point of view been more needed

in the formulation of a tax law. The subcommittee report gives evidence of an earnest attempt to be fair and considerate. For this, business should be grateful and I am sure it is.

But, this proposal for an excess-profits tax comes at a time when the conditions as to corporate taxes and corporate incomes are entirely different than they were during the earlier excess-profits tax period. Then, our corporations showed a relatively high income. And taxes, Federal, State, and local, were relatively low—today these factors are reversed. Corporate incomes are relatively low, and taxes are tremendously inflated.

Take the year 1937 as an example. It is the best year we have had since 1929. The aggregate net income before taxes of all corporations in 1937 was something like 10 percent under the average of the three war years 1917–19, but the total taxes paid by these corporations was greater by some 44 percent. This notwithstanding the fact that excess profits and war profits taxes are already included in the 1917–19 figures. As a consequence, the 1937 corporate net income after taxes (but of course without an excess-profits tax) was smaller by nearly 40 percent than the 1917–19 figures after excess-profits taxes.

Only within the past few weeks, taxes have been further increased, this time by about a billion dollars a year. Now, no one really can be sure how far you can go on increasing taxes without running the risk of scuttling our entire economic machinery, but the risk is certainly there.

I take it that right now, our defense program is of primary importance. Everything else is secondary. I should think, therefore, that before subjecting industry to still further additional taxes, we would want to do what we can to get our industries going under full steam. Tax yields would then automatically increase with the increase in national income while nondefense expenditures and made-work expenditures would disappear from our budget. This could go a long way toward helping meet out defense budget.

I do not mean to imply that further additional taxes will not be needed. I am convinced, however, that we must go about that process very cautiously, for the good of the maximum results which we are striving for in our defense program. We are now quite a way from the point of full employment of men, machines, and money. The possibilities, therefore, of meeting our defense needs through expanding production are still very great. The chances of substantially increasing our national income and revenue from present taxes are correspondingly great.

I lay emphasis on this point, not in the hope of convincing you gentlemen that no excess-profits-tax law at all should now be enacted, but rather in the hope that you can see with me eye to eye the wisdom of taking a liberal attitude toward some of the basic provisions of any law that you do enact.

For instance, the provision in this law regarding a base period, 1936–1939, for determining net earnings as an excess-profits-tax credit, is, to my way of thinking, a rather narrow and restricted provision. Many industries had no revival to speak of during that period. Their then earnings are accordingly subnormal as a yardstick for measuring excess profits at the present time. Also, the alternative provision for an invested capital credit in such cases is entirely inadequate.

Then again, why an excess profits tax on 1940 income, if it is intended to be a tax on profits flowing from our defense program? Here it is almost the middle of August and the defense program is hardly under way. It will probably be the end of the year before we begin to feel the stimulating effect of the large-scale defense expenditures. A liberal attitude in that regard, therefore, would not justify making such a tax effective before 1941.

The CHAIRMAN. If there are no questions, we thank you for your appearance.

Mr. SEIDMAN. Thank you.

The CHAIRMAN. The next witness is Mr. John Benson, representing the American Association of Advertising Agencies.

## STATEMENT OF JOHN BENSON, PRESIDENT, AMERICAN ASSOCIATION OF ADVERTISING AGENCIES, NEW YORK, N. Y.

Mr. BENSON. Mr. Chairman and gentlemen of the committee, I represent the American Association of Advertising Agencies, whose members do approximately two-thirds of the national advertising of this country, and I desire to point out to this committee the effect upon our business of the three alternative methods of figuring excess profits tax recommended by the subcommittee.

We do not expect nor are we entitled to any lesser tax burden than is imposed on other business; we merely want to avoid discriminatory hardship as between our own business and any other and as between one advertising agency and another.

We wish specifically to point out, first, how inequitable it would be to base excess-profits tax on invested capital in the agency business, and, second, how inequitable it would be to base excess-profits tax on net earnings in excess of a 4-year previous average, whenever that average falls below the normal earning power of our industry. The subcommittee report takes care of this for general business by providing an exemption of 6 percent of capital invested; but this does us no good in view of the fact that percentage of capital could not apply to a professional and personal service business making a very minor use of capital and that mostly not for operating needs.

To put us on a par with other business nonprofessional in character, some basis for minimum normal exemption comparable to the 6 percent allowed on capital invested should be provided.

The third alternative of a personal service corporation exemption from excess-profits tax would be a very considerable help for advertising agencies which can qualify. Many of them can do so, but quite a number probably cannot in view of the fact that they have some nonactive stockholders who furnished capital when the agency started and thus hold a nonactive interest in the business. Nearly all advertising agencies start small and short of capital, so that it sometimes becomes necessary to obtain it by giving an investor some interest. There are also other reasons which might disqualify an agency under the terms defining a personal service corporation. This proved true under the old excess-profits tax in effect in connection with the World War, and led to much dispute and some litigation

with the Treasury Department. It is quite likely that quite a number of our members could not take advantage of this exemption.

Before developing this argument in more detail, I would like to briefly describe the nature of the advertising agency business and its professional, personal service, character; also how much capital is used in it and for what purposes; also the net earnings of it and what would be a normal rate thereof.

Now as to the nature and character of advertising agency business, it is entirely a professional service in that its end product is not a commodity or physical service which is manufactured, but purely a mental product, in the form of ideas, plans, and counsel to clients. In this respect it is much like any of the other professions, such as law, medicine, architecture, or accounting. While no formal professional schooling is as yet required by law, skilled technique is indispensable in appealing to the public; so are scientific methods in evaluating media and appraising markets, and a wide knowledge of successful methods.

When we buy space or radio time for a client, he is always disclosed as the user; advertising media would not sell us their facilities without such disclosure and understanding; such space and time could not be diverted to the use of any other client without the consent of all concerned. We are not permitted to trade in advertising space or radio time; we can not buy it or use it for our own account, nor resell it in the market.

Any pay-roll or other out-of-pocket expenditures we make are incidental to the producing and disseminating of the advertising message and its proper coordination with sales effort of the client.

Now as to our need for capital and its employment: It follows from the above-recited character of our business that agencies can operate with relatively very little invested capital. We purchase no stock of raw materials; carry no inventory of goods in stock; need no plant other than office equipment; and the advertising space and time we purchase for a client are reimbursed to us by him before we pay the media.

Invested capital in 1939 averaged but 5.77 percent of annual volume done by a representative group of our members whose profit and loss statements happened to be available, and it ranged from 4.56 to 11.73 percent according to size group of agency. And a mere fraction of this percentage would be needed for current operation; its major need being for insurance against possible losses as herein below indicated.

These losses occur in two ways: Either through sudden loss of an important client or several of them, thus abruptly reducing gross income to a point which cannot cover expenses, unless the organization is badly disrupted; or, through serious credit losses. Both of these contingencies are serious and not infrequent hazards in our business, because of the relatively few clients each agency services and the large commitments often made on their account. There is considerable turn-over in clients, more so than is true of other professions, due to keen and active competition for them; and, if any clients should fail to observe the custom of our business of paying promptly for the

space and time we purchase for them, we would need some liquid reserve to pay the media.

The attached exhibit of bad debt losses and of operating deficits among our members will illustrate the hazards above referred to.

(Said exhibit is as follows:)

*Bad debt losses*

[Each horizontal line refers to a single agency]

| Year | Percent which bad debt losses were of gross income | Percent which bad debt losses were of average monthly billing | Estimated bad debt loss |
|---|---|---|---|
| 1929 | 17.20 | 31.0 | $9,700 |
| | 8.70 | 15.7 | 4,900 |
| | 6.41 | 11.5 | 1,900 |
| | 6.07 | 10.9 | 1,800 |
| | 4.27 | 7.7 | 9,600 |
| | 4.08 | 7.3 | 25,000 |
| 1930 | 27.63 | 49.7 | 62,000 |
| | 8.50 | 15.3 | 4,800 |
| | 6.00 | 10.8 | 3,400 |
| | 4.67 | 8.4 | 20,500 |
| | 4.08 | 7.3 | 23,000 |
| | 2.82 | 5.1 | 83,000 |
| 1931 | 10.97 | 19.7 | 10,300 |
| 1932 | 18.88 | 34.0 | 10,600 |
| | 11.95 | 21.5 | 11,200 |
| | 7.57 | 13.6 | 2,300 |
| | 6.29 | 11.3 | 1,900 |
| | 6.09 | 11.0 | 1,800 |
| | 4.29 | 7.7 | 2,400 |
| | 4.18 | 7.5 | 9,400 |
| | 2.74 | 4.9 | 82,000 |
| 1933 | 17.48 | 31.5 | 5,200 |
| | 13.00 | 23.4 | 3,900 |
| | 10.33 | 18.6 | 3,100 |
| | 9.79 | 17.6 | 5,500 |
| | 7.80 | 14.0 | 4,400 |
| | 6.51 | 11.7 | 3,700 |
| | 4.22 | 7.6 | 9,500 |
| | 4.13 | 7.4 | 2,300 |
| | 4.11 | 7.4 | 9,300 |
| 1934 | 7.02 | 12.6 | 2,100 |
| | 6.98 | 12.4 | 3,900 |
| | 6.63 | 11.9 | 3,700 |
| | 5.44 | 9.8 | 12,200 |
| | 4.35 | 7.8 | 1,300 |
| | 3.87 | 7.0 | 43,500 |
| 1935 | 10.21 | 18.4 | 3,100 |
| | 9.40 | 16.9 | 2,800 |
| | 4.00 | 7.2 | 1,200 |
| | 4.00 | 7.2 | 1,200 |
| 1936 | 8.00 | 14.4 | 2,400 |
| 1937 | 9.08 | 16.3 | 2,700 |

*Operating losses*

[Each horizontal line refers to a single agency]

| Year | Percent which net loss was of gross income | Percent which net loss was of average monthly billing | Estimated net loss |
|---|---|---|---|
| 1929 | 27.03 | 48.6 | $8,100 |
| | 13.20 | 23.8 | 7,400 |
| | 10.65 | 55.2 | 17,200 |
| 1930 | 30.70 | 55.3 | 17,300 |
| | 15.90 | 28.6 | 20,800 |
| | 8.41 | 15.1 | 95,000 |
| 1931 | 31.89 | 57.4 | 9,500 |
| | 31.38 | 56.5 | 17,600 |
| | 26.81 | 48.3 | 8,000 |
| | 23.47 | 42.2 | 30,800 |
| | 19.25 | 34.7 | 10,800 |
| | 16.71 | 30.1 | 9,400 |
| | 16.70 | 30.1 | 37,500 |
| | 15.25 | 27.5 | 4,500 |
| | 14.01 | 25.2 | 4,200 |
| | 13.00 | 23.4 | 7,300 |
| | 12.46 | 22.4 | 7,000 |
| | 4.80 | 8.64 | 28,800 |
| 1932 | 68.51 | 123.3 | 64,200 |
| | 59.56 | 107.2 | 17,800 |
| | 35.40 | 63.7 | 10,600 |
| | 32.78 | 59.0 | 18,400 |
| | 29.32 | 52.8 | 8,700 |
| | 25.26 | 45.5 | 7,800 |
| | 24.77 | 44.6 | 23,200 |
| | 24.46 | 44.0 | 13,700 |
| | 22.77 | 41.0 | 6,800 |
| | 21.52 | 38.7 | 12,100 |
| | 21.50 | 38.7 | 6,400 |
| | 17.00 | 30.6 | 5,100 |
| | 16.97 | 30.5 | 15,900 |
| | 15.94 | 28.7 | 4,700 |
| | 15.90 | 28.6 | 8,900 |
| | 12.60 | 22.7 | 28,300 |
| | 11.34 | 20.4 | 25,500 |
| | 6.54 | 11.8 | 24,500 |
| 1933 | 44.32 | 79.8 | 13,300 |
| | 43.84 | 78.9 | 13,100 |
| | 43.05 | 77.5 | 12,900 |
| | 41.75 | 75.2 | 12,500 |
| | 24.89 | 44.8 | 7,400 |
| | 22.93 | 41.3 | 51,500 |
| | 20.88 | 37.6 | 6,200 |
| | 19.89 | 35.8 | 5,900 |
| | 18.10 | 32.6 | 10,100 |
| | 16.39 | 29.5 | 15,300 |
| | 11.36 | 20.4 | 3,400 |
| | 10.53 | 19.3 | 3,200 |
| | 10.63 | 19.1 | 23,900 |
| | 10.51 | 18.9 | 9,800 |
| 1934 | 82.27 | 148.1 | 24,600 |
| | 52.08 | 93.7 | 15,600 |
| | 35.79 | 64.4 | 10,700 |
| | 12.69 | 22.8 | 11,900 |
| | 12.13 | 21.8 | 6,800 |
| | 10.38 | 18.7 | 5,800 |
| | 10.16 | 18.3 | 5,700 |
| 1935 | 94.35 | 169.8 | 28,300 |
| | 57.77 | 104.0 | 17,300 |
| | 30.19 | 54.3 | 9,000 |
| | 21.18 | 38.1 | 6,300 |
| | 10.35 | 18.6 | 5,800 |
| 1936 | 39.83 | 71.7 | 11,900 |
| | 10.92 | 19.6 | 3,200 |
| 1937 | 14.00 | 25.2 | 18,300 |
| | 13.03 | 23.5 | 3,900 |
| 1938 | 46.60 | 83.9 | 28,300 |
| | 42.15 | 75.9 | 12,600 |
| | 35.73 | 64.3 | 10,700 |
| | 20.04 | 36.0 | 26,200 |
| | 15.45 | 27.8 | 57,900 |
| | 14.72 | 26.5 | 4,400 |
| | 12.05 | 21.7 | 6,700 |
| | 11.57 | 20.8 | 3,400 |
| | 6.40 | 11.5 | 38,400 |
| | 4.51 | 8.1 | 135,000 |

On the proposition that agency capital is not materially an income-producing factor, let me say capital in our business is merely incidental to our way of serving clients and does not produce income except in the following two minor ways: First, if the liquid reserves held by the agency as insurance against loss are invested, they would earn some interest, but under present conditions of no interest on bank deposits and but a meager return on prime short-term securities, such earnings are bound to be negligible. Second, when a client fails to earn the cash discount of 2 percent by prompt payment, which seldom occurs, the agency retains it and makes a slight profit; otherwise not.

It is impractical to base net profit on invested capital, to determine exemptions.

The amount of capital held by various agencies of the same approximate size varies widely, simply because capital is really not needed for operating and is held mainly as an insurance against loss, as above indicated. Just as opinions differ about the amount of insurance needed to protect against mishaps, such as fire, accident, or death, so opinions differ about amount of liquid reserve needed in our business to protect against unforeseen losses.

To give you an idea how widely earnings, based on volume of business done, differ from their rate based on invested capital, I submit herewith a schedule of figures taken from profit and loss statements furnished by 52 representative agencies and the only ones so far made available to us.

These indicate that a rate of net profit based on volume averaging only 2 percent would amount to over 35 percent based on invested capital, an extremely high capital return in general business and heavily taxable as excess profits under the provisions recommended by the subcommittee.

It thus becomes evident how inequitable it would be to base an excess-profits tax exemption on rate of net profit earned on invested capital in a business like ours. It might easily involve a high excess-profits tax on earnings which actually are away below normal. There is no standard or normal rate of profit known in our business as a percentage of invested capital. It is always based on volume or gross income. The only way to make this method work as an exemption would be to substitute the latter for the former. In other words, some rate of profit on volume would have to be found comparable to the 6 percent on invested capital allowed by the subcommittee. We believe this could easily be established by the Internal Revenue authorities for our business, as well as any other professional or personal service classification.

The next point relates to our normal net profit on volume of business handled.

From the attached schedule of figures above referred to and herewith submitted, the rate of net based on volume varies from 0.95 percent to 2.70 percent, and averaged 2.04 percent for all-size groups. The latter figure might be considered too low a normal return, considering the risks and skill required in our business. Three percent might be a fairer figure. The percentage earned by the group doing $5,000,000 and up of 2.70 percent, would be reasonable for all sizes of agencies, and this 2.70 percent on volume would equal 59.2 percent on invested capital. It represents efficient operation, which all agencies strive to

attain. The less efficient should not be used as a criterion, nor an average of efficient and inefficient. Many smaller agencies and some larger ones cannot earn that much because they lack volume enough to spread their necessary overhead. A few earn as high as 5 percent, either because exceptionally well run or unusually fortunate in the type of clients they serve.

Depriving advertising agencies of a minimum normal rate of profit exemption might work a serious hardship.

How serious this can be is illustrated by a case which recently came to my attention. The agency was one of the largest in this country and averaged nearly $20,000,000 of volume during the years 1936, 1937, 1938, and 1939, on which an aggregate net income of $478,000 was earned during the 4 years, or about six-tenths of 1 percent on a total volume for the period of $77,365,000.

During the year 1940 the net earnings of this agency have so far averaged 2½ percent of volume, which would all be taxable as excess profits over and above the six-tenths of 1 percent averaged during the preceding 4 years. And 2½ percent cannot be regarded as any more than normal for a business of that size and is considerably less than was earned in years prior to the 4-year period.

Mr. REED. Do you have any printed copies of your statement?

Mr. BENSON. No, sir; but I can have some copies made.

Mr. REED. Did I understand you to say that that six-tenths of 1 percent was on the capital?

Mr. BENSON. No, sir; on the volume of business. It is on the volume of business that we base our calculations as to net profit, overhead, and so forth.

Mr. REED. How much did you say that amount was?

Mr. BENSON. $478,000. That represents six-tenths of 1 percent.

Such discriminatory hardship can be prevented only by having a rate of net profit on volume normal for the industry allowed as an exemption, comparable to 6 percent on invested capital allowed to general business. Younger agencies in particular would suffer which had been using gross profit during the previous years to build up their business. They would be deprived of even a moderate profit, sorely needed to compensate for a series of lean years.

As to the exemption afforded by personal-service corporation status, it is highly important to enable advertising agencies to utilize the previous years' profit level as a basis for figuring excess-profits tax, with a normal rate of profit in the agency business as a minimum exemption, as many of our members might not be able to qualify fully as a personal-service corporation, as above indicated. An actual alternative should be afforded us between the two methods offered to a business which is professional in character and has a very minor capitalization and still in many cases might not be able to qualify as a personal-service corporation because of the distribution of its stock among active and inactive stockholders, and its nondistribution among keymen who contribute materially to the firm's income.

Of course this would apply to all professional and personal service business similarly affected.

Now, as to the third method, qualifying as a personal service corporation, there are a number of reasons why it might be difficult for most of our members to qualify. For instance, as has been referred

to earlier today, an agency starts out with meager capital, and sometimes will sell an interest in it to obtain additional capital from investors. Then the agency grows and becomes prosperous, and it is natural for the investor to stay in with a share of the profits, and that might invalidate our status as a personal service corporation. Again, some agencies have very large staffs of key men, just as you have in many other concerns, who are not stockholders. Perhaps they do not want to be stockholders, but would rather be employees. In the next place, we have cases where a principal stockholder becomes disabled, but is still carried by the agency—maybe as long as he lives. Or, a founder of the agency may retire and be inactive for many years. Perhaps he may attend board meetings and make reports now and then, but he is not producing income for the company. Yet he still enjoys a large share of the dividends. That might also disqualify the agency as a personal service corporation. Also, an agency that could qualify might be badly embarrassed by being a personal service corporation. If it is a growing agency and needs additional reserves to support its credit, it is difficult for it to pay out substantial dividends until it has reached a safe credit level. It cannot have stockholders paid the full earnings of the corporation without taking income from the corporation with which to finance itself. The well-established agency, which is well financed, may be able to pay out all of the earnings in dividends, and, of course, some might be well served by the provision for personal service corporations.

To get down to the nubbin of the problem, it is this: We feel that perhaps half of our people are unable to qualify—many of them, I am quite sure—and must have some relief at the other end similar to that afforded general business with the 6-percent exemption on invested capital, which we now cannot take advantage of, but could if you establish a smaller comparable rate on volume of business done. That is the only basis on which any net profit in our business can be figured. I think that is a feasible thing to do. We have reports in our office at headquarters which would give the Internal Revenue people a guide by which they could establish the normal earning power in our business. I think that would be true of the accountancy people and all others who are engaged in professional service. That would give all of us relief. It would also afford some relief if we could take advantage of the personal service corporation status in cases where we could qualify.

These are my suggestions.

Mr. McCORMACK. Did you hear the testimony of Mr. Davidson this afternoon?

Mr. BENSON. Yes, sir.

Mr. McCORMACK. Have you any observations to make as to his suggestion with relation to personal service corporations; that is, about putting in a certain number of stockholders, not to exceed 10 or 20, as he said?

Mr. BENSON. Well, it seems to me—I do not want to counter his testimony—that the simpler we keep it, the better, from that angle. The difficulty you have now is that while it excludes a number of our people——

Mr. McCORMACK. Do you think Mr. Davidson's suggestion would go a long way toward meeting the situation that confronts the men

who are in your particular line of business, as well as other personal service corporations?

Mr. BENSON. If you limit it to a number of stockholders, it would certainly not. We have stockholders running, in the large agencies, from 125 down the line to 80 or 60, to 15 or 20. It would exclude a great many of them.

Mr. MCCORMACK. Of course, on the question of allowing an exemption on gross business, I imagine every business would like to have that if they could.

Mr. BENSON. It would have to be commensurate with 6 percent on capital.

Mr. MCCORMACK. Your suggestion is that it would not give any relief——

Mr. BENSON. It would not give any additional relief. What we want is *comparable* relief. That is, you will have to coordinate 6 percent on invested capital with a percentage on volume, which is the only way we can figure it.

Mr. MCCORMACK. What would be the percentage on volume that would be comparable to 6 percent on invested capital?

Mr. BENSON. We figure about 2.7 percent.

Mr. MCCORMACK. About 2.7 percent?

Mr. BENSON. Yes; from the standpoint of that being a normal operating profit in an efficient agency of substantial volume.

Mr. MCCORMACK. I want to have the record as clear as possible, and I do not want you to draw any inferences as to my state of mind from my questions. You are the gentleman with whom I had breakfast this morning, are you not?

Mr. BENSON. Yes, sir.

Mr. MCCORMACK. A good friend of yours and mine, Mr. Malloy, called me up; that is right, is it not?

Mr. BENSON. Yes.

Mr. MCCORMACK. Assuming that the committee did not adopt your suggestion, have you any other suggestions to present? If so, now is the time to do it.

Mr. BENSON. It seems to me my suggestion is much the simplest.

Mr. MCCORMACK. But, I say, assuming the committee did not adopt that.

Mr. BENSON. Well, a liberalizing somewhat of the definition of a personal service corporation. But it depends on how wide you can make it; if you make it too wide, you might destroy the definition.

Mr. MCCORMACK. Have you taken it up with any of the officials of the Treasury Department?

Mr. BENSON. Yes, sir.

Mr. MCCORMACK. With whom have you discussed it?

Mr. BENSON. I have talked to Mr. Tarleau; I have talked to Mr. Stam, of your joint committee. I have talked to Mr. Cooper. But that was before the development of the personal service corporation status that was introduced into this proposal of the subcommittee.

Mr. MCCORMACK. The only thought I had in mind, Mr. Benson, was that it might be well for you to put in your suggested remedy, or suggested amendments that might meet the situation; that is, put in the maximum one and then put in an alternative one. If the committee did not see fit to follow your first suggestion—the proposal you make is to allow a certain percentage on the gross business, 2.7 percent?

Mr. BENSON. Of course, that rate, Mr. McCormack, is something that the Treasury Department will have to determine for each of these personal-service divisions.

Mr. MCCORMACK. Having in mind 6 percent under $500,000 and 4 percent above.

Mr. BENSON. That is right. We do not name any rate. We are only indicating how.

Mr. MCCORMACK. The suggestion of Mr. Davidson is along the line that you have in mind?

Mr. BENSON. Yes; he feels the same difficulty.

Mr. MCCORMACK. In other words, if the suggestion you have made is not acted upon favorably, you would want to see something along the line of Mr. Davidson's suggestion?

Mr. BENSON. Yes; I think that would give some relief. It would take in more people who could qualify. On the other hand, if it gets to be a matter of the number of stockholders, it would lead to a lot of confusion in our ranks. It would lead to discrimination as between one agency and another of equal tax merit.

Mr. MCCORMACK. If there are no further questions, thank you, Mr. Benson.

(Mr. Benson submitted the following document:)

*Profit as percentage of total annual volume and total gross income, compared with its percentage of net tangible assets (invested capital)*

[NOTE.—Data taken from standard A. A. A. A. balance sheets of 52 members whose profit and loss statements are available]

| Agency billing classification | Number of agencies | Total annual volume | Total gross income | Net profit | Profit as total annual volume | Percentage of tangible gross income | Total net tangible assets | Rate of net profit on total net tangible assets | Ratio of net tangible assets to annual volume |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | *Percent* | *Percent* | | *Percent* | *Percent* |
| Under $500,000 | 26 | $5,896,960 | $888,044 | $55,760 | 0.95 | 6.31 | $690,533 | 8.07 | 11.73 |
| $500,000 to $1,000,000 | 12 | 8,268,600 | 1,240,290 | 96,207 | 1.16 | 7.76 | 677,900 | 14.19 | 8.20 |
| $1,000,000 to $2,000,000 | 5 | 7,374,000 | 1,106,100 | 70,413 | .95 | 6.37 | 455,722 | 15.45 | 6.18 |
| $2,000,000 to $5,000,000 | 6 | 16,080,000 | 2,412,000 | 223,429 | 1.39 | 9.26 | 938,706 | 23.80 | 5.84 |
| Over $5,000,000 | 3 | 48,540,000 | 7,281,000 | 1,309,971 | 2.70 | 17.99 | 2,212,882 | 22-1 | 4.56 |
| All | 52 | 86,149,560 | 12,922,434 | 1,755,780 | 2.04 | 13.59 | 4,975,743 | 173-1 | 5.77 |

The next witness is Congressman Crawford, of Michigan.

## STATEMENT OF HON. FRED L. CRAWFORD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. CRAWFORD. Mr. Chairman and gentlemen of the committee: The committee is well aware of the concern I personally have had pertaining to our approach to the excess-profits tax and the amortization-allowance problems. I congratulate the committee in having brought these matters to a head without further delay.

Enough facts have been presented to cause all of us to fully realize that either one of two courses must now be taken.

Federal revenues must be very materially increased, far beyond that called for by the recent revenue act adding more than $1,000,000,000 to prospective income and the proposal now under consideration, or, the direct Federal debt must be greatly increased over the $49,000,000,000 now authorized. We shall probably have to do both. Personally, I shall assume in my brief presentation that the tax burden will, within a few months, be increased far beyond that now indicated.

Specifically, I wish to address my remarks to the excess-profits tax phase of the proposal now before the committee. In view of the great confusion of thought concerning what would represent an equitable basis upon which to determine the proposed excess-profits tax, I should like to suggest most respectfully the logical approach to the subject is to answer the following question: "What constitutes excess profits?"

In no way do I wish to have you understand I am disputing the necessity for providing funds with which to finance the defense program. That decision has been made; we are now on our way; funds must be provided.

Now, that an excess-profits tax is to be provided or adopted, the question then is:

What would be the most workable and equitable plan to each individual business in relation to the treatment accorded to all business in general?

We may classify business broadly as to: (*a*) Established businesses with demonstrated earnings records: (*b*) new businesses whose history is so short that its earning power has not yet been demonstrated.

Either we establish a differentiation between these two classes of business enterprises or the tax burden will hit the newer business just at the time it is getting on its feet, and in this manner contribute to defeating the defense program and also place in operation discriminatory applications of the tax burden.

I believe we are forced to admit that excess profits are only those profits in excess of the demonstrated profits of a corporation over a business cycle. We must recognize that we have suffered violently disrupted conditions since the late twenties. In 1929 we had distorted profits and incomes. There followed the deflation which was inevitable because of the blown-up character of business in 1929, and this resulted in terrific "accounting" losses which actually did not belong to subsequent fiscal periods. I suggest, therefore, that the last business cycle to be considered in this connection should therefore commence some time after 1929.

Looking ahead with the full realization that amendments will be made in the excess profits taxes provisions now about to be put in

the law, and having in mind that the formula now established should be one that will stand up in the future, therefore, it is suggested that a company's earning record which might be called normal in relation to present-day conditions would be the average of the three or four high earnings years since 1929. If we take the average of 3 or 4 years we can thus side-step the use of the highest year, which in many instances might have been in the nature of a flash in the pan.

It would appear that the policies of corporations in general are very closely related to or governed by or based upon the consideration of two things:

(1) Their performance in the 3 or 4 years above referred to, and

(2) Their immediate future prospects.

I would assume we desire to insure a reasonable degree of continuity of business, and that we would desire to determine tax policy with due regard to general business policy. So, I suggest that we make the the determination on the average of the best 3 or 4 years prior to 1940 and subsequent to 1929—not necessarily consecutive years.

The excess-profits-tax approach has no doubt been chosen, not just as another tax, but in view of past tax history, as the one familiar way of getting the revenue, popular or unpopular. But the job must be done. Consequently, beyond the average of the profitable years to which I have referred, we can well justify a substantial tax levy on the excess. Beyond that point, I do not believe business would object to splitting at least 50-50 with the Government. The principle of the graduated taxes under the above circumtances would seem to be unnecessary.

Of course, every business should contribute to the financing of the national defense program. But, no business should be crippled by it. Computing the tax on the basis outlined above, should the computed tax be less than 10 percent of the taxable income for the year, the minimum excess profits tax payable should be set at say 10 percent of the taxable income. On the other hand, the maximum payable as excess profits tax should not amount to more than say 20 percent of the taxable income for the year, irrespective of the computed tax.

Returning to the matter of the so-called "new businesses," that is, one incorporated say within 6 years of the enactment of the act, I would suggest the substitution of the earnings for any one year, or alternatively, the average of any 2 years (including as such a year the calendar year 1939 and even a fiscal year ending not later than June 30, 1940), as the fairest base for the matter of the computation of the tax, subject to the application of the minimum excess profits tax of 10 percent of the taxable profit and the maximum excess profits tax of 20 percent of the taxable profit for the year.

Now, Mr. Chairman, let me conclude by reiterating the logical approach to the matter of excess-profits taxes is to answer the question:

"What are excess profits?" and

"Why the consideration of the profits history of a business is not a more logical approach than a consideration of an abstract computation of a so-called return on invested capital, is difficult for many of us to reconcile with the title of excess profits."

I suggest that if we permit the corporation to select an average of its best performance over a business cycle, that we will have provided an equitable answer even to those like the steel businesses who claim

the invested capital basis to be more equitable than the average earnings basis, in that, if they have not been able to earn intermittently in some years in the cycle a full return on their invested capital, the present emergency should not provide them with the means of doing any better than they have demonstrated they could do before the present emergency.

All businesses should contribute if they are profitable businesses. So long as the minimum contribution payable be determined exactly on the same basis for old and new, large and small, and likewise the maximum contribution—payable by the more fortunate businesses—the equitable and desirable object will have been accomplished.

May I further suggest that the minimum and maximum percentages and the excess-profits-tax percentage could be changed from year to year to meet the requirements of the defense program.

Tax lawyers and accountants will, no doubt, object to these suggestions, because they carry the "absurd" merit of being determinable by the man in the street without professional assistance.

Mr. McCORMACK. Thank you, Mr. Crawford.

The next witness is Mr. Paul D. Seghers, representing the Federal Tax Forum, New York City.

## STATEMENT OF PAUL D. SEGHERS, PRESIDENT OF THE FEDERAL TAX FORUM, 120 BROADWAY, NEW YORK CITY

Mr. McCORMACK. Will you state your name and address, and whom you represent?

Mr. SEGHERS. My name is Paul D. Seghers, 120 Broadway, New York; president of the Federal Tax Forum.

Mr. McCORMACK. You are recognized for 15 minutes, Mr. Seghers.

Mr. SEGHERS. Mr. Chairman and gentlemen of the committee, I should like to say that I am here as the president of an organization of men who are so interested in the study of taxes that we meet together two nights a month and spend several hours discussing tax problems and interchanging ideas. It is the ideas of this group of tax men, lawyers, and accountants in public practice and in tax departments of corporations that I am here to present with, perhaps, some of my own ideas.

The Federal Tax Forum is an organization of men actively engaged in Federal income tax practice, who meet two evenings a month for the interchange of ideas and the discussion of problems in the field of taxation. Its members include lawyers and accountants both privately employed and engaged in the public practice of their profession, many having been active in Federal income tax matters since the days of the 1921 war and excess profits taxes. The various proposals for some form of corporate excess profits tax for defense purposes have been exhaustively discussed at a number of recent meetings, and the consensus of the opinions of the members concerning the various problems involved in such taxation obtained by means of a questionnaire.

It is our feeling that the defense of the United States must be put above every other consideration. Such defense requires the united effort of every one of us, and in every way within our means. Raising the necessary funds is only one of many pressing needs, but it is a vital one. The objective is simple, though the solution is difficult:

> How to raise the largest amount of funds needed for defense
> From those able to bear the burden with the least hardship

The members of the Federal Tax Forum do not seek to express any views on behalf of any class of taxpayers, or on behalf of taxpayers as a body, but to do our part as citizens toward working out a tax measure which will best achieve these two aims.

No attempt is made to present a complete plan of excess profits taxation nor opinions on the various features of the plan of the subcommittee just made public, since the short notice did not afford time for such an approach. Instead, the intention is to give the committee the views of the members of the Federal Tax Forum who participated in the questionnaire concerning some of the elements which are believed to be of the greatest importance in any scheme of excess profits taxation.

The great majority of the members of the Forum have expressed the opinion that no plan of excess-profits taxation can operate satisfactorily without the use of invested capital, either as a primary base or as an alternative, at the option of the taxpayer, where prior-year earnings do not afford a satisfactory measure of the portion of the income to be considered normal and thus exempt from the excess-profits tax. This principle is recognized in the subcommittee's plan—hence, no further discussion of the general principle is necessary.

However, it might be added that the majority favor using the 1921 Revenue Act as a model for those provisions relating to invested capital, with such modifications as experience has shown to be desirable. This would appear to present advantages over devising entirely new provisions which, no matter how perfect they might appear at the moment, would be as likely to develop unexpected difficulties as did the original ones. Those of us who have had the most experience with taxes under the old invested-capital provisions believe that a great many of the complexities found under the old law could and should be eliminated. Solutions of many difficult questions of fact in the case of corporations subject to tax under the earlier excess-profits-tax acts would afford a ready basis for the determination of invested capital today, even though the business may have passed through one or more reorganizations. After all, invested capital is the amount invested in a business, including the accumulated and undistributed earnings, and once that has been determined for a given date, the projection to a later date is in most cases comparatively easy.

When corporations or their original stockholders are considered as the real taxpayers, it would seem that invested capital unquestionably affords the fairest way in which to measure the ability to pay higher taxes. However, one practical consideration cannot be overlooked—the position of those who have invested in corporate stocks on the basis of their earnings records, without regard to the amount actually invested by the original stockholders. This is a condition, not a theory, and a failure to recognize it would put a crushing burden upon such recent stockholders. It is largely in recognition of this fact that the recommendation of the Forum coincides with the committee's provision that the taxpayer is to have the choice of either the invested capital or the average earnings base for the computation of the amount of income to be exempt from the excess-profits tax.

It is suggested that, as between a very low rate of exemption from excess profits (based upon invested capital) coupled with a relatively

low rate of tax upon the excess, and a much higher exemption with a higher and steeply graduated scale of taxes, the latter appears preferable. This is so because a high exemption means that a business is allowed to earn a fair return upon its capital before the impact of any excess-profits tax, so that under such conditions those who have to bear a high tax, nevertheless must recognize that they are allowed a fair return upon their capital before any excess-profits tax is payable. On the other hand, with a low exemption, corporations which are unable to earn even a fair return upon their investment will nevertheless be called upon to pay an excess-profits tax, against which there will be natural feelings of resentment. Is this not obvious?

I might mention briefly that in the questionnaire which was sent out, one of the questions submitted was whether producers of war goods should be subjected to a higher or a lower rate. I might say that of our members there is only one who is directly interested in a war industry.

The great majority of the Forum reached the same conclusion as the subcommittee; that producers of war commodities should pay the same rate of excess-profits tax as other taxpayers, and that the Vinson-Trammell Act should be repealed. This conclusion undoubtedly was influenced by the desire to avoid any taxing provision which might hamper production for national defense.

The use of consolidated returns, either mandatory or at the option of the taxpayer, is strongly recommended. It is our belief that their use, under conditions such as existed at the time they were abolished in 1934, rarely if ever operates to defeat the legitimate purpose of a tax upon incomes, and that they are essential in a great number of cases in order to present an undistorted picture of the true income and true invested capital of a business entity. Many difficulties can be foreseen if consolidated returns are not provided for in the case of an excess-profits tax.

The Federal Tax Forum makes the recommendation that the bill contain a provision substantially as follows:

> 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.

Doubts have been expressed quite frequently that such a provision would be considered, while recognizing that it would be highly desirable. Since arguments against this provision cannot be found, is it not at least worth careful study? Experience indicates that it would have eliminated many of the difficulties which have arisen in the past where a situation having an obvious solution from an accounting viewpoint was held not to be covered by any specific provision of statute. Certainly such a provision would win acclaim from businessmen.

As a means of limiting the impact of the tax on any business, a maximum over-all rate of tax is recommended, especially if the top bracket of income is subject to a relatively high rate of tax. The need of such a maximum over-all is less where the rate scale is less sharply graduated.

The determination of average earnings for the base period, where there have been losses, is bound to cause hardship. Those who favor the use of average earnings as the principal measure in determining

what constitutes excess profits, feel that loss years should be entirely eliminated in computing average earnings. Likewise, a carry-over to the following year of any excess of the exemption over the income subject to the excess-profits tax in a given year is believed desirable in the interest of fairness, since an early year may show relatively small profits during a period of expansion and development, with subsequent years getting the benefit.

In order to secure the maximum cooperation from corporate taxpayers, it appears desirable that proper provision be made to relieve cases of relative hardship, which might be unbearable under higher rates of tax. For this reason, the need of some form of special board to afford relief in cases of hardship is apparent. One means of limiting the number of cases appealed might be to provide that it would be open only in those cases where the over-all tax on net income or the ratio of net income to invested capital was in excess of certain percentages. Such cases might be given the right to appeal, without necessarily being entitled to relief.

Concerning the extractive industries, such as mining and others where depletion is allowable, it seems likely that special provisions will be necessary in order to prevent freezing production at its level for the base period in those cases (probably the majority) where the tax is determined by reference to the average earnings for such base period. It is obvious that where the tax can be avoided by deferring extraction of the mineral deposit or other asset until some later year when taxes may be lower, there will be an incentive upon the restriction of output.

The subcommittee's complete elimination of any arbitrarylimitations based upon par value of capital stock coincides with the recommendation of the Forum on this point. It is felt that whatever limitations may be necessary should be based upon realities and not upon accidental forms.

One other feature seems highly desirable in this bill in order to convince taxpayers of the intention to deal fairly with them. That is to expand the provisions of section 3801, Internal Revenue Code, to provide for mitigation of the harsh provisions of the statute of limitations in 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 it had held that the loss had not yet been realized. Such cases are all too common, and they are bound to leave taxpayers with a feeling that the cards are stacked against them, since the Treasury would obtain equitable relief in a reverse of the same situation under section 3801. Let me close on that note—that the best way to make a tax measure effective is to secure the good will of taxpayers, and provisions designed to afford taxpayers justice and equitable treatment are the most effective for that purpose.

I say that in memory of the old 1921 days when taxpayers started out by being willing to pay a tax on a fair interpretation of the law and later became educated to go into the courts for technical relief.

Such a plan, with proper provisions for "consent dividends," credit for dividends paid with notes, etc., and for income set aside for the payment of indebtedness, etc., such as now exist in the law, might approach very closely the two objectives of the proposed defense tax:

By forcing large amounts of dividends into the hands of individuals subject to high surtaxes, the revenue yield would be large, and

By measuring the burden of taxation by the size of the income of the ultimate individual recipient, it would fall most heavily on those best able to bear it.

A plan for an entirely different form of defense tax will be mentioned, even though it may have small chance of adoption. This plan, devised by a businessman and received too late for detailed consideration by the membership of the Forum, has the great merit of extreme simplicity.

Under this plan, corporations would be subject to a normal tax of say 18 percent; undistributed income in excess of 40 percent thereof to be taxed at the rate of 100 percent. In other words, corporations would be permitted to retain 40 percent of their taxable income (after deducting income tax) and be taxed 100 percent of the undistributed remainder.

I thank you.

Mr. McCORMACK. What is this forum organization; how many members?

Mr. SEGHERS. We have about 70 and in our meetings the attendance runs from 35 to 40.

Mr. McCORMACK. How long has it been in existence?

Mr. SEGHERS. We have been in existence about a year and a half.

Mr. McCORMACK. You discuss tax measures and other public questions?

Mr. SEGHERS. No other public questions—only taxation.

Mr. McCORMACK. It is a voluntary organization or association?

Mr. SEGHERS. Yes.

Mr. McCORMACK. And you came down here to represent that forum?

Mr. SEGHERS. Yes.

Mr. McCORMACK. I think the Forum and its members ought to be congratulated, and we thank you for your appearance.

Mr. SEGHERS. Thank you very much.

## STATEMENT OF GEORGE ROGERS, WASHINGTON, D. C.

The CHAIRMAN. The next witness on the calendar is Mr. George Rogers.

You may proceed, Mr. Rogers.

Mr. ROGERS. Mr. Chairman and gentlemen of the committee: for the record my name is George Rogers. I represent the Electrolux Corporation, which manufactures vacuum cleaners, sells such merchandise on the installment plan, and employs the installment method of reporting income. This corporation, we believe, and many other corporations which sell merchandise and report their income on the installment basis, find themselves at a distinct disadvantage with respect to the proposed excess-profits tax because they have used the installment method of reporting income.

Since 1926 the Federal revenue acts have permitted the use of the installment method of reporting income. The essence of such method is that only a portion of the profit in a sale of merchandise is reported in the year of sale, and the remaining profit is reported in a subsequent year or years when the balance of the selling price is received. By contrast, a corporation reporting on the accrual basis will have taken up all the profit in the year of sale, even though payments are received over the next year or two. For excess profits tax

purposes, therefore, a corporation on the accrual basis is at a distinct advantage, in that its invested capital will include all the profit on all 1939 sales, while a corporation using the installment method may include in its invested capital only a part of the profits in its 1939 sales. My appearance here is simply to ask that mercantile corporations using the installment method of reporting income be accorded substantially the same invested capital computations as similar corporations using the accrual method of accounting; and that if such corporations change to the accrual method, they be permitted to make the change under fair and reasonable conditions.

With your permission, we will leave with you a printed memorandum which contains a suggested provision of law designed to place mercantile corporations reporting income on the installment basis on the same footing as similar corporations reporting income on the accrual basis. This suggested draft has been discussed with representatives of the Treasury Department and has been revised to reflect their views; so far as we have been advised, the Treasury Department does not consider such proposed provision to be unfair or objectionable from the point of view of the Government.

There are two ends which would be accomplished by the suggested provision. The first can be clearly illustrated by a very simple example. Suppose a corporation on November 1, 1939, sells for $1,500 an automobile which cost $1,000 to manufacture; half the purchase price, $750, being paid at the time of the sale, and the remaining $750 being payable 6 months later, May 1, 1940. If the company reports income on the accrual basis, it will include in its gross income for 1939 the entire profit of $500, with a corresponding credit to earned surplus and increase in invested capital at the end of 1939. If, however, the company reports income on the installment basis, it will include in its gross income for 1939 only $250, and the remaining $250 will be returned in 1940, with the result that the credit to earned surplus and increase in invested capital at the end of 1939 will be only half as much as though the company had reported on the accrual basis.

At the close of any year a very large part of the invested capital of any company selling on the installment basis consists of profits appertaining to installment payments not yet collected. In the case of Electrolux Corporation, which is typical, the company would receive approximately half of the credit for invested capital which it would receive if it had filed its 1939 return on the accrual basis. A real inequality will result unless appropriate provision is made to give companies on the installment basis the same credit for invested capital as companies on the accrual basis.

A second point should be covered in order to protect corporations on the installment basis from unjust discrimination as compared with similar corporations on the accrual basis. Section 44 (a) of the Internal Revenue Code and its earlier counterparts, which have permitted the reporting of income by the installment method, were intended by Congress to facilitate the reporting of income by mercantile corporations engaged in the installment sales business.

Mr. DISNEY. May I interrupt you for a question?

Mr. ROGERS. Yes.

Mr. DISNEY. Whether you report on accrual basis or not is optional with the corporation, is it not?

Mr. ROGERS. Yes; it is optional with the corporation except that if you start on one basis you must adhere to that basis, unless and until you get permission from the Commissioner to change.

Mr. MCCORMACK. I still cannot see why it would not average itself out over a period of years.

Mr. ROGERS. In this particular instance, Mr. McCormack, the corporation had operated a subsidiary up until June 30, 1938, at which time the operating subsidiary was liquidated and this company became the operating company. The law as now proposed excludes 85 percent of the dividends which the Electrolux Corporation received in the prior years from the operating subsidiary, and therefore its earnings base is so much reduced by the dividends, which in turn effects the excess profits tax.

However, Mr. Chairman, for substantial business reasons many such corporations starting out on the installment method of reporting income have found it necessary to change to the accrual method of reporting income.

Before the new excess profits tax was proposed, Electrolux Corporation applied to the Commissioner of Internal Revenue for permission to change its method of reporting income for 1940 and subsequent years from the installment basis to the accrual basis. The Commissioner's regulations permit such a change, provided that the corporation, in the year of change, acrues as income not only the profit on the sales of the current year but also the profit derived from the sales made in prior years, to the extent that such prior years' profit has not yet been returned for tax purposes.

This is a perfectly fair requirement in a determination of income subject to the normal tax, because payment of the normal tax on part of the profit on 1939 sales was actually deferred by reason of the installment basis of accounting. On the other hand, such a requirement is quite unfair in determining the income subject to the excess profits tax. For example, the net income of Electrolux from 1940 sales will be approximately $2,000,000. If in 1940 Electrolux is permitted to change its method of accounting from the installment to the accrual basis, the regulations will require it to add $3,000,000 of profit from sales made in 1939 but not reported in such year because of the operation of the installment method. Thus, by reason of the change of accounting methods, the income of Electrolux in 1940 may be determined to be $5,000,000; whereas, the income earned during that year actually amounts to only $2,000,000.

It is submitted, therefore, that provision should be made to correct both points above described, that is, (1) the proposed excess-profits-tax statute should permit corporations upon the installment method of accounting to include in their invested capital, as a part of their earned surplus as of December 31, 1939, all the profits on installment sales contracts made before such date, and (2) provision should also be made to protect installment corporations changing to the accrual method of reporting income by excluding from income subject to excess-profits tax in 1940 the income earned through sales made in 1939 and earlier years but properly taxed in 1940 for normal tax purposes.

Now, Mr. Chairman, in the brief which has been handed to you the entire situation has been set out in full, with a proposed section which would take care of these points, set out on page 2 in the brief.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. MCCORMACK. I would like to include in the record a statement which has been furnished to me showing revenue in the United States and Great Britain from excess-profits taxes during the years 1917 to 1921.

Also a letter I have received from W. W. Schneider secretary of the Monsanto Chemical Co., of St. Louis, Mo., enclosing a copy of suggestions made on this question.

(The matter referred to is as follows:)

REVENUE

It seems that the World War excess profits taxes afford some index as to the revenue to be expected from a tax levied on these two bases. The British tax was based on previous earnings; the United States taxes were mainly upon an invested capital base. The United States was approximately three times Great Britain in national income, national wealth, and population. The revenue derived and rates in effect by years in the two countries are shown as follows:

| | United States | | Great Britain | |
|---|---|---|---|---|
| | Revenue | Rates in effect (percent) | Revenue | Rates in effect (percent) |
| 1917 | $1,638,000,000 | 20 to 60 | $708,075,000 | 50. |
| 1918 | 2,505,000,000 | 30 and 65; 80 per cent war profits. | 1,115,360,000 | 60 and 80. |
| 1919 | 1,431,000,000 | | 1,419,885,000 | 80. |
| 1920 | 908,000,000 | 20 and 40 | 1,446,080,000 | 60. |
| 1921 | 335,000,000 | | 1,090,495,000 | 60 |
| Total | | | 5,780,075,000 | |

The British tax was levied on corporations and individuals throughout; the United States tax was in 1917 on corporations, partnerships and individuals; the United States tax in 1918, 1919, 1920 and 1921 was on corporations only.

The CHAIRMAN. Without objection it will be included in the record.

(The statements referred to follow:)

MONSANTO CHEMICAL CO.,
*St. Louis, Mo., July 23, 1940.*

Hon. JOHN W. MCCORMACK,
*c/o House of Representatives,*
*Washington, D. C.*

(In re: Excess-profits tax legislation).

DEAR MR. MCCORMACK: The purpose of this memorandum is to offer constructive suggestions respecting excess-profits tax legislation. It is probable that Congress will adopt such legislation at this session, and although we doubt the wisdom of such legislation, nevertheless our purpose is to suggest suitable and sound provisions for embodiment in such legislation.

Senator La Follette's amendment to the Revenue Act of 1940, which was adopted by the Senate but rejected by the conference committee and eliminated on final passage, was patterned very closely after the World War laws on excess-profits taxes. We believe that the passage of time has demonstrated the weakness and defects in that earlier law, and that the law of twenty years ago is not suited to the conditions of the present day.

Accordingly, we requested our income tax counsel to study the La Follette amendment with a view to suggesting constructive changes in it, based upon present day conditions and experience under the earlier law. Their analysis and suggestions are contained in the attached letter to us dated July 18, 1940. These attorneys have had many years experience with income-tax matters including the World War excess profits-tax laws, and we believe their criticism and suggestions are valuable and well-founded.

We particularly call attention to their criticism on pages 8 to 12 of the discrimination against taxpayers issuing par value stock and in favor of taxpayers issuing no par value stock, in computing invested capital. In our opinion, their criticism of that provision is justified and cogent. It is grossly unfair not to allow the market value of par value stock to be used in computing invested capital, in the same manner that such market value is used in the case of no par value stock. It is just as easy to ascertain the market value of par value stock as it is to ascertain the market value of no par value stock. In computing taxes under the income tax law and the estate and gift tax laws, the market value of par value stock is used as the basis of valuation, the same as for no par value stock. The actual or market value of par value stock might be, and in many cases is, substantially more than its par value. We sincerely urge that the improper treatment and injustice respecting par value stock contained in the law of 20 years ago not be repeated in any new law.

It has been suggested that instead of using invested capital as the sole basis, the tax, at the taxpayer's option, be assessed against that portion of the profits in excess of the average profits for the 3- to 5-year period preceding last July 1, such as Canada has done. If the primary purpose of such tax is to reach profits arising out of the present rearmament program then such an alternative basis is proper because, obviously, no profits from the present rearmament program could have been earned prior to July 1. All profits prior to that date have no relation to the present rearmament program. If the primary purpose of such tax is not to reach such rearmament profits, but is to permanently establish an additional form of taxation, then the invested capital would seem to be the proper basis.

This subject is very important to the business and industrial interests of this country, as well as to the Government, and we hope that you will take the time to read the attached comments. We have endeavored to limit our comments to the more important aspects of such legislation.

Yours very truly,

W. W. SCHNEIDER, *Secretary.*

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LOWENHAUPT, WAITE & STOLAR,
*St. Louis, Mo., July 18, 1940.*

MONSANTO CHEMICAL CO.,
*St. Louis, Mo.*

GENTLEMEN: You requested that I advise you of the experience under the excess-profits tax law prevailing during the last war and my thought as to the effect oupn the national economy of the restoration of such law. I have had a very active experience in tax practice, extending over many years. My practice went through the administration of the excess-profits tax and I saw its results.

Preliminarily, the excess-profits tax imposed under the Revenue Acts of 1917 and 1918 were concededly emergency measures. The tax was not continued because experience showed that it was difficult of administration; also economic analysis in that period concluded that it was a deterrent to initiative, not primarily because of the principle of the law to put a ceiling over profits in private enterprise, but for the following reason: There are two measures of excess-profits taxes: (1) invested capital, and (2) income. What is income is difficult and uncertain, but, with the addition of the uncertainty and complication of facts and law resulting from the necessity of determining invested capital, there could never be, until the expiration of many years, any satisfaction at all that taxes owing had been paid. The incubus of large pending tax claims was frequently a deterrent to industrial development. Even more, sometimes, when the taxpayer was wrong he found himself in bankruptcy.

When the 1918 law was under consideration, a committee of the Treasury Department held extensive hearings upon the question whether the tax should be applied to individuals and partnerships. It was found that the 1917 law was incapable in this respect of equal administration. Individual and partnership invested capital could not be determined. It was for this reason that the 1918 law was limited to corporations.

Developments since 1920 in relation to income tax changes in the law as to what is income, changes in corporate financing and capital set-up, demonstrate that the harsh taxpayer experience under the 1918 law, even with the relief provisions written in that law and omitted from Mr. La Follette's bill, will be magnified many times under a similar law if made now effective. I shall develop this thought later.

Before doing so, I want to address myself to one statement made by Mr. La Follette in moving an amendment to H. R. 10039, to wit: that, since the tax upon individuals is increased, it is unfair not to impose an excess-profits tax on corporations. I do not believe that this is presently true for the following reasons:

Corporations are not the ultimate beneficiaries of corporate income. Corporations receive income for the benefit of their stockholders. Under existing laws, corporations no longer dare accumulate any substantial part of the net income remaining to them after the payment of normal taxes. Examination of the conduct of the large corporations of this country in this respect over the last 5 years, that is, since January 1936, will disclose that the income retained by them and not distributed to stockholders is relatively a very much smaller percentage of their total net income than in any preceding period. If you make the comparison with the period, say, from 1916 to 1929, it is almost startling. This is in a large measure the result of section 102 of the Internal Revenue Code as now revised, which penalizes a corporation's accumulation of profits with the purpose of preventing the imposition of surtax on stockholders. Some of those few corporations which have retained a substantial part of their earnings for any year since 1936 find themselves faced with assessments under section 102.

Although provisions existed in the Revenue Act of 1918, and even in the Revenue Act of 1916, similar in purpose to section 102, those sections were never enforced and as written were probably not enforceable. I do not believe that any corporation was ever taxed for not distributing its profits under the Revenue Acts of 1916, 1918, or 1921.

The result under existing income tax law is that substantially all corporate income, remaining after the normal corporate tax, is distributed to stockholders. This is as it should be because individuals use income. Corporations cannot spend income—they can only distribute it. If a corporation distributes all its income, its stockholders pay tax upon all its income and there is no unfairness in not taxing the corporation or increasing the taxes against the corporation. To the contrary, it is unfair, to tax the corporation at all. It penalizes individuals—stockholders—who receive their income that way.

Insofar as the use of a corporation as a means of accumulating income has been prevented by the present section 102 of the Internal Revenue Code, there is nothing unfair in omitting to impose an excess-profits tax on corporations because whatever income is received by the corporation, being distributed to the stockholders, is taxed against them at the appropriate rates.

The excess-profits tax in 1917, 1918, 1919, 1920, and 1921 operated in an entirely different atmosphere. The Personal Holding Company law had not been passed; the unlawful accumulation section of those acts was ineffective, probably invalid; corporations in some instances were withholding distributions to prevent taxes against the stockholders. The excess-profits tax upon corporations in that setting was necessary, but the setting has been entirely changed.

The personal holding company tax and the unlawful accumulation act are both very effective. Corporations are no longer the means of accumulating profits for the benefit of stockholders because they are generally compelled to distribute substantially all of their profits.

If a few corporations may be found which since 1938 have not distributed at least 70 percent of their net income in every year, it is necessary, before considering them an exception to the truthfulness of the foregoing statement, to determine whether or not they are not now faced with deficiency tax under section 102. The tax under this section is substantially as high upon undistributed income as any proposed excess-profits tax. Considering that corporate net income is substantially all distributed to stockholders and taxed against them at the very high rates under the new law, there is nothing unfair in omitting to impose higher taxes upon the corporations. If, as Mr. La Follette says, corporations do benefit from the increased expenditures due to present disturbances and prospective war, generally they cannot retain the benefit because they must distribute it and it will then be taxed with the high rates which are imposed upon individual income. The fairness of taxes between the various citizens of the United States can only be determined by comparison between those who ultimately benefit from income, corporate income inclusive.

The question should not be approached from the viewpoint of fairness between corporate and individual stockholders because that is untrue in fact. It should be approached solely from the viewpoint of procuring the desired governmental revenue with the smallest possible burden upon the national economy.

From the viewpoint expressed above, an undistributed profits tax—a tax upon profits not distributed by a corporation, such as was imposed by the Revenue Act of 1936 (clarified and made less inequitable)—unfortunate as the necessity for such a law would be, would be fairer than an excess-profits tax. But every-

body in authority is proposing an excess-profits tax and I do not flatter myself that my reasoning will prevail. The remainder of this letter, therefore, is devoted to consideration of an excess-profits tax law in theory similar to the Revenue Act of 1918, which I shall consider the skeleton upon which to base my criticism and suggestions.

1. INCOME

(a) The Revenue Act of 1918 was approved February 24, 1919. It was not put into final shape until after the end of the World War. Subdivision 12 (a) of section 214, providing for an allowance due to shrinkage in the value of inventory at the end of the year 1918, was written in the light of the fact that the war had ended. It was anticipated that a shrinkage of inventory values would result when war inflation ended. I refer particularly to this provision because Mr. La Follette included it in the bill proposed by him. It was a troublemaker under the 1918 act, did no one any substantial good, and would have no proper place in an act enacted today. As written in the Revenue Act of 1918, it was a deduction from income, not only for income tax purposes, but also for excess-profits tax purposes. To allow it for one of these two taxes and not for the other, as Mr. La Follette proposed, would create a discord between the two, because one does not know what to do with a deduction (allowed for excess-profits tax and not for income tax, as Mr. La Follette proposed) in the next succeeding year. Would it carry forward affecting the income of the second year, and, if so, would it affect income for both excess-profits tax and income tax?

(b) Net income, gross income minus deductions allowed by the Revenue Act of 1938, as amended, is not the concept which is the subject of the proposed tax—excess profits. Concededly net income, subject to income taxes, is an arbitary concept. Congress has the power to tax gross income. The allowance of deductions is discretionary with Congress but when net income is defined arbitrarily, although possibly fairly for the purposes of an income tax, the result must be reexamined in determining the fairness of imposing an excess-profits tax on the thing defined.

In canvassing this question, comparison should be made, not only with the Revenue Act of 1918, but with the subsequent court decisions which have brought into income many items which formerly were ruled to be not income. In the limited extent of this statement it is impossible to present the many changes in the concept of income which have broadened that concept and extended it to many new subjects since the Revenue Act of 1918 expired. I list the following items which are treated now differently than under the Revenue Act of 1918 and which, in my opinion, require modification or change in order to reach anything approaching a proper concept of excess profits.

1. A deduction for the amortization of the cost of facilities acquired by the taxpayer for the production of articles contributing to the prosecution of the war, if one is declared, or contributing to the advancement of the Nation's policy in wars in other lands (for instance, if it is the policy of the Nation to contribute as much as possible, short of entering the war, to the assistance of Great Britain) should be allowed. Unless this is done, corporations cannot afford to invest their funds in such facilities which would probably in large measure be useless when the war ends. The deduction should be allowed as against income subject to income tax, as well as income subject to excess-profits tax, not only because that is fair, but the allowance of such a deduction for one purpose and not for another seriously distorts accounting and makes income questions which are very burdensome.

The statute should be much plainer than the corresponding section in the Revenue Act of 1918. There was always a question under that act as to the basis of amortization. Some companies were fortunate under it and others went busted. The commissioner's first regulations provided that the basis should be the excess of the actual cost over the cost of reconstruction in the settled post-war period. It appeared then that, in any period of time during which taxes for the war years were subject to revision, this basis would not permit any deduction and companies which had taken a deduction were threatened with substantial deficiencies. From the viewpoint of taxpayers, in the years 1918 and 1919, this proposed regulation was a complete denial of any relief and unless the law is made very certain now experience under the former law would make everybody hesitant to venture under a similar promise. Afterward the regulation was changed, providing for the allowance of the value of the facility in the use in the settled post-war period. Large deductions were eventually allowed to many taxpayers. But this basis was so indefinite and uncertain that there were broad rumors and allegations of favoritism and many taxpayers were compelled to pay very sub-

stantial engineers' and attorneys' fees before they secured a modicum of what they considered their rights.

The statute should provide for the amortization of the total cost over the period of the emergency, war or other national policy described above, allocated to the years in this period in the proportion which the net income prior to this deduction in each year is to the total in all of the years. Inasmuch as this allocation cannot be made until the end of the war, the statute should provide for a tentative deduction in each year of say one-fifth of the cost, subject to revision when the war ends.

2. Dividends upon the stock of a corporation subject to the tax should not be included in the income of the recipient to any extent at all. To include such dividends in the income of a recipient corporation merely duplicates the tax upon such income.

3. Short-term capital losses. Such losses are disallowed as a deduction from income for the purposes of the income tax, but for the purposes of excess-profits tax the propriety of the deduction of such losses is apparent. Short-term net capital gains are included in taxable income, so that if such gains occur in one year and the losses in the next year, the distortion is aggravated. If one is excluded, the other should also be excluded, but the sounder method would be to include the income and correspondingly allow the loss.

4. Depreciation. The burden of establishing reasonable allowance for depreciation is so great under present regulations that most taxpayers are compelled to accept the rates which the revenue agents allow. The method of calculating depreciation, when the revenue agent reduces the rates previously in effect, results in such a small allowance for the year under audit and subsequent years, that the method seriously distorts income for such years and cannot possibly reach a proper concept of excess profits. For instance, if one took depreciation at say 10 percent for 7 years on an asset costing $100, or $10 per year, and the revenue agent then upon audit said that the life of the asset is 20 years, he would spread the undepreciated balance, or $30, over the remaining 13 years, resulting in an allowance of $2.31. Combine this method with the rule that where depreciation is taken upon mixed aggregate of assets, the life of which is various upon the weighted average rate, no loss may be taken upon the discarding or retiring of any of such assets unless it is shown that such discard or retirement resulted from an unanticipated change and the distortion of the concept of excess profits is demonstrable.

The law as passed by Congress is always fairer than the application of the law as administered by the administrative agents and as construed by the courts. The recent act of Congress removing the bar of the statute of limitations against refund and assessment ought to be extended and broadened for the benefit of taxpayers. It could well be made to apply to depreciation adjustments, such as is described above. If the taxpayer is willing to waive the statute of limitations upon resulting assessment of deficiencies for years which are barred.

5. Since the 1918 act was in effect, the purchase by a corporation of its own bonds at a discount and their retirement has been found to produce income. Generally prior to 1923 gain was not recognized from the compromise of indebtedness. Income thus derived really does not enhance profits and should not enter into the calculation of excess profits. Gain derived from improvements made by lessee is in a similar situation. The inclusion of such items in income subject to excess-profits tax in many cases prohibits normal business adjustments. It is generally conceded that an allowance for the amortization of facilities provided for the production of articles contributing to the prosecution of the war, if war is declared, must be allowed in order that required production can be obtained. Certainly normal business adjustments such as that commented on in this subdivision and in the previous subdivisions should not be penalized as heavily as the excess-profits tax would penalize them. To do so would burden production by existing corporations with existing facilities which is as necessary to the prosecution of the war as new facilities.

I could extend this list further. For instance—the burden of satisfying administrative inquisition into the year when a bad debt becomes uncollectible, or an investment becomes bad, is frequently impossible, and many other cases, where administrative review makes the yearly statement of income untrue, occur to me. The application of a high tax in many such cases would be ruinous. But the list is already much longer than I originally intended. It is sufficient to show the necessity for reexamination of the propriety of the definition of net income as the subject for the application of an excess-profits tax.

### 2. Invested Capital

Section 325 of the Revenue Act of 1918 defined "invested capital." Subdivision (a) contained a definition of "intangible property," "tangible property," "borrowed capital," "inadmissible assets," and "admissible assets." Concerning "inadmissible assets," it provided in part:

"The term 'inadmissible assets' means stocks, bonds, and other obligations (other than obligations of the United States), the dividend or interest from which is not included in computing net income."

This provision would be wrong under the existing law because dividends are included in full, with a tax credit against certain taxes.

Under the further provisions of this definition, where all or part of the interest derived from a bond which was nontaxable was in effect included in income because money was borrowed against the bond to purchase or carry it, the interest upon which borrowed money was nondeductible, then the cost of the bond was part of the invested capital. This provision worked badly. Invested capital, under the excess-profits rates prevailing after the year 1918, if the company's income entered into the 40-percent bracket, was worth about 5.6 percent, so if a corporation purchased a municipal bond bearing say 3 percent interest, by borrowing the money with which to purchase and carry the bond at a rate of interest, say 3 percent, it in effect paid taxes upon the interest which was denied as a deduction equal to about 1.4 percent on the principal of the bond and was allowed the principal of the bond as invested capital, thereby saving 5.6 percent. The definition of "inadmissible assets" embodied in the Revenue Act of 1918, would have to be changed so that, while permitting business to continue, this method of avoiding tax was not permitted.

One limitation under section 326 (a) (2) on invested capital, on account of tangible property paid in for stock or shares, was "the par value of the original stock or shares specifically issued therefor," and paragraphs (4) and (5) of section 326 without relief of any kind limited invested capital, because of intangible property paid in for stock or shares, to "(b) the par value of the stock or shares issued therefor, on March 3, 1917." But if a corporation's stock was without par value, paragraph (b) of section 325 provided that the par value shall "be deemed to be the fair market value as of the date or dates of issue of such stock or shares."

At the time the Revenue Act of 1918 was passed, there were very few corporations with capital stock without par value. New York was the first State which authorized the issuance of such stock. This was in 1912. Prior to that date no State of the United States authorized stock without par value. Legislation authorizing such stock was enacted as follows:

1912, New York; 1916, Maryland; 1917, Delaware, California, and Maine; 1918, Virginia; 1919, Alabama, Illinois, New Hampshire, Pennsylvania, Wisconsin, and Ohio; 1920, Massachusetts, New Jersey, Rhode Island, and West Virginia.

Thus at the close of 1920 16 States authorized such stock. By June 23, 1921, it was permitted in 21 States. This number increased to 34 in 1923, and I believe at the present time every State permits it. (See 5 Minn. L. R. 493, 497; 21 Columbia L. R. 278, 279; *Randle* v. *Winona Coal Co.*, 206 Ala. 254.) When the Revenue Act of 1918 was framed, only 6 States of the United States authorized stock without par value and it is apparent that such stock was comparatively rare at that time and that its growth did not commence until later.

In the hearings before the Joint Interstate Commerce Committees of the Senate and House at Washington in regard to railroads, on December 2, 1916, Senator Cummins said (p. 399), in regard to the suggestion of the railroads that they incorporate under Federal charters and issue stock without par value:

"I recognize that it is a method. That simply deludes the country, that is all. It avoids realization of the fact that the value of the property is less than the capitalization."

In 1923, when the eighth edition of Cook on Corporations was issued, there was still considerable controversy as to the propriety of such stock. Section 45d, Cook on Corporations, comments as follows:

"The issue of stock without any par value whatsoever * * * legalizes instead of restricting large issues of stock for property. The theory of this recent innovation is that the American public should be educated up to the idea that a share of stock represents but a proportion of the corporate property. The American public, however, is incurably imbued with the idea that a share of stock represents or should represent a fixed sum, instead of the imagination or machinations of promoters. As a matter of fact, the public generally has no definite idea of the value of property turned in for stock, and hence if unlimited stock may be issued for all kinds of property the danger of fraud is greatly increased. Unreliable men may issue stock without par value to an amount limited

only by their capacity to induce the public to buy it. It is of course safer for promoters to issue stock without par value for choice assortments of property, but how the investor and the public benefit has not as yet appeared. Preferred stock of no par value is sometimes issued at a low figure and yet with a preference not only as to dividends but of $100 per share on dissolution. This adds a gambling feature, but does not add to the usefulness and standing of corporations. It is to be borne in mind that the corporation is the greatest instrument of modern industrial progress. It gathers the surplus funds of millions for enterprises involving billions. That which tends to discredit it is not for the public good. Blue-Sky Laws check watered stock; stock with no par value has an opposite effect. Stock with no par value renders possible watered stock with no liability. The hundreds of cases in this chapter involved corporations which pretended to have a capital, which they had not. Stock without par value practically requires no capital and hence may prevent such suits, but it puts a premium on doing business without capital and without liability. That proportion is almost a fraud in itself. 'Blue sky' laws may be some check on stock of no par value, but it will be difficult to put a value on that which has no fixed value of its own. As an eminent judge wrote the author 'Stock without par value is at most certain to amplify the frauds through corporations, already sufficiently extensive.' Stock without par value adds to the mystery as to what the stock really represents, and the public still compares the market price of such stock with $100 par, without regard whether or not the stock is without par value."

Since the broad development of the use of no-par-value stock, the implication in the assignment of par value to stock (that payment of equal amount was made) has gone. Par value of stock no longer measures the value of property paid in. The responsibility of directors under State laws, for the issuance of stock with par value in excess of the actual value of property uniformly, in the case of responsible persons, causes them to issue considerable less par-value stock than the appraised value of the property. Speculative flotations are usually handled through stock without par value. In the case of stocks with par value, new corporations usually show a substantial paid-in surplus. This is particularly true if the corporation starts with preferred stock because it sets aside a part of the paid in surplus to sustain the dividends upon the preferred stock for a limited period of time until the minimum anticipation of earnings of the corporation will suffice for such payments. Many corporations use par-value stock where the enterprise is legitimate only because under State laws the organization expense is less and under Federal statutes the stock issuance and transfer taxes are more fairly and accurately measured.

The provisions of the Revenue Act of 1918, limiting invested capital under the circumstances above stated to par value where a stock has par value and to market value where the stock is without par value, discriminate in favor of the stock without par value. Their relative merits call for favor to par-value stock because par-value stock has been used in the great majority of conservatively set-up companies; in considerably less of watered flotations than has stock without par value. It is just as easy to determine market value of par-value stock as of no-par-value stock. There is no reason for treating the two differently.

My suggestion is as follows:

Section 325 (a) (2) (3) and (4) of the Revenue Act of 1918 should be changed in the new statute so as to read as follows:

(2) Actual cash value of tangible property other than cash, bona fide paid in for stock or shares, at the time of such payment but in no case to exceed the fair market value of the original stock or shares specifically issued therefor as of the date or dates of its issue, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such fair market value of such stock or shares, in which case such excess shall be treated as paid in surplus.

(3) Intangible property, bona fide paid in for stock or shares, in an amount not exceeding (a) the actual cash value of such property at the time paid in, or (b) the market value of the stock or shares issued therefor at the time of issuance, whichever is lower.

The foregoing change is essential in the case of many corporations. For instance, assume that a corporation starts with 1,000 shares of stock of the par value of $100 each, has operated for 10 years and accumulated a surplus of $900,000, so that the actual book value of its stock is $1,000 per share. If this corporation purchased property of the value of $500,000 by the issuance of 500 additional shares, par value $50,000, there would be no sense or reason for limiting invested capital by the par value of the shares or even making par value a primary limitation. It has nothing to do with the value of the property. The estate-tax and income-tax laws pay no attention to par values of stock. If a seller of property

has income from the exchange of property for stock, it is not measured by par value but by market value. An examination of mergers and consolidations effected in the last 10 years will demonstrate that the par value of stock issued for property in no manner measures the value of the property acquired. It has frequently happened that stock listed on the stock exchange, quoted at many times the par value, has been accepted at the stock-market value for property transferred to the corporation. Par value in such cases has no bearing or meaning upon the value of property or the value placed upon it by the seller or the purchaser.

The Revenue Act of 1918 contained a further limitation on invested capital resulting from the acquisition of intangible property by the issuance of stock therefor, in the case of par value stocks, to wit: It was limited to 25 percent of the par value of the total stock or shares of the corporation outstanding at the beginning of the first excess-profits tax in 1917 in the case of intangibles acquired prior thereto, or in the case of intangibles acquired after such date, 25 percent of the par value of the stock or shares outstanding at the beginning of the taxable year. If some arbitrary limitation were essential, it could, of course, be measured by market values in the case of par value stock as well as no par value stocks. But I can see no reason for any such arbitrary limitation. In the case of many businesses intangibles are the only substantial values, for instance, Coca-Cola companies. If intangibles acquired with capital stock have a cash value in excess of 25 percent of the total stock outstanding, why should the invested capital be limited arbitrarily to any percentage of the stocks outstanding or issued at any date?

Sections 327 and 328 of the Revenue Act of 1918 provided for an adjustment of the tax where invested capital could not be determined under the normal rules or where, owing to abnormal conditions affecting capital or income, the tax determined under the normal rules would work an exceptional hardship upon the corporation. In such cases the tax was determined under section 328 at "the amount which bears the same ratio to the net income of the corporation * * * as the average tax of representative corporations engaged in a like or similar trade or business bears to their average net income." Although these sections were the source of very severe criticism, something similar to them must be preserved. Where a corporation is to a substantial extent a personal service corporation in which invested capital is responsible for a part of the income, or where corporations account for income for long-term contracts on the completed contract basis, so that reported income is not annual income and in many similar cases special treatment must be accorded. The change in the definition of invested capital suggested above will remove many of the cases brought under sections 327 and 328 of the 1918 act from the application of a similar provision. The limitation of intangible assets as invested capital by the par value of the stock or shares issued therefor required assessment under sections 327 and 328 in many cases. But there was a severe impediment to the granting to substantial corporations of consideration under sections 327 and 328. They were considered representative and were used to measure the tax upon other corporations, so that notwithstanding their merit sections 327 and 328 did not afford any relief to corporations if they were among the largest in the industry. The impediment to the fair measure of the tax in such case should be removed so far as it can be done by a fair definition of invested capital.

The war-profits tax of 1918 and the Canadian excess-profits tax were measured by a basis other than invested capital. Under the war-profits tax of 1918, the profits of the years 1911, 1912, and 1913 were considered normal and these profits, plus 10 percent of the increase of invested capital since 1913, or 10 percent of the invested capital for the year 1918, whichever was higher, was allowed as a deduction from income and the balance was subject to the war-profits tax. The Canadian excess-profits tax is similar in its skeleton form. Such a tax is essentially an emergency tax. In my opinion the country cannot sustain and will not function under it until after the citizens of the Nation have been enthused with the fervor of war and the profit motive has lost its usual superlative influence. Such a tax, absent the enthusiasm of war, is destructive of the enthusiasm of the pursuit of profit. Neither income nor deductions are things of exact character Net income is not uniform from year to year. Some years may result in loss. Such a tax is not the percentage of actual net income which it purports to be. In many cases it would equal or exceed all real net income, particularly over a series of years. Such a tax can be sustained for 1 year. In my opinion it cannot be sustained over a period of years, except possibly during a war in which the Nation is united. If imposed now, it will be unfair and possibly break down the economic, financial, and operating facilities of the Nation.

Yours very truly,

A. LOWENHAUPT.

## STATEMENT OF JOHN V. LAWRENCE, GENERAL MANAGER, AMERICAN TRUCKING ASSOCIATIONS, INC., WASHINGTON, D. C.

The CHAIRMAN. The next witness is Mr. John V. Lawrence, representing the American Trucking Association.

Please give your name and address to the stenographer.

Mr. LAWRENCE. Mr. Chairman and gentlemen 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.

Mr. Chairman, I regret that, through a misunderstanding, I arrived after my name had been called.

Mr. TREADWAY. May I ask you a question with reference to your association?

Mr. LAWRENCE. Yes.

Mr. TREADWAY. You say it is a federation?

Mr. LAWRENCE. 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.

Mr. TREADWAY. Do you mean that it has a board of directors in the different States?

Mr. LAWRENCE. That is correct.

Mr. TREADWAY. And they are all individual operators?

Mr. LAWRENCE. They are individual associations, some 50 associations which have been federated into a corporation under one head. They vote in the national organization through seven delegates from each State. We have, since the Massachusetts motortruck law, incorporated in Massachusetts, and that corporation is located in that State. And also throughout the other States.

Mr. TREADWAY. The headquarters is at Boston, Mass.?

Mr. LAWRENCE. That is correct.

The CHAIRMAN. Are you testifying as a businessman or as an attorney?

Mr. LAWRENCE. I am not an attorney. I am manager of the association here.

Mr. TREADWAY. You have had practical experience in the business?

Mr. LAWRENCE. I have been connected with this business for about 16 years, in 47 different countries, and have had to work with these operators in various capacities.

Mr. TREADWAY. And you are qualified then to speak?

Mr. LAWRENCE. Well, I hope so.

We had been fearful that, as in the La Follette amendment to the Revenue Act of 1940, excess profits would be assessed on a basis of "return on invested capital." We filed a memorandum with your tax advisers—pointed out the punitive effects which such a basis of assessment would have on our industry, a service industry, as compared to an investment industry. We do appreciate the efforts made by your subcommittee to be fair with this and other industries similarly situated, as indicated by our conception of the proposals now before you.

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. 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. This further special imposition was placed on the trucking industry, 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 the so-called highway subsidy question. 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 the year 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 vehicle.

Thus, Mr. Eastman's report shows that 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. It is thus paying more than its pro rata share of Federal government imposts.

Proposals such as embodied in the La Follette amendment, 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.

This industry has grown, particularly in its intercity branches, during the last decade and a half. In the for-hire branch, the units that compose it today had humble beginnings in the main. They were started in a modest way by a rate clerk from some industrial concern or from some other form of transportation; by a man who bought a truck and started in business by driving it himself; by small-business men from other fields of endeavor who saw an opportunity in this industry; and by people in similar stations in life. These little lines grew as time went on without the benefit of outside capital. They expanded in the American way by plowing back their earnings into the operation. And it must be remembered that as they grew they made a tremendous contribution to reemployment in this country during the depression years and since. In the letter of transmittal of the N. R. A. Code for the Trucking Industry by General Johnson, it was estimated that over 300,000 persons had been reemployed by this industry by 1934. This reemployment has continued since 1934 at almost the same pace.

To accomplish this reemployment required capital. On an average, 50 cents of every dollar taken in goes into wages in our industry. But equipment must be bought, terminals and garage facilities ex-

panded, heavy investments made in license plates. The truck operator was faced with the capital-acquiring problems of all small-business men, only more so than the average because of the nature of his business. He paid through the nose for short-term financing, as a general rule.

These firms started by individuals and operated as either partnerships or sole proprietorships, have in recent years incorporated, to keep alive rights and franchises obtained by them under the Federal Motor Carrier Act of 1935.

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.

As I have stated, the motor carriers have had to finance themselves largely. Those who have obtained capital from banks or other outside institutions are so few that their number is practically negligible. Reconstruction Finance Corporation financing of the motor-carrier industry is likewise almost negligible. Testimony being given at a hearing pending before the Interstate Commerce Commission, concerning the merger of a number of operations along the Atlantic seaboard to be capitalized at only $25,000,000, shows that the greatest stimulus to the proposed merger is the desire among those participating in it to obtain capital sufficient to take care of the needs of their expanding businesses. So far the history of the trucking industry has shown that it has had to earn its own capital before it could expand.

The motor-carrier industry is what might be termed a hazardous business insofar as business risk is concerned. One notes that in a recent study made by the Federal Government on the subject of trade barriers that interfere with the free flow of interstate commerce, approximately one-third of the State laws so labeled had to do with motor-vehicle operation. In the past 2 years over 10,000 bills applying to motor vehicles in some form or another were introduced in the 48 State legislatures. Many of these were inimical to the motor carrier industry, prompted by their competitors. The industry in every State is constantly living under the threat of punitive legislation such as burdensome restrictions as to sizes and weights of its vehicles, or the taxes that they will pay, any of which might drive out of business the carrier himself or render useless his fleet of vehicles.

In a business of this kind, so situated insofar as its ability to obtain financing is concerned, a fair rate of return must of necessity be considerably higher than an industry not confronted with these business risks.

To demonstrate how the industry would be affected by an excess-profits tax based on invested capital, we should like to refer to certain figures from statement No. 4012 of the Bureau of Statistics, Interstate Commerce Commission, entitled "Statistics of class I Motor Carriers for the Year Ended December 31, 1938." The 944 class I carriers reporting, both corporations as well as sole proprietorships and partnerships, had a total invested capital of $55,164,615. The same carriers had for the period a gross revenue of $310,688,686. In other words, their turnover of invested capital in relation to gross business done was at the rate of 5.63 times per year.

This turn-over of nearly six times per year in relationship between invested capital and gross revenue of the motor-carrier industry can be compared to a turn-over of once every 6 years as reflected in an investment industry like the railroads.

During the year 1938, these 944 class I motor carriers had a combined net income before income taxes of $7,725,373. This would show a profit of 2.49 percent on the gross revenue, and 14 percent on the invested capital.

At this point, it is interesting to note a concurring opinion of Commissioner Joseph B. Eastman 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 operating ratio of 70 or better.

In 1938, the operating ratio of these class I motor carriers, that is, the ratio of their operating expense to operating income, was slightly in excess of 97 percent. 1938 was not a very good year. In figures just released by the Interstate Commerce Commission on 1939 revenue and expenses, 1,105 class I motor carriers of property showed an operating ratio of 95.14 percent.

In both these years the operating ratios were considerably higher, and thus less favorable, than what Commissioner Eastman indicated was a prosperous condition for a motor carrier, namely, an operating ratio of 90 percent. And yet, if for instance 10 percent was considered a fair return on invested capital, motor carriers even in the poor year of 1938 would have been subject to a levy for excess profits, having earned as shown 14 percent on their invested capital.

One point which we have not previously mentioned in connection with motor-carrier capitalization is the fact that in a growing industry of this kind terminal properties are not usually owned. They are leased. The La Follette amendment to the Revenue Act of 1940 made no allowance for property used in the business but not owned. The property owned and used, but not fully paid for, contributed toward the net earnings in the same ratio as the property which is debt free. Likewise the lease hold estates and other leased properties make the same contribution. The inclusion of both owned and/or used property in the investment base would be strictly in accord with the policy followed in other cases, such as the recapture provision of the Transportation Act of 1920. By the very nature of operating practices in this industry, it would have a marked effect on the base

for assessment of excess profits, if invested capital was chosen as the base.

To illustrate, let us again refer to the Interstate Commerce Commission's report on class I motor carriers of property for 1938. In table 6, under the heading of "Operating expenses," we find an item of "Operating rents—Net" of $7,239,446. With little exception, this covers rental of terminal, warehouse, and garage properties mainly. Rentals on this type of property yield generally a low gross return, as compared to apartment houses, for instance, where the owner furnishes so many services and pays so many maintenance charges. Such properties, therefore, would be valued at at least 7 times, if not 10 or more times, the rentals. Taking the low figure of 7, class I carriers' invested capital would be increased from $55,164,615 by $50,676,122 to $105,840,737, if principles of the Transportation Act of 1920 were applied. Thus the return of 14 percent on invested capital would be reduced to one of 6.7 percent.

Furthermore, as we have already shown, while motor carriers have no right-of-way investments, they do pay public authorities for their rights-of-way through license fees and gasoline taxes. In I. C. C.'s 1938 report on class I motor carriers, table 10, "Operating taxes and licenses," two items appear. They are "Gasoline, other fuel, and lubricating oil" at $7,816,637 and "Public utility taxes and licenses" at $6,040,335, a total of $13,856,972. Most of this figure are these special State motor-vehicle taxes that go to build highways, the trucks' right-of-way. Under railroad valuation procedure established by Congress, leased trackage rights were capitalized and included in valuation of the lessee road, unless they were joint trackage facilities shared with the owner and thus included in the owning road's valuation. This payment for trackage facilities or highway use, by motor carriers through special taxation, if capitalized on accepted principles, would more than double the capital of this industry.

Finally, we believe the term "invested capital" should include and not exclude borrowed capital. As I stated, our industry, like other industries composed of little-business men, has not had free and economical access to capital sources. This capital has been borrowed under difficult conditions and terms, and at heavy cost. A small return may be earned on it to compensate the carrier to some small degree for the risk taken, the increased purchases of supplies made, and the employment afforded. Yet, under such a base for excess profits as contained in the La Follette amendment, such borrowed capital would be ruled out of the base, and even meager earnings on it would fall in many cases on the narrow definition of invested capital with heavy impact, subjecting the excess-profit levies returns otherwise considered modest from all ordinary business standards. In other words, the little man, who did not have the money, but who, in the words of a figure in American history, "hired the money," but who, contrary to that incident, does pay the hire and pays back the money, too, should not be penalized.

In this connection, may I point out that table 1 of the I. C. C.'s 1938 report on class I motor carriers of property shows the following item of borrowed capital: "Total equipment and other long-term obligations," totaling $15,921,872.

We believe also that surplus is a part of capital and as such should be included in the base. This is particularly true in this industry.

Motor carriers are subject to financial control both by the Interstate Commerce Commission and the State public utility commissions. Past experience indicates that it would be most difficult, in some cases impossible, to secure permission to convert those surpluses into capital stock. In table 1, class I carriers are shown as having total unappropriated surplus of $16,396,477 at December 31, 1938.

Thus, even forgetting capitalization of highway rights-of-way paid for by special taxes, combining the invested capital of $55,164,615 with $50,676,122, the valuation of leased properties, $15,921,872 of borrowed capital, and $16,396,477 of unappropriated surplus, would yield a total capital base of $138,159,186. With this figure as a base, earnings would have been at the rate of 5.6 percent in 1938, instead of 14 percent under the La Follette proposal.

At first glance, allowing an option to the taxpayer to take average earnings from 1936 to 1939, inclusive, as a base for figuring excess profits, would be eminently fair. But let us look at what happens to this industry.

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 oppposite. Interstate motor freight rates had not been generally public information. 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. It continued until the fall of 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 as regards motor carriers in specific terms. In the *Fifteen Percent Rate Increase Case*, Ex parte 123, before the Interstate Commerce Commission, a witness for our association testified as to reports received from our carriers for 1935, 1936, and the first 9 months of 1937. For 1935, 389 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. Comparing these operating ratios 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, exemptions 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 the 2-year period 1938–39. We do not ask this for our own industry alone. We feel that many other industries similar in character are in the same boat.

The motor-transport industry is fit, willing, and able to cooperate with the Government both in the present defense program now under way or in any emergency that might confront this country.

In the last war, motor trucks, even the cumbersome, solid-tired, poorly engined vehicles of those days, operating without benefit of the far-flung hard-surfaced highway system our country enjoys today, did an outstanding job both in the theater of war in Europe and in the service of supply on this side of the Atlantic.

Since the World War, tremendous truck fleets have been built. These trucks are not the old-time inefficient vehicle of war days, but modern light-weight, fast, full-powered pneumatic-tired vehicle. Efficient operating methods have been developed and personnel has been trained as the fleets grew.

We had 326,000 trucks in 1917, expanded to 4½ million today. We had little or no organization in the industry then. We have it today.

Every week brings further news from Europe showing the increasing importance of motortruck transportation. In the newspapers, the great bulk of the news of this kind covers the use of motorized equipment in actual battle. But the greatest story to be told will be the use by Germany of motor transport in its service of supply.

Long residence in Europe in the late twenties and early thirties, and intensive travel in all countries on that continent, gave me some inkling of the planning that was done to use motor transport to the fullest in the present war. Scattered information from former connections and acquaintances indicates that when our military intelligence service has the full story of this phase of the war, it will find that motor transportation played the dominant role in not only actual combat but also in the service of supply.

Since 1917–18, too, there has been a revolutionary change in our production set-up. Production methods have been brought to a far higher degree of perfection by the use of fast, flexible motor transportation working as an integral part of the system.

The motor-transport industry has grown to giant proportions. It is a separate, independent industry, developing along different lines and furnishing a different type of service from any other form of transportation. One has only to examine the interplant operations, as well as the methods used in assembling parts from other manufacturers in the automobile and airplane industries, to realize the extent of this change at a glance. As many industries expand beyond civilian requirements to care for increased defense needs, demand by these plants for their customary fast overnight truck service will rise proportionately.

If the motor carriers of this country are to carry on and to take their full share of the burden of national defense, any taxes which would be punitive in effect would be disastrous.

In conclusion, we ask that, in view of the vital need of this country for efficient transportation, now more than at any other time, the following proposals be considered by the committee.

1. That where the taxpayer elects to use average earnings, the base to determine exemptions be changed from the years 1936 to 1939, inclusive, to the 2-year period 1938 and 1939.

2. That where invested capital be used as the base to determine exemptions, the term be broadened from the restricted definition of the La Follette amendment to the Revenue Act of 1940 so as to include—

(*a*) At reasonable valuation all property or facilities used in the business and paid for through lease or otherwise, but not owned.

(*b*) Unappropriated surplus of the carriers, and

(*c*) Borrowed capital, such as equipment obligations and bonds and other obligations.

Mr. COOPER. I would like to ask a question, if I may.

Mr. LAWRENCE. Yes.

Mr. COOPER. I did not quite understand what you said about the excise tax. I must have misunderstood you. I got the impression that you said $100,000,000 a year on tubes and tires.

Mr. LAWRENCE. That was the estimate based on the rates prior to the last revenue act, with the 1 cent gas tax.

Mr. COOPER. You do not mean the industry pays $100,000,000 a year in excise tax on tires.

Mr. LAWRENCE. That is both for hire and for private; the tax runs——

Mr. COOPER (interposing). You mean on tires alone? The total revenue for automobile tires last year was not more than $41,000,000.

Mr. LAWRENCE. Pardon me. I am not talking about tires, but on parts and the trucks themselves; that is on all parts of the trucking industry, with the 1 cent gasoline tax.

Mr. COOPER. I misunderstood you.

Mr. LAWRENCE. I am sorry if I gave you that impression. I meant the entire group of taxes, of excise taxes.

Mr. COOPER. You recommend that the years 1938 and 1939 be used as the base period, leaving out the years 1936 and 1937?

Mr. LAWRENCE. Those are our preference for the 4 years, yes, in view of the operation.

Mr. COOPER. You mean that is what would be preferable to your business, but you would not advocate that as a tax policy?

Mr. LAWRENCE. I have just tried to show what effect it has on us. We might have to select certain years out of the four.

Mr. COOPER. I am talking about the recommendation which you make as the base period which would be the years 1938 and 1939. For many businesses in this country the years 1936 and 1937 were the best years we had, were they not?

Mr. LAWRENCE. That is quite possible. I am not sufficiently informed to say.

Mr. TREADWAY. Mr. Lawrence, in that very connection, while you have a very good brief, I think you can see from this how difficult the situation confronting the committee is. I do not know whether you were here, but when Mr. Davidson was testifying he

said that it would be terrible to leave out 1936 and 1937, and you advocate leaving them out, which leaves the committee in a rather difficult position.

Mr. LAWRENCE. As I said, we would be perfectly willing to take 2 years, but it would suit us if those 2 years could be used of the 4.

Mr. COOPER. Of course, if we provide a base period for 4 years, the years 1936, 1937, 1938, and 1939 and also provide that a corporation might use any 2 of the 4 it wanted to, some of them might want to take 1938 and 1939.

Mr. LAWRENCE. I think we would take 1936 and 1939.

The CHAIRMAN. How would it do to let the taxpayer select the years?

Mr. LAWRENCE. What I am trying to point out, Mr. Chairman, is that an industry of this kind, as Mr. Eastman has pointed out, where your results come from the public itself and not from invested capital, a base of this kind does hit heavy upon it where your very poor years have to be taken care of in your good years.

Mr. TREADWAY. Mr. Lawrence, I am under the impression your brief was prepared before the subcommittee's report.

Mr. LAWRENCE. That is correct.

Mr. TREADWAY. Because in your No. 2 on page 8 and I think in one other place you made reference to the so-called La Follette amendment.

Mr. LAWRENCE. Yes.

Mr. TREADWAY. If you examine the report the subcommittee made yesterday or the day before you will find the definition contained therein is very different from what was formerly the La Follette amendment.

Mr. LAWRENCE. I understand it is.

Mr. TREADWAY. How long has the trucking industry been building up to its present proportions?

Mr. LAWRENCE. It is probably the oldest form of land transportation. It is the horse-drawn vehicle changed into a motor. The real first development of the over-the-road development came in the last war. We only had 300,000 of the solid-tire vehicles in the country, and most of them had difficulty. The real development comes from about 1927, when the first pneumatic tires were adapted to trucks, when they could build lighter vehicles and power them more heavily. So the real development comes from about 1927.

Mr. TREADWAY. They have been in existence about 12 or 13 years and grown into large proportions.

Mr. LAWRENCE. That is true.

Mr. TREADWAY. Do you represent the so-called interlocking method of transportation? For instance, the truck industry will accept a freight shipment from Boston to San Francisco, will it not?

Mr. LAWRENCE. That is rather rare, over those distances.

Mr. TREADWAY. There is an agreement whereby that could be done?

Mr. LAWRENCE. Under the Motor Carriers Act, of course, joint rates were entered into, and transfers are made at New York of shipments from Boston to Washington.

Mr. TREADWAY. As a matter of information, because I am interested in transportation matters, how many licenses are your members obliged to have? You have to have a Federal license and a license in each State, as I understand. What is the arrangement there?

Mr. LAWRENCE. Not exactly in each State. For instance, the State of Maine has no reciprocity while on the other hand Massachusetts has a receiprocal agreement with certain other States.

Mr. TREADWAY. I see a great many trucks going through Massachusetts from Ohio. That must be quite a central point for distribution.

Mr. LAWRENCE. That is true. As a rule, these trucks have to have State plates and I. C. C. plates, and they all cost quite a little money.

Mr. TREADWAY. And do you count that in the payment you make?

Mr. LAWRENCE. Yes; a medium-sized concern will have to invest at the beginning of each license year from $15,000 to $20,000 in plates.

Mr. TREADWAY. How many trucks would that mean?

Mr. LAWRENCE. About 20 or 25 trucks.

Mr. TREADWAY. That would be about $800 for one truck.

Mr. LAWRENCE. They have to have multiple plates.

Mr. TREADWAY. The Federal plate does not entitle you to any State privileges?

Mr. LAWRENCE. That is merely an identification tag that the Interstate Commerce Commission uses, and I think it is at a very small cost, about 25 cents, to send it to the carrier.

Mr. TREADWAY. It is really the State licenses that are expensive?

Mr. LAWRENCE. That is true.

Mr. TREADWAY. That is the reason you say you are entitled to use of the highways constructed by the States in which you are paying a share of the upkeep and construction, through State licenses and the purchase of gasoline and supplies as you go through the various States.

Mr. LAWRENCE. I would like to mention the fact that we depend a great deal on suggestions made by Mr. Eastman recently published, going into all those matters under his original duties as Federal Director of Transportation.

Mr. TREADWAY. Of course, we all have a very high regard for Mr. Eastman's official opinion, and therefore I feel very cordial toward the attitude of the trucking industry or trucking companies.

Mr. KNUTSON. What is the average net income on investment earned on the average.

Mr. LAWRENCE. I have some figures in this statement. This is based on those carriers reporting. It depends on what you take as investment. If we just took the invested capital, in the full year of 1938 it was 14 percent on the invested capital. That is quite low. In many cases they are subjected to the jurisdiction of the Interstate Commerce Commission and the State public utilities commissions and very often the people would like to issue stock, but they are not permitted to do so by the regulatory body. If we took in the leased properties at even seven times their value, it would be quite low, and if you took the unappropriated surplus, that 14 percent would be reduced to about 6½ percent return on the investment, including borrowed capital as well.

Mr. KNUTSON. What are the average earnings per truck?

Mr. LAWRENCE. Those trucks vary so much it is hard to say. I have tried to work that out with the Commission people, but it is rather difficult to do it.

Mr. KNUTSON. Do you suppose you folks pay a gross-earnings tax of 5 percent?

Mr. LAWRENCE. You do not earn 5 percent.

Mr. KNUTSON. The railroads have to pay it whether they earn it or not, in Minnesota, regardless of whether they are in the red or in the black.

Mr. LAWRENCE. We have the corporate tax and the licenses, and we have to invest in license plates whether we make any money or not.

Mr. KNUTSON. How does the tax on a trucking company compare with the tax on railroads?

Mr. LAWRENCE. If you ask that question, it can be pointed out that we will have a turn-over on our capital, depending on its usage, three or six times a year, so the gross earning tax is very heavy on trucking operations. The railroads have a turn-over once every 6 years.

Mr. KNUTSON. Of course, the railroads maintain a right-of-way whereas trucks use the public highways.

It would be pretty hard, I assume, to arrive at a fair comparison.

I am wondering, as I have heard you make your statement, how it would affect the trucking companies operating in Minnesota if they were obliged to pay the State 5 percent of their gross.

Mr. LAWRENCE. They do have to in most States. There are many States that assess carriers for hire on a similar gross income. In Virginia, for instance, it is 2 percent on gross receipts of carriers. If I understand your question, it is whether, with all of our other taxes, we could afford to pay 5 percent.

Mr. KNUTSON. Could you afford to pay a 5-percent tax on gross income in lieu of all other taxes?

Mr. LAWRENCE. We would be getting a big reduction.

Mr. KNUTSON. How much does the average truck earn per year?

Mr. LAWRENCE. They should gross $1,000 a month, or $12,000 a year. That is the road truck. There are various others.

Mr. KNUTSON. And the tax on that truck is about $800.

Mr. LAWRENCE. That is merely the licenses; yes, sir. That truck will burn gas at the rate of about 2½ or 3 miles to the gallon.

The CHAIRMAN. We thank you very much for your appearance and for the statement you have given the committee.

We will now adjourn until next Monday morning at 10 o'clock.

(Thereupon, at 5:15 p. m., the committee adjourned to meet Monday, August 12, 1940, at 10 a. m.)

# EXCESS PROFITS TAXATION, 1940

MONDAY, AUGUST 12, 1940

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, D. C.*

The committee met at 10 a. m., Hon. Robert L. Doughton (chairman) presiding.

The CHAIRMAN. The committee will please come to order.

The first witness on the calendar this morning is Colonel Gorrell.

Will you please give to the reporter your name and address and the capacity in which you appear.

## STATEMENT OF COL. EDGAR S. GORRELL, PRESIDENT, AIR TRANSPORT ASSOCIATION OF AMERICA, CHICAGO, ILL.

Colonel GORRELL. Mr. Chairman and gentlemen of the committee, my name is Edgar S. Gorrell. I am president of the Air Transport Association of America. The Air Transport Association of America is a voluntary organization of the scheduled air lines of this country.

The members of that organization are American Airlines, Inc., Boston-Maine Airways, Inc., Braniff Airways, Inc., Chicago & Southern Air Lines, Inc., Continental Air Lines, Inc., Delta Air Lines, Eastern Air Lines, Inc., Inland Air Lines, Inc., Inter-Island Airways, Ltd., Mid-Continent Airlines, Inc., National Airlines, Inc., Northwest Airlines, Inc., Pan American Airways System, Pennsylvania-Central Airlines Corporation, Transcontinental & Western Air, Inc., United Air Lines Transport Corporation, Western Air Express Corporation, Wilmington-Catalina Airline, Ltd.

Associate members are Canadian Airways, Ltd., Trans-Canada Air Lines.

The officers of the organization are Edgar S. Gorrell, president, Thomas F. Ryan, III, vice president; Fowler W. Barker, secretary and treasurer.

The board of directors are T. E. Braniff, Jack Frye, C. Bedell Monro, W. A. Patterson, E. V. Rickenbacker, Robert F. Six, and C. R. Smith.

The Pan American organization is not a regular member. It is an associate member, an overseas member.

The objects and purposes of the association are:

1. To promote and develop the business of transporting persons, goods, and mail by aircraft between fixed termini, on regular schedules, and through special service, to the end that the best interests of the public and the members of this association be served.

2. To advocate the enactment of just and proper laws governing the air line business.

3. To promote closer relations with and cordial cooperation among the members.

4. To promote friendly relations with, and to secure the cooperation and good will of the public.

5. To improve the transportation service by its members.

6. To promote the construction of proper airports and airway aids over such routes as will best insure benefit to the public and the air line business, and to promote the maintenance, repair, and improvement of all airports used by air line operators.

7. To promote the establishment of necessary terminals and connecting schedules.

8. To cooperate with all public officials in securing the proper enforcement of all laws affecting air transportation.

9. To promote aviation safety in general.

10. To do all things tending to promote the betterment of air lines business, and in general to do everything in its power to best serve the interest and welfare of the members of this association and the public at large.

I have never appeared before this committee or the Finance Committee of the Senate on any prior occasion, and as far as I know, no member of our organization has ever appeared before either committee. I speak only, with your permission, in the layman's language, and if you desire to have me crystallize any point I make, I would like the privilege of submitting for the record a paragraph covering any point you would like to have crystallized.

The CHAIRMAN. Without objection, it is so ordered.

Colonel GORRELL. The air lines of the United States, as a successful commercial air-transport system, are a creature of a farseeing Congress.

Prior to the summer of 1938, they were on a basis that was not sound, either from a Federal point of view or a business point of view. In 1938 the Congress passed the Civil Aeronautics Act. If I may, Mr. Chairman, I would like to read a statement made by the President of the United States concerning that act.

On January 24, 1939, in a communication to the National Aviation Forum he said:

> Civil aviation is clearly recognized as the backlog of national defense in the Civil Aeronautics Act which set up the effective machinery for a comprehensive national policy with respect to the air.
>
> Underlying the statute is the principle that the country's welfare in time of peace and its safety in time of war rests upon the existence of a stabilized aircraft production—an economically and technically sound air transportation system, both domestic and overseas—an adequate supply of well-trained civilian pilots and ground personnel.
>
> This new national policy set up by the Congress views American aviation as a special problem requiring special treatment. Aviation is the only form of transportation which operates in a medium which knows no frontiers but touches alike all countries of the earth. One fact which stands out is that hardly another civil activity of our people bears such a direct and intimate relation to the national security as does civil aviation. It supplies a reservoir of inestimable value to our military and naval forces in the form of men and machines, while at the same time it keeps an industry so geared that it can be instantly diverted to the production of fighting planes in the event of national emergency.

As Secretary Stimson testified before the Ways and Means Committee on August 9, 1940, "Air power today has decided the fate of nations."

Germany has dominated invaded countries because it had both fighting planes and planes to transport men and material quickly to any point. Fighting planes alone are often helpless.

This Nation's military cargo and transport complement for its fighting planes is exceedingly small. The reason is that our war plans contemplate that the scheduled air lines will furnish necessary additional cargo and transport complement as need arises. At a moment's notice, they are to devote their resources to this purpose for days or weeks or months or longer as required from time to time and place to place as emergencies arise.

With our greatly augmented military Air Force, the scheduled air lines must greatly increase their equipment in order to play this part and to meet the other needs of an emergency, such as the purchase of special radio facilities, gasoline depots, and so forth.

This contemplated use of the scheduled air lines saves the taxpayers many millions of dollars. Even as of 2 years ago, with our then small air force and the correspondingly smaller air transport network then existing, the cost to the Army of maintaining a transport complement the size of that then provided by the air lines—and not counting the cost of purchasing the planes—would have been between $30,000,000 and $40,000,000 annually.

For this reason, among others, the military has seen to it that provision is at all times made in the factories for meeting air line orders along with the military orders.

And Secretary Edison of the Navy announced on June 24, 1940, that the policy of the Navy Department considered the air lines "as a necessary adjunct of national defense with requirements second in importance only to those of the armed forces."

Because of their peculiar place in our national life, the air lines have begun an equipment purchasing program which in the next few years may have to run to over $150,000,000, despite the small investment of the industry, which totals only about $60,000,000 for all our lines, foreign and domestic.

Indeed present orders already exceed cash available by 300 percent. Through carrying out this program the airlines will ultimately save the Army probably more than a total of $800,000,000 in the cost of maintaining a transport complement of the size otherwise necessary. In addition they will save the Army the cost of purchasing these planes—perhaps a saving of an additional $100,000,000. This figure is four times the amount that Saturday's testimony indicated this excess-profits act might raise in 1940.

This program was made possible by the Civil Aeronautics Act of 1938. In title IV of that act Congress provided that an expert Civil Aeronautics Board should from time to time determine how much income the carriers need in order to meet these defense and commercial requirements, and should through mail pay make up the difference between ordinary commercial revenues and the total sums required. But no more than that amount is to be permitted. See section 406 (b). Thus the Board determines exactly how much each carrier must have and provides that sum through mail pay. Since mail pay is about one-third of the carrier's total revenues, this means that the Board absolutely controls profits. And it does so according to its determination of the needs of national defense and commerce.

The Board likewise regulates passenger and express rates for the domestic carriers, and controls the accounts, records, and practices of all carriers under a system of regulation even more comprehensive than that applicable to the railroads. See Fifty-second Annual Report of Interstate Commerce Commission at page 8.

Furthermore since the Board reaches its determination in the light of "need" of each carrier, it can, if during a particular year a carrier derives more income than anticipated at the outset, make a correspondingly great reduction in the income to be derived in the succeeding year.

In short, the Board, which can, if necessary, act in a "mail pay" case very promptly, absolutely fixes the income of each carrier. And it has each carrier's operations under constant surveillance.

If the excess-profits tax is applied to the air carriers, it will provide one measure of income and the Board's decisions will fix another measure. They are bound to come into conflict in some or all cases.

This will result in the very situation which Mr. John L. Sullivan, Assistant Secretary of the Treasury, said should not exist. In testifying before the Ways and Means Committee on August 10, 1940, respecting a conflict between the proposed excess-profits tax bill and another existing law, he said:

> It does not seem necessary or desirable to have what are in effect two profit-limiting provisions outstanding at the same time.

The Civil Aeronautics Board may provide that a particular carrier should receive much or little income. It depends upon that carrier's particular situation and upon the needs of the air force and the national defense and commerce with respect thereto. With expansion of equipment, a great deal of income will have to be provided to enable some carriers to make the indispensable purchases for these purchases very often cannot be classified as ordinary expenses.

In such cases an excess-profits tax would take away what the Board provided.

Since the Board does not permit one penny more of income than is necessary, there is no purpose served by applying an excess-profits tax to the carriers. To apply it merely works at cross purposes with the Civil Aeronautics Act and will be bound to cripple the effective administration of that act.

Not only would the tax on air carriers conflict with the Civil Aeronautics Act, but it would work peculiar hardship on the carriers.

The air transport industry has been in the red almost constantly since it was born. Some lines have never made a profit. Only in the last year has the industry begun to climb toward a position of stability. Indeed, in 1938, all but three companies were facing bankruptcy. For the years 1936–39 there is only 1 year of black ink for the industry as a whole, and but few companies have 2 years of black ink in that period.

Thus the suggested average earnings base will, for the air carriers, give virtually no exemption. Furthermore, the investment base will be greatly reduced for the air carriers because of the necessity, under the proposed bill, to deduct losses from stockholder's investment.

To develop an essential national-defense adjunct, the air carriers have been suffering large losses in the immediate past. The bill, as proposed, would penalize these pioneering efforts.

Likewise it has been the consistent policy of the Civil Aeronautics Board to encourage a greater degree of support of the air lines among the general public. In the present equipment-purchasing program a great deal of private borrowing has been and will be necessary. Already, since the adoption of the Civil Aeronautics Act 2 years ago, the air lines, with this private lending, have purchased and taken delivery of over $24,000,000 worth of equipment, have on order an additional $31,000,000, and anticipate purchase of probably over $150,000,000 in the near future.

Since with each new purchase the planes are larger and more costly, due to the advance in the art and the growing needs of national defense, normal depreciation from current income is inadequate to meet a continuing and expanding program. The proposed tax bill would, moreover, disallow as part of the investment base all but a fraction of this borrowed money. Unless the air carriers are permitted to treat all of this borrowed money as part of their investment for purposes of computing an excess-profits tax—if one is imposed upon them—their equipment-purchasing program will be seriously jeopardized.

The air-carrier industry, under the Civil Aeronautics Act, does not come within the list of industries which can derive large or inordinate profits, and therefore is not within what is usually thought of as being one of those industries which come within the classification of those to which excess-profits taxes would apply.

For some 4 years our Government has had a plan for the use of the air carriers of this country. The role of the air carriers in time of emergency is to act as an arm of the General Headquarters Air Force. For each airplane the air carriers purchase, the Government does not have to purchase one.

The General Headquarters Air Force must remain ready to go to the scene of action and into action on a moment's notice.

When the General Headquarters Air Force is ordered to the scene of action in an emergency, it is helpless if it gets there without certain special materials and personnel to keep the machines going. It is the role of the civil air lines, which act as the arm of the General Headquarters Air Force, to carry that matériel and the necessary personnel to the destination of the General Headquarters Air Force at the same time the fighting forces get there.

That plan was implemented by Congress when it set up the Civil Aeronautics Authority, now in part the Civil Aeronautics Board, which sits permanently. In the act's declaration of policy, the C. A. A. is instructed to provide an air-transport system which will provide for the present and future needs of national defense.

I would like to show, if I may, a map that will give you a bird's-eye view not only of this entire country but also of the location of the scheduled air lines throughout the world [indicating map]. You will see that they run in all directions.

Without mentioning names of places, but to show you the role of the scheduled air carrier in times of emergency, let us say the enemy was supposed to be coming in this direction [indicating on map] toward the United States. Our General Headquarters Air Force is scattered in several directions. The first telephone call goes to the General Headquarters Air Force to concentrate in this area

[indicating on map]. It must have its ground personnel and special matériel there before it can fight effectively.

The second telephone call goes to the commercial air lines to pick up special matériel and men and take them to the destination of the General Headquarters Air Force within a certain number of hours.

That means, as the air force varies in strength and size the commercial air lines must likewise vary in carrying capacity instantly and simultaneously available.

To accomplish that purpose, Congress, in the summer of 1938 set up the Civil Aeronautics Authority, now in part the Civil Aeronautics Board, sitting here constantly with the authority to vary the size of the air-transportation system within the limits set forth in that act, and to match the capacity of this carrying force with the requirements of the General Headquarters Air Force from time to time.

If the General Headquarters Air Force increases in size, according to the policy of the Government, then the Civil Aeronautics Board has the power and the duty to provide for the carrying capacity of the air lines likewise to increase in size.

That is done through the medium of varying the mail rates. The law says that the air carriers shall be paid that sum which represents the need of the individual carrier, to the extent that it does not get it from the public. In other words, the law requires the Civil Aeronautics Board to ascertain the amount of money derived by the air carrier in the carrying of passengers and express, to determine the need of that particular carrier in the national interest, and the sum not obtained from passengers and express is paid to the carrier in the form of mail pay.

Mr. REED. To clarify what you have stated, is this leading up to the question of excess profits?

Colonel GORRELL. Yes; I am coming to that in my next sentence by saying that under the law there is no excess profit in the air-carrier industry. The Civil Aeronautics Board gives each company the sum of money it needs in the public interest at any particular moment. If the air carrier's income from passengers and cargo increase and if that increase would exceed the amount the carrier should have, then the Civil Aeronautics Board reduces the compensation for mail pay. At no time can the compensation from mail passengers, and express be greater than the need of the carrier in the public interest. It is not the need of the industry, it is the need of the individual company that is considered.

It might be determined that on the west coast, for example, there is need for building up both our military and civil air power. The companies operating out there would have that taken care of by the Civil Aeronautics Board fluctuating mail pay. That could be done by giving the companies additional mail pay to assist in buying additional planes where necessary.

Under the Civil Aeronautics Act the Civil Aeronautics Board is authorized to act in the present and in the future, and also retroactively. If the national emergency needs so-and-so then the Civil Aeronautics Board allots a sum of money to meet that need, and it can go back and act retroactively, if it has made a mistake.

Then along comes the excess-profits tax and nullifies what you gentlemen set up in 1938. For it would take away what the Civil Aeronautics Board provides.

The air industry is a small industry. It has been in business only since Mr. Lindbergh originally flew across the orean.

In the early days the air lines received 100 percent of their income from pay for carrying the mail. Then the Government said, "We will have you carry passengers and cargo, and income from that business will relieve the Post Office Department of paying a certain portion of this money."

Since that time the payment to domestic carriers has dropped from 100 to 30 percent. As soon as the mail pay began to fluctuate the percentage of returns on the business fluctuated. The fluctuation of the mail pay controls the profit. There is no profit permissible under the law except to the extent necessary in the public interest.

I might say in passing that at all times the military not only makes provision for manufacturing the fighting machines that are needed, but on the production lines, even in the same factories, there are provisions for building transport planes.

When you have relieved the taxpayer of the cost of buying one fighting or one transport plane, you have not only saved the Government the cost of that plane but also you have saved the annual upkeep.

In calculating factory production, you will notice that the figures given include military planes and commercial transports. Fighting planes, by themselves, must have transport planes to get their supplies up to the air base. The cost of these planes, from year to year is increasing, and therefore the air lines today must foresee the time when they will have to pay a larger price for each plane, which means that they will need more capital.

Mr. REED. Have you any figures showing the increased cost of the planes?

Colonel GORRELL. In 1926, new planes on the air lines cost around $10,000 each. They increased in size, so by 1934 some transports cost about $70,000, and by 1936, $110,000; by 1937, sleeper planes cost $120,000. This year some four-engine planes cost over $300,000. Next year, four-engine land planes will cost about $450,000, and clipper flying boats cost about $1,000,000 each. To illustrate just one case of how increasingly large sums of capital are required, may I say that, about 4 years ago an air line got a contract to carry the mail from Chicago to New Orleans. Today the price that line is paying for radio alone is greater than it paid for all of its airplanes 4 or 5 years ago. During the World War we paid for an airplane an average of about $7,000; today the average cost is from $110,000 to $120,000 for land planes and nearly a million for clippers. The last experimental plane we purchased cost over $1,500,000. The next one will probably cost about $3,500,000.

Mr. WOODRUFF. There is also, as I understand it, an increase in the cost of matériel for airplanes. That is due to a very large extent to the increased size of the airplane, is it not? It varies according to the increased size and efficiency of the plane?

Colonel GORRELL. Yes, sir.

Mr. WOODRUFF. What percent of the cost of labor enters into the increased cost of the equipment?

Colonel GORRELL. The total cost of labor in building airplanes is very high because airplanes are not well "tooled up." The reason that fighting planes are not well tooled up is because the question of quality must go along hand in hand with quantity.

Mr. WOODRUFF. My point is this. To what extent and in what percentage has the cost of this splendid labor that you must necessarily employ to manufacture airplanes increased?

Colonel GORRELL. I would have to ask the manufacturers to get exactly that percentage. Labor has gone up and the cost of the airplane has gone up because of the specialized things in airplanes. For example, some airplanes will contain as many as a quarter of a million rivets. They have to be put in one at a time and many are of different specifications. An airplane is a hand-made job, with each particular point subject to stresses and strains in the operation of the plane. If a structural failure occurred at one point, you might be faced with a tragedy.

Mr. WOODRUFF. I am more or less familiar with that.

Colonel GORRELL. From the business angle of the scheduled airline industry, that industry had to put up originally from $125,000,000 to $140,000,000. The industry lost about half of that sum; so Congress stepped in, in 1938, and passed a Civil Aeronautics Act and tried to put it on a stable basis as soon as possible. It is tending toward that at the present time.

I took the liberty over the week end to try to ascertain the figures for the industry for the last 10 years. I find, in a quick survey, that in the last 10 years 7 were losing years. Last year was the first year of profit which the air-line industry has had since 1933. Last year it made about $3,400,000, and one reason for that year being the first really profitable year in 10 is the fact that the weather was exceptionally good. If the atmospheric conditions had been bad there would have been more groundings, and there would have been less return.

The second reason is because there has been no fatal accident for seventeen months. One accident may cost around a million dollars in losses, and two accidents might cost something better than two million. If we had had bad weather during the winter months and one or two accidents, the industry would have been in red ink last year.

I say that the air industry some day will be stable, but it is not yet stable. When you try to find a base, as the proposed bill attempts to do by taking into consideration a period of 4 years, and when you deduct your red ink losses from the years of black ink, I think that is unfair to this industry because atmospheric conditions and accidents may have control of profits, and, to a considerable extent, do have such control. By the method proposed in the sub-committee's report, the air-line industry would be given an exemption of a sum of money too small to represent any normal condition for the industry.

Mr. TREADWAY. Will not the atmospheric conditions average themselves up over a period of time?

Colonel GORRELL. They may, and probably will.

Mr. TREADWAY. You lay a good deal of stress on last year being a particularly favorable year from the standpoint of atmospheric conditions.

Colonel GORRELL. That is correct.

Mr. TREADWAY. Of course, over a period of 365 days there would be more or less of a level reached; would there not?

Colonel GORRELL. But the previous 2 years were bad and caused a considerable loss, and caused several accidents. They caused losses which put the industry in red ink, due to atmospheric conditions and accidents, and, also, it is a young industry.

When you take a 4-year period for the base and subtract your losses therein, you do not get a fair base for the exemption of the industry.

Mr. COOPER. Are you advocating that Congress legislate on the basis of atmospheric conditions?

Colonel GORRELL. No, sir; I am advocating, and I intend to make the suggestion, in calculating the sum to be exempted from the tax, if you do not choose to give the air lines a complete exemption—so that the excess profits act will not conflict with the Civil Aeronautics Act—that you take the black ink dollars within the base period and divide that amount by the number of years in black ink during the base period you are using.

Mr. COOPER. You are asking for special consideration?

Colonel GORRELL. Because it is a young industry which is not yet stabilized and because of the other reasons I have already stated.

Mr. COOPER. We have other young industries: therefore you advocate special legislative consideration for every young industry?

Colonel GORRELL. No, sir.

Mr. COOPER. How would we wind up in writing a tax bill upon such a premise as that?

Colonel GORRELL. No, sir; I do not advocate that. My first point is that this bill would nullify the Civil Aeronautics Act. In that act you have already set a control over profits and have done so in the public interest.

Mr. COOPER. You are advocating special treatment for your industry and not for other industries.

Colonel GORRELL. For our industry in which profits are already controlled. We happen to be the only industry that I know of in America in which you have such constant and complete control over profits at the present time.

Mr. COOPER. You might be surprised to know how many others think that they are in a special classification and that they are entitled to special consideration.

Colonel GORRELL. I only know what the law is.

My point is that you have legislated for the air-transport industry, which was practically going out of business and which could not otherwise perform its part in national defense. This industry would have failed before now if that act had not been passed. Since then, as I have said, the industry has purchased $24,000,000 worth of equipment, since 1938, and has on order $31,000,000 worth more. It has only $10,000,000 in cash. Therefore it must go out and obtain these airplanes by borrowing money, and the amounts it is allowed to borrow depend on the rates which the Civil Aeronautics Board provides for.

They do not permit excess profits, inordinate profits. You have already legislated on that point in the interest of national defense.

Mr. REED. Do you know anything that is more important to national defense, as shown by the war abroad, than the development of that line of defense?

Colonel GORRELL. The country that does not develop it is destined to serious consequences. Aviation is changing the map of the world.

Mr. REED. And the reason you are here is that you feel the law as proposed might not take care of a vital industry for national defense?

Colonel GORRELL. I do feel that very strongly.

There is no other industry that can go to war as an entity and instantly, except this one industry. That is due to its mobility. Uncle Sam does not provide the transport and cargo planes that provide to America that mobility. We hope we may be allowed to carry out our national duty efficiently. If you do not let the transport industry carry on with its present designated role, you will have to pay for it with taxpayers' money and it will cost many times the amount of taxes you will get out of the industry by a bill like this one. You will have to spend about a billion dollars—$100,000,000 to provide the planes, in the first place, and about $800,000,000 during the life of the planes to keep them up—if you do not continue the provision for the scheduled air carriers to carry on with their allotted function.

The CHAIRMAN. Could not that be taken care of and those people be protected in the contracts being made with the Government?

Colonel GORRELL. The Civil Aeronautics Act dispensed with contracts and substituted certificates. The rate of pay under the certificates, within the limits of the law, is whatever the Civil Aeronautics Board may set. That Board is required to reduce the rate of pay as the income of the carriers from the public becomes greater, and the Board can do that in effect, retroactively by making correspondingly future reductions where past pay proves to have exceeded needs.

However, if you do not care to give an exemption, then we suggest a fair method of amendments in the type of bill you are considering. One part of that fair method is this:

The proposed excess-profits tax bill, as outlined in the recommendations of the subcommittee, will operate (1) to exclude from taxation the well financed prosperous company which has maintained a steady rate of earnings during the base period 1936-39. (2) It will also exclude from excess-profits taxation the established company with a large investment which has a relatively low rate of return on invested capital. On the other hand the tax will operate with great severity against the airlines, a young and growing industry, particularly those companies which have shown deficits for some part of the base period. So far as the report indicates, deficits incurred during the base period must be subtracted from profits during the base period in arriving at average earnings. The result is therefore that the air line which has incurred heavy development expenses and thus has operated at a loss for all or part of the base period may have all or the greater part of its profits in 1940 or succeeding years treated as excess profits, even thought in fact these profits no more than make up for the losses which have been incurred in earlier years in the development of the business.

The air lines, young, well managed, growing enterprises, employing additional men year after year, are in a position to contribute most effectively to the prosperity and advancement of the country as we emerge from a great depression. It would be particularly unfortunate to use taxation as a means for penalizing young businesses which have just been developed, at the same time that old established businesses are left untouched. The use of an invested capital base really affords no relief to a young air line which is just now turning the corner. If that air line is to continue in existence it must make a better than 10 percent rate in order to make up for the development years in which it showed losses.

For these reasons, it is absolutely necessary that some method should be devised to insure that this industry pays its fair share of the tax burden but no more than its fair share. Recognition must be given to the fluctuating character of our earnings and to the long period of development losses which we have incurred. If an excess profits tax is to be used, at least the two following adjustments should be made:

(1) In computing average earnings a corporation should not be compelled to reduce profits for some of the years during the base period by losses in other years in the base period. It would be more equitable to provide that for the years in which the company had losses it should be given a credit equal to a fair percentage (8 or 10 percent) of its invested capital.

(2) Because of the direct connection between the air lines and the national defense—every airplane that we buy is one less that the Army needs to buy—money which we borrow to purchase equipment should be allowed 100 percent in our invested capital.

Mr. DISNEY. Will you state your theory of exemption?

Colonel GORRELL. What I would suggest to be done would be to insert in the bill a provision that the excess-profits tax should not cover the air carriers that are subject to title IV of the Civil Aeronautics Act. That is the title that controls the economics of the carriers. I am not speaking for any air carrier that is not subject to that title.

The CHAIRMAN. If the committee should not adopt your recommendation you have an alternative suggestion, have you not?

Colonel GORRELL. Yes; if the committee does not see fit to do that, then I suggest that you keep in mind that about a year and a half ago these carriers could not borrow any money; they were faced with bankruptcy, and most of them would probably have gone out of business.

You passed the Civil Aeronautics Act and thus inspired confidence and the industry has already gone out, since that act was passed in 1938, and bought $24,000,000 worth of aeronautical equipment, and now have on order $31,000,000 more. We will need, in my judgment, to purchase another $150,000,000 or $200,000,000 worth of equipment to enable the air carriers to keep pace with the growth of the G. H. Q. Air Force. To do that we will have to borrow the money, because the industry today has only $10,000,000 of cash, and it could not yet sell large stock issues.

Under the confidence you inspired by the Civil Aeronautics Act of 1938, we can borrow the money we need, and as soon as we get some record of earnings we can sell additional securities. But now

we cannot yet sell securities fast enough and we will have to borrow a large portion of this $150,000,000. That means that we have and will continue to have a very small capital, but huge sums of borrowed money.

My second suggestion is that the money so borrowed be considered as capital. In other words, by so doing you will not tie our hands and we will be able to go out and borrow large sums of cash in the next couple of years or so and thus save the taxpayers the need of paying for great quantities of transport and cargo planes.

The CHAIRMAN. Do you consider that 100 percent should be provided for?

Colonel GORRELL. That is my suggestion, provided it is devoted to the public interest, by being spent on such vital things as additional aircraft, radio, and so forth.

Now the third point I wish to make is this, sir——

Mr. DISNEY. One other question, there: you think the provision in the report is not broad enough; that you need 100 percent on borrowed capital?

Colonel GORRELL. Yes, sir; because it will all be devoted to the public interest, and the taxpayer will not have to put it up.

The next point I wish to make is this: This industry put up, to begin with, somewhere around $125,000,000, and in 1934 the companies in the business were required to get out of the business, and other new companies came in; so that, as to paid-in capital, they are generally cut off in 1934. Some of the new companies were more or less the same stockholders, but under different name. Now the industry has been a losing proposition. If I started in the air line business 4 years ago, and if I put in $10,000,000 of capital in this losing industry, I would by 1939 have lost perhaps $5,000,000 of that. Then my exemption under the proposed bill would be calculated on a base of only $5,000,000. Now you go in this year and, not having gone in before, you get an exemption on a base of $10,000,000. So it seems to me the losses I suffered to develop this industry, in the public interest, should not be deducted in calculating the exemption.

Mr. BOEHNE. Why cannot you capitalize on the money you lost in the past and charge it to promotion?

Colonel GORRELL. Sir, I am delighted you asked that question, because I expected to make that point and had forgotten to do so. Our books are controlled by the Government. They tell us what books to keep and how to keep them.

Mr. BOEHNE. What do you mean by "controlled by the Government"? I would like to have you explain that.

Colonel GORRELL. Up to 1938, the regulations of the Post Office Department told us what to charge and what to capitalize. Since that time, the regulations of the Civil Aeronautics Board have told us what to charge and what not to charge.

If I may summarize what I have said, may I hand to the recorder the recommendations I have made; first, that in the public interest there be a provision in the act that the excess-profits tax should not cover the air carriers, subject to title IV, of the Civil Aeronautics Act.

Mr. MCCORMACK. Right there let me ask how many companies are subject to title IV?

Colonel GORRELL. About 19 really, sir; in the continental United States. With a minor exception, you have a list of them already in the record.

Mr. MCCORMACK. The companies are in there?

Colonel GORRELL. Yes, sir; the names.

There are 24 air carriers subject to title IV of the Civil Aeronautics Act of 1938. (This figure counts the several companies making up the Pan-American Airways System as one carrier, but does not include certain former small star-route carriers in Alaska whose future status is not yet clear but is now under investigation by the Civil Aeronautics Board.)

One of these 24 has a certificate authorizing it to carry mail, passengers, and property, but it has not yet started operations. Its operations will be inconsiderable for several years since it will be operating across the Atlantic and will have a long period of preliminary flights.

Of the 24 carriers, all but 4 are authorized to transport the mail. These other 4 are engaged in common-carrier operations, and are therefore subject to title IV of the Civil Aeronautics Act, but at the present time do not carry mail because of the limited or experimental character of their operations: They are very small and will, in one case, do no business whatsoever in the future since its operations have been taken over by another of the air carriers which does carry the mail. Of the other 3, 1 operates seasonably around Cape Cod, 1 operates between Catalina Island and the California mainland, and 1 operates a purely experimental service between a few small towns in western Pennsylvania, West Virginia, and Ohio. In all 3 cases the rates charged are regulated by the Civil Aeronautics Board, and in 1 of the 3 cases no passengers can be carried, its operations being limited to a small-package business.

The air carriers which are subject to title IV of the Civil Aeronautics Act, and which are air-mail carriers are:

American Airlines.
American Export Airlines (operations not yet inaugurated).
Boston-Maine Airways.
Braniff Airways.
Chicago and Southern Airlines.
Canadian Colonial Airlines.
All-American Aviation.
Continental Air Lines.
Delta Airlines.
Eastern Air Lines.
Inland Airlines.
Inter-Island Airways.
Mid-Continent Airlines.
National Airlines.
Northwest Airlines.
Pan American Airways System.
Pennsylvania-Central Airlines.
Transcontinental & Western Air, Inc.
United Airlines.
Western Air Express.

Mr. MCCORMACK. Those companies under title IV, as to their business, the Civil Aeronautics Authority determines the profits they can make; is that right?

Colonel GORRELL. Yes, sir.

Mr. MCCORMACK. And it allows them a certain profit?

Colonel GORRELL. Yes, sir.

Mr. MCCORMACK. And in a general way, regulates their business because of certain subsidies they are receiving?

Colonel GORRELL. Yes, sir.

Mr. MCCORMACK. That is the reason, because certain subsidies are received?

Colonel GORRELL. That is right.

Mr. McCORMACK. And those companies have to submit to certain regulations by the Authority?

Colonel GORRELL. That is right—and they can do all that even retroactively.

Mr. McCORMACK. Now the bill we passed, and even prior to the passage of the bill, the legislation putting them under the Post Office Department was a subsidy; it was not any kind-hearted act on the part of the Government just to give some companies money, but was to build up aviation in this country and in foreign fields and was definitely connected with our national defense, as I understand?

Colonel CORRELL. Yes, sir.

Mr. McCORMACK. In other words, the Government was not just giving the money out to those companies but the Government had a definite objective in doing so and, rather than to incur the tremendous expenses on the part of the Government in relation to direct action, was doing it by inspiring private business to make the investment and expand? Is not that right, in a general way?

Colonel GORRELL. Yes, sir.

Mr. McCORMACK. How many other companies are there not covered by title IV?

Colonel GORRELL. All those that do not carry mail.

Mr. McCORMACK. All the ones that do not carry mail?

Colonel GORRELL. The ones that do not carry mail are not covered by title IV. They fly more miles and carry more passengers than we do.

Mr. McCORMACK. How many of them are there?

Colonel GORRELL. I imagine there are several hundred that are not covered by title IV.

Mr. McCORMACK. Let me ask you this: Do the companies covered by title IV charge less rates than the other companies?

Colonel GORRELL. No, sir. The rates, not only for the mail, are fixed by the C. A. A., but the rates and the charge to the public for passengers and cargo are controlled by the C. A. A.

Mr. McCORMACK. What about the other companies that are not controlled by title IV?

Colonel GORRELL. The other operators of which you speak, sir, are charter operators and are not within title IV of the Civil Aeronautics Act. They come under the safety provisions of the act but not under the economic provisions of the act.

Mr. McCORMACK. Are they subject to the jurisdiction of the Commission as to rates?

Colonel GORRELL. Only as to the safety provisions; not on rates.

Mr. McCORMACK. So, in other words, any company not covered by title IV can charge any rates to the public which the traffic will bear?

Colonel GORRELL. That is right; and your excess-profits bill would take from them anything that becomes inordinate or not desirable.

Mr. McCORMACK. So that they are in an entirely different position than those under title IV?

Colonel GORRELL. Yes.

Mr. McCORMACK. And, under title IV, you are just as completely under the supervision of the Civil Aeronautics Authority as the railroads are under the supervision of the Interstate Commerce Commission?

Colonel GORRELL. Much more so, sir; at least my lawyers tell me this and, also, the I. C. C. so advises in its Fifty-second Annual Report.

Mr. MCCORMACK. I just want to get a clear picture, so that you will present your most complete evidence on the differentiation between the companies under title IV and the companies not under title IV.

Colonel GORRELL. That is what I was attempting to do.

Mr. MCCORMACK. In other words, the companies under title IV, having accepted mail contracts, also accept the other limiting conditions?

Colonel GORRELL. Correct, sir.

Mr. MCCORMACK. They are subject to the regulation and control, as to operation and profits, of the Commission, which has broad jurisdiction over them with reference to control, supervision, and direction; is that correct?

Colonel GORRELL. Correct, sir.

Mr. MCCORMACK. Whereas, as to the other companies, the Commission has supervision only as to safety?

Colonel GORRELL. That is correct.

Mr. MCCORMACK. Which is important?

Colonel GORRELL. Yes, sir.

Mr. MCCORMACK. But are those companies in any way directed by the Commission in any respect other than as to safety?

Colonel GORRELL. No, sir; as to safety only.

The CHAIRMAN. Thank you, Colonel Gorrell.

Mr. MCCORMACK. He had not completed his statement, Mr. Chairman.

The CHAIRMAN. I thought he had. Had you completed your statement?

Colonel GORRELL. Yes, sir; I have handed to the reporter a summary of our recommendations.

(The summary above referred to is as follows:)

AMENDMENTS SUGGESTED BY AIR TRANSPORT ASSOCIATION OF AMERICA

RECOMMENDATIONS

1. In the light of the foregoing considerations it is suggested that in any excess profits tax bill there should be an exemption covering "air carriers subject to title IV of the Civil Aeronautics Act of 1938."

This exemption will cover approximately 20 air lines at the present time. It will not cover the numerous miscellaneous charter operators who do not carry the mail and whose passenger and property rates are not regulated by the Civil Aeronautics Board.

2. As an alternative, provision covering the air lines should be made to the effect that—

(*a*) In computing the average net income for the base period, losses in any taxable year or years should be excluded, and in any such loss year there should be recognized a net credit of 10 percent of the first $500,000 of "equity invested capital" and 8 percent on any amount of such capital in excess thereof; or

(*b*) Loss years should be excluded in computing both the base period and the average net income for that period; and in either event

(*c*) In computing the "equity invested capital" for the air carriers a deduction on account of "the deficit in earnings and profits account as of the beginning of the taxable year" should not be made; and

(*d*) Borrowed money, when devoted to the purchase of aircraft and other such purposes in the public interest, should be fully included in "equity invested capital."

Mr. DINGELL. I would like to suggest to you, Colonel, that you have prepared, certainly for my benefit if not for the benefit of my colleagues, the three alternative suggestions which you indicate should be considered. I would like to analyze them myself at my leisure.

Colonel GORRELL. I have them prepared right here, sir, and, with your permission, may I summarize, just in a few paragraphs, what I have said about our role in the interest of national defense and try to crystallize that in just a few paragraphs for you?

The CHAIRMAN. Do it as briefly as possible.

Mr. MCKEOUGH. Mr. Chairman, he desires to do that in connection with the revision of his remarks. Is that it?

Colonel GORRELL. Yes, sir.

The CHAIRMAN. There is no objection to that.

Colonel GORRELL. With respect to the proposed excess-profits tax bill the scheduled air carriers, subject to title IV of the Civil Aeronautics Act, are in a position quite different from the rail carriers or other regulated utilities, such as electric light companies.

In the first place, all such utilities would have a much larger exemption, computed on the investment basis, because of the much larger investment of such utilities in relation to the amount of business done. While it is difficult to secure any precise figures, careful estimates indicate that the railroads have an investment in proportion to dollars of gross business which exceeds that of the air carriers in the ratio of nearly 8 to 1; similar estimates indicate a comparable disparity in the case of other utilities, such as electric light plants, as contrasted with air carriers.

In the second place, the profits of the air carriers are regulated much more strictly and exactly than are the profits of other utilities. In the case of the railroads and other utilities, such as electric light companies, profits may be affected only by involved and complicated proceedings involving the rates charged to the public. In such cases, rate changes may or may not control profits in the way anticipated, depending entirely upon the amount of business from the general public which is generated under the new rates. In the case of the air carriers the situation is quite different. Aside from the fact that the Civil Aeronautics Board controls passenger and property rates of the domestic air carriers just as the Interstate Commerce Commission controls those of the railroads, the Board's control over the compensation paid for transporting the mail gives an immediate and direct control over total income. The studies of the Post Office Department indicate at all times how much air mail there will be; the amount does not depend upon the payment to the carriers—it is determined by the Government itself. Therefore all that the Civil Aeronautics Board has to do is to figure out what each carrier will need, subtract its other revenues, and divide the difference by the units of air-mail service it will perform; that will give the rate of air-mail compensation. And since the air-mail pay is so large a portion of the carrier's total revenues, the control over this air-mail pay provides a simple and direct control over profits. Since an air-mail pay case can be handled very quickly, involving none of the complications of an overhaul of the passenger rate structure, the Board is at all times in a position to exercise this control expeditiously when necessary.

The CHAIRMAN. The next witness on the calendar is Mr. Clarence D. Laylin, representing the Ohio Chamber of Commerce, of Columbus, Ohio.

Will you please give the stenographer your name and address, and the capacity in which you appear before the committee?

## STATEMENT OF CLARENCE D. LAYLIN, COLUMBUS, OHIO, APPEARING AS ATTORNEY FOR THE OHIO CHAMBER OF COMMERCE

Mr. LAYLIN. My name is Clarence D. Laylin; I live in Columbus, Ohio; I am appearing directly as attorney for the Ohio Chamber of Commerce. I hope to confine my testimony to 15 minutes.

The CHAIRMAN. You are recognized for 15 minutes.

Mr. LAYLIN. The Ohio Chamber of Commerce is, in part, a federation of local chambers of commerce and I am privileged also to speak directly for one of those local chambers, the Youngstown Chamber of Commerce.

Recognizing that the Congress would very probably consider the enactment of a special excess-profits tax as an incident of the national-defense program these organizations, through their proper committees, prior to the publication or release of the report of the subcommittee which is before the committee at this time, had considered the general subject and had reached certain general conclusions.

Through the courtesy of Mr. Jenkins, of your committee, I have had the privilege of examining the report of the subcommittee for a day or so and comparing it with the conclusions arrived at by the group which I represent. And let me say at the outset that I am happy to say, in their behalf, that the subcommittee's recommendations are, generally speaking, in accord with the conclusions of those Ohio business groups for which I am speaking. I do not mean to say that these groups advocate a special excess-profits tax, but they recognize what the situation doubtless is and, on their behalf, I may say, if such a tax is to be enacted, the principles contained in the recommendations of the subcommittee are the right ones, in their judgment, and the approach taken by the subcommittee appeals to them as, in the main, fair and reasonable.

It is my duty, however, to suggest for the consideration of the committee a few matters which, if incorporated in the measure, would not in any wise distort or mutilate the general plan of the subcommittee. If I seem by mentioning such matters to be critical of the report, please understand that such implied criticisms are intended to be constructive.

Referring to those matters in the order in which they appear in the report: On page 1, the subcommittee, for reasons with which we entirely agree, recommends the suspension, during the excess-profits taxable years, of the profit limitation provisions of the amended Vinson-Trammell Act. I am left in some doubt as to just how comprehensive that recommendation is. Our people, reading the amended Vinson-Trammell Act, see in it two provisions which might be regarded as profit limitations. The one prescribes the maximum contractor's fee which may be agreed upon when a Government contract is let on the cost-plus basis; the other provides for recapture by the Government of profits in excess of a prescribed maximum, when the work is contracted for on a lump-sum basis. The subcommittee's recommendation, as I intimated, may cover both or only one—the second. Our groups are of the opinion they should be both treated alike, believing that they manifest a single consistent policy in the Vinson-Trammell Act and that they have substantially the same deterrent effect on the procurement of materials and sup-

plies for national defense, and are equally inconsistent with an excess-profits tax of general application.

Now, the Maritime Act, so called, contains a similar profit limitation. It is something, however, like the act referred to by the witness who just preceded me—Colonel Gorrell—in that the profit limitations are part of a subsidy scheme. Now, we suggest, without being too firm about the suggestion, that perhaps those profit limitations belong in the same category. The subcommittee in its report says, or intimates, there seems to be no good reason for treating any limited type of business differently from the way in which other businesses are treated in respect to profit limitations, and I draw attention to that particularly as one.

The second recommendation of the subcommittee is with reference to the amortization of emergency facilities. We favor the proposal as made and subscribe to the reasons by which the subcommittee supports it. In this connection, however, the groups which I represent have thought of an additional reason to which a company which has installed special facilities for emergency national-defense purposes may be subject; that is, the risk of sudden loss by inventory devaluation. It has seemed to us that, in addition to the taxpayer's options with respect to inventory which are to be found in the Internal Revenue Act, there might well be afforded to companies certified in the manner recommended an election to set up, under suitable restrictions, a reasonable reserve whereby this risk might be spread over the period of the emergency and recognized in each taxable year for income- and excess-profits-tax purposes.

Coming now to the excess-profits-tax recommendations proper, the general plan of the tax as set forth in the subcommittee's recommendations is in accord with the views of the organizations which I represent. They had declared for the annual election privilege with respect to the computation of excess-profits credit, as outlined at page 3 of the report and elaborated at page 10. They favored the use of invested capital as one of the two alternative bases and although they did not attempt to devise a formula of their own they were firmly of the opinion if invested capital were used as a base in the law, the formula for determining "invested capital" should be set up with some particularity in the law. And that is what the subcommittee recommends.

Now, these matters are regarded as vital, Mr. Chairman, by some of Ohio's most important industries, such as the manufacturers of steel and machine tools. The members of the committee know, of course, that in those and other so-called heavy-goods industries, business and resulting earnings are highly cyclical as compared with those of the makers and sellers of consumers goods.

To get a fair basis for the determination of what profits are excessive in the heavy-goods industries, the normal fluctuations of the industrial barometer in those industries ought to be borne in mind, it seems to me, and the scale of earnings during the past few years, the base period, may not be the criterion of what is normal any longer for a few industries of that character; so that these corporations are pleased to have the privilege that the recommendations would accord to them of electing another alternative base, the invested capital base, in lieu of the earnings for the period known as the "base period."

The Youngstown Chamber of Commerce, in pressing this point of view, has voted to recommend to this committee the inclusion in any excess profits tax measure of special relief provisions such as found in the Revenue Act of 1918. That, of course, was before the publication of the subcommittee's report. Whether the special limited relief granted by the subcommittee and the reasons for its policy in that regard, as set forth on pages 8 and 9 of the report, would meet all the possible situations which the Youngstown Chamber of Commerce had in mind, I cannot, of course, positively say, but I should fear not. With some hesitation, I think I ought to advise the committee there is likely to be a feeling in these quarters that even with the features of this plan which the subcommittee recommends, there should be more leeway for special assessments of excess profits, in cases of peculiar hardship.

Now, the business groups for which I am speaking had adopted a resolution favoring a provision which does not appear in the recommendations of the subcommittee. I find nothing in the document, either, about this. I believe it has been mentioned by the preceding witness, and I am going to shorten my remarks about it and make no argument for it, because I think it needs no argument, that is, for excess-profits-tax purposes that at least the privilege of filing consolidated returns should be accorded. I will not elaborate on that, because my time is going, but I want to state it as positively as I can, it being the deep conviction of the groups which I am trying to represent.

Now, that is as far as my positive duty goes. I had intended, Mr. Chairman, to refer to just one matter of detail, yet a very important one which these chambers of commerce for which I am speaking had not had an opportunity to consider, because they had not seen the report, that is, the differential between the rate of return allowed and deducted on new capital, and the minimum credit allowed in the bill on invested capital during the base period, after $500,000 is reached. The one is 8 percent; the other 4 percent. They are used for the same purposes—perhaps the most important purpose of the bill to those who will be driven to the invested capital option, and of particular importance to the heavy goods industries, because of the extremely light investment during the base period.

I will summarize what I had in mind to say, in order to stay within my time, by saying it seems to me, and I think would seem to those I am trying to represent, to be a too wide differential. And the cure for it, it seems to me, is to raise the 4 percent—perhaps both of them.

There are many companies which will be forced by circumstances to elect the invested capital basis of determining excess profits credit, and the effect will be this, on those companies: they will be told that anything they may make by way of profit over 4 percent is excessive and they will be taxed in a rather punitive way because they have made that 4 percent and that 4 percent, Mr. Chairman, I think deserves your careful consideration as to whether it is generous enough, or not.

The CHAIRMAN. Are you through?

Mr. LAYLIN. I am through.

The CHAIRMAN. We thank you.

Mr. JENKINS. Mr. Chairman, I should like to ask a question or two.

Mr. Laylin, you did not discuss very extensively your idea about the fluctuation of inventory and how it would fit in with this plan. Would you like to extend your remarks further in that respect? Personally, I should like to know what your ideas are more fully than you have expressed them.

Mr. LAYLIN. You will appreciate, Mr. Jenkins, I am the mouthpiece to a certain extent for the views of others. So far as that point is concerned, I have tried to get from them a formula, which I presume is what you have in mind——

Mr. JENKINS. Yes.

Mr. LAYLIN. But they have none in mind. It is the principle in which they are interested and if that principle meets with the approval of the committee they are, of course, well advised; that means they leave it to the hands of the committee to provide a satisfactory formula.

Personally, my own opinion is if such a thing is done, and I can see the reason for it, it should be properly restricted in the bill. What is desired, of course, is the privilege of writing off, through reserve, an anticipated loss—not on all inventory, of course, but on inventory of this special class, of the same special classes indicated already in a bill of this kind by which the amortization privilege would apply. It is just applying the same principle to "inventory" as is applied to "capital" by the amortization plan.

Mr. JENKINS. Another question I should like to ask, and that is this: I understood you to say that Ohio is especially interested in that phase of this bill as it applies to the heavy industries?

Mr. LAYLIN. Yes.

Mr. JENKINS. In other words, I think it goes without saying, with reference to these machine tools, which is a very important item in this defense program, that Ohio is the outstanding State in the Union in the manufacture of machine tools?

Mr. LAYLIN. Yes.

Mr. JENKINS. Now, if that is the case, and Ohio also being a great State in reference to the production of steel, I should think you have not expressed yourself sufficiently in what you have said and, when you extend your remarks, it would be well for you to do so. Because if these great industries all over the Nation—steel and machine tools—are in danger of being encroached on in this bill, we ought to know about it with facts and figures before the bill is written. And if you care to extend your remarks in that respect, I am sure the chairman will permit you to do it.

The CHAIRMAN. Yes; you may have the privilege of inserting a brief in the record.

Mr. LAYLIN. Thank you.

Mr. TREADWAY. Mr. Laylin, you referred to the desirability for including consolidated returns. How difficult a task do you think it would be to draft the proper language for that?

Mr. LAYLIN. Well, I do not know that I am qualified to express an opinion, Mr. Treadway.

Mr. TREADWAY. You are a lawyer?

Mr. LAYLIN. Let me say this, that I have made no suggestion here today that, to me, appeared to involve delay in the consideration of

this bill, and I would suppose it would not be an excessively difficult matter to draw a provision for consolidated returns for excess-profits tax purposes.

Mr. TREADWAY. The reason I ask that question is the fact that the subcommittee, whose report you have seen and referred to, were given to understand that it would take some time to draft a proper provision providing for consolidated returns and would delay the passage of this measure in order to include it at this time.

Mr. LAYLIN. Well, we had not been aware of that.

The CHAIRMAN. We thank you.

Mr. LAYLIN. Thank you, Mr. Chairman.

(The following supplemental statement was presented by Mr. Laylin):

If we are to have an excess profits tax, we heartily endorse the recommendations of the subcommittee of the Committee on Ways and Means of the House of Representatives in their report on the proposed excess profits taxation, in that it allows the taxpayer the privilege of electing his average earnings for the base period of 1930–39, or his invested capital.

However, we do feel that the minimum credit, for excess profits taxation purposes, of 6 percent on the first $500,000 of invested capital and 4 percent on all invested capital over and above $500,000, is too low. We believe that the minimum credit should be at least 8 percent on the first $500,000 of invested capital and at least 6 percent on all invested capital over and above $500,000.

Even with the raised minimum, the excess profits tax will greatly penalize our heavy industries which have just gone through a severe depression and many years of great losses, whereas it will not be any particular hardship to those consumer industries which, even during periods of depression, had relatively constant earnings.

The following table of two hypothetical companies clearly illustrates our point:

| | Company A (consumers' goods) | Company B (producers' goods) | |
|---|---|---|---|
| Invested capital | $10,000,000 | $10,000,000 | |
| Average annual earnings, 1930–39 | 500,000 | 25,000 | |
| Average annual earnings, 1936–39 | 650,000 | 400,000 | |
| | | Under 6—4 percent | Under 8—6 percent |
| Excess profits, net income | 750,000 | $750,000 | $750,000 |
| Less excess profits, credit | 650,000 | 410,000 | 610,000 |
| | 100,000 | 340,000 | 140,000 |
| Less specific exemption | 5,000 | 5,000 | 5,000 |
| Excess profits subject to tax | 95,000 | 335,000 | 135,000 |
| Excess profits tax | 25,250 | 123,750 | 38,750 |

Company A manufactures and sells consumers' goods. Company B manufactures and sells producers' goods.

As you will note, both corporations have an invested capital of $10,000,000.

During the 10-year period, 1930–39, inclusive, company A had average annual earnings of $500,000, while company B had average annual earnings of but $25,000.

During the years 1936–39, inclusive—the base period—company A had average annual earnings of $650,000 while company B had average annual earnings of $400,000.

During a given year under the proposed excess-profits tax, both corporations had annual earnings of $750,000. However, company A can take, as an excess-profits credit, $650,000 plus the specific exemption of $5,000, which would mean it would have an income of but $95,000 subject to excess-profits tax. Company B could take but the minimum allowance of $410,000 plus $5,000 for specific

exemption, which would mean it would have an income of $335,000 subject to the excess-profits tax.

Under the present recommended provisions, company A—which is in an extremely healthy condition and has had average annual earnings of 5 percent on their invested capital for the past 10 years—would pay but $25,250 in excess-profits taxes while company B—which has weathered a severe economic storm and had only average annual earnings of but one-fourth of 1 percent on their invested capital for the 10-year period—would pay $123,750 in excess-profits taxes.

If the minimum credit were raised to 8 percent on the first $500,000 of capitalization and 6 percent on all capitalization over and above $500,000, company B would have a minimum credit of $610,000 which, plus the $5,000 specific exemption, would leave $135,000 subject to the excess-profits tax on which company B would have to pay an excess-profits tax of $38,750.

Even under the advanced scheme of minimum credits, company B would pay $38,750 against company A's $25,250 in excess-profits taxes, or over 53 percent more taxes than company A.

While the examples of the two companies we have given are hypothetical, this condition actually does exist in a great many of the machine-tool and heavy industries in the State of Ohio and in the rest of the country.

For example: One of the steel companies in Ohio has an invested capital of $115,376,000. For the 10-year period, 1930–39, this company had average earnings of but $1,303,000, or 1.1 percent on their investment. During the period 1936–39 they had average earnings of $1,757,000, or 1.5 percent on their invested capital.

An engine compressor and machinery building company has an invested capital of $6,626,000. During the 10-year period, 1930–39, they had average annual earnings of but $15,000, or 0.2 percent return on their invested capital, and in the 4-year period, 1936–39, they had average annual earnings of $103,000, or 2.0 percent on their investment.

A machine-tool company which has a capital investment of $3,000,000 for the 10-year period 1930–39, average annual earnings of $30,800, or 0.8 percent of their invested capital, and for the period 1936–39 had average annual earnings of $192,000, or 4.0 percent on their invested capital.

On the other hand, one of the outstanding consumers' goods concerns of the country had an average invested capital of $55,730,000 and for the 10-year period 1930–39, had average annual earnings of $4,233,000, or a profit of 7.9 precent, while for the 4-year period, 1936–39, this concern had average annual earnings of $4,617,000, or a profit of 8.3 percent in their investment.

Another outstanding consumers' goods company has an average invested capital of $129,068,000. This company also has a very large funded debt, so for excess-profits tax purposes their capitalization is low. On the basis of this invested capital for excess profit, during the 10-year period 1930–39, this company had average annual earnings of $18,008,000, or a return of 14.6 percent on their investment, and during the period from 1936–39 they had average annual earnings of $21,445,000, or 16.5 percent on their investment.

These are but a few examples of the inequalities which so low a minimum credit base will work. From reports made to us by 25 outstanding machine-tool, steel, and other metal-products companies in Ohio, we have computed the following table on percentage earnings:

NUMBER OF COMPANIES

| Percentage earnings are to invested capital | For 1930-39, inclusive | For 1936-39, inclusive | Percentage earnings are to invested capital | For 1930-39, inclusive | For 1936-39 inclusive |
|---|---|---|---|---|---|
| Loss | 11 | 1 | 5 to 6 percent | 1 | 0 |
| 0 to 1 percent | 6 | 2 | 6 percent and over | 1 | 7 |
| 1 to 2 percent | 2 | 4 | | | |
| 2 to 3 percent | 0 | 4 | Total number of companies | 25 | 25 |
| 3 to 4 percent | 2 | 4 | | | |
| 4 to 5 percent | 2 | 3 | | | |

You will see from the first column of the above table that during the 10-year period, 1930–39, inclusive, 11 of these companies had net annual losses, 21 earned less than 4 percent, while 4 earned 4 percent or more, and but one earned over 6 percent on its invested capital.

Even during the 4-year period, 1936-39, inclusive, one of these companies had a net loss, 15 earned less than 4 percent, while only 10 had earnings of 4 percent or more. Thus 15 of these 25 companies would be entitled to only the minimum credit of 6 percent on the first $500,000 of capital investment and the 4 percent on all capital invested over $500,000.

It is quite obvious that the 6- and 4-percent minimum credit is too low and that to be really fair even the 8 and 6 percent is still relatively low.

As an example of why this is true and why it probably should be a flat 10-percent minimum credit, we will take a steel-castings company that has, for the 4-year period of 1936-39, an average capital investment of $5,804,000. During this period they had earned $600,150, or 10.3 percent return on their invested capital. This company, during the 10-year period 1930-39, had an average invested capital of $6,284,000. During the same 10-year period they had average earnings of $204,000, or a return of 3.2 percent on their investment.

As has been noted, this concern has earned 10.3 percent on its invested capital during the 4-year base period. However, if the excess-profits tax had been in existence during the 4-year period of 1936-39, this company would have had to pay $210,337 in excess-profits taxes, or 14.2 percent of their entire earnings for the decade 1930-39, when they earned but $2,010,526, or averaged annually $201,053.

A tax of 14 percent of the earnings of a company that earned but 3.2 percent on its invested capital cannot be a reasonable excess-profits tax, as surely no one will call 3.2 percent an excessive profit.

Therefore, we respectfully request that the present recommended minimum credit of 6 percent on the first $500,000 of invested capital and 4 percent on all invested capital over and above $500,000, be raised to at least 8 percent on the first $500,000 of invested capital and at least 6 percent on all invested capital over and above $500,000.

The CHAIRMAN. The next witness on the calendar is Mr. Bradley Dewey, president of the Dewey & Almy Chemical Co., Cambridge, Mass.

Mr. DEWEY. Mr. Chairman, may I have from 12 to 15 minutes?

The CHAIRMAN. You are recognized for 15 minutes.

## STATEMENT OF BRADLEY DEWEY, PRESIDENT, DEWEY & ALMY CHEMICAL, CO., CAMBRIDGE, MASS.

Mr. DEWEY. My name is Bradley Dewey; I am president of Dewey & Almy Chemical Co., of Cambridge, Mass. I appear here not only as a representative of my company, but also as an individual who, as colonel in charge of the Gas Defense Division of the Chemical Warfare Service, spent about $100,000,000 during the last war for gas-defense equipment. So that I think I am at least in sympathy with the problems of defense procurement.

Although my own company has an enviable earnings record, which is in the three to four million dollars of invested capital range, my company would not be seriously affected by the excess-profits tax now proposed and is not seeking relief. If the proposal which I favor were adopted as an amendment to your present bill, I and my associates would pay considerably more income tax and would probably turn around and reinvest much of the remaining distributed profits in our own company. So that I think that I am not particularly prejudiced. I approach you as one advocating what seems to me a fair method of lessening the possible harmful impact of the proposed legislation on the national economy, without appreciably lessening the return to the Government.

To present my ideas in their most accurate shape, I would like to read to you a short memorandum in condensed shape.

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 up to 60 days after the close of their taxable year all of their excess earnings, together with two-thirds of their base earnings shall obtain a credit equal to the excess-profits tax that they would otherwise pay.

Mr. DISNEY. Will you restate that?

Mr. DEWEY. 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 up to 60 days after the close of their taxable year all of their excess earnings, together with two-thirds of their base earnings, shall obtain a credit equal to the excess-profits tax that they would otherwise pay.

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 legitimately be 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 profits tax.

Mr. TREADWAY. May I interrupt there?

Mr. DEWEY. Yes, sir.

Mr. TREADWAY. The excess over normal—how would that be reached?

Mr. DEWEY. I am leaving it to you to draw your bill as you want to and suggest this be a relief provision in the bill to accomplish the purpose I am now going to state.

Mr. TREADWAY. In other words, Congress would designate what are normal and what are excess earnings?

Mr. DEWEY. Exactly. And I recognize, in saying that, it is very complicated and difficult work you are engaged upon and you are going at it very fairly and undoubtedly you all recognize the fact you cannot draw an excess-profits tax provision that won't break some eggs in making an omelet.

Mr. TREADWAY. I am wondering whether that provision you are suggesting would not add to the complications?

Mr. DEWEY. This would be simply to provide that those who distribute their profits so as to get them in the hands of the taxpayer where they can be reached by the surtax, would be relieved, and the Government would collect its money from the taxpayer.

Mr. TREADWAY. From the taxpayer. That, of course, is a provision I know of.

Mr. DEWEY. Since it is a natural ambition of management 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 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.

The proposed credit will not deprive the Government of any revenue which it would otherwise receive and has the distinct advantage of increasing the turn-over 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. 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 state of hopelessness as industries in totalitarian countries. The proposed credit preserves these incentives without depriving the Government of revenue. It promotes the employment of both labor and capital.

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.

Growing businesses are benefited by the insertion of the proposed credit in the law. 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.

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 monpolies.

Such a 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.

So much for the proposition. In closing, I cannot help but add that I think that any who may not be receptive to the foregoing proposal, should realize that it might greatly facilitate the defense pro-

gram if you were to alter the provisions of paragraph 9 (6) on page 9 so as to allow new capital in companies whose invested capital is already over the $500,000 mark a return equal to 10 percent rather than the proposed 8 percent. I feel this would do much to attract new capital with which to finance the defense program as well as to finance the type of new industries I have spoken of.

Mr. McCORMACK. Mr. Dewey, your proposal, so far as the excess-profits tax is concerned, is confined to that, and is on the theory of the undistributed surplus tax: Is that correct? You are confining it to the excess-profits tax?

Mr. DEWEY. Yes, sir.

Mr. McCORMACK. But you are not in any way advocating a return to the undistributed-surplus tax in the form in which it became law?

Mr. DEWEY. No, sir.

Mr. McCORMACK. You realize, of course, that there is a difference between the undistributed-surplus provision as reported out of this committee and the way in which it passed the Senate and as it was agreed on in conference?

Mr. DEWEY. I do; yes, sir. I, for one, think it would have been more reasonable as you reported it, with some minor changes.

Mr. McCORMACK. Your suggestion is confined, or your testimony is confined, along the line of this proposal as an alternative plan which would be optional with the corporation that desired to utilize it, confining it to the excess-profits tax?

Mr. DEWEY Yes, sir.

Mr. McCORMACK. Under your plan, the question of invested earnings would not have to be considered by the corporation?

Mr. DEWEY. No, sir.

Mr. McCORMACK. And the question of average earnings would not have to be considered.

Mr. DEWEY. If they were making a distribution of their excess earnings, together with two-thirds of their base or normal earnings, they would only have to consider it, to be sure, up to within 60 days after the close of the taxable year.

Mr. McCORMACK. There are many concerns engaged in business of a purely speculative nature. In other words, they are liable to make a good profit 1 year, and to be clipped the next year.

Mr. DEWEY. Yes, sir.

Mr. McCORMACK. A lot of those businesses are directly engaged in the handling of raw products, or wool products from the producer to the consumer.

Mr. DEWEY. Yes, sir. I have been sitting beside a man who will present the same sort of a question, and you have heard a statement about the situation as to airplanes. I think you will be beset by so many special considerations here, all of which will have some merit, that only a blanket catch-all proposal of the type I suggest can possibly keep this bill from being overburdened with exceptions.

Mr. McCORMACK. Under your suggestion, have you any opinion as to whether or not, in the long run, the Government would obtain a considerable amount of tax dollars?

Mr. DEWEY. I have stated that I think it would, and I sincerely think so. My opinion is based on informal consultations with men who purport to know something about the question of tax revenues. I am not talking as an expert. I am just a lowly businessman up

there in Boston, and I do not want to set my opinion against that of the Treasury people, who ought to know.

Mr. McCORMACK. There is no question but that if this money goes back to the stockholders, it will come back in substantial amount in the form of income taxes, especially from those who may be in the surtax brackets. Such a proposal as this would also meet the objections of some other businessmen, or it would be of concern to some other kinds of business, such as personal service corporations. It might go a long way toward meeting their problem.

Mr. DEWEY. I elected to come down here as an individual businessman, and I came from a sense of duty. I have talked with many businessmen, and a great majority of them have expressed the opinion that it was a good thing. There have been some, however, who expressed very frankly such an undying hatred of the undistributed-profits tax that they did not like anything that had the words "undistributed profits" in it.

Mr. McCORMACK. You are confining it to excess profits?

Mr. DEWEY. Yes, sir. I do not feel that objection would hold.

Mr. McCORMACK. A corporation electing to be subject to this proposal would be subject to as little restraint or supervision by the Government, or the Internal Revenue Department, as could be possibly obtained.

Mr. DEWEY. There would be a minimum of restraint. If the operations are efficient, or if you show a good business record, and wanted to go out and get new capital, the earning record would make it attractive to new capital. That is essentially the crux of the proposal I am making.

Mr. McCORMACK. If a corporation has a small invested capital, and yet has substantial returns, because most of their invested capital is in the form of personal services, it would be benefited by this proposal. In some corporations, like a personal service corporation, the capital is really the contributions of the individuals composing it.

Mr. DEWEY. Yes, sir; there are a lot of companies that are really selling their "know-how," and that "know-how" was built up during the depression when they were losing money, but they had vitality enough to go through. With the depression behind them, there is no possible formula I can think of other than proceeding along this line. There is no basis, or no other basis, that would recognize the contribution that they made during the depression when they were fighting for their very existence. I am referring to companies that really had the guts and vitality that enabled them to get themselves in shape to go ahead in the building up of this economy that you people have worked so hard to promote, and which I believe may be only in its infancy.

Mr. McCORMACK. Those corporations have stock of a higher value because the dividend returns seem to be substantial in comparison with the capital actually invested.

Mr. DEWEY. Yes, sir.

Mr. McCORMACK. And unless something like this is done, the value of that stock will be sharply depreciated?

Mr. DEWEY. Yes, sir. It is not only reflected in that way but the earnings record is reflected in the position of the independent investing

public, when the prospects are such that they are willing to invest.

Mr. McCORMACK. Newspapers would be benefited by it?

Mr. DEWEY. You are away out over my head now, because I do not know anything about the newspaper business.

Mr. McCORMACK. In other words, this is simply a proposal suggested by you under which a corporation may continue in its ordinary business as heretofore, but if it declares a dividend of a certain amount of the net earnings then it is not against the excess-profits tax credit, but when it passes into the hands of the stockholder the Government gets the tax back through the medium of the income-tax return of the individual stockholder.

Mr. DEWEY. That is correct.

Mr. McCORMACK. It is your opinion that if such an option is given the corporation it would meet many difficulties that now confront a substantial percentage of our corporations, and that it would bring in at least as much, if not more, in the way of tax dollars than would be the case under any plan proposed in the bill, and that it would interfere in a minimum degree with the orderly conduct of business.

Mr. DEWEY. That is exactly my feeling. There will be some exceptional cases of corporations that will not get the relief contemplated here, and they will elect to pay taxes in the manner now proposed in the bill.

Mr. McCORMACK. The value of stock in the hands of stockholders would in no way be affected?

Mr. DEWEY. That is correct. I think those of you who have studied the finance of Germany will appreciate it was built up by the speed of money or the velocity of money. I do not know that it is a good thing, but certainly it does not hurt them over there, because it enabled them to stay alive with the minimum of money.

Senator KING. Would not your plan interfere with the program of many corporations which depend upon profits for capital investments to expand the business? In other words, if they are not permitted to utilize some of their excess earnings for business expansion or capital expansion, their business would deteriorate rather than advance.

Mr. DEWEY. You will notice that I propose that they be allowed to keep one-third that you, in your wisdom, would set up as base earnings or normal earnings. I believe that they would make the distribution, and this would only apply to those who had excess profits. It would enable them to get new capital. I recognize that there are a few who do not need to get new capital in that way. I think their answer would be realized under the present formula through borrowing, or keeping the money, and fighting it out with the Treasury as to whether it was an unreasonable accumulation or not. I think there would be very few of them.

Mr. TREADWAY. Mr. Dewey, you said you had interviewed a good many business people about this proposal that you are now offering us. Is that correct?

Mr. DEWEY. Yes, sir.

Mr. TREADWAY. And in these interviews, you have had, you found some opposition to your proposition?

Mr. DEWEY. Yes, sir.

Mr. TREADWAY. On what was it based?

Mr. DEWEY. Only on the fact that it was a revival of the undistributed-profits tax.

Mr. TREADWAY. That would depend on the nature of the language written into the law, would it not?

Mr. DEWEY. It seems so to me.

Mr. TREADWAY. So their opinion was based on a wrong premise, or a wrong impression, because of their experience with the previous tax.

Mr. DEWEY. That is my interpretation of it. I hate to speak for my opposition, but that is the only opposition I am conscious of being articulate at all.

Mr. MCCORMACK. Your proposal does not apply to that?

Mr. DEWEY. No, sir. I think they want this method. Then they could go ahead. I am thinking of the time that is coming when the real war starts here. The real war will be an economic war. That war, or the economic war, will be as serious as the other war over in Europe. If you do not have the country hitting on all eight cylinders, with both capital and labor employed, we will take a worse beating than the others have been taking from tanks and airplanes.

I thank you.

Mr. DISNEY. The next witness is Mr. K. T. Norris, of Los Angeles. How much time do you want, Mr. Norris?

Mr. NORRIS. About 15 minutes.

Mr. DISNEY. You may proceed.

## STATEMENT OF K. T. NORRIS, REPRESENTING THE NORRIS STAMPING & MANUFACTURING CO., LOS ANGELES, CALIF.

Mr. NORRIS. Mr. Chairman and gentlemen of the committee, I appreciate the opportunity of appearing before this committee in connection with the proposed legislation covering excess profits, amortization of special equipment installed for defense contracts, and related matters. We will be vitally affected by the legislation which is finally adopted. For 2 years we have been manufacturing ordnance materials for the Navy Department, and at the present time we have large contracts for such materials from both the Army and the Navy. Our current contracts require substantial expansion of our facilities involving the question of amortization of special equipment.

Mr. DISNEY. What business are you engaged in?

Mr. NORRIS. In the metal-stamping business. At the present time, we have contracts with the Army and Navy for the manufacture of cartridge cases and cartridge tanks. Those contracts total about $4,000,000. We have contracts that come under the provisions of the Vinson-Trammell Act, and we have the problem of the amortization of special equipment required for carrying out our contracts.

Mr. TREADWAY. You had those problems previous to the time the suggestions contained in this bill were made?

Mr. NORRIS. Yes, sir.

Mr. TREADWAY. You are carrying out those contracts now?

Mr. NORRIS. Yes, sir.

Mr. MCKEOUGH. May I ask whether, or not, there were any squabbles between you and the departments in reference to these contracts, or whether you received full information from them regarding the status of the contracts?

Mr. NORRIS. I am glad you asked that question. When I came back here, I attempted to find out what we would be allowed to do. I

went to the Treasury Department, and spent practically a day there at the Treasury Department, and learned almost exactly nothing. I went to the Navy Department and other offices, and at every place I went, I found out very little. Then I went to the Council of National Defense office, and talked with Mr. Smith, in Mr. Stettinius' office, and there I learned of the proposal which is now under consideration, or that the proposal had reached a certain stage, and would be given consideration. I learned that with respect to contracts entered into, or former contracts entered into, there was no provision with respect to a write-off at all. However, I can say that when I was here about a month ago talking with representatives in the various bureaus and departments, from what was said, I was satisfied that we would receive fair treatment.

Mr. McKEOUGH. And you are proceeding with your contracts?

Mr. NORRIS. Yes, sir.

Mr. DINGELL. You say you were in contact with the National Defense Commission?

Mr. NORRIS. Yes, sir.

Mr. DINGELL. I presume you discussed the question of amortization with them?

Mr. NORRIS. Yes, sir.

Mr. DINGELL. And, in all probability, they gave you some inkling of the kind of relief that would be extended under your contracts?

Mr. NORRIS. I was told that meetings had been held that very day in which the Treasury Department participated and that the plan then under discussion was one that would permit a write-off under the 4-year period, with the accumulation, and that 25 percent depreciation would be allowed for the first year and 50 percent the next year.

Mr. DINGELL. They recognized the fact that the problem of amortization was delaying the work insofar as the production of war supplies was concerned, and that something had to be done immediately to correct it?

Mr. NORRIS. Yes, sir; that is correct.

Mr. TREADWAY. May I ask what are the approximate dates of the contracts you have already entered into?

Mr. NORRIS. Do you mean all the contracts, including the contracts already completed?

Mr. TREADWAY. Yes. You spoke of having several contracts.

Mr. NORRIS. The first contract was entered into in April 1938.

Mr. TREADWAY. How recently have you had a contract?

Mr. NORRIS. We made a contract as recently as January for 75-millimeter cartridge cases. That amounted to $500,000.

Mr. TREADWAY. That was in January?

Mr. NORRIS. Yes, sir. We received a contract in February for cartridge tanks amounting to approximately $700,000, and we have another contract for cartridge tanks and cases amounting to $345,000.

Mr. TREADWAY. The suggested amortization period begins July 10, and on contracts made previous to that time there would be no amortization benefit if this recommendation should be adopted. You have stated that you have entered into contracts previous to that time. Do you think that would be fair?

Mr. NORRIS. No, sir; I think it should be retroactive.

Mr. TREADWAY. How far back?

Mr. NORRIS. I would say back to the first of this year, so far as I am concerned.

Mr. TREADWAY. And it would take care of others similarly situated with yourself?

Mr. NORRIS. Yes, sir.

Mr. TREADWAY. In order to successfully carry out those contracts, did you have to enlarge your plant?

Mr. NORRIS. Yes, sir; very materially.

Mr. TREADWAY. So you would feel that you were not being treated as fairly as the others, unless you were included in a proposition dating back earlier than July 10?

Mr. NORRIS. That is right.

Mr. CARLSON. The contract entered into in April 1938 would come under the Vinson-Trammell Act?

Mr. NORRIS. No, sir. I think the contract was started some time before. We have contracts that come under the Vinson-Trammel Act.

Mr. CARLSON. How much have you earned under the operation of the Vinson-Trammell Act?

Mr. NORRIS. They are only under manufacture, and there are no returns from them. They are not completed.

Mr. CARLSON. You have not completed any contracts under the Vinson-Trammell Act?

Mr. NORRIS. No, sir.

Mr. CARLSON. You accepted them on the basis of the profits allowed under the Vinson-Trammell Act?

Mr. NORRIS. Yes, sir; but I had no idea of an excess-profits tax being imposed on top of that.

Mr. CARLSON. You would like to be permitted to complete the contracts without the excess-profits tax being imposed, and you would favor the suspension of the Vinson-Trammell Act?

Mr. NORRIS. Yes, sir.

Mr. MCCORMACK. Have you put much money in plant expansion?

Mr. NORRIS. Yes, sir.

Mr. MCCORMACK. And that was the company's own money?

Mr. NORRIS. Yes, sir.

Mr. MCCORMACK. It is one of those types of cases where you feel there should be some special plan provided. It is your idea that Congress should consider some special plan of amortization in connection with those contracts?

Mr. NORRIS. Yes, sir.

Mr. MCCORMACK. But your company went ahead with the work?

Mr. NORRIS. Yes, sir.

Mr. MCCORMACK. You did not wait to see what law would be written, but you took your chances?

Mr. NORRIS. Yes, sir.

Mr. MCCORMACK. Your own company met the capital problem of plant expansion?

Mr. NORRIS. Yes, sir. We invested approximately $100,000 on account of the 75 millimeter cartridge case and cartridge tank contract, and $150,000 more on account of a current contract we have.

Mr. KNUTSON. Is there any provision in your contract for a readjustment in the light of subsequent legislation?

Mr. NORRIS. No, sir; there is not only no adjustment provision, but if we make a gain, we expect you will take it back in taxes. If we are short, it will be our own hard luck.

Mr. KNUTSON. The Government will take it if there is a profit?

Mr. NORRIS. Yes, sir. In that connection, I feel that the legislation is discriminatory to people who were, for instance, supplying parts to the Navy. There will be some manufacturer, we will say a steel company, producing something like angle iron. A steel company in delivering iron for a battleship will be subject to the profit limitation, but, if at the same time, someone is furnishing angle iron to some other purchaser, he is not subject to that profits limitation.

I will say this at this time: My business is one of those businesses that was an individual proprietorship and was only recently incorporated. The reason it had to be incorporated was that the income-tax laws were so severe there would have been no money left with which to expand the business.

Mr. DISNEY. How recently was it incorporated?

Mr. NORRIS. Only April 1 of this year. All the business I have ever secured has been on a strictly competitive basis. I have not had that handed to me at all. The fact of the matter is, I have had to overcome handicaps because of our location in Los Angeles. The majority of this munitions material that we are making is being delivered right back on the Atlantic coast, and the raw materials originate there. In spite of that, over a period of 10 years that I have been in business, I have been able to average a percentage of better than 40 percent on my investment—better than 40 percent. Those profits were not taken away from anybody, the Government, or any of my customers. They got their money's worth. They got as good merchandise as they could get anywhere. They got it at the right price. They got it under competitive conditions. My labor was as well paid as other labor was paid, and I received a satisfactory return.

My point is that those profits are a measure of the efficiency of the organization and the ability of that organization, and they do not constitute an excess profit.

Under this proposed legislation, the most favorable provision would allow a return of 10 percent on the invested capital. That might be all right for a concern which had not earned 10 percent before, but what it does is, it constitutes a penalty on efficiency. It is going to tax me much heavier than the inefficient, overcapitalized concern, which cannot make that money under the same conditions.

Senator KING. And you propose to rectify this inequality of inefficiency as against efficiency, skill and ability?

Mr. NORRIS. Yes; my proposal is the elimination of the 10 percent provision, which is proposed in the Treasury plan, and that the excess profits should start at the point where they exceeded the earnings during the previous year.

The next point is that the earnings which I have made have all been reinvested in my business. They have been put right back in there. They have not been taken out. I have not squandered them. I do not own any yachts or anything like that. And with that, I have built up a business which is in a position to serve the Government at the present time.

With the tax which is now proposed, it would have been impossible to do that. The earnings would not have been available. They would have been taken away in view of the higher return which we have made on the capital investment.

Mr. KNUTSON. Is it your thought that the proposal, if put in effect, would hinder rather than aid expansion?

Mr. NORRIS. Very definitely so. I am talking now with reference to the excess-profits tax as proposed. I am not talking about the amortization plan.

Mr. KNUTSON. I am talking about the excess-profits tax.

Mr. NORRIS. Yes.

Mr. KNUTSON. Based on your own experience, do you say that you are of the opinion that it will definitely cripple expansion?

Mr. NORRIS. Very definitely so. It will take a large percentage of my earnings which I would otherwise use for this purpose.

And when I speak for myself, I am also speaking for every small, efficiently operating business organizations, where the principal stockholders are the managers of the business. They are in there running it.

Mr. KNUTSON. Have you examined the alternative that is presented?

Mr. NORRIS. One alternative that was presented was that we would be permitted a credit equal to the average fixed earnings for a 4-year period. In other words, if we had earned $100,000 a year for 4 years, as an average, we would be permitted $100,000. But, of course, that does not take into consideration the growth of the business, and the relative size of it at the end of the 4-year period as compared with the previous period.

Mr. KNUTSON. In other words, then it would have an adverse effect on comparatively new industries, as contrasted with old, established concerns.

Mr. NORRIS. Yes, sir; that is exactly my point. I feel I represent that type of concern.

I know that there have been meetings in the last 2 weeks in Los Angeles of the small businesses engaged in supplying parts and doing machine work and grinding, and other work of that type for the aircraft industries. I have been at those meetings, and I have heard the purchasing agents of the Douglas Co. and of the Lockheed Co. tell those men, "We want you to put in additional equipment. We want you to expand. We will guarantee you the business. We need your help on this thing."

But what are these fellows going to do? On what are they going to expand if these profits are taken away from them?

Mr. KNUTSON. In other words, then, the Government is not leaving anything to plow back into the business.

Mr. NORRIS. I would say that they are leaving something.

Mr. KNUTSON. Well, something but not enough.

Mr. NORRIS. Not enough. I feel that—and this is my personal opinion, which may be entirely at variance with others'—but I feel that the amount of revenue which is going to be received from this excess-profits tax is hardly enough to justify the risk of holding back the defense program. I feel that concerns like mine are the ones most particularly needed on this thing. We get out and we do things quickly. We do not have to have a board of directors' meeting and a stockholders' meeting, and all that sort of thing. We do the thing right now. We do not have the delays that these large corporations have.

Mr. BOEHNE. You stated, Mr. Norris, that in your opinion this bill as proposed would not give you enough for any accretions to your invested capital after you take your earnings for the base period. Under the alternative plan, reading from the report, the amount so arrived at, being the average earnings for your base period, shall be increased by 8 percent of the additions to capital occurring after the beginning, and so forth, and decreased by 6 percent for any reductions.

Do you think that ought to be increased?

Mr. NORRIS. You mean that the amount which would be considered not subject to the excess-profits tax would be increased by 8 percent of the additional investment?

Mr. BOEHNE. Eight percent of the additional invested capital.

Mr. NORRIS. Of course, that gets right back to the same thing. You are going to allow 8 percent on the reinvested capital going into a business that has been earning 40 percent under strictly competitive conditions.

Mr. BOEHNE. Eight percent does amount to something.

Mr. NORRIS. Oh, there is no argument about that.

Mr. TREADWAY. Is it fair to ask you how many stockholders you have in your company?

Mr. NORRIS. Myself and my wife.

Mr. TREADWAY. I do not wish to be personal in this but——

Mr. NORRIS. Just myself and my wife; that is all.

Mr. TREADWAY. The family is in control then?

Mr. NORRIS. Yes.

Mr. TREADWAY. You heard the testimony of the gentleman preceding you?

Mr. NORRIS. Yes, sir; I did.

Mr. TREADWAY. How did you like his suggestion to take care of a case like yours?

Mr. NORRIS. I did not like it at all. He is going to put me right back into an individual proprietorship.

Mr. TREADWAY. In other words, instead of having the dividends paid you, which was the method suggested and then you paying a higher income tax, you would rather keep the profits, or you and your wife would keep the profits, and put them back into the business?

Mr. NORRIS. That is right. When the time comes, that the profits are not needed in there to expand the business, there are existing laws which will require us to declare them out, and then we will pay the income tax upon it.

Senator HERRING. I understand you to say that you have been making 40 percent on your capital?

Mr. NORRIS. Yes, sir.

Senator HERRING. And you are not satisfied to make 40 percent out of this defense program?

Mr. NORRIS. I did not say that.

Senator HERRING. Well, you are not content with that; because you are allowed to take your earnings over the base period, are you not?

Mr. NORRIS. I did not say that. Under the Treasury plan——

Senator HERRING. There is an optional plan; you have the option of another plan, you know.

Mr. NORRIS. I did not understand there was such an optional plan which would permit me to figure on 40 percent on my currently invested capital.

Senator HERRING. Not on your currently invested capital, but based on your earnings over the 4-year base period. You would be allowed that.

Mr. NORRIS. I did not understand that.

Senator HERRING. That is according to the bill as originally introduced.

Mr. NORRIS. I thought that that provision was that we would be permitted a flat amount of earnings equal to the earnings—some amount like $100,000; but that would apply regardless of the increase in the capital investment.

Senator HERRING. That amounted to 40 percent on your invested capital, according to your statement.

Mr. NORRIS. That is right; that is, 40 percent of the invested capital; not on the capital investment now. It might amount to less than half of that on the currently invested capital.

Senator HERRING. Would you not be satisfied with 40 percent based on your former earnings, and then 8 percent on the increase of your invested capital? You would not be satisfied with that?

Mr. NORRIS. I am not saying that I would not be satisfied; no.

Senator HERRING. You are proposing something else.

Mr. NORRIS. I am only proposing this—well, as an illustration, the best illustration I can make——

Mr. DISNEY. If you and the Senator will allow me to interrupt; he would have to go into the matter of invested capital and average earnings at the time; this is a newly formed corporation. He would come under the invested capital provision because he has no other alternative, for the reason that his is a newly formed corporation.

Senator HERRING. I did not know that that provision had been changed; under the 4-year base period provision, he could go back to 1936 to 1939. Were you not in business at that time?

Mr. NORRIS. Yes.

Mr. DISNEY. But as an individual. Under the proposal suggested now, he would not have any alternative, because he has no base period as a corporation. He organized his corporation in April.

Senator HERRING. I see.

Mr. MCCORMACK. Mr. Norris, I can see your point with reference to Mr. Dewey's suggestion, you and your wife being the stockholders of the corporation. It is a family type of corporation, and 90 percent of our businesses started out in that way. That is very commendable. But if you had 1,000 stockholders, you could see where you might be interested in his proposition?

Mr. NORRIS. If there were no single large stockholder, or no single stockholder holding too large a percentage of the stock.

Mr. MCCORMACK. As an alternative proposition, while it would not appeal to your corporation, nevertheless you would have no objection to a plan of that kind as an alternative which might blend in with the organization of a number of other corporations which may not be in the same organizational form as yours.

Mr. NORRIS. I would have no objection, as long as there was an alternative and I was not bound by it.

Mr. DISNEY. Are there any other questions, gentlemen? Have you finished your statement, Mr. Norris?

Mr. NORRIS. I started to illustrate one point here that I hoped to bring home. That is, take two corporations, one of them with a half million dollars capital and the other with a million dollars capital. We will assume that both of them sell the same amount of the same item at the same price, and each winds up the year making $100,000 apiece. We will assume that the $1,000,000 corporation previously has earned 10 percent, or in excess of 10 percent, of its invested capital. Under the proposed plan, that corporation would not be considered to have made an excess profit. But the small corporation, doing the same work, selling the product at the same price and making the same product, would be severely penalized.

I feel that that is not an equitable situation. And that is multiplied when you get into the percentages that apply as against my business.

Mr. MCCORMACK. Mr. Norris, the only observation I want to make is that, in the consideration of an excess-profits tax, there is no such thing as equity. It starts out being inequitable. About all you can do is to make it as equitable as possible, having in mind that the origin of the whole proposal is inequality.

Mr. NORRIS. Of course, in that respect, I get back to what is the purpose of an excess-profits tax. As I first read about it in the newspapers, the purpose was to prevent a crop of war millionaires, presumably on the theory that, because the facilities were going to be taxed to the limit, competition was going to be lessened or eliminated, and people were going to be able to get more for a job than it was worth, and that we were going to try to do that. If I did that, I would still be subject to an excess-profits tax.

I am only arguing that the profits that I have made in the past are a measure of the efficiency and ability of my concern, and do not represent excess profits.

Mr. MCCORMACK. I recognize the power of your argument, and I am not disagreeing with you. I completely agree with you. But I simply made the observation, as a personal observation, as to how we must approach this bill. There is something more involved than the creation of war millionaires. There is a question of the gouging of the public, where we are changing from a peacetime to a war economy. Broader aspects are involved.

I simply wanted to make the observation that a proposal of this kind, in its origin, is inequitable. If you were a member of this committee and were trying to pass as equitable a law as is humanly possible, and obtain the objective desired, when the original suggestion is based on inequality—and you must understand that I am not drawing any adverse inference from your testimony; but if we took care of every individual case, much as we would like to, and we would have no excess-profits-tax law at all. All we can do is to try to have as fair a law as is possible. That is why I think the suggestion of Mr. Dewey meets a very, very important gap in this law.

Mr. NORRIS. I felt this way. The United States Steel Corporation, I felt, would present their view of it. If I did not present mine, in behalf of people who are in the situation such as I am in, you gentlemen might not have all the facts on which to base your fair decision, which I am sure you are going to make.

Mr. MCCORMACK. I think you ought to be complimented, and it would be a fine thing if all businessmen were to appear before legis-

lative committees to present their views. We were talking about inequalities. There has got to be a measure of equality even within inequalities.

Mr. NORRIS. It is a relative term, you mean.

Mr. MCCORMACK. Yes.

Mr. KNUTSON. Is your business all war business?

Mr. NORRIS. No, sir. My business is not built on that at all. I am a manufacturer of all kinds of metal parts; automobile parts, cosmetic containers, water-heater parts, anything anybody wants made out of metal. We do not make any products of our own. We are a manufacturing concern doing a strictly contracting business.

At the present time this war business does represent the major portion in dollars and cents. But I have to look ahead to the time when that will be quite different. As far as the equipment is concerned, with reference to some of this equipment that we have to install, it is entirely special. It would have no value for general commercial use. We have to gamble on further business.

That is one other thing I would like to bring home: that when we bid on these jobs, and we get a contract, it is going to run a year or a year and a half, but we have no assurance that we are going to get any more business after that. We have to go out and bid for it competitively, to get it. And we are taking the biggest risk.

The CHAIRMAN. Are there any further questions? We thank you for your appearance, Mr. Norris.

Mr. NORRIS. May I file this statement, which I had intended to read in the beginning, but did not owing to the fact that questions started immediately.

The CHAIRMAN. Without objection, the statement may be filed.

(The statement filed by Mr. Norris is as follows:)

NORRIS STAMPING AND MANUFACTURING CO.,
*Los Angeles, California, August 12, 1940.*

Mr. CHAIRMAN AND MEMBERS,
*House Ways and Means Committee,*
*Washington, D. C.*

I appreciate the opportunity of appearing before this committee in connection with the proposed legislation covering excess profits, amortization of special equipment installed for defense contracts, and related matters. We will be vitally affected by the legislation which is finally adopted. For 2 years we have been manufacturing ordnance materials for the Navy Department and at the present time we have large contracts for such materials for both the Army and the Navy. Our current contracts require substantial expansion of our facilities involving the question of amortization of special equipment.

All of the business which we have ever secured, whether for the Government or commercial business, has been secured on a strictly competitive bidding basis and there has been plenty of competition. We have had to compete with concerns located throughout the United States and have had to overcome handicaps due to excessive transportation costs resulting from our unfavorable location. Such competitive conditions would, naturally, result in holding our profits in relation to selling price to a relatively low level but by doing an annual volume of business running five to eight times our invested capital, our average earnings have been in excess of 40 percent on invested capital. These earnings are in no way attributable to defense contracts awarded to us since the start of the so-called emergency, but represent strictly normal profits resulting from efficient management, ingenuity, and hard work.

REINVESTMENT OF EARNINGS

The profits have all been put back into the business and it is only through this reinvestment of earnings that the business has grown. I know that there

are thousands of small and medium-sized concerns the growth of which is dependent entirely upon the reinvestment of earnings. Generally speaking, concerns of this type are managed by the principal owners and I believe on the whole represent the most progressive and most efficient group of business organizations.

This group is definitely needed for rapidly carrying out the defense program. Firms of this type can and do move quickly and get things done, but the owners of such businesses generally are not willing to reduce their percentage of ownership by bringing in outside capital. Consequently these firms can grow only by reinvestment of earnings.

Newspaper reports indicate that the amount of revenue expected from an excess-profits tax is relatively small when compared with the total Budget, but this tax will greatly retard the entire defense program by preventing the most efficient and progressive organizations from expanding out of earnings.

### WHAT ARE EXCESS PROFITS

Assuming, however, that some form of excess-profits tax is finally considered necessary, then this tax should apply to real excess profits, should be equitable to all sizes and types of corporations and should not constitute a penalty for efficiency. The purpose of the proposed excess-profits tax is to prevent the creation of war millionaires, presumably on the theory that higher than normal profits will be realized because producing facilities will be used to capacity and competition will be lessened or eliminated. Profits made under such conditions might properly be called excess profits, but I contend that any profits made, regardless of the rate of return on invested capital, not in excess of profits realized during a highly competitive period, are not excess profits but are merely a measure of the ability and efficiency of the concern earning such profits.

The plan which I understand was proposed by the Treasury Department would permit corporations to earn on currently invested capital the average rate of return obtained during a base period 1936 to 1939, inclusive, but such profits would be limited to 10 percent on the invested capital. Another plan proposed would permit earnings equal to the average annual earnings for the base period. The first of these methods takes no cognizance of the variation in normal earning capacity resulting from the efficiency of the management and would severely penalize companies turning their capital several times annually and at the same time exempt overcapitalized companies. The second method does not take into consideration the growth of the business and the increase in the capital investment. I contend that the limitation of 10 percent on invested capital in the Treasury Department's plan should be eliminated and that no profits should be considered as excess profits unless they are actually in excess of normal profits computed either on a basis of the return on invested capital or in relation to volume of sales.

I would like to compare two corporations, one having an invested capital of $500,000 and the other having an invested capital of $1,000,000, both companies selling the same quantity of the same item at the same price and each making a profit of $100,000. The rate of return on the investment in the case of the smaller company is 20 percent and with the larger company 10 percent. Assuming that the larger company had earned 10 percent or more on its investment in a base period, then under the plan proposed by the Treasury it would not be subject to the excess-profits tax, but the smaller concern would be heavily taxed. Certainly this would be a very unfair situation and one which would discriminate against the progressive, efficient, and well-managed companies, the very ones which are most needed for promptly carrying out the defense program.

### VINSON-TRAMMELL ACT

The Vinson-Trammell Act limiting profits on any complete naval vessel or portion thereof or Army or Navy aircraft or portion thereof, discriminates against one group of suppliers. It presumes that a contractor knows in advance what his costs will be, whereas this is certainly not true with respect to nonstandard items. It requires that the contractor take the risk of loss, it limits the profit which he can make if he comes out as well or better than expected, but it guarantees no profit. It has to a certain extent restricted competition, particularly with respect to subcontractors, many of whom refuse to take a subcontract subject to this act.

If an excess-profits tax is passed, the Vinson-Trammell Act should be made inoperative not only with respect to new contracts but also with respect to any contracts previously entered into and now being carried out. When we took the Navy contracts which we now have we took into consideration the fact that the Vinson-Trammell Act applied, but we certainly did not anticipate a further penalty in the form of an excess-profits tax.

AMORTIZATION OF SPECIAL EQUIPMENT

Newspaper reports indicate that a special equipment installed for defense purposes may be amortized over a period of 5 years. The provisions for amortization of equipment should be very liberal. I am sure that any contractor would be willing to distribute the cost of equipment over any reasonable period of time if he had any assurance of business for that period. In our case the contracts which we have bid on have required approximately 15 months to fulfill. We have to gamble that there will be future business. To encourage manufacturers to increase facilities, the Government should reduce this gamble to a minimum.

Actually, it will make little difference in the amount of revenue which the Government will receive in taxation whether the equipment is charged off in 3 or 5 years. Assuming that equipment was charged off over a 3-year period and the contractor continued to secure contracts for an additional 2 years, the Government would automatically receive the benefit of a reduced price due to the elimination of depreciation charges or would collect in taxes the major portion of any excess profit which the contractor might make.

On the other hand, if the contractor installs the special equipment for one contract, charges off 20 percent during the first year and then does not secure additional business, not only his profits are wiped out but he would stand a substantial loss on the entire transaction.

I would like to summarize my statements as follows:

1. The amount of revenue anticipated from the proposed excess-profits tax does not justify taking the chance that the entire defense program may be greatly retarded by preventing efficient organization from expanding out of earnings.

2. If an excess-profits tax is passed it must not penalize small and medium-sized efficient organizations with minimum capital investment.

3. Any profit made, regardless of the rate of return on invested capital, not in excess of the profit realized during a normal base period should not be considered as excess profits.

4. If an excess-profits tax is passed, the Vinson-Trammell Act should be made inoperative with respect to all uncompleted contracts as well as all new contracts.

5. The provision for writing off special production facilities installed for defense purposes should be as liberal as possible so as to encourage the installation of such equipment and eliminate the possibility that the capital invested in such facilities would be wiped out by the passing of the defense emergency or the failure of the contractor to secure additional orders after completion of the original contract.

Respectfully submitted.

K. T. NORRIS,
*President, Norris Stamping & Manufacturing Co.*

The CHAIRMAN. The next witness is Mr. L. M. Benedict, representing the Merchants & Manufacturers' Association of Los Angeles, Calif.

## STATEMENT OF JAMES C. INGEBRETSEN, WASHINGTON REPRESENTATIVE, LOS ANGELES CHAMBER OF COMMERCE

Mr. INGEBRETSEN. Mr. Chairman, I am the Washington representative of the Los Angeles Chamber of Commerce. Mr. Benedict is indisposed, and has asked me to present his statement to you. Mr. Benedict's statement was prepared by him as a representative of a group of small Los Angeles manufacturers, most of whom are engaged in the production of aircraft accessory parts.

This is a short statement, and I should be glad to read it or file it for the record, as you desire.

The CHAIRMAN. Would it be satisfactory to you to insert it in the record for our study?

Mr. INGEBRETSEN. That would be satisfactory to me.

Mr. CROWTHER. Mr. Chairman, in view of the fact it is a short statement, I suggest that the gentleman be allowed to read it.

Mr. INGEBRETSEN. I shall be very glad to read it. I would like to say, the fact that I am reading the statement does not necessarily indicate that it expresses the viewpoint of the Los Angeles Chamber of Commerce. I am simply doing this as a personal favor to Mr. Benedict.

The CHAIRMAN. You may proceed.

Mr. INGEBRETSEN. Mr. Chairman, I am reading Mr. Benedict's words.

(Mr. Ingebretsen read the following statement:)

AUGUST 12, 1940.

To the WAYS AND MEANS COMMITTEE,
*House of Representatives, Washington, D. C.*

Mr. Chairman and gentlemen of the committee: I am here as the representative of a large number of small corporations in and near Los Angeles which fear that the excess-profits-tax measure now under consideration may, unless great care is taken, place an undue and possibly fatal burden upon small, new businesses.

I am not a tax expert and am not prepared to discuss the legislation in technical details. As a matter of fact, I had not intended asking a personal appearance before the committee. This was arranged while I was en route from Los Angeles in an exchange of telegrams between the committee chairman and Mr. Paul Shoup, president of the Merchants and Manufacturers Association of Los Angeles. Mr. Shoup, as you all know, was for many years president of the Southern Pacific Railroad and is one of the business leaders on the Pacific coast. In wiring Chairman Doughton, Mr. Shoup said:

"Our organization, 40 years old, representing 1,600 principal business institutions this area has among its members great many small-business men who are much disturbed over both Treasury and joint committee formulas for excess-profit tax, former being more disastrous than latter. Both subject to criticism, being involved in detail using as measure for exemption capitalization and earnings under prior and very different conditions, failing to take into consideration volume and turn over in business as related to capital invested. They feel not sufficient recognition given value of management which is vitally important both in war defense and other business activities. Too much tendency to measure situation on basis of invested capital alone whether wisely made or not. Also that program distinct deterrent to growing lines of business."

In another communication on the subject, Mr. Shoup said that the suggestion among many small-business men in Los Angeles was that the tax situation be dealt with simply by raising the ante in the present tax law and placing a profits limitation on Government armament contracts. Mr. Shoup gave it as his own opinion that "there is, of course, a very real value to the thought that all lines of business are familiar with the present tax measures and the rulings arising therefrom, and there would be less additional work and less confusion if familiar ground is not departed from, except as necessary."

As I have said, I am not a tax expert and I shall only attempt to convey some of the apprehension southern California businessmen feel over this legislation, together with their suggestions for making the bill equitable.

May I say right here that there is no opposition in California or elsewhere on the Pacific coast to the proposed special taxes to meet preparedness expenses. All businessmen are agreed that extra taxes are necessary to finance American security and everyone is more than willing to do his share. The only question raised—the only possible difference of opinion—is over the method to be used.

The principal fear is that the proposed tax bill may, by unintentional discrimination, make it difficult if not impossible for many young and small but growing businesses to remain in business and expand. This fear is felt, especially, in the case of companies which do not need a great deal of money to operate and so have low capitalization.

They feel that a corporation which has been in business for only a year or a few years should be given an opportunity to continue to grow at its present rate until it has achieved solid, mature stature. It may be fair to hold an old, well-established business which has reached the limit of its expansion to an average earnings base for tax purposes, but in the case of a young corporation struggling to make good such a plan would mean stagnation or perhaps ruin. Who would invest money in a new business venture which, in addition to the usual hazards, was limited to an excess profits exemption of 8 or 10 percent on capital invested?

Such a formula would seem absolutely to preclude any new industry getting started. The aviation industry in southern California and throughout the Nation would not have attained its present growth had it been shackled at the outset by a tax such as is here proposed. The automobile industry could not have been developed under such a tax policy.

We feel that a tax based upon invested capital would be most unfair to corporations honestly capitalized only for what money they actually need in their business. Such companies would be severely penalized while concerns with high, even though fictitious, capital structure would receive preferential treatment amounting to a cash tax bonus. We all know of companies which have included in their capital set-up excessive valuations and appraisals for inventory, land, buildings, good will, patents, worthless accounts receivable and other items of little or no real value and contributing nothing to the conduct of the business. The Federal Government, through the Securities and Exchange Commission and other agencies, has attempted to put an end to this practice and encourage legitimate capitalizations. Now comes a tax bill which may, it is feared, encourage capital stock padding or even necessitate it. Corporations are not likely to follow sound, conservative stock policies if, by putting in all possible capital items, they can hold down their tax burden.

Under the invested capital theory a company capitalized at $50,000 may, by good management, earn as much money as a competing corporation capitalized at $250,000, only to be penalized for its efficient effort through being required to pay more taxes—this inequity resulting from the tax base figured on so-called capital investment. This seems to put a premium on inefficient management and overcapitalization. If Congress and the administration wish businessmen to set up their corporations with the highest possible amount of capital, so that their earnings in percentage will be small, it seems to many that a very harmful condition in industry will be the outcome.

Believing that taxes should be based upon actual profits in dollars and cents, many corporations in southern California would favor raising the rates of the present Federal tax law for the defense money needed by the Government. Some would support a straight transactions tax, with the Government taking a percentage out on the profits of each business deal.

A major suggestion of the small-business men of southern California—

I understand this has been taken into consideration by the subcommittee report, which was not before Mr. Benedict when he prepared this statement [continuing with his statement]:

A major suggestion of the small-business men of southern California is that an average percentage of profits to invested capital over a period of years be adopted as the rule for determining excess profits, instead of a lump-sum averaging of net earnings. Such a formula would give a company the opportunity of making the same average earnings as in the past several years. It would produce the revenue desired with fairness to small companies and at the same time prevent profiteering. It would enable young businesses to pay their just share of defense taxes without losing their incentive to grow.

To many it would seem, as stated by Mr. Shoup in his telegram to Chairman Doughton, that the sensible and simple thing would be for Congress to up the ante in the present tax law, place a profits limitation on armament contracts, and let matters go at that. This would raise the money required without making millionaires out of the Nation's defense needs. It would fill the bill without discrimination, at least any new discrimination, and with a minimum of confusion. Every businessman is familiar with the present tax law and has his bookkeeping attuned to it. It would get at excess profits just as well as the method under consideration.

It is suggested, in the case of new companies just starting and companies which have been operating at a loss the past few years, that a flat sum credit of $50,000 be allowed before excess-profits taxes would apply. This would give life blood to a surprising number of corporations which are just beginning to see daylight, due to new conditions, but which face continued dark prospects under the tax plan proposed.

In a general sense, what the small-business men of southern California ask is that careful consideration be given to the tax problem of the small, new business with low capitalization, to the end that this class of business shall be given reasonable encouragement and opportunity to live and grow.

No need is seen for haste in connection with the excess-profits-tax measure, since the amortization feature could easily be lifted and put through Congress as separate legislation.

Businessmen on the west coast are only just now having a chance to study the report of the subcommittee, headed by Mr. Cooper, and the request is respectfully made that a few more days at least be allowed for filing briefs before the Ways and Means Committee proceeds to the actual task of writing a bill. If opportunity is given, it is believed that specific suggestions with reference to the proposed legislation will be forthcoming from the Merchants and Manufacturers Association, the chamber of commerce, and other Los Angeles business organizations and from individual business leaders.

The committee's courtesy in permitt' ; this presentation is very greatly appreciated.

Mr. BOEHNE. Of course, you stated there that that statement was prepared before Mr. Benedict had an opportunity to see the subcommittee's report.

Mr. INGEBRETSEN. That is my understanding.

Mr. BOEHNE. And in the subcommittee's report, they give this alternative plan about which he speaks.

Mr. INGEBRETSEN. Yes, sir.

Mr. BOEHNE. With reference to the average base earnings.

Mr. INGEBRETSEN. I understand that.

Senator HARRISON. Mr. Chairman, in this connection, I received a letter from Senator Downey, of California, asking that I present for the record or have read, a letter which he encloses from the Aircraft Parts Manufacturers Association.

The CHAIRMAN. We shall be very glad to have it read or receive it for the record, just as you wish, Senator.

Senator KING. I suggest that the letter and the statement be read.

The CHAIRMAN. I am sure there is no objection to that.

Senator HARRISON. Senator Downey's letter is as follows:

UNITED STATES SENATE, *August 6, 1940.*

HON. PAT HARRISON,
*Chairman, Finance Committee, United States Senate,*
*Washington, D. C.*

DEAR SENATOR HARRISON: I herewith enclose a letter dated August 2, 1940, from the Aircraft Parts Manufacturers Association, a California organization, relevant to the pending hearing on the excess-profits law. The arguments and statements in this communication appeal to me and I would be deeply appreciative if you could have the letter read to the joint committee upon its hearings on the proposed excess-profits tax law.

I would, likewise, appreciate it if you would communicate to the members of the committee my own idea that it may prove unfair and burdensome to the smaller business groups participating in the defense program if their earnings exempted from the excess-profits tax are limited to $5,000. In my own opinion, this limitation is entirely insufficient, and I hope a figure of approximately $50,000 may be written into the law.

I think all of the members of the committee will concede that any small business, especially at its beginning, faces extreme hazards and uncertainties with the utmost probabilities of failure and losses, that the possibility of profit and gain

should be commensurate with the risk involved, and that no great tax loss could accrue to the Government or any large social maldistribution of wealth result from the proposed exemption of $50,000.

Sincerely,

SHERIDAN DOWNEY.

The statement of the Aircraft Parts Manufacturers Association, sent to Senator Downey, is as follows:

AIRCRAFT PARTS MANUFACTURERS ASSOCIATION,
*Los Angeles, August 2, 1940.*

Hon. SHERIDAN DOWNEY,
*Senate Office Building, Washington, D. C.*

DEAR SENATOR DOWNEY: It would be presumptuous on the part of a layman to point out the importance of American national defense at this time. The efforts of all administrative departments of the Government as well as those of every patriotic American are unanimously expended in endeavoring to meet the demands of national rearmament. Probably no means of defense faces a more tremendous period of expansive production than that of the aviation industry. Press reports tell of a series of conferences existing between executives of major aircraft companies and officials of various governmental agencies with a view to speeding up production and formulating necessary legislation to conform with anticipated conditions.

Here on the west coast, which we are proud to consider the major center of aviation, the phenomenal growth of the aircraft industry has created a growing activity in aircraft parts processing and manufacturing. Today this important branch of the aviation industry must be considered, not only as an integral and necessary factor in national defense, but as the subsistence of a hundred small companies with their thousands of stockholders, employing approximately 10,000 persons.

The Aircraft Parts Manufacturers Association recently was organized from this group for the purpose of cooperating with governmental agencies, aircraft manufacturers, and other interested bodies, in keeping its members informed of regulations, conditions, and hazards akin to the industry. There can be no question regarding the attitude of these suppliers on American national defense. They are unanimous in expressing their desire to serve in building up an American defense superior to any in the world. In this connection, many have gone much further than the requirements of military regulations in respect to fingerprinting of employees, installation of factory guards, elimination of undesirables, etc. We feel safe in saying that the aircraft parts manufacturers stand ready to cooperate with the military services in any program to further the cause of national safety. They do feel, however, that their existence as an industry is an important element in carrying out the plans of national rearmament. And in this respect we hear alarming reports regarding proposed tax measures now being drafted which may place an excessive and discriminatory burden on corporations which are young and just beginning to develop.

The aircraft-processing industry in reality is a group of specialized trades serving the major aircraft companies—machine shops, plating companies, and precision manufacturers of all kinds. Many are new in business. Only indirectly engaged in military work, usually small in capital, and lacking Washington representation, the aircraft processor often is unaware of the legislations and regulations affecting him. In such a position, these small-business men are not consulted and are uninformed as new legislation is drafted. Consequently our information as to the effects of the proposed legislation, which has been gathered from various sources, may be at variance with the facts. In this, we hope you will bear with us.

The information we have indicates that profits in excess of 8 percent of capital investment, after a $3,000 exemption, are to be considered excess, the alternative being to accept the experiences of the last 3 or 4 years as average. Few persons will deny the justification of profit limitations in times of national emergency, but this type of legislation appears to place an unreasonable burden upon the new companies who are increasing their capital conservatively as needed in sound development and who have not as yet had opportunity to build up a stable earnings record for a fair basis of evaluation.

The aircraft-parts industry is exceptional in this regard and faces the unusual situation of having little experience or precedent from which to gage its future policies. 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 unforseen contingencies occur. Machines formerly operated 8 hours a day often are in use 12, 18, or even 24 hours a day. Accepted methods of depreciation become pure conjecture and costs can be only roughly estimated.

A fair and equitable return is one of the prime requisites of the investor and it may be critical for the aircraft subcontractor, under strict profit limitation, to find himself in the position of having to choose between work involving economic hazards and uncertainties, and work for other industries requiring his output.

The alternative providing for acceptance of 3 out of 4 years' experience as reasonable profits may be discarded insofar as most aviation subcontractors are concerned. Many are new corporations, small in capital, struggling to establish themselves on a firm basis while those who have been engaged in aviation for a period of 3 or 4 years, have suffered the pains of experimentation and changing conditions precluding any reasonable return on investment.

One of the major economic problems facing the aircraft supplier today is that of expansion. While reasonable and early expansion must be considered in the speeding up of national-defense production, necessary financing will be difficult if not impossible if excessive taxes are placed upon aviation investors. The alternative of borrowing for such expansion appears unlikely if loans are not to be considered as capital investment. In this connection, such a stipulation seems discriminatory against the small-business man with limited assets inasmuch as his larger competitor may borrow on outside assets and invest it in his business, thereby enjoying a larger measure of tax exemption.

We feel sure that the intent of the proposed legislation is to provide a reasonable control on profits over all business, both large and small, without discrimination. However, the aviation industry, and more particularly the small-parts manufacturer whose capital is limited, will be forced to carry an exceptional burden because of the competition and immaturity of the business. Unless special provision is made for such companies, it is feared that many of them will be taxed out of existence, thrown on the mercy of creditors, or, at least, denied normal opportunity to expand at a time when their progress is of great importance to the national welfare.

No doubt various alternatives will be suggested. One may be the exemption of those companies under a certain capitalization who are engaged in national-defense work, or the exemption of companies who have not shown a reasonable profit during the past 3 years, with average percentage of earnings in invested capital over a period of 3 years to be used as the basis for determining excess profits for those who have served aviation during this period instead of a fixed average of net earnings as proposed. In this way, the increased capital of a small business during the last year or two would be taken into consideration permitting that business to make the same percentage of earnings on its increased investment each year.

The Aircraft Parts Manufacturers Association boasts no representation in Washington, nor are we in a position to verbally present the case of the subcontractor before the committee which will discuss the bill.

We do feel, however, that the cause of the "little fellow" will be championed by those who are in a position to scrutinize proposed legislation in its early formation. We are appealing to you to consider these facts when the bill reaches the Senate committee and would appreciate your keeping us informed as to its progress. We also respectfully request an opportunity to present a brief outlining the position of the aircraft parts processor when the bill is in the stages of serious consideration.

Respectfully yours,

AIRCRAFT PARTS MANUFACTURERS ASSOCIATION,
JACK FROST, *Secretary.*

The CHAIRMAN. The next witness on the calendar is Maurice Thorner. You may proceed, Mr. Thorner.

## STATEMENT OF MAURICE THORNER, LOS ANGELES, CALIF.

Mr. THORNER. Mr. Chairman and gentlemen of the committee: I am a member of the bar of Massachusetts and of California.

It is my suggestion that the following amendment be incorporated into the newly proposed revenue law dealing with excess profits now under discussion by your honorable committee:

In the case of any corporation engaged in the mining of rare minerals (which term may be specifically defined in the section relating to definitions), the portion of the net income derived from the mining of said rare minerals shall be exempt from the tax imposed by this title, and the tax on the remaining portion of the net income shall be the same proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income.

Or:

In the case of any corporation engaged in the mining of antimony, platinum, tungsten, quicksilver, tin, molybdenum, and manganese the portion of the net income (derived from the mining of said metals or minerals shall be exempt from the tax imposed by this title, and the tax on the remaining portion of the net income) shall be the same proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income.

Mr. CROWTHER. May I interrupt you for a question?

Mr. THORNER. Yes.

Mr. CROWTHER. You do not include gold in that list?

Mr. THORNER. I have deliberately omitted gold.

Mr. CROWTHER. The previous act did not apply to gold.

Mr. THORNER. That is very true, and in my argument I shall touch upon that.

Congress and the administration by the adoption into law of the Strategic Minerals Act in June 1939, last year, have definitely committed themselves "to encourage as far as possible the further development of strategic and critical materials." The avowed purpose of that law was to encourage and stimulate the exploitation, development, and production of these rare minerals within the territorial limits of the United States. The very language of the act, in section 1, declares this to be the stated policy of the Government, and the act specifically provides not only for the purchase and accumulation of these strategic minerals, but imposes upon the Bureau of Mines and Geological Survey certain duties with regard to the discovery and development of these substances found in the United States "which are essential to the common defense or the industrial needs of the United States, and the quantities and grades of which are inadequate from known domestic sources, in order to determine and develop domestic sources of supply."

In pursuance of that act the Army and Navy Munitions Board in 1939 defined "strategic materials" as "Those essential to the national defense for the supply on which in war dependence must be placed in whole or in part on sources outside the continental limits of the United States, and for which strict conservation and distribution control measures will be necessary.

Failure to exempt the production of these rare minerals from the excess-profits-tax provisions will virtually nullify the Strategic Minerals Act. If as a nation we are to be freed from the necessity of relying upon importations to supply our vital needs of these metals then it is of the first importance that no further tax load be placed upon this infant industry. The search for these new mineral deposits has already received some impetus from the Government by the Strategic Minerals Act, but there is grave danger that the advantages

gained thus far will be lost unless the proposed amendment is adopted. Its adoption will give the further necessary stimulus to discovery, exploitation, and production of rare metals in the United States and thus outweigh any slight loss of revenue that may result from the exemption. It is the judgment of some of the most eminent mining engineers in the country that the necessary mineral deposits are here, that the United States can be self-sufficient with regard to these rare minerals, but that exploitation and production will tend to dry up and new-venture capital discouraged if the tax burden is increased at this time. On the contrary, the granting of the exemption would act as a magnet to attract new capital for the discovery and exploitation of these rare mineral deposits

Mr. DINGELL. Mr. Chairman, may I interrupt for a question?

It is your suggestion that these rare minerals can be produced sufficiently in this country?

Mr. THORNER. That is the opinion of many mining engineers.

Mr. DINGELL. Do you think the country can be made self-sufficient in the matter of the supply of tin?

Mr. THORNER. That seems to be the one single mineral about which there is question.

Mr. DINGELL. And I wish the record to show that is one mineral that we will not be able to supply and that is as essential as any single mineral on the list.

Mr. THORNER. I agree with you.

Mr. DINGELL. And we cannot exist without it.

Mr. THORNER. That is quite right.

A backward look at the experience of our country during the World War would not be amiss. As a result of the intensive submarine warfare and the commandeering of shipping we found ourselves under the necessity of speeding up our industrial production for the prosecution of the war. The steel industry, upon which we place so much dependence for war preparations, found that it was unable to obtain sufficient supplies of manganese, tin, platinum, tungsten, antimony, and vanadium. We were almost dependent upon the outside world for these vital supplies. Delay, inefficiency, and confusion resulted to such an extent that ultimately the Army and the Navy were obliged to lower their specifications for military and naval equipment, and the insufficient supplies of these strategic minerals had to be rationed to consumers under strict regulation. Let us learn and benefit from experience and so arrange our economy that we may no longer be dependent upon others in times of crises.

While the strategic mineral situation since the World War has undergone some change for the better, more especially with regard to nitrates, potash, and molybdenum, it has in certain other respects deteriorated further and it is still fraught with great danger for us from the standpoint of national defense. Because of the rapid increase of alloys in the last 30 years, we are more than ever dependent upon foreign sources of supply for manganese, tungsten, tin, quicksilver, platinum, and antimony. Any action of Congress now in putting an additional burden upon the limited capital engaged in this highly essential mining activity would have the immediate effect of limiting and curtailing development and production work and would effectively repel new and much-needed capital. These strategic minerals are the lifeblood of the steel industry, which requires an ade-

quate and continuous supply of them, and instead of depending upon Europe and Asia and Africa for these supplies we should be bending every effort to develop our own resources.

To exempt these rare minerals from the operation of the excess-profits tax would be strictly in accordance with the precedent established by Congress during the World War. The excess-profits tax laws in effect during 1917 to 1922 exempted profits derived from the mining of gold. See section 304 (c) of the Revenue Act of 1921, which provided:

> In case of any corporation engaged in the mining of gold the portion of net income derived from the mining of gold shall be exempt from the tax imposed by this title.

Mr. CROSSER. Did you have any specific objective in removing gold from the effect of this statute?

Mr. THORNER. Yes; I think we have. I think it is obvious to everybody that gold requires no special treatment at this time.

Mr. CROWTHER. Because of the quantity of gold in storage?

Mr. THORNER. The pot of gold on hand.

Mr. CROWTHER. The pot of gold in Kentucky.

Mr. THORNER. Yes. The situation then, in 1922, was in some respects analogous to the present situation. It was the desire of Congress during the World War to stimulate and encourage the production of gold. It was apparent then that if the gold-mining industry were subjected to the additional burden of excess-profits taxes, on top of normal corporate taxes, that the production of gold would be adversely affected. Excessive taxes would have meant that the mines producing gold would have closed down in order to await a better tax atmosphere.

Mr. CROWTHER. Does not the price of gold stimulate the production?

Mr. THORNER. Yes; it puts more mines in operation. A mine closed down is not a wasting asset. It will be there years hence and may be reopened and work resumed at a later time, when the tax situation is such as to encourage the investment of capital. While no one would suggest today that there is any compelling reason for stimulating the production of gold, the "rare minerals" are very much in the same position that gold was in 25 years ago. In fact, from the standpoint of utility and strategic necessity the analogy ends there, because anyone conversant with the industrial situation will readily concede that these rare and startegic minerals are well-nigh indispensable in this highly mechanized age.

And third: Those who are engaged in the production of these rare minerals have no wish or desire to avoid their fair share of the national burden of taxation at this time. Those companies with net earnings in excess of $25,000 a year will be subject to the normal corporation tax of 20.9 percent plus capital-stock tax plus whatever State corporate taxes may be levied. A further burden of taxation in addition to the present load will, in the opinion of many in the industry, result in the shutting off of production and perhaps in higher prices, in view of the increased difficulty of obtaining these supplies from abroad.

Mr. COOPER. Dr. Crowther has another question.

Mr. CROWTHER. In addition to the taxes you mentioned we now have an excess-profits tax in the existing law.

Mr. THORNER. I have taken that into account.

Mr. CROWTHER. You do that?

Mr. THORNER. Yes; and just by way of digression I might give you an illustration that I am familiar with. We worked for years in an effort to develop tungsten property up in the high Sierra Mountains. Not until this year, not until January of this year, were we able to get into production. The company, consequently, has no background of earnings; nothing at all. We must look to the invested capital, and the invested capital, let me say, will be something around $100,000. and in 1940 the chances are that it is going to earn $100.000, after these years of development.

Now, if this proposed law is enacted, this company is confronted with the necessity of paying something like 21 percent, plus 1 percent more for capital-stock tax, or 22 percent. plus 4 percent to the State of California, plus 40 percent under this proposal, or 66 percent, or, let us say, an average of 60 percent.

In other words, instead of continuing to produce, the company will curtail its production. And that is a typical case. The same thing is true of most of the corporations in the rare-mineral industry.

Fourth: Conceding that the primary function of a revenue law is to raise money for the Government needs, it is our contention that the exemption of income derived from the "strategic minerals" will have very little effect, if any, on the gross revenues derived under the proposed bill. During 1938, according to figures issued by the Bureau of Mines, the total value of these minerals, produced in the United States, was approximately $20,000,000 as against a total value of all metal produced of about $1,000,000,000. If it is assumed that the average net profit on such production is about $5,000,000 the Treasury experts will agree that at least one-half of that amount would be attributable to individuals and not corporations. As to the other half, $2,500,000, it can readily be seen that after normal corporate taxes are deducted that the net corporate profits remaining, subject to excess-profits schedules, would be almost negligible. On the contrary, to exempt this industry, is much more likely to increase the revenues from the normal corporate tax of 20.9 percent because of the increased production brought about through the attraction of new capital.

It is fair to say that most of the corporations in this field are under-capitalized, so that a company getting into production after all of these years of effort has no favorable background of earnings and instead of trying to pay this tax will curtail its production.

Now as a matter of fact, the revenues of the Government will be very much less affected by the granting of this exemption than they were during the World War when the "gold" exemption was incorporated into the law. During those war years the average annual production of gold was about $75,000,000. Comparing that figure with the probable total value for the current year for all "rare metals" in the United States, or about $30,000,000, it must be obvious that from the point of view of loss of revenue this exemption cannot reasonably be objected to.

In conclusion I wish to say that this amendment has the support of the entire industry, all over the country. It is the consensus of opinion among mining engineers that with the aid of the Depart-

ment of the Interior and the Treasury Department, working under the Strategic Minerals Act, and the encouragement that would be given as a result of the exemption sought in this amendment, that in a few short years the United States would be completely self-sufficient with respect to these minerals. This will not only assure us of increased production and lower prices, but will put us in an impregnable position from the standpoint of supplies in promoting our national defense.

I wish to submit a statement, which I shall not take the time to read outlining the rare minerals referred to; also a letter addressed to Senator Downey by E. T. Stettinius, Jr., of the Advisory Commission to the Council of National Defense on this subject.

The CHAIRMAN. Without objection it will be made a part of the record.

(The statement referred to follows:)

SCHEDULE A

Antimony is used principally as an alloying element to alter the physical properties of lead and tin. Domestic production of antimony ore runs from nothing up to a thousand tons per year. Imports average about 10,000 tons yearly, the ore coming most from Mexico and the metal from China.

Platinum is produced in Alaska, California, and Oregon, the 1938 production in the United States being valued at about $2,000,000.

Tungsten is indispensable for high-speed tools; also finds important uses in hard-faced articles like valve seats and for incandescent lamp filaments. From 1925 to 1934 the average production in the United States was a little under 500 short tons of contained tungsten, and for the last 5 years it has averaged 1,200 tons. It is produced in California, Arizona, Nevada, Utah, and Colorado. China has been the chief source of our imports and during the past 5 years our imports have averaged about 1,400 tons annually. The 1938 domestic production was valued at about $4,000,000.

Quicksilver or mercury is used principally in making industrial and pharmaceutical chemicals, in pigments and in fulminates. The 1939 production in the United States consisted of about 18,000 flasks (about 76 pounds each) valued at about $2,500,000. Importations, principally from Spain and Italy, have been averaging about 13,000 flasks per year. Produced in California, Nevada, Oregon, Arizona, Arkansas, Idaho, and Texas.

Tin: The United States consumes half of the world's supply of tin and yet we produce far less than 1 per cent of our needs, the imports coming principally from the Dutch East Indies and Bolivia.

Molybdenum is produced in Colorado, Arizona, New Mexico, and Nevada.

Manganese ore is used predominantly to make alloys for the steel industry. During 1939 our production of manganese ore (35 percent or more manganese, natural) was about 28,000 tons, and during that same year we imported about 300,000 tons from Russia, the Gold Coast of Africa, India, Cuba, and Brazil. Our production comes from Alabama, Arkansas, Georgia, Montana, New Mexico, Tennessee, Utah, Virginia, Washington, and West Virginia, with Montana and Tennessee contributing the largest part of it.

THE ADVISORY COMMISSION TO THE
COUNCIL OF NATIONAL DEFENSE,
FEDERAL RESERVE BUILDING,
*Washington, D. C., July 30, 1940.*

The Honorable SHERIDAN DOWNEY,
*United States Senate, Washington, D. C.*

MY DEAR SENATOR: Mr. Knudsen has forwarded me your letter of July 24, addressed to him, together with accompanying letter from Mr. Maurice Thorner, of Los Angeles.

I can readily appreciate the tax problem that might confront the small mining companies with rapidly expanding programs. I trust that the recommendations from the Treasury Department will give due consideration to such companies with low capitalization, as well as to those operating at comparatively

low profits during the past few years, to the end that the proposed tax program may not limit the production of the essential mineral requirements for national defense.

As requested, I am returning herewith Mr. Thorner's letter to you.

With kindest regards,

Sincerely yours,

E. T. STETTINIUS, Jr.

Mr. CROWTHER. You spoke of concerns having a great deal of difficulty after experimenting in research for a number of years.

Mr. THORNER. Yes.

Mr. CROWTHER. In fact, it is difficult to get capital to go into this line, is it not?

Mr. THORNER. Very difficult.

Mr. CROWTHER. Someone has said there has been more put into the ground than there has ever been taken out.

Mr. THORNER. I think that is true; there is no question about that.

I might add, Mr. Chairman, that I listened to the testimony given by Mr. Dewey a little while ago and while that was the first time I had heard the proposition advanced, and while I have not had time to give it careful study, at first blush I would say it is fine. I think it is an excellent idea. As a matter of fact, if some such idea were incorporated into this law I do not think I would have flown 3,000 miles from Los Angeles to tell you my story.

Mr. COOPER. Mr. Treadway has a question.

Mr. TREADWAY. Do I understand that you approve of what Mr. Dewey said?

Mr. THORNER. I do.

Mr. COOPER. We thank you.

Mr. THORNER. Thank you.

## STATEMENT OF ROBERT H. STRANGE, BOSTON, MASS.

Mr. COOPER. The next witness on this calendar is Robert H. Strange. How much time will you require?

Mr. STRANGE. Not more than 5 or 10 minutes.

Mr. COOPER. You are recognized.

Mr. STRANGE. For the record my name is Robert H. Strange, of Boston, Mass.

I have a half ownership in an Alaskan nickel mine; and I also have other mining interests in the West.

Several months ago in its study of idle men and idle money the TNEC noted the dearth of venture capital in this country.

That dearth, the dearth of venture capital, is related to the taxation theory. I propose to show the tangible connection wherein taxation may tend to curtail such venture capital.

I have been following mining ever since I was 14 years old. I have looked over 500 mining deposits in the West. I have seen 1 mine come through, at Mountain City, Nev. When I first went there in 1932 there were only 3 men living in Mountain City. Today there are over 1,200 men employed in the mine. Further employment is provided on the railroad, at the smelter in Utah, and at the smelter and refinery in Connecticut. That is 1 mine that has really paid dividends to a cross-section of American industry. It results in the employment of good proportion of the people in the State of Nevada. If my father had not had the faith in mining that he has

and if he had not put the money in the mine, it would probably still be a mere hole in the ground.

Now, behind this story you have a group of hard facts. The odds against discovery of new mines are very high. In order to maintain the mining industry we need constant new mineral discoveries. This involves a large group of prospectors working in the hills. We need money to provide capital to back up those mines. Say out of 100 properties examined by a mining engineer you get 5 or 6 perhaps that are worth further exploitation and if 1 of those 6 properties comes through it may be a worth-while investment. But it is necessary for you to have a high rate of return on that 1 property.

Now, if you are going to lower the earnings ceiling through an excess-profits tax the scope of activity in the development of more mines is accordingly going to be curtailed. Now, we say the rate is 6 mines out of 100 which are worth further exploitation. If you have to cut that down to three in 100 that results in lowering the rate of employment, and consequently a loss to the mining industry because we do not have enough mines—enough new mines coming up.

That is a tangible case that I have stated. For this reason I am opposed to an excess-profits tax. That is a tangible case of the inequity of the taxation.

The CHAIRMAN. Mr. Dingell wishes to ask you some questions.

Mr. DINGELL. Did you hear the testimony given by the preceding witness, Mr. Maurice Thorner?

Mr. STRANGE. Yes; I did.

Mr. DINGELL. In which he made reference to the availability of rare minerals?

Mr. STRANGE. Yes.

Mr. DINGELL. And he seemed to predicate his position on certain proposals of the committee with regard to applicable taxes.

Mr. STRANGE. Yes.

Mr. DINGELL. He said it might restrain activities and prevent the development of all these needed minerals.

Mr. STRANGE. Yes.

Mr. DINGELL. I challenged him upon the question of the availability of tin and he admitted that tin was one exception.

Now I am led to believe, from what I learn and know about available metalliferous minerals in this country, that mining of very few of the minerals, such as manganese and chromium and tungsten and other similar minerals, will be induced by a method of taxation; in other words, there is nothing that can be done that is visible, at least within the next decade, to relieve the situation, because there is no abundant undeveloped supply of these metals in America.

What is your opinion of that statement?

Mr. STRANGE. Development mining is largely unpredictable. For instance, I have an interest in a quicksilver mine in Oregon which has just come through in the last year. That mine is producing quicksilver at the rate of 500 flasks a month and they are installing equipment that may provide a means of stepping up production to 9,000 flasks a year. Domestic consumption runs around 30,000 flasks annually.

Mr. DINGELL. How much is there in a flask?

Mr. STRANGE. Seventy-six pounds. Now, that mine was entirely out of the picture until 2 years ago, that is to say, it was largely unproductive.

Mr. DINGELL. A statement of that kind, linked with taxation, would hardly have any real effect, would it?

Mr. STRANGE. Yes; I think it goes directly to it. I think there is a definite relationship between the discovery of new mines and the number of prospectors in the field.

When my father went out West at the end of the last century or the beginning of this century there were men in Nevada and Utah and in various Western States who were out there in the hills chopping off rocks and bringing back their samples. Now today you find very very few men working at that.

Mr. DINGELL. But the tax question has no bearing on stimulating that, does it?

Mr. STRANGE. Oh, yes; it does. It definitely does.

Mr. DINGELL. In what way?

Mr. STRANGE. Those people need to be grub-staked.

Mr. DINGELL. How is that related to the excess-profits tax?

Mr. STRANGE. Well, the persons who grub-stake those prospectors; provide tools for them to go out and discover mines.

Now if they figure that the earnings ceiling on the expected mining operations are going to be cut down they will have to be more discriminating in their grubstaking and developmental expenditures.

Mr. DINGELL. There is no immediate proposal to the law, is there, that would figure in that if this tax feature is not applicable?

Mr. STRANGE. But I think it would be in getting people interested in mining.

Mr. DINGELL. I cannot see it. I do not think the argument holds good that this tax proposal, if it is adopted, is going to eliminate the chances of mine discoveries of the rare minerals.

Mr. STRANGE. If I did not have funds available to grubstake prospectors in the West then I could not carry on those activities. If developmental funds are not available this will restrict other mining activities in the West.

Mr. DINGELL. We might concede the point you make about prospectors discovering the mines, but how will that effect the development of these rare minerals.

Mr. STRANGE. It is only through the work of these people that the mines are discovered.

Mr. DINGELL. You mean through pick and shovel?

Mr. STRANGE. Yes; they are found through a very tedious process.

Mr. BOEHNE. Who furnishes the funds for these prospectors?

Mr. STRANGE. Largely through individuals; there are very very few prospectors financed by corporations. They are staked largely by individuals.

Mr. BOEHNE. You mean the money comes from individuals?

Mr. STRANGE. Largely from individuals.

Mr. BOEHNE. But this proposed legislation does not apply to individuals.

Mr. STRANGE. No; it could not.

Mr. BOEHNE. They are exempted, are they not?

Mr. STRANGE. But you cannot own a mine until it has been discovered, until the mine comes into existence, and you have to grubstake the individual, the prospector, to go out and discover the mine.

Mr. BOEHNE. Then I understand you to say this: That the persons who are interested in grubstaking are those who spend their personal money?

Mr. STRANGE. Yes.

Mr. BOEHNE. And you might have 100 prospects, but only one of the entire group will be worth anything. And you mean that a corporation then is organized to operate the property.

Mr. STRANGE. Yes. As a matter of fact, they may take over the six. Various methods are used, depending upon the type of mine and the total expenditures necessary. If I could find a mine that I could develop all by myself I might do it, but if I found a mine that I could not develop financially I would have a corporation.

The CHAIRMAN. We thank you. Are there any questions?

I have received from Mr. J. W. Hooper, one of the witnesses who appeared before the committee on Saturday, a statement relating to the proposed draft for consolidated returns, requested by one of the members.

That will be made a part of the record.

Also, I have herewith a statement from Stephen T. DeLaMater enclosing a copy of suggested solution of the amortization problem. Without objection, that will be made a part of the record.

Also, a statement from Martin Popper, secretary of the National Lawyers Guild, Washington, D. C., relative to the pending legislation. Without objection it will be included in the record.

Also, a statement from the Rochester Chamber of Commerce relative to the pending legislation. Without objection, it will be included in the record.

(The statements referred to follow:)

J. W. HOOPER,
BROOKLYN CHAMBER OF COMMERCE.
*Brooklyn, N. Y., August 10, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Committee on Ways and Means,*
*House of Representatives, Washington, D. C.*

DEAR MR. CHAIRMAN: When I appeared before your committee today on behalf of the Brooklyn Chamber of Commerce, you stated that I should submit draft of a provision relating to consolidated returns such as I believe might properly be included in the proposed new tax law.

I have been reviewing the provision of section 141 of the present law and the simplest suggestion I can make is that this provision be adopted with the following changes:

Section 141 (d)—change the present wording "95 percent" to "a majority of" in paragraphs (1) and (2).

Omit paragraph (3) which limits consolidated returns to railroads (thus making the provision applicable to all corporations).

Subsection (j) would be omitted (being no longer applicable under the amendment of the Revenue Act of 1939).

Insert a new provision (j) as follows:

"(j) In any case in which a consolidated return is filed for excess-profits-tax purposes for any taxable year, the determination of average earnings and invested capital for the years 1936, 1937, 1938, and 1939 shall be made as if the members of the affiliated group had been thus affiliated in the same relationships as existed for the taxable year.

I have recommended in my presentation to the committee, under the heading "Alternate basis for tax" (second paragraph, p. 3), the creation of a board authorized to give special relief. Among the cases upon which such a board shall be empowered to act should be the granting of special relief in each case in which a stock relationship is not indicative of the real affiliated situation existing between corporations closely affiliated through securities other than capital stock.

In order to effectuate the practical application of the foregoing, the repeal of the present excess profits and capital stock tax provisions is called for as recommended in my statement to the committee at today's hearing.

In submitting this proposal I have not had the benefit of conference with your staff and I do not know what particular thoughts they may have with respect to any of these points, but I believe there should be no serious difficulty in agreement regarding all important features if the provision recognized is one of broad equity to give the right to file consolidated returns in all cases in which an affiliated group of corporations might reasonably elect so to do.

It is inconceivable to me that the matter of finding language to express a mechanism of operation should stand in the way of granting to the taxpayer a course of action so necessary to the fair determination of taxable income for excess profits and normal income-tax purposes. To advance such an explanation as the reason for delay in getting on with the defense-tax program is equally difficult to understand.

Respectfully submitted.

J. W. HOOPER.

JWH/rsm

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AUGUST 7, 1940.

Representative DOUGHTON,
*Chairman, Ways and Means Committee,*
*House Office Building, Washington, D. C.*

DEAR SIR: Herewith enclosed you will find a copy of Suggested Solution of the Amortization Problem. This was mentioned in our previous article of July 11 as forthcoming.

We understand that a public hearing on this subject is to be held on August 9 and it is requested that this be considered at that time.

Very truly yours,

STEPHEN T. DELAMATER.

## SUGGESTED SOLUTION OF THE AMORTIZATION PROBLEM

### (Second Article)

It is estimated that the aggregate of amortization allowed the taxpayers as deductions from income by reason of expenditures for World War activities was over $2,000,000,000, on an estimated expenditure of $5,000,000,000. The present program for preparedness will entail a much greater amount, although the Government may supply a larger proportion of the capital required than was supplied during the World War. It is apparent, therefore, that the question now under consideration is one of vast proportion and not to be too hastily considered.

The amortization provision of the tax law in World War days was very brief. It merely provided that in the determination of taxable income there be a reasonable allowance for amortization of the cost of facilities acquired for the production of articles contributing to the prosecution of the war. The responsibility for interpreting the law was placed on the Treasury Department.

The interpretive regulations of the Bureau of Internal Revenue, promulgated from time to time, set forth general rules for the guidance of the Government engineers in determining the reasonable allowances for amortization but in the actual determination of such allowances very many questions arose; it gradually became necessary to formulate policies in the amortization section for the further uniform guidance of the engineers.

It was incumbent upon the taxpayer to clearly establish what facilities were acquired for war work, the exact cost thereof, the possible post-war value or "value in use" as it was termed, or the scrap or sale value, and thereby arrive at the amount which should be allowed as amortization.

It was the duty of the Government engineers to verify the data presented and recommend allowances or disallowances in accordance with their findings.

The result was many disagreements, endless conferences, many reinvestigations by other Government engineers, many appeals, and many compromises.

The contemplated law to provide for the amortization of the cost incurred by industry in providing adequate national defense at this time should be more definite than was the former law and the regulations should be more detailed.

In our opinion any law which is passed, governing this subject, should not arbitrarily fix time as a basis for the spread of amortization allowances. The reasons for this statement are readily understandable.

Some of the following statements are axiomatic. However, they are repeated to clarify the issue. The reason for taking a Government contract is made up of X percent patriotism and Y percent profit. We shall let the reader assign his own value to these variables. If a capital expenditure is necessary for the fulfillment of a contract, and no provision is made for the return of this capital to the investor, the Y or profit variable can very easily become nil. Even though the capital is returned by way of an amortization allowance which is deductible from income, if this deduction is not allowed to be applied in the right period, Y may still be nil. The time or period when the deduction is needed is the time when production and sales, and consequently income and taxes, are high. That is to say, industry should be permitted to apply amortization allowances when the capital expenditures are producing, or against income derived from these expenditures. It would seem that such a basis is necessary to give equitable relief.

To illustrate: If a contract is awarded to build 1,000,000 articles and it should take 2 years' time to acquire and install the facilities necessary for production, and then only 1 additional year to make the million articles, it is in that year that the income would be derived. It would seem obvious in this case that the taxpayer needs relief in the third year. Income on that particular contract has been zero for the first 2 years. In fact, operations may have been conducted at a loss. Amortization during those years is worthless.

On the other hand, the source of revenue from which the Government must pay for its defense program is taxation. Amortization cannot be used as a cloak by industry to deprive the Government of a fair and equitable tax. There must be an equitable balance arrived at, so that the burden shall fall on all equally and does not exact an unjust toll from those willing to invest to aid defense measures.

In order to efficiently handle the many problems which arise in connection with this subject, it is our opinion that a separate authority should be set up in the Treasury Department, the functions of which should include, among other things, a review upon specific request, of any pending Government contract for supplies or materials of any nature whatsoever and for the execution of which capital expenditures are necessary. The purpose of this review would be to:

First. Decide in advance whether any specific contemplated capital expenditure is of such a nature as to fall within the scope of the proposed amortization provisions. The tests for this would be:

(*a*) Is the expansion out of line with the normal growth of that particular industry, or does it reflect a normal plant expansion?

(*b*) Is the expansion necessary to fulfill a specific contract with any governmental department?

(*c*) Is the expansion necessary to fulfill a subcontract?

(*d*) Is the expansion necessary to fulfill a service to a contractor or subcontractor? This would include public utilities, common carriers, etc.

(*e*) Has amortization of the cost of facilities already been provided for in the contract or specifically included as an element of the cost of the product? If so, a certification should be obtained from the new authority which would be honored by the Bureau of Internal Revenue and preclude further allowances

Second. Decide in advance, in cooperation with the individual contractors, the basis for determining the amount of amortization to be allowed. This would, of necessity, weigh the following factors:

(*a*) Salvage value.

(*b*) Value in use in postemergency period.

(*c*) Relationship of the articles produced to the normal production.

Third. Decide in advance, with the contractors, the basis for computing the amount of amortization allowance applicable to any particular time. This would take into consideration:

(*a*) Number of units to be produced.

(*b*) Dollar value of units to be produced.

(*c*) Nature of units to be produced.

Further duties of the authority would be the promulgation of regulations setting forth the policies of the authority in connection with items enumerated above. It would include the preparation of special regulations for such special cases as might arise which are not now apparent.

In some cases contracts will be completed in shorter time than originally contemplated and in other cases contracts will not be completed within the estimated time. It may develop that the emergency may end sooner than now believed and that contracts will be canceled. It may be that we shall become actively engaged in war, in which event the use of the facilities provided for national defense will be continued much longer than originally contemplated. All of these factors, and many others, must be considered in the determination of the allocation of the amortization allowance. Provision may have to be made for adjustment of prior year taxes in the event of such changes.

As indicated above, the cost incurred, and which has been determined as amortizable, is not necessarily allowable in full as a deduction. At the end of the emergency some of the acquired facilities will be scrapped and there will be salvage value. Some facilities will, no doubt, be continued in use, possibly to a lesser degree of capacity, and will have a going value or value in use. The amount of amortization to be allowed should be the amortizable cost less the salvage or residual use value. This allowable amortization should be spread as hereinbefore indicated.

Facilities that are salvaged present few difficulties in determining the amount of amortization allowable. If, however, the facilities remain idle or are continued in normal use and are not essential to defense, proper consideration must be given in the final analysis if these factors have not been previously considered. It may be that appraised value should be set up and restated as income at the date they go into use in other than defense work; such restated values being subject to regulations normally enforced for ordinary capital expenditures.

In the opinion of the writers it is doubtful that any scheme can be worked out which would properly solve the amortization problem and at the same time completely eliminate the necessity for investigation and verification by Government engineers. A highly desirable object to accomplish is the formulaton of such regulations and policies, in advance, as will reduce to a minimum such engineering investigation.

It is thought that the formation of a separate authority as above discussed will go along way toward harmonizing the various viewpoints and supplying the incentive to industry to wholeheartedly participate in the defense program, and with its own capital.

FRANK FISHER,
*Former Chief of Engineers, Amortization Section, Bureau of Internal Revenue.*
STEPHEN T. DELAMATER,
*Former Chief of Amortization Section, Bureau of Internal Revenue.*

NEW YORK, N. Y., *July 25, 1940.*

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NATIONAL LAWYERS GUILD.
*Washington, D. C., August 8, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Committee on Ways and Means,*
*House of Representatives, Washington, D. C.*

DEAR CONGRESSMAN DOUGHTON: The subcommittee considering excess-profits tax legislation has reported a proposal to repeal the profit limitations set up in the Vinson-Trammell Act of 1934, and in the so-called Navy Speed-up Act of June 28, 1940, which imposed an 8 percent profit limitation on ship and aircraft contracts. Your committee has tentatively approved a 5-year amortization provision which would be coupled with the excess-profits tax bill. These concessions to industry are being made, it seems, because of the demands of industry.

The National Lawyers Guild advocates legislation to eliminate all excess war profits. Until the enactment of such legislation it will continue to oppose the repeal of the Vinson Act and the Vinson-Trammell Act and favors their extension to all manufacture of munitions and war materials. The last convention of the guild went on record in favor of obtaining funds for essential defense purposes by "the adoption of a corporate 'abnormal-profits' tax desig-

nated to tax the annual profits of corporate enterprises in excess of their normal profits, exempting therefrom corporations earning no more than $25,000 per year."

There is no justification for eliminating the profit limitations now applicable to contracts for vessels and aircraft. The Vinson-Trammell Act was passed in 1934, at a time when Government orders were relatively slight, compared with the huge appropriations made during 1940. This profit-limitation legislation sought to reduce the cost of armaments to the Government while granting the producer a liberal profit. The original limitations were 10 and 12 percent. These were reduced to 8 percent in the so-called Navy Speed-up Act of June 28, 1940. Surely no one will deny that 8 percent is a reasonable rate of profit. Congress has, in fact, so determined. Especially is this so in view of the colossal expenditures which the Government is now making.

It is obvious that the cost of defense to the Government will mount if the profit limitation is abandoned. Nevertheless industry is ready to strike against defense plans until it is allowed to squeeze enormous profits without limitation. Already some $15,000,000,000 have been appropriated for defense. Without the profit-limitation legislation, more billions will be required. At a time when demands are being made to cut social services to the bone, it comes with ill grace from those who are given stupendous Government contracts to demand their pound of flesh, while clamoring that the country rearm with the greatest speed.

The National Association of Manufacturers is now demanding an immediate amendment to the tax laws to permit defense manufacturers the 5-year depreciation period without waiting for the enactment of the excess-profits tax measure. Tax experts on our committee on taxation state that the usual and normal write-off for depreciation and obsolescence is approximately 16 years. Let us not forget the revelations of the Nye Munitions Investigating Committee. In its report to the Senate in 1936 the Nye committee said of experiences in the last war:

"A strike is a stoppage of production in order to gain certain demands. The term has generally been applied to the actions of labor, but the committee has pointed out that in time of war corporations and industries can and will take a course of action which is really a strike by industry against the Government."

Industry is striking and refuses to build and expand plants for national defense unless favorable terms are extended with respect to amortization. This extraordinary demand is based upon the argument that the end of the war would result in idle plants. The argument is fallacious. A German victory will mean rearming for America for many years, while a British victory could only come after a long war, during which enormous armament orders would come from abroad. There is therefore no justification for allowing a 5-year period for depreciation.

It is apparent that if such extraordinary rates (20 percent) of depreciation are allowed, the paper profits of such corporate enterprises will be very substantially reduced and the imposition of a tax on excess profits will yield little revenue. This serves to explain why the National Association of Manufacturers is so anxious to have the 5-year depreciation period written into the law without further ado.

The recently enacted Defense Act saddled the low-income groups with a heavily increased tax burden. Income taxes have been levied on annual incomes as low as $800. Excise taxes have been sharply increased. Up until now the entire burden of defense is being loaded onto the backs of those who can least afford it. The consumer, labor, and the farmer are asked to sacrifice for defense, while industry is sacrificing defense.

It should also be pointed out that for several years, at the specific request of industry and the Army and Navy Departments, Congress has refused to pass legislation making it mandatory for corporations and individuals contracting with the Government to conform with the provisions of the National Labor Relations Act. Industry demands huge profits as its price for patriotism, while labor is deprived of rights granted by law. The proposal of the Subcommittee on Ways and Means falls in line with and gives further encouragement to these undemocratic demands. It can engender very little faith among the people that national defense is to be carried out in a democratic spirit and in a manner best calculated to achieve real national unity.

The National Lawyers Guild respectfully urges a change of policy consistent with the suggestions made above. Please include this letter in the record of the hearings.

Respectfully yours,

MARTIN POPPER, *Secretary.*

## 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 expenditures 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 of legislation 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 possessed 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 admitting 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-denfense purposes.

Respectfully submitted.

ROCHESTER CHAMBER OF COMMERCE,
WARREN S. PARKS, *President*,
ROLAND B. WOODWARD, *Executive Vice President*.

(At 12:25 p. m. a recess was taken until 2 p. m. of the same day.)

AFTER RECESS

The committee reassembled, pursuant to the taking of the recess, at 2 p. m., Hon. Robert L. Doughton (chairman), presiding.

The CHAIRMAN. The next witness is Mr. Alfred Jaretzki, Jr., of New York.

Will you give your full name, your address and the capacity in which you appear to the reporter.

## STATEMENT OF ALFRED JARETZKI, JR., OF SULLIVAN & CROMWELL, NEW YORK, N. Y.

Mr. JARETZKI. My name is Alfred Jaretzki, Jr. I am a member of the law firm of Sullivan & Cromwell, of New York, and am appearing on behalf of a group of investment companies of the so-called "closed-end" type.

First, let me say that my clients and I appreciate the importance in this national emergency of prompt action on the proposed tax legislation. We do not wish unnecessarily to add to the burdens of this committee, but in view of the serious effects upon investment companies of the proposed tax—which we believe was not intended by the committee—I felt that we had no alternative but to appear and urge our views upon you. What we suggest can be accomplished in a very simple manner.

My purpose is to ask for exemption from the proposed excess-profits tax of diversified investment companies registered under the Investment Company Act of 1940. The proposals in the report of your subcommittee now under consideration already exempt so-called "open end" or mutual investment companies but do not exempt "closed end" investment companies. The failure to exempt "closed end" companies of the diversified type further aggravates an already existing unfair and burdensome situation.

During the past several months I have represented a substantial portion of the "closed end" investment company industry in formulating jointly with the Securities and Exchange Commission, under the auspices of the Senate Committee on Banking and Currency and the House Committee on Interstate and Foreign Commerce, proposals for the regulation of investment companies. These proposals, jointly recommended to the Senate and House committees by the Securities and Exchange Commission and my group, received the endorsement of both committees and the bill so recommended was passed by the House on August 1 and by the Senate 1 week later.

In recommending this legislation both the Senate and House committees dwelt upon the importance of investment companies to the national economy, particularly as a means of affording to the small investor an opportunity for diversification of risk and of securing expert management through the pooling of his funds with those of others. In its testimony before these committees, the Securities and Exchange Commission called attention to the serious tax problem already affecting investment companies of the diversified closed-end type, even without an excess-profits tax, and concern was expressed in this regard by these committees.

For as a result of the taxes imposed on these investment companies, the shareholder of small income is required to pay, directly or indirectly, taxes at rates far greater than would be applicable to him if he invested directly in the underlying securities. I quote from the report of the Committee on Interstate and Foreign Commerce:

> Representatives of the Securities and Exchange Commission in connection with the bill and members of the industry who appeared at the hearings called the attention of the subcommittee to the serious tax problem affecting investment companies. This problem has already been recognized by the Congress in the case of certain open-end management investment companies which receive special tax treatment under existing Federal revenue acts. The record before the committee indicates that the tax problem is very pressing with

respect to closed-end management investment companies of the type classified in this bill as "diversified." If the bill is passed, the committee believes that the tax problem of these companies should receive prompt consideration by the Congress.

Similar language will be found in the report of the Committee on Banking and Currency.

And yet, while the existing tax situation as affecting these companies and their stockholders is one for grave concern, the situation will be greatly aggravated if the proposed excess-profits tax is made to apply to this type of investment companies. This is not the appropriate time for agitating the whole question, but without prejudice to either side of it, an injustice can be avoided by not adding this still further layer of taxation. In other words, at the very time when the House and Senate have passed a bill to regulate investment companies and through this regulation to encourage their growth as a medium for investment on the part of a man of moderate means, there is proposed to apply to investment companies legislation which would make this growth virtually impossible, would penalize drastically the small investor, and would depreciate the value of his investment.

The best way to make this clear is by examining the position of the stockholder of the diversified "closed-end" type of investment company. The studies of the Securities and Exchange Commission show that in 66 representative investment companies, as a group, the average market value of the common shares held per shareholder in 1935 amounted to $1,774. These same studies show that approximately one-half of the common-stock holders of investment companies hold common shares with a market value of $500 or less. Therefore, it is certainly fair to assume that the typical shareholder in investment companies is a person of moderate means the range of whose personal income tax would be, say, 4.4 to 10 percent. (I may recall to your attention the fact that the Securities and Exchange Commission studies showed an estimated 1,500,000 security holders in investment companies of all types.)

Now to what tax burdens is this typical small stockholder of an investment company subject, directly and indirectly? First, investment companies must pay taxes at the regular corporate rate of 20.9 percent on their net income apart from dividends. The stockholder of the investment company, other than the "mutual," must pay his own income tax, say at 4.4 to 10 percent, when such income is distributed to him, notwithstanding the fact that such income has already been subject to the 20.9 percent tax.

And now it is proposed to place upon him the further burden of the excess-profits tax, an additional penalty on the small stockholder who seeks diversification and expert management through investment in a "closed-end" diversified investment company.

Now as to this additional burden of the proposed excess-profits tax. This will apply primarily to profits realized on securities held for less than 18 months. As has already been stated, such profits by an investment company under existing law would be subject to the normal corporate tax of 20.9 percent. The precise amount of excess profits on this item cannot be stated because that would depend upon the earnings base. Under the first proposed alternative the average

profits of this nature realized by the company during the years 1936 to 1939 would be deducted before the excess-profits tax would become applicable, but a preliminary survey indicates that it is not likely that such deductions would be substantial. What the base for calculation of credit under alternative 2 would be is not at all clear from the report, but it is doubtful whether such credit would be substantial. In the main it is believed that profits of this nature above a very modest amount would be subject to the excess-profits tax running up to 40 percent and averaging close to that amount. These two taxes of 20.9 percent and approximately 40 percent together would amount to something like 52 percent on the profit. Let me go back to the effect upon the small stockholder of an investment company. In the case of such a small stockholder, for every $100 of income derived from these sources through an investment company, the shareholder might benefit by only $48 whereas if the same $100 profit were made as a result of his own direct ownership of securities he would have from $90 to $96 net after paying taxes. I am sure that this result is not intended by your committee.

Insofar as the excess-profits tax is applied to the income or profits of an ordinary business, the tax falls primarily upon the regular earnings of the company. Any profits derived from the sale of capital assets held for less than 18 months would be of relatively minor importance. In the case of the investment company, however, the burden of the excess-profits taxation falls almost entirely on profits made from the sale of capital assets within this 18 months period. This results from the fact that the variation of dividend and interest income is not likely to be great, and that 85 percent of dividend income is excluded under alternative 1 and all dividend income is excluded under alternative 2. While there may be such a thing as a normal return or rate of return from the ordinary business, there is no such thing as a normal profit or rate of profit from sale of investments held for less than 18 months, and accordingly the whole conception of excess profits has no application to this type of profit. In years of declining security values there would be no net profits from this source, whereas in years of appreciating security values profits are to be expected. But aside from the fact that no reasonable yardstick can be obtained against which to measure a profit, these profits or losses, as the case may be, have no real relationship to the profits or losses of an ordinary business company in respect of which excess-profit taxes are conceived.

I have attempted the utmost brevity in my presentation to you of the foregoing considerations which lead to the conclusion that diversified closed-end investment companies should be exempted from the proposed excess-profits taxation. To summarize in a few words, they are (1) that such taxation constitutes an unfair addition to a discrimination already existing between the stockholder of a diversified "closed-end" company and the stockholder of a so-called mutual "open-end" company, (2) that the burden on the stockholder in the diversified "closed-end" company would be excessive, (3) that this excessive burden would prevent the growth of these companies and greatly impair, if not entirely destroy, their usefulness, and (4) that the conception of excess-profits taxation has no real application to investment companies, which perhaps accounts for the disruptive result

of such application. I believe the subjection of diversified "closed-end" investment companies to the excess-profits tax would be particularly unfortunate after these companies have undergone an exhaustive 4-year investigation by the Securities and Exchange Commission, after they have cooperated with the Commission not only in this investigation but in recommending to Congress legislation for their own regulation, after such legislation has been passed by both Houses upon reports by the Committee on Interstate and Foreign Commerce of the House and by the Committee on Banking and Currency of the Senate advocating such legislation as an encouragement to the further growth of investment companies which both committees have found to be an important part of the national economy, and after both such committees have called attention to the necessity of considering the already excessive tax burden under which investment companies now operate. I may add that I have discussed this matter with representatives of the Securities and Exchange Commission, and I am confident that if they were called to testify they would agree with these conclusions.

Mr. TREADWAY. I would like to have you define the two types of corporations you speak of as the open-end and closed-end corporation.

Mr. JARETZKI. The open-end company is a company the charter of which provides that a stockholder may at any time tender his shares of stock and receive the liquidating value of such stock, as a result of which there are constant liquidations which have to be offset by constant selling.

The closed-end type does not have this feature. A corporation is organized which issues stock as a block. There is no constant selling and no constant liquidation. Some investors prefer one feature and some the other feature.

Mr. TREADWAY. Is one more speculative than the other?

Mr. JARETZKI. No, sir. There is often confusion on this point. It is true that the open-end companies, in the main, do not have senior securities. The closed-end companies sometimes have senior securities.

That is a subject which was gone into at great length by the committees of the House and Senate to which I have referred and they have set up what you might call a standard form of company with senior capitalization.

Mr. TREADWAY. You spoke several times of other committees of Congress having passed on the question. Of course, they did not deal with the tax problem.

Mr. JARETZKI. What they have done is to call attention of Congress to the fact that there is a serious tax situation which confronts these companies.

Mr. TREADWAY. There is a very serious tax situation confronting the whole country.

Mr. JARETZKI. Yes; but there is this situation. An investment company is primarily a pooling of the assets of individuals, and the record shows that generally they are men of moderate means who find that they can obtain a diversification of their investments through the pooling of their assets and who find that with $5,000 or $10,000 they cannot buy 20 or 30 different stocks and get a diversification. But if a man puts his money in an investment company and

joins with others he gets a diversification and a part interest in all these securities. If in doing that he is subjected to this terrific tax burden, where he would have to pay taxes amounting to approximately 52 percent, compared with paying a tax of from 4 to 10 percent if he made an investment himself, if he cannot afford to invest through this medium, that type of company would go out of business.

It is purely a question for Congress to decide. Do you wish to encourage investment companies? Are they a valuable part of our economic structure? If so, do not tax them out of existence.

Mr. TREADWAY. Why should one be favored and not the other?

Mr. JARETZKI. I say they should not.

Mr. TREADWAY. I thought you were advocating the exemption of one type.

Mr. JARETZKI. No; I want the exemption of the mutual investment company to stay, and I want the diversified companies to receive the same treatment.

I am against discrimination. I would not for a minute advocate changing the status of the so-called mutual companies. I only ask that we receive similar treatment. I am not asking for any consideration as to the normal tax.

Mr. TREADWAY. As I understand it, this type of company that you represent pool their investments and pay dividends to the stockholders?

Mr. JARETZKI. Yes, sir.

Mr. TREADWAY. Those stockholders are, of course, taxed on the basis of their incomes?

Mr. JARETZKI. Yes.

Mr. TREADWAY. Therefore you consider that where they have a pool their investments should not be taxed in that pool.

Mr. JARETZKI. I look at it as if the investor himself were making the investment.

The CHAIRMAN. We thank you for your presence and the statements you have given to the committee.

The CHAIRMAN. The next witness on the calendar is Mr. Otis M. Shepard. Will you give your full name, your address, and the capacity in which you appear to the reporter?

## STATEMENT OF OTIS M. SHEPARD, NEW YORK, N. Y., VICE PRESIDENT, SHEPARD STEAMSHIP CO.

Mr. SHEPARD. Mr. Chairman, my name is Otis M. Shepard; my address is 205 East Forty-second Street, New York City. I am vice president of the Shepard Steamship Co., a New England corporation, with its office in Boston, Mass.

The Shepard Steamship Co. is a subsidiary of the Shepard & Morse Lumber Co., a concern which has been manufacturing and wholesaling lumber and forest products for more than 50 years.

The Shepard Steamship Co. for more than 10 years has been engaged as a common carrier in the intercoastal trade, transporting freight between ports on the Atlantic coast and ports on the Pacific coast of the United States. The principal ports which they serve on the Atlantic coast are Boston, New York, and Philadelphia, and

on the Pacific coast, Los Angeles, San Francisco, Portland, and Seattle. They serve also many of the minor ports and transport a limited number of passengers.

I am appearing here this afternoon, gentlemen, not in opposition to the principle of an excess-profits tax but to point out that in applying that principle, in order to have it work satisfactorily, special considerations have to be carefully handled, applying to the different industries and that is because of inherent conditions prevailing in those industries.

Ocean transportation is one of the important industries to the prosperity of our country. It enables manufacturers to reach distant markets with their products and also keeps the price of material down through economical transportation.

For example, the price of lumber on the Atlantic seaboard is made up just about 50–50, including the cost of producing the lumber and the cost of transporting it to market. If the ocean service were eliminated, the price of lumber on the Atlantic seaboard would advance between 15 and 25 percent because of the increased cost of transportation via rail rather than via water.

There is a real need for the merchant marine. Congress, in all of its laws enacted during the past 10 years have set forth a policy of fostering and developing the American merchant marine, and I want to point out that in enacting this legislation, Congress should not be unmindful of the necessity for carefully guarding against anything which will disrupt or destroy steamship companies which are part of the merchant marine.

The history of the steamship industry has been unique in one respect, and that is that over 90 percent of the time steamship companies are operating at cost or at a loss. About once in every decade a period comes around where the demand for water transportation is great and where abnormal profits are developed in steamship operations.

The steamship companies depend upon those one or two prosperous years in a decade to continue their operations.

An excess-profits tax which would take away the bulk of those profits during the 1 or 2 good years without taking into consideration the losses accumulated during the lean years will destroy a number of steamship services.

I am, therefore, appearing this afternoon to urge that special consideration be given in assessing the principle of excess profits on steamship operations.

During the last year the Maritime Commission set up by Congress in Docket 514 carried on a lengthy examination into intercoastal steamship operations. I believe in other dockets they have done the same thing in connection with coastwise and offshore steamship operations.

But the facts are that for the past 10 years no profit whatsoever has been earned by any steamship company in the intercoastal trade. On the contrary, a great many of them have sustained such heavy losses that they have been forced out of the trade, and others who have been able to carry on and are still carrying on have no profits accumulated with which to purchase new equipment, new ships, and are counting on the good years in order to enable them to continue their operations.

Out of 20 lines in the intercoastal trade at least 6 of them have been reorganized, have withdrawn, or have gone into bankruptcy

during the past 10 years because of this condition existing in the steamship industry. We feel that whatever excess-profits tax is assessed on steamship operations, the steamship companies, considering their taxes now assessable, such a city, State and Federal taxes, should be allowed some deduction to make up for the losses which they have been consistently suffering over the past decade before the excess profits tax is applied.

Steamship operations are a service industry. All they do is to furnish service for manufacturing concerns who earn the profits which make the industry successful, and we feel that nothing should be done that would cripple or force any of the steamship companies to discontinue their services.

I thank you, gentlemen; that is about all I have to say.

The CHAIRMAN. We thank you.

Mr. TREADWAY. I would like to ask the gentleman just one question. You argue that the heavy money loss in your business in the past decade, now with a chance to do better and make some money, you ought to be exempted from any tax. Why would not that same argument apply to every corporation that suffered during the period of the depression?

Mr. SHEPARD. I do not argue we should be exempted from any tax.

Mr. TREADWAY. No; I did not mean to say that. I am talking about the excess-profits tax.

Mr. SHEPARD. Well, I do argue that we should have some special consideration, because of the nature of the business, which is different from the general run of industry.

I happen to have been engaged, as I told you, in the lumber industry for the major part of my business career. I am not appearing asking for any special consideration for the lumber industry. That industry is not subject to the conditions prevailing in the steamship industry which, as I have stated, are that the service is carried on generation after generation for 6, 7, 8, or 9 years at less than cost and then, when ocean transportation is particularly needed for a few years, the industry has an opportunity to mend its fences, renew its capital structure and enable it to continue.

The steamship industry is unique in that type of operation and is different from other operations which normally reap profits pretty regularly year after year. But an examination of water transportation will show that not only during the past 10 years but during the past three or four generations the steamship business has been subject to that peculiar condition.

Mr. CROWTHER. How do you amortize your ships that you use in your line? What I am trying to get at is what is their life and service?

Mr. SHEPARD. The average life of ships such as we use is about 25 years, but a great many of the ships last for 30 years and some of them will go up to 35 or 40 years. But I think they become nearly obsolete with the new developments after 25 years.

Mr. CROWTHER. Then you have about two decades and a half during which you have two good periods, and then your capital asset is practically wiped out?

Mr. SHEPARD. That is right, sir. And unless we are allowed to keep some of the profit made in those two periods, why, we have to discontinue.

The CHAIRMAN. If there are no further questions, we thank you.

The next witness is Mr. Russell T. Fisher, president, National Association of Cotton Manufacturers, Boston, Mass. Mr. Fisher, give the stenographer your name, address, and whom you represent.

Mr. FISHER. My name is Russell T. Fisher.

The CHAIRMAN. Whom do you represent?

Mr. FISHER. I am president of the National Association of Cotton Manufacturers, 80 Federal Street, Boston.

Mr. Chairman, when I requested time before your committee, I had expected to be able to have a tax expert here to discuss the matter. The time did not permit, and I have a very brief statement which I will either read or file—whichever you want.

The CHAIRMAN. How is that?

Mr. FISHER. I have a very brief statement which I will either read or file, just as you wish.

The CHAIRMAN. That is all right; you may proceed.

## STATEMENT OF RUSSELL T. FISHER, PRESIDENT, THE NATIONAL ASSOCIATION OF COTTON MANUFACTURERS, BOSTON, MASS.

Mr. FISHER. The northern textile industry, despite tremendous liquidation in the past 15 years, still furnishes a means of livelihood for more than 80,000 wage earners, whose wages amount to over $70,000,000 annually. While many communities have suffered severely from the liquidation that has taken place in the industry, many other localities are still dependent wholly or in large part on the one-hundred-eighty-odd mills now operating.

The annual consumption of cotton has naturally decreased with the number of mills, but the northern section of the industry still consumes upward of 900,000 bales of cotton annually and furnishes the cotton farmer with a market for approximately one-seventh of his entire domestic sales.

This brief picture is given to indicate that while the northern mills admittedly comprise a small part of the industry, they are still an important factor both to the wage earner, the community, and the cotton farmer.

We do not think there is any question that the industry, individually and as a whole, believes in building up our defenses so that they will be adequate to protect the country's interests. Likewise, we do not believe there is any difference of opinion as to the need for excess-profits taxes to help defray the cost of such defense measures. However, our industry is vitally concerned with the method of assessing such excess-profits taxes. We comment on the proposals in the subcommittee report with the idea of safeguarding the interests of the mills so that they may continue as employers and consumers of cotton, and not with the idea of evading any responsibility to the Nation.

The cotton-textile industry of the North, as a general statement, has operated without profit since 1930. To be sure, there have been earnings in some years during this period but losses in other years have more than offset these relatively small earnings.

As we understand it, the two proposals of the subcommittee of the Ways and Means Committee concerning excess-profits taxes are: First, that a corporation be allowed a credit for excess-profit tax purposes equal to its average earnings from 1936 to 1939, inclusive, but not to

exceed 10 percent of its invested capital plus an additional credit of $5,000; and, secondly, that a credit of 6 percent be allowed on the first $500,000 invested capital, with a 4-percent credit on capital above $500,000 plus an additional credit of $5,000.

The first proposal would be of no practical value to our section of the industry, as the average return for that period of years, in most instances, was less than nothing and deficits were incurred.

The second alternative offers many serious obstacles if our industry is to continue to operate. First, because a cotton mill represents a relatively high investment. It has been estimated that stockholders must furnish in the neighborhood of $3,000 for each wage earner employed. To state it another way, the estimated cost of building a mill is about $45 per spindle, and on the basis of our member mills whose average equipment is in the neighborhood of 60,000 spindles, an investment of $2,700,000 per mill would be required. Actually, of course, this is an empirical figure and does not represent any one mill.

If the excess-profits tax were figured on the second method suggested above, a mill would then be allowed 6 percent on the first $500,000 of capital and a fixed rate of 4 percent on $2,200,000, or a total return of $118,000, plus a credit of $5,000, before the application of the tax. Return at this rate would be entirely inadequate to enable a mill to restore capital losses of the last 10-year period. A number of mills would be faced with even more drastic consequences due to the set-up of their capital structure, providing for cumulative dividends on preferred stock. The suggested rates of return would not permit them to even clear themselves of debt, except over a long period of years.

It is with the idea of trying to preserve the remaining mills as sources of employment as well as for the stockholders that we request the committee to give careful consideration to the framing of the excess-profits tax act, so that these mills may be maintained not only for the present but for the future. We feel that companies that have shown profits less than 10 percent of their invested capital should be allowed a substantially higher percent than the rate proposed, and that some provision should be made in the law to assist a corporation in liquidating any arrearages in cumulative dividends.

Another matter not directly concerned with the figuring of excess-profits taxes but having a direct bearing on the financial condition of our mills is the fact that the northern section of the industry makes relatively few products required by the Government for defense purposes. For that reason, a large majority of the orders for cotton textiles for these purposes, both in volume as measured by pounds and dollars, have been placed with the southern section of the industry. Such profits as will accrue to the northern mills will come primarily from the demand that may develop due to the increased purchasing power of the public through the expenditure of defense funds. Therefore, it is not anticipated that profits in the northern section of the industry will in anyway compare with those of the last World War, when the productive equipment of the industry was more evenly divided between the two sections.

The CHAIRMAN. Does that conclude your statement?

Mr. FISHER. That concludes my statement.

The CHAIRMAN. Are there any questions? If not, we thank you. The next witness is Mr. Haskell Cohn.

The CLERK. He will not be here, Mr. Chairman.

The CHAIRMAN. Then the next name on the calendar is Mr. C. H. Brook, Goodyear Tire & Rubber Co., Akron, Ohio. Mr. Brook, please state your name, address, and the capacity in which you appear before the committee.

## STATEMENT OF CHARLES H. BROOK, COMPTROLLER OF THE GOODYEAR TIRE & RUBBER CO., AKRON, OHIO

Mr. BROOK. My name is Charles H. Brook, certified public accountant, and presently comptroller of the Goodyear Tire & Rubber Co., Akron, Ohio.

The CHAIRMAN. How much time do you think you want?

Mr. BROOK. A very few minutes; a couple of minutes, I think. Most of my points have been covered by the previous speakers.

I would like to reiterate, if I may, the consolidated principle. I think the consolidated principle was so helpful to all large concerns in the years 1917 to 1921 and that principle continued in effect until 1933—it is still in effect; it is still in the statutes for railroad companies—so, therefore, I should think it could be extended to all other companies who have subsidiaries, owning, say, 95 percent or more.

Another point I would like to make would be the elimination, the entire elimination, of foreign income. The proposals of the Ways and Means Committee have omitted or eliminated foreign dividends, but I think we should eliminate foreign earnings, too.

My company has large rubber plantations and I think we should be allowed to eliminate the earnings of those rubber plantations, which are very heavily taxed in Sumatra.

I think the rate of 4 percent is too low, but I think that was already mentioned by one of the other speakers this morning.

That is all I have to say, sir.

The CHAIRMAN. Are there are questions?

Mr. DISNEY. How heavily taxed are you in Sumatra?

Mr. BROOK. About 63 percent of the income.

Mr. DISNEY. What is the system used for the calculation of the income?

Mr. BROOK. Well, I am not thoroughly familiar with it in all its details. It is just the net income of the company and they have a sliding scale of tax running up to a total of about 63 percent.

Mr. DISNEY. Do they have a surtax system?

Mr. BROOK. No; I think not. I am not sure, but I would be glad to submit a memorandum on that, if you want.

Mr. DISNEY. What is the excess-profits tax in England?

Mr. BROOK. In England the total tax, I think, is somewhat over 60 percent.

Mr. DISNEY. It is 100 percent, is it not?

Mr. BROOK. Is it 100 percent? I really do not know.

Mr. DISNEY. That is what I understand.

Mr. BROOK. I am not thoroughly familiar with all those details. I am just trying to say I think foreign income should be omitted and you have only omitted it so far in connection with dividends and on the invested capital principle. I think foreign income should also be omitted on the average-earnings principle and also not only dividends, but direct foreign earnings.

Mr. DISNEY. Did you have the benefit of hearing Colonel Dewey's statement this morning?

Mr. BROOK. I did; yes, sir.

Mr. DISNEY. Do you care to discuss that?

Mr. BROOK. No. I think, as I understand that, if the taxpayer has the option, it would be perfectly all right; but I think it should be on the basis of the taxpayer's option.

Mr. DISNEY. I think that was his proposal—that it should be optional.

Mr. BROOK. Yes; that is right.

Mr. TREADWAY. Mr. Brook, I understood you to be asking that the profit that came to a company, like the Goodyear Co., from its foreign investments, should be exempted from the tax?

Mr. BROOK. Yes, sir.

Mr. TREADWAY. On the ground that a high tax is paid where the company's business is carried on; is that correct?

Mr. BROOK. Yes; that is correct. In fact, you have already eliminated it in your proposals; you eliminate foreign dividends.

Mr. TREADWAY. I understand that, but supposing your company made $100,000 in some foreign plant net above its tax, you feel that money should go into the treasury of the company without any reference to any tax laws here?

Mr. BROOK. I would think so. It does at present.

Mr. TREADWAY. Well, when you speak of the high tax, that applies just the same to the taxes levied here. Our tax rates are getting pretty well up, you know.

Mr. BROOK. Yes.

Mr. TREADWAY. And are going up higher, probably. Now, why exempt it just because the business is transacted in a foreign country? It goes into the general treasury of the company, as I understand you, or would go into the general treasury of the company.

Mr. BROOK. I think the reason is that I am merely following present legislation. I mean, under present conditions, foreign incomes are not taxed; that is, they are taxed and then a foreign tax credit is allowed on the normal tax. Now, I think the same principle should apply on the excess-profits tax. The proposals of your committee have eliminated foreign dividends entirely, which I think is very fair, and I am merely suggesting the elimination should not only be of foreign dividends, but should also be of foreign income.

Mr. TREADWAY. Or profit?

Mr. BROOK. Yes; that is right.

The CHAIRMAN. We thank you.

Mr. BROOK. Thank you.

The CHAIRMAN. The next witness is Mr. E. G. Sperry, of Sperry Products, Inc., Newark, N. J. Please give your name and whom you represent to the reporter.

Mr. SPERRY. Edward G. Sperry, vice president, Sperry Products, Inc.

The CHAIRMAN. How much time do you think you would like, Mr. Sperry?

Mr. SPERRY. Oh, a very short time. I think 10 or 15 minutes would be enough.

The CHAIRMAN. Suppose we compromise on 10?

Mr. SPERRY. Well, my case is outlined in this very short letter of less than two pages, which I would like to read and, just before that, I would like to give just a few words of a background.

The CHAIRMAN. Proceed in your own way.

## STATEMENT OF E. G. SPERRY, VICE PRESIDENT, SPERRY PRODUCTS, INC., NEWARK, N. J.

Mr. SPERRY. The Sperry Products, Inc., was organized by Elmer A. Sperry, who also started the Sperry Gyroscope Co., which company some of you may know. He was a prolific inventor and had a wide range of inventions, many of which were highly technical inventions for the Navy.

His son, Elmer A. Sperry, is head of our research department and is responsible for many important inventions of what is now standard equipment for the Army and Navy.

I merely mention this to show that our research is of a high order and our products are essential to the Army and Navy and to the defense program of the United States.

Our case is as follows:

The Sperry Products, Inc., consists of two entirely separate divisions. Because the products of these two divisions are of a completely different character, they are operated separately from each other. One division has been in operation for about 8 years and has only one product, a safety service to railroads. It has prior earnings and invested capital. Here the proposed excess-profits tax does not work a great hardship.

The other division has been in existence a comparatively short time. It is engaged in inventing, developing, and manufacturing new types of highly technical control apparatus for the Army and Navy. The chief asset of this division is the inventiveness of its research personnel and the value of its highly specialized technical organization. Research departments of this type often conceive of a new product from their past wide knowledge and experience and are able to perfect it with comparatively little re-research on the product itself. The funds expended for developing the type of new products produced in this manner are comparatively small, and these products are, therefore, represented by a relatively small capital. This does not mean that the wide knowledge and experience of the research workers are not acquired at a considerable expense over a long period of years, but it would be difficult to resurrect and capitalize these expenditures from many years back. Hence there is no exemption of any consequence possible on the basis of capitalization, nor is there any exemption on the earnings. We are, therefore, faced with the prospect of having all our profits on these new products taxed without exemption at the maximum excess-profits tax rate.

Contrast our case with that of an older company developing similar products. Here, because the majority of its products have been in production for a number of years, this company has substantial prior earnings and therefore adequate exemption. Consider a new aviation company which, because of the size of the aeroplane it produces, must necessarily have a large amount of capital invested in extensive buildings and tools. This company also has adequate exemption.

Mr. DISNEY. How long has the older company been in business now?

Mr. SPERRY. The older division of the company has been in business for about 8 years.

Mr. DISNEY. How long has the other company been in business?

Mr. SPERRY. The younger company for about a year and a half.

Mr. DISNEY. Both are a part of the same corporation?

Mr. SPERRY. They are both divisions of the same corporation.

As I say, consider a new aviation company which, because of the size of the airplane it produces, must necessarily have a large amount of capital invested in extensive buildings and tools. This company also has adequate exemption. In other words, it is the new company manufacturing highly technical control apparatus, whose products have not been in production to date, which is most severely handicapped by the proposed excess-profits tax.

Another important point to be considered is as follows: A number of our highly technical products are exempt from profit limitation under the Vinson-Trammel Act. This is to allow recovery of additional losses inherent in the development of highly technical control equipment. This means that these products should receive more profit than noncontrol products. In contrast with this, our products, under the proposed excess-profits tax, would clear less profit after taxes than noncontrol products limited by this act. Here the inequities of the excess-profits tax fall on the class of companies that can least afford to bear them.

The inequities of the proposed excess-profits tax could be remedied if a board or commission were to be set up independent of the Treasury Department to determine, among other things, a fair standard of profit for a new company developing and manufacturing highly technical control apparatus. This board could be empowered to construct a capitalization for the new products based on their potential earning power and importance and on the value of the company's highly specialized research organization. Or it might set up an arbitrary exemption based on the exemption existing for like companies but which have been producing for a number of years.

Another proposal would be to raise the corporate income-tax rate from 20 percent to, say, 25 percent on new companies in lieu of an excess-profits tax.

If no relief is allowed companies like ours, profits without exemption will be subject to the 20-percent normal tax, and the balance to 40-percent excess-profits tax. With profits reduced so drastically, a company can hardly afford to take the risk of continuing in this hazardous type of business where, in addition to the usual business risks, there is an added loss on many unsuccessful experiments.

Our company, therefore, would be forced to curtail new research and development on further products essential to the Army and Navy, which would delay and impair the defense program of the United States as far as the resources of this company are concerned.

There are a number of us confronting this problem and I urge that you provide relief.

Now I have a summary in just three points here in which I would like to summarize the whole thing:

(1) It is the new instrument companies which have little or no production that are treated unjustly under this tax law because they have neither prior earnings nor capital on which to base exemptions.

(2) The majority of products of our company are exempt from profit limitations under the Vinson-Trammell Act. They are, therefore, just the companies that can least afford to have their profits excessively reduced because of unjust treatment under the excess-profits tax law.

(3) This company's products are essential to the Army and Navy, and any curtailment forced by the inequities of this tax would delay and impair the defense program of the United States.

Mr. DISNEY. Can you draw us a picture in figures as to how the two different companies would be affected by this tax proposal?

Mr. SPERRY. Well, the oldest division of our company has prior earnings and an adequate capitalization. There, of course, we have exemptions at once set up under your excess-profits tax and we are only taxed on the balance and the profits over the exemptions. This will be a hardship, to be sure; but, under wartimes, it can be borne, and I think this is the typical company which you gentlemen have in mind when you set up the excess-profits tax.

The other division of our company is new, has no prior earnings, and has very little if any capital, and this is the division which would suffer under the excess-profits tax.

Mr. DISNEY. Are they separate companies?

Mr. SPERRY. No; they are the same company, but two separate divisions. The products are so different that they are run as two separate and distinct divisions.

Mr. DISNEY. Well, under this bill, drawn as proposed, they will be treated as one company.

Mr. SPERRY. I know they would be, but this one section of this company would be highly penalized. The divisions are so different that it might almost be considered two companies, and this one division of the company, if it were a separate organization—we could separate it out easily enough if we wished, and reorganize it and you could consider this was one separate organization, because its products are so different, and this division will suffer very greatly.

Mr. DISNEY. You do not separate the taxes either?

Mr. SPERRY. No.

Mr. DISNEY. You would not pay a separate tax on the new organization, under the excess-profits tax?

Mr. SPERRY. However, all the profits on the products of the new division would be subject to the excess-profits tax without exemption, and that is the point I am bringing out.

Mr. COOPER. You just have one corporation, do you not?

Mr. SPERRY. One corporation; yes.

Mr. COOPER. And it is engaged in two different lines of activity?

Mr. SPERRY. That is right.

Mr. COOPER. Well, now, just that one corporation is the only thing that is dealt with here.

Mr. SPERRY. Yes, I know; but I am showing that the profits obtained by one division of that corporation would be very unjustly taxed.

Mr. COOPER. Well, we do not levy any separate tax on different divisions; we just levy the tax on the corporation.

Mr. SPERRY. I know that. Then I would say the total profits of the company from both divisions would be very unjustly taxed.

Mr. COOPER. It won't have to pay any excess-profits tax unless it makes excess profits.

Mr. SPERRY. It will make what might be called excess profits, which will have no exemptions.

The CHAIRMAN. If there are no further questions, we thank you.

The next witness is Mr. A. C. Nielson, president of A. C. Neilson Co., Chicago, Ill. State your full name and address and whom you represent.

## STATEMENT OF A. C. NIELSON, PRESIDENT, A. C. NIELSON & CO., CHICAGO, ILL.

Mr. NIELSON. My name is A. C. Nielson; I am president of the A. C. Nielson Co., Chicago.

My corporation is probably classifiable as a personal-service business. We render marketing research service to large corporations to help them with their sales and advertising programs. We have about 600 employees and do a business of about $2,000,000 a year and pay about $100,000 to $150,000 of taxes.

I just want to show you a few charts here, to explain what our problem is in connection with this proposed tax.

The most discussed bases for excess-profits tax, of course, are the average of previous earnings and the return on invested capital. You are probably all aware of the fact that the average of previous earnings basis is unfair to the Government unless the natural trend of the corporation's earnings is downward, as shown here for 1936, 1937, 1938, and 1939. Such a corporation, if it were not for the war, would keep right on going down.

The CHAIRMAN. Mr. Nielson, you may continue.

Mr. NIELSON. As I was explaining, we are engaged in market research work. It is a statistical business service that is rendered corporations that need facts to guide them in their advertising and selling campaigns. Now it is not my purpose to argue against the excess-profits tax—I think you should have it—but I am trying to point out certain situations that exist in all personal-service corporations which I think can be taken care of very easily if the committee will recognize certain factors. Now let me show in a practical way what happens when you use the average-earnings provision as a basis for determining the excess-profits tax. Let me show how it may be unfair to the Government and in certain other instances unfair to the taxpayer. We will take a case where the earning trend of a corporation is downward during the 4 years, 1936, 1937, 1938, and 1939. During that 4-year period, the corporation's earning trend is downward, and then along comes 1940 when the trend is upward.

In the normal course of events, that corporation would go along with the same trend, but along comes this war emergency that boosts its earnings up. In the case of some corporations it is still not up to the 4-year average, on which you are basing the excess-profits tax. You do not do that in the case of a corporation that is going downhill, and in most cases they have either a long period of downward trend or of upward trend. In many of those cases, if you take the average basis, or the 4-year period, it would be unfair to the Government. For instance, here is a corporation which has a certain department which we will call "X", which is producing a good amount of profit. The total amount of profit would seem large for 1936, 1937, 1938, and 1939, but along comes 1940, when we have to discontinue that department or division, and the profit would drop from the former level. Then along comes the war, which might boost the profit

up, but still not up to the 4-year average. Now how would you get the excess-profits tax out of the war boost with that kind of a system?

The CHAIRMAN. What is the reason for that, if you have boosted the profits away above every one of the 4 years?

Mr. NIELSEN. I am trying to show that this system of averages is not a fair one.

The CHAIRMAN. The profits, you say, would have moved above the 4-year average?

Mr. NIELSEN. Here [indicating on chart] is a corporation which earned that amount of money in 1936. It earned the same amount in 1937, the same amount in 1938, and the same amount in 1939, but of that profit one-third is earned by a certain division that goes out of business for some reason or other. In 1936, so far as this company is concerned, the profits would decline to this point [indicating]. It would be the same in 1940, if it were not for the war emergency, when they make profits. The profits for this company start upward, when they otherwise would have gone down. It helps this company which would otherwise have gone down. Under your proposed base for excess-profits taxes, you would not reach it under your plan, because the company is not up to the 4-year average.

The CHAIRMAN. What does that dark part on your chart represent?

Mr. NIELSEN. That is all profit. This part shows the earnings of a certain division, or division X.

The CHAIRMAN. I do not see that.

Mr. NIELSEN. This chart indicates the trend.

The CHAIRMAN. What does the dark part mean?

Mr. NIELSEN. This represents the total profit of the corporation, and this part [indicating] is due to department X, or division X. That division produces this amount of the total profit. That condition goes on for 4 years, thereby establishing this average profit for 4 years. Then we will say this department goes out of business for some reason or other. For some reason or other, it is forced out of the business, and that part of the profit disappears, and in 1940 there is left only this much profit. Then the war comes along, adding to the profit, but you do not get at that because the company is still not up to the 4-year average. Here is a case [indicating] where, in spite of the fact that the company earns a lot of money during the war, your method does not get at it.

Mr. MCCORMACK. How would you eliminate that?

Mr. NIELSEN. I do not know that I can. That is not my objective. I am simply trying to give you a clear picture of it.

The CHAIRMAN. When it is not up to the 4 years' average, do you claim you should not have any excess profit?

Mr. NIELSEN. Yes, sir. In this case, the company made it because of the war. The war helped it. The war has replaced the department which the company had discontinued. This is a case where you have a corporation with an initial trend downward, and then the war comes along and saves it, but you do not get the tax. This is the same situation here, showing the earnings in 1940.

Now, I am a marketing consultant. This is a $100,000 marketing corporation, and we know that this is the trend. This is a case where the average provisions for earnings is unfair to the taxpayer. Here is a company that is new, and is getting more efficient all the time, and their profits are increasing. This company comes up to here [indicating] with its profits in 1940. We will say that this com-

pany has nothing to do with war orders, but, nevertheless, they would be paying the so-called excess-profits tax. The money they get comes from the so-called excess profits.

Mr. COOPER. The Government is turning loose 14 billion dollars, and almost everybody will get something out of it.

Mr. NIELSEN. Yes, sir; I believe you are right about that.

The CHAIRMAN. In one instance you say it is unfair to the taxpayer and in another you say it is unfair to the Government.

Mr. NIELSEN. Yes, sir.

The CHAIRMAN. How do you suggest we can make it fair to both?

Mr. NIELSEN. I am coming to that. Here is a special condition, and this is the thing I am here to talk about. Here is a company that earned this amount indicated in green in 1936. It is my own company. During the past 4 years this company has been investing large sums of money in research work, and developing a new division of business. That amount, which is shown right here, happens to be about $100,000 a year. That is in the case of my own company. In 1940 the research expense shows a reduction, because we are finishing with it, and are ready to go into production. So the whole thing becomes an addition to the profits. While I add this on the profit side instead of the loss side, because we start making a profit in this new division, our profits will shade up and increase in 1940. Now, the only thing I am protesting against is that I think we will be taxed too heavily.

The CHAIRMAN. Of course, if you do not make the profit you do not pay a tax on the profit. If I understand your argument, if we take a reasonable share of the profit in the form of taxes you should be satisfied.

Mr. NIELSEN. In the first place, we are taxed 29 percent, and then pay the 40 percent or 50 percent excess-profits tax. When the dividends are paid out of the remainder to the stockholders some of them have to pay a surtax as high as 70 percent. That would be out of the 4 or 5 percent left to distribute.

The CHAIRMAN. While you are doing that you are not losing money.

Mr. NIELSEN. No, sir; we would be making a normal profit.

The CHAIRMAN. If you are making money, I cannot understand your point.

Mr. NIELSEN. The point is this: That now we are in a position to put 400 more people to work. We have had 600 people working during the past few years. Then, for 10 years we will say, we have been losing money. From 1923 to 1933 we lost money in finding out what we should look for in the business market. Now, today, we are able to employ 600 people. Then we spend money in developing a radio service. You want that kind of thing done in this country. Do you not want your enterprises and brain power used in developing things that will employ more people?

The CHAIRMAN. If you carried that argument to its logical conclusion, there would be no tax imposed where you put people to work.

Mr. NIELSEN. Where the money is distributed, we are paying these heavy tax rates, with a surtax rate as high as 70 percent.

Mr. COOPER. Where do you get that 70-percent rate you are talking about?

Mr. NIELSEN. I mean in the 62-percent bracket. I understand that you pay 10-percent surtax on that. That would make 68.2 percent.

Mr. COOPER. The 10 percent is on the amount of the tax. It is not 10 percent added to the tax basis, but just 10 percent on the amount of the tax.

Mr. NIELSEN. Then, it would be about 65 percent.

The CHAIRMAN. You are talking about the 62-percent bracket and 70-percent bracket, implying that all the income is taxed at that rate, or at 65 or 70 percent. Everybody knows that the income is not taxed in that way. You know that no individual income is taxed in that amount on the income. Only a certain amount of it would be in the higher brackets. That is brought up every time anyone appears here, and that question is raised.

Mr. NIELSEN. I imagine you get tired of that, and it was not my intention to make that statement. What I am talking about here is that the individual might pay a surtax of 65 percent on profits, after having taken 20.9 percent, and the question is whether, with the excess-profits tax, there is enough left there to provide an incentive. I do not think there would be any incentive to go ahead. One might say why develop a new division at all, if the Government gets 80 percent if we win, but you would get nothing if you lose.

The CHAIRMAN. If the people all over the country did the same thing, there would be very little coming in.

Mr. NIELSEN. Whether we make any profit, or not, I am disposed to help the Government if it is necessary. Now, I want to show you how this affects a personal-service corporation. In the first place, the invested capital in such a corporation is hard to determine. There is no uniform method of determining that as in some other corporations. Here is a manufacturing corporation, with an investment in machinery, accounts receivable, inventories, and so forth. Now, here is a personal-service corporation, and they have invested, say, $1,000,000 in the business, but only half of that amount could be accounted as invested capital. The major portion of their capital consists, not of buildings, machinery, accounts receivable, and so forth, but of unusual professional skill of the officers and executives, and the professional reputation of the company itself.

Under this proposed method, it would not be shown, because half of it may represent work over a period of 10 years while developing the professional reputation of the corporation, in the meantime sustaining losses. I do not know whether you can do anything about that, or not, but if it is placed on the invested capital basis, insofar as this personal service type of corporation is concerned, it will be unfair. In other words, the personal service corporation has invested its money in intangibles that cannot be recorded on the books, but, nevertheless, it does represent an actual cash investment, because it is usually acquired only by operating at substantial losses for many years, while acquiring individual and corporate professional skill and corporate reputation. As I have said, my own company showed a deficit after its first 10 years of operation. If such companies were budgeted for a return of, say, 8 percent on invested or book capital, their profits might amount to only 1 or 2 percent of the sales. That is because of the high ratio of sales to capital. Under those conditions, it would take only a slight drop in sales to throw the company into red ink; and since sales are so large in relation to capital, even a small percentage of loss on sales would quickly eat up the company's

capital and destroy the entire enterprise, which took so many years at such heavy operating losses to build.

As a practical matter, this type of corporation usually finds it necessary to budget for a net profit of about 15 percent of sales in order to avoid undue vulnerability to fluctuations in sales volume. In the next place, invested capital varies widely, dependent on the sales. For instance, here is a company with sales which have a book value of $1,000,000, and it must have that much invested capital. In order to hold $1,000,000 of sales over the years, it must have $1,000,000 of capital. That would be the case with a steel company. Now, a personal-service corporation may have only $100,000 of capital in order to handle $1,000,000 of sales. That is because it has no bills receivable, inventories, and so forth, to carry. A corporation of this type has a low ratio of capital to sales. In a personal-service corporation the ratio may be $1 of capital to $10 of sales. The reason for that is, in the first place, because of the wide differences in the hazards involved. In the first place, it is a hazardous business, and, in the next place, while the margin of profit on their capital might be 10 percent, it would be only one-half of 1 percent on the capital. That is because the sales are more than 10 times the amount of the capital. If the amount of sales are 10 times the capital, and they earned 10 percent on the capital, it would mean 1 percent on their sales. Now, you may say what of it? If they make only 1 percent on the sales, and the sales are knocked down 10 percent, the company goes out of business. If our company did not have a profit ratio of 10 or 15 percent on sales, we would go out of business. Any advertising agency will tell you that same thing.

Mr. BOEHNE. What would happen if the recommendation of the subcommittee with regard to personal-service corporations were enacted into law?

Mr. NIELSEN. It is my understanding that you are proposing to permit such a corporation to avoid excess-profits taxes if it puts out its current earnings in dividends, so the stockholders would pay income taxes on it.

Mr. BOEHNE. What would be the effect of that?

Mr. NIELSEN. How could that be done, or how could the corporation force the stockholder to include dividends that he did not get? In my particular case the stockholders are executives in the company, or the chief men; but I do not see how we could force Mr. Jones, who is an outside stockholder, to pay $25,000, or income tax on $25,000, unless we paid him the $25,00, or could pay it all out in dividends. The objection to that is that companies of our type have to make investments during the next year. We will have to spend $250,000 for additions to the building; $150,000 for new technical instruments for use in the business; and $100,000 to train 400 new employees. So in a corporation of that type which needs capital, they cannot pay all of it out.

Mr. COOPER. What is keeping you from getting more capital in your business?

Mr. NIELSEN. The only thing that is keeping us from doing that is the highly speculative character of the business. We find it practically impossible to go to investment bankers for that purpose.

Mr. COOPER. You can put back all you want to, if it goes through the tax mill.

Mr. NIELSEN. In our particular case we could do that, where we have a few officers who own the stock, but it would be different where the rest of the stock is held around among a lot of people in small amounts.

Mr. DISNEY. The subcommittee's report contains some definite suggestions. Do you have any to offer?

Mr. NIELSEN. Yes, sir.

Mr. DISNEY. What are they?

Mr. NIELSEN. Here is a suggestion: In the application of the excess-profits tax to any corporation which derives the majority of its income from sales of services rendered, and not from manufacturing, public utilities, and so forth, allow the corporation to earn a percent on sales equal to its weighted average for the 4 preceding years, but not more than 15 percent. I would allow new corporations of this type to earn 15 percent on sales. Allow corporations of this type to operate on the sales basis instead of the capital basis, because it depends, not on capital but upon the professional skill of its partners.

Mr. DISNEY. You would use a different alternative. You would base it upon sales.

Mr. NIELSON. My proposition is to base it upon a percentage of sales. If the company earned 10 percent on sales during the last 4 years, and earns 10 percent next year, you would apply the excess-profits tax accordingly.

Mr. DISNEY. That would be upon the average earnings.

Mr. NIELSON. Yes, sir; except in the case of a company which is developing something, or developing a new division it needs to increase sales. For instance, here is a company that invests money for 4 years in developing a new division.

Mr. DISNEY. We could hardly divide a company up into divisions; we have no means of doing that.

Mr. NIELSON. You are putting the brake on new enterprise, that is all I am pointing out. If we had been earning 10 percent on our sales, and we create a new division which sells another million dollars a year, what I say is, let us earn 10 percent on that $1,000,000.

Mr. DISNEY. Will you restate that, please?

Mr. NIELSON. If my company for the past 4 years earned a profit amounting to 10 percent of its sales——

Mr. DISNEY. You are now talking about the whole corporation, including all of the divisions?

Mr. NIELSON. Of the whole company; I say, during the next year, 1940, let us earn 10 percent on our sales; if the sales go up, due to our having developed a new division of the company, or due to the fact that our company is on the upward trend in sales, generally, then let us earn 10 percent on that. If the war helps us, I assure you, we will earn more than 10 percent.

Mr. DISNEY. Is not that exactly what the subcommittee report proposes?

Mr. NIELSON. No; because you are basing it on a return on capital. I am talking about a percentage of return on sales.

Mr. DISNEY. We are basing it on an average base period of 4 years.

Mr. NIELSON. In dollars, is not that true?

Mr. DISNEY. Yes.

Mr. NIELSON. If we have earned $200,000 a year for the past 4 years, you will let us earn $200,000 in 1940 before applying the tax. But we are going to earn $400,000 in 1940, because we are just at the point of

getting the fruits of a development on which we spent money for 4 years.

Mr. DISNEY. Why should you not pay an excess-profits tax on that extra $200,000?

Mr. NIELSON. It depends on what the purpose of the excess-profits tax is. I thought the major purpose was, aside from raising revenue which is always a purpose, to get at the war profits.

Here is a company that has depressed its profits for 4 years deliberately to spend money for experimentation which reaches its fruition, and the trend of its business starts upward.

Mr. COOPER. Did you not say awhile ago that this was a radio division that you were talking about?

Mr. NIELSON. That is right, but not a different corporation.

Mr. COOPER. The division on which you had been making this research was the radio division, and now you think the results from that will begin to shoot up. Now, do you know of anything that is causing the people to listen more to the radio, than the war? Everybody in this country has their ear glued to a radio all the time listening for war news. That certainly would help you out, if you are advertising something over the radio, because the people are glued right to the radio, listening to what you say.

Mr. NIELSON. It happens, sir, that our business is not the selling of radio time. It has nothing to do with that. Our business is the gathering of facts about radio and is simply a research service. You would be correct in the case of a company that was advertising on the radio.

Mr. DISNEY. I should like to continue with just another question or two. Under the law, we cannot single out corporations and say, "You are producing battleships," and not have the law apply generally otherwise. We would run into legal difficulties. We have got to cover the whole field of industry.

Mr. NIELSON. It may not be possible; in other words, it may not be possible to define a personal service corporation and give it special treatment? Is that what you mean?

Mr. DISNEY. I would not say that quite.

Mr. BOEHNE. If the gentleman will yield; with reference to a definition of a personal service corporation, have you read the report of the subcommittee?

Mr. NIELSON. Yes, sir.

Mr. BOEHNE. Do you agree with the subcommittee's definition of a personal service corporation?

Mr. NIELSON. I thought that was rather good; yes, sir.

Mr. DISNEY. Would you go as far as Mr. Davidson did in his testimony, and enlarge that definition, or make it less restrictive? Perhaps you did not hear his testimony.

Mr. NIELSON. I could hear part of it. It is rather difficult to hear in the back of the room.

Mr. BOEHNE. If the gentleman will allow me to continue with this for just a moment. This subcommittee report defines a personal service corporation in these words:

A corporation whose income is to be 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.

Now, did you not say awhile ago that this money that your personal service corporation is making, this profit that you are making, you could not recapture a lot of it because your shareholders are not active in the business?

Mr. NIELSON. That is right.

Mr. BOEHNE. Those two statements do not agree, because a personal service corporation, according to this definition, is that type of a corporation where all the principal owners are active participants in the business.

Mr. NIELSON. If it says "all," then I do not agree with the definition. I did not think it said "all."

Mr. BOEHNE. I do not think you need to read "all" into the definition. It says a corporation whose income is to be attributed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs, and so forth.

Mr. NIELSON. My company would have about 75 percent of its stockholders actively engaged in the business, and the other 25 percent of the stock is owned by outsiders, people who have nothing to do with the business. In other words, you have many combinations like that.

I do not know just how we could classify such a company. I thought the definition was a good definition, but when I see that you can interpret it differently from the way I would interpret it, perhaps it is not so good.

You will find that there are advertising agencies that have perhaps 80 percent of the stock owned by the partners, but there may be some fellow on the outside who used to work for the company, and got fired 10 years ago, but still retains his stock.

There may be difficulties in defining that. Then, also, you would require some rule like this, allowing new corporations of this type to earn a stated percentage on their sales instead of on their capital.

I have an alternate suggestion which may apply, if you think this is impractical.

Modify the proposed option for service corporations, that I have just been talking about. That option, as I understand it, permits a corporation of this type to avoid the excess-profit tax entirely if it pays out all of its earnings in dividends. I would suggest that that would be very satisfactory, if you would simply modify it so as to permit such corporations to retain some stated percentage of their net income, say 25 percent, for general expansional purposes, plus whatever increase they have in the book value of their fixed assets on a capitalized development cost.

For instance, my company has to build an addition to their building in order to house these 400 new employees that we are going to hire. We cannot pay out all of our earnings this next year, because if we did, we would not have enough money to pay for the building.

So I do not see why you would not be justified in exempting from the requirement of dividends that portion of the capital which is really invested in bona fide assets used to operate this company; in our case, these buildings, office machinery, and so forth.

And I would also urge some additional percentage, say 25 percent, to allow for the general expansion, because if we are going to do $4,000,000 worth of business a year instead of $2,000,000, we need to

have twice as much cash in the bank for emergencies, or else we may have to throw a lot of people out of work when the storm hits us.

Mr. DISNEY. You heard the squawk about the undistributed-profits tax for about 2 or 3 years. Would you have this undistributed-profits tax apply simply to personal-service corporations?

Mr. NIELSON. That is my intention. I am not here speaking for other types of corporations. I do not feel that I am qualified to do that. I think an undistributed-surplus tax is a bad tax essentially, but I think this might be a practical compromise on the thing. After all, all taxes are bad, but we have got to have a lot of them if we are going to get ready for a war, and I am for that. But I would not want to see one type of corporation penalized because it happens to be a type that is, perhaps, not generally understood.

Mr. DISNEY. Are personal-service corporations great in number?

Mr. NIELSON. I would say they are very great in number, but most of them are rather small. You have big corporations, like Dun & Bradstreet; F. W. Dodge Corporation. You have advertising agencies that handle some forty or fifty million dollars worth of billings a year. You have companies, such as my own, with 600 employees. Then you have industrial engineers. You have people like Stone & Webster, Lockwood Green, J. E. Cyrene & Co.

Mr. DISNEY. Would an automobile agency be a personal-service corporation?

Mr. NIELSON. An automobile agency?

Mr. DISNEY. Yes.

Mr. NIELSON. Not in my opinion. He is a retailer. He is like a department store. I think you could define that all right. It might take a little study, of course.

The CHAIRMAN. Why do you say that all taxes are bad any more than all living expenses are bad?

Mr. NIELSON. Do you want me to answer that question, Your Honor?

The CHAIRMAN. Why should you say that taxes are bad, when they are paid to support a government, any more than the expenses of food, or the expenses of maintaining churches, and so forth?

Mr. NIELSON. It was a semifacetious remark, Mr. Chairman. Any tax acts as a brake on business enterprise, of course.

The CHAIRMAN. I do not think you were serious in that statement, were you?

Mr. NIELSON. No, sir; not 100-percent serious.

Mr. CROWTHER. It looks to me as though this witness is just in a hard-luck position, in the fact that 1940 is the year when he is getting ready to spread his wings and do some business. I just think that you are in hard luck.

Mr. NIELSON. If that is the case, I can take it; that is all right. But I think there is a more important principle here; it is a principle whether you are going to discourage corporations like the Sperry Gyroscope man who talked ahead of me.

Mr. CROWTHER. I am not quarreling with your premise; I think that is all right. But it seems to me it is too bad that 1940 is your fifth year, when you are about to do some business and make a little "mazuma," and we are going to get some of it.

Mr. NIELSON. You have been getting quite a little from me as it is.

Mr. CROWTHER. I appreciate that.

Mr. NIELSON. However, I think the important point here is with relation to discouraging corporations from embarking on long-term research programs. Those things do not develop overnight in business. It takes years and a lot of money, and a lot of guts and stick-to-itivness, and then you finally put it over, and you run up against something like this. I think that is a thing that discourages businessmen in this country and causes unemployment.

Mr. CROWTHER. I think your premise is sound, but it is just too bad that it happens at this point.

Mr. NIELSON. I think you can remedy it, if you want to, by a simple provision for this type of corporation. You already have a provision that if we pay out all of our earnings in dividends we do not have to pay excess-profits taxes. Well, I do not object to paying excess-profits taxes, but I think you should recognize that a company has a right, and a duty, to invest money in fixed assets to handle its increasing business, and you should let it invest that money at least before you start requiring it to pay out money to its stockholders. I would like to see something additional for the purpose of allowing them to increase their working capital.

The CHAIRMAN. Have you finished your statement?

Mr. NIELSON. Yes.

The CHAIRMAN. If there are no further questions, we thank you for your appearance and for the information you have given the committee.

Mr. NIELSON. Thank you.

The CHAIRMAN. The next witness is Mr. Paul W. Adams, representing the Manufacturers Association of Connecticut.

## STATEMENT OF PAUL W. ADAMS, LEGAL COUNSEL FOR THE MANUFACTURERS ASSOCIATION OF CONNECTICUT

The CHAIRMAN. State your name and whom you represent.

Mr. ADAMS. My name is Paul W. Adams. I am legal counsel for the Manufacturers Association of Connecticut.

I have just received a copy of the subcommittee's report, and there are a few things in it which do not agree with the proposals we were planning to make today.

One is in connection with amortization. The amortization is retroactive in the proposal only to July 10, 1940. It would seem to us that this should include equipment or facilities that were acquired, or to be acquired, for use in connection with the emergency declared by the President to exist on September 8 so that corporations who were brave enough to use their own capital for expansion at that time should also be entitled to the privilege of amortizing the investment which they have made in new plant expansion and facilities.

Another suggestion in connection with the Vinson-Trammell Act. I note that it is only to be suspended. It would seem to us a much more satisfactory arrangement to repeal the Vinson Act so as to force reconsideration at the time, whenever it is, that the excess-profits tax shall no longer be necessary.

Mr. DISNEY. Will you restate that, please?

Mr. ADAMS. In the proposal of the subcommittee, they suggest suspending the Vinson-Trammell Act so long as the excess-profits tax applied. My suggestion is that it be repealed because there is

no time limit on the excess-profits tax and at the time when the excess-profits tax should no longer be necessary, it would seem wise to force a reconsideration on whether or not the Vinson-Trammell Construction Act is wise and desirable tax procedure at that time.

In connection with the excess-profits tax, there is nowhere mentioned in the report a reference to the present excess-profits tax being repealed. I hope that that is to be included in the proposal.

I would suggest also that the anomalous capital-stock tax—it will be anomalous when the excess-profits tax is repealed—be also repealed. The proposal calls for averaging over the past 4 years the earnings of corporations. There was at one time a suggestion which I believe the committee was considering, that any 3 out of the last 4 years be allowed as the basis for average earnings. We would suggest that this would be a more equitable basis for determining average earnings, because a corporation might very easily have had considerable reverses in 1 year which could be taken to offset the other years, by selecting the 3 best years.

Several of the other witnesses have struggled with a problem which I believe can be taken care of by putting a ceiling on the aggregate tax which a corporation is required to pay. Recently, in the Wall Street Journal, there was a summary of the earnings and the taxes paid by numerous large corporations. On the basis of those facts, it would appear that no corporation had paid a tax, regardless of how high its earnings, that was in excess of 25 or 30 percent of its net income. If you put a ceiling on all corporation taxes of a certain percentage of the taxable net income, situations such as those just presented to you, it seems to me, would be taken care of.

Perhaps the ceiling could be arranged in another way, by saying that the excess-profits tax shall not be more than 12 percent above the present tax rate on total taxable net income. That would mean that the present corporation tax rate for corporations whose income is in excess of $25,000 would be 19 percent, plus the 1.9 percent defense tax, and then plus 12 percent for the excess-profits tax, making a total of 32.9 percent of net income as the ceiling above which the Federal tax cannot go.

Mr. REED. You spoke of repealing the present excess-profits tax, whenever that would occur, and repealing the capital-stock tax.

I would just like to call attention to the fact that in 1939, the excess-profits tax yielded $27,000,000; the capital-stock tax in 1939 yielded $127,000,000. This bill that is before us now contemplates raising only $200,000,000. If you wiped out the excess-profits tax and the capital-stock tax in the old law, we just would not raise the revenue. I just did not want you to be laboring under the misapprehension that there is any intention to repeal these two taxes that are in the old law.

Mr. ADAMS. Nevertheless, I do urge the point; and would point out further that although the estimate, as I understand, is $200,000,000 for the present year, for 1940, it is considerably in excess of that for future years.

There is one further problem which I doubt has been considered in connection with average earnings and invested capital for corporations who are now producing for defense. We have Connecticut corporations who are likely to find themselves in a position where the Government has made them an offer to buy factories and furnish

them with complete equipment for producing armaments or defense products.

Take, for example, a corporation that ordinarily has a $10,000,000 invested capital and their earnings have been low, so that they would be at a better advantage electing to come under part B which would be the 4 percent of invested capital. The Government supplies them with two other plants, each of which represents an investment of $10,000,000. They are operating those plants. The Government stands no overhead, simply furnishes the plant and the equipment. The corporation furnishes all of the management, all the materials and supplies that are necessary to produce the article, and receives in return a price for the article. Now, it would seem to me some adjustment should be made in a case like that, where a corporation, in the interest of national defense, has expanded, has spread its organization with such a large investing capital, but only gets credit for $10,000,000 of invested capital.

My particular reason for bringing up this point is that in the case of advances in similar situations by foreign governments, the company is allowed to treat that as a loan and therefore borrowed capital, and the corporation would be entitled to certain percentages on that borrowed capital as part of their invested capital, as recommended by the subcommittee. It is my suggestion that it certainly behooves us to give more credit to a management who is in cooperation with the Federal Government in a situation like this than one that is simply cooperating with a foreign government.

Mr. DISNEY. What kind of credit would you suggest?

Mr. ADAMS. I think if something were adopted similar to that provided for borrowed capital, that would be satisfactory; 100 percent for the first $40,000, I believe it is; 66⅔ percent up to $900,000; and 33⅓ percent above that.

Mr. DISNEY. It must be that I am not following you accurately. Did they invest the capital where the Government put up the building and furnished everything but administration and organization?

Mr. ADAMS. No, sir; they do not invest any capital in the building and the equipment. It is simply furnished to them free of charge. They operate it. They supply the men and the materials and the management, and operate the plant for as long as the Government desires them to operate it, because they are experienced in these things. You understand the reason. It would seem that some adjustment should be made in a case like that where they have expanded a plant, spread their organization over such an extended field for the purpose of national defense. They should be entitled to some further credit on the excess-profits tax because a person who has a similar arrangement with a foreign government may treat it as borrowed capital whereas the Federal Government is not allowed to do that except through the R. F. C. The company doing that business with a foreign government would be in a better position than a company doing the same kind of business for the United States Government.

Mr. CROWTHER. There are some companies here for whom money is being furnished for plant extension and equipment by foreign countries? Are there not some companies making defense materials on that basis for foreign countries?

Mr. ADAMS. Yes, sir. And as I understand, it is treated as a loan. The Treasury Department has recognized that treatment.

The CHAIRMAN. Are there any further questions?

We thank you for your appearance and for the information you have given the committee.

Mr. ADAMS. I thank you, sir.

## STATEMENT OF KENNETH E. ARMSTRONG, COMPTROLLER OF MARSHALL FIELD & CO., MERCHANDISE MART, CHICAGO, ILL.

The CHAIRMAN. Mr. Kenneth Armstrong of Marshall Field & Co. Please give your full name and address for the record.

Mr. ARMSTRONG. Mr. Chairman and gentlemen of the committee: My name is Kenneth E. Armstrong. My address is Merchandise Mart, Chicago, Ill.

Gentlemen, it will take me about 10 minutes to say what I have to offer.

Gentlemen of the committee, the company that I represent here today recognizes the need for the Federal Government to secure additional revenue to support expenditures for national defense, and your desire to enact a tax bill which will provide the additional revenue needed in a manner equitable to all the taxpayers. I shall confine my remarks to part III of the report of the subcommittee which relates to excess-profits tax.

We applied the proposed tax formula to the estimated earnings of this company for the year 1940, which are based on the actual results for the 12 months ending July 1, 1940, and find we would be obliged to pay in addition to the normal tax of 20.9 percent, an excess-profits tax equal to 23 percent of our net income for the year, or a total Federal income and excess-profits tax for the year of 39.34 percent of our income before Federal taxes.

We feel confident that it is not the intention of this proposed tax report to levy any such tax rates as 39.34 percent on normal profits, and it is for that reason that we are here today to point out to you the result of the actual application of the proposed bill, the reasons for the result, and a suggestion to more equitably distribute the tax burden.

Marshall Field & Co. was established in Chicago in 1856 and its business up to 1936 was dealing in merchandise at retail and wholesale. For a number of years, the wholesale was the more profitable end of the business, but in the twenties a change occurred in the buying habits of the country and the retail end of the business forged ahead, whereas, the wholesale started a downward trend. The retail business of this company has always been successful. There was only one year in its entire history when the retail did not show a profit which was in 1932.

During the proposed base years, 1936 to 1939, the two main retail stores of this company located in Chicago, Ill., and Seattle, Wash., showed satisfactory and consistent profits which followed the trend throughout the country. I refer to the statistics tabulated by the bureau of business research, Harvard University, in reporting the operating results of department stores doing an annual volume of $10,000,000 and more.

I mention this group because we are in that classification and our figures are included therein.

In 1936, 28 stores reported their figures and showed an average percentage of return on net worth of 11.5 percent; for 1937, an average return of 8.9 percent; for 1938, 4.6 percent; and for 1939, 8.3 per-

cent. Incidentally, the results of our own retail stores showed an average return even higher than those reported above.

The wholesale end of our business which specifically imported, converted, jobbed, and manufactured merchandise to distribute at wholesale was losing ground so rapidly, that in 1935 a survey was made of this end of our business by a well-known firm of industrial engineers who recommended that we get out of the wholesale business as rapidly as possible. It was perfectly obvious that the losses in the wholesale business were absorbing the profits made in the retail store to a very great extent, and that as long as that condition continued, the stockholders of this company could expect no return on their investment, and there might be an unfavorable effect on the financial structure of the company.

Permit me to quote from a remark in the annual report of this company to stockholders at December 31, 1935: "During the 5-year period 1930 to 1934, inclusive, the accumulated losses of this (wholesale) division were more than $12,000,000."

The management, after a careful study of the report, laid out a program of liquidation of the wholesale business and reorganization of the financial structure of the company, so that today the business of Marshall Field & Co. is no longer that of a wholesaler and retailer, but it is primarily a retailer, and should expect to enjoy the satisfactory return on its investment that is enjoyed by other large retailers throughout the country.

This corporation filed its tax return for the year 1936, showing an income of only $873,000. Yet, the two retail stores showed a profit of $4,532,000 for that year. In the year 1937 the corporation filed a tax return showing a loss of $2,613,000. Yet, the two retail stores had a profit of $4,394,000. In 1938 this corporation filed a return showing a profit of $226,000, and the two retail stores had a profit of $3,734,000.

Mr. BOEHNE. Will you explain what you mean by the corporation as distinguished between the two operations?

Mr. ARMSTRONG. I referred before to the fact that the company which had been established in 1856 had two principal parts in its business, one of those parts being wholesale and the other retail.

Mr. BOEHNE. I thought you said you went out of the wholesale business in 1936.

Mr. ARMSTRONG. Started. I did not mean to say we went out; the program was started in 1936. I am sorry if I did not make that clear.

In 1939 the liquidation program had been completed and the financial reorganization had been also completed and the corporation was then able to show its true earning power after the discontinuance of its unprofitable wholesale business. For that year the corporation filed a tax return showing a profit of $4,893,000. This reversal in profits was not due entirely to an uplift in business, but was due to the fact that the unprofitable ends of the business were no longer siphoning out the profits.

It is easy to see that if you have a business with a store in one city making $1,000,000 a year, and a store in another city losing $1,000,000 a year with the result you have no profits to give to your stockholders, you would be better off to dispose of the store losing $1,000,000 a year no matter how much loss you had to incur in the liquidation of the assets. That is exactly what happened to this company, because as this liquidation program progressed, it in-

curred large losses in the liquidation of the assets for that part of the business being liquidated. As a result, this company finds itself today realizing much larger earnings with a substantially reduced invested capital.

The net worth of this company has dropped from $60,465,000 on January 1, 1936 to $50,688,000 on January 1, 1940.

While this company recognizes the necessity of taxing excess profits, we point out to you here that as this tax bill is now drawn you are not only taxing the excess profits of this company, but you are taxing at a very high rate the normal income of this company.

This bill does not give this company relief to which it is entitled, because of the changes that have occurred in the business during the base period. Therefore, it is our recommendation that there be included in the proposed bill "special relief provisions." We do recommend this, because the reasons given by the subcommittee for not having provided special relief provisions do not in any instance make reference to the type of special case such as we have just presented. Surely there must be many other companies similarly circumstanced.

An exemption of only 4 percent on the invested capital of this company results in an almost confiscatory tax rate on the top income of this company, as it is estimated that 41 percent of this company's income will be subject to the combined rate of 52.54 percent this year.

The special relief provision should provide for a board of review with full power to consider cases of this type presented to them and apply the appropriate remedy so that where the profits for the base period were so low that it would not be just to ascertain the normal profits of the taxpayer by reference to such profits because either the business is of a class which, during the base period, was depressed or because the business of the taxpayer was for some reason peculiar to itself abnormally depressed during the base period when compared with other businesses of the same class.

Recognizing the need for additional revenue, we hesitate to make any recommendation as to what is an adequate return on investment but we do believe that provision should be made for relief of taxpayers in a position similar to that outlined for this company.

Mr. CROWTHER. I would like to say, because you appear to be in about the same position as the gentleman who testified before, that it is unfortunate that you liquidated in those 4 years and now are beginning to pay a pretty heavy tax. I do not know that anything can be done to help you, but it just so happens that you are in about the same position as the company that has spent a lot of money during 4 years for research and development and 1940 is to be a big year, whereas you began the liquidation of the losing end of the corporation in 1936 and starting out in 1940 you are going to be hit.

Mr. ARMSTRONG. Yes.

Mr. CROWTHER. It seems to be your unfortunate luck.

Mr. ARMSTRONG. Well, sir; it may be just a matter of luck, but on the other hand it may be something of planning.

Mr. CROWTHER. I do not doubt the value of the premise of your suggestion. And I am not arguing with it; I think you have got a good case. But it seems to be just a bit unfortunate for your part that it was brought about in this 4 years, the base year period, and that the year that you are going to cut a little hay happens to be 1940 and you are going to be met with a considerable tax bill.

Mr. ARMSTRONG. The difference, and it is not my duty, I recognize, to draw a difference between witnesses but I do recognize this, that this company is not the same type of company that it was when it started the liquidation 4 years ago.

Now, as we have liquidated this end of the business over here we have invested in a new type of business. This company has invested, in the last 4 years, in physical properties, $23,000,000 of new money, which under the bill as it now stands it gets no benefit from, because the bill does not recognize that capitalization.

Mr. CROWTHER. By developing new retail outlets?

Mr. ARMSTRONG. By the money which we have put in North Carolina and Virginia, for instance, 2½ million dollars during the last 4 years in putting in new looms and new buildings and putting in conditions down there which did not exist before.

Mr. CROWTHER. This may not be pertinent to the issue, but does your concern handle the products of any foreign concern, that is, the total products of any foreign concern?

Mr. ARMSTRONG. The retail store sells merchandise of foreign concerns, yes.

Mr. CROWTHER. I understood at one time that Marshall Field Co. took the entire toys of the Muhlenberg or some other store abroad and handle the entire products.

Mr. ARMSTRONG. We have no connection whereby we buy and take the entire output of any foreign factory in a foreign country.

The CHAIRMAN. It looks like your company is the victim of a situation that has confronted many small concerns, except that you were able through the liquidation of your wholesale end of the business to get relief from taxes, by offsetting your losses in the wholesale against earnings in the retail. However, that is just a matter of management and certainly was not the fault of the Government.

Mr. ARMSTRONG. No, but I take it the purpose of this bill is to tax excess profits and this company has no objection to paying on any excess profits is it believed the increased industrial activities of the country are going to realize, because it will make business better. We are going to have better profits this year because of it, and we are perfectly willing to pay on those increased profits that result from increased activities.

The CHAIRMAN. Mr. McKeough has some questions.

Mr. MCKEOUGH. You stated that in the last 4 years your company had spent $23,000,000 in developing new activities in connection with your retail trade?

Mr. ARMSTRONG. In retail, the Merchandise Mart in Chicago and in our mills in North Carolina and Virginia.

Mr. MCKEOUGH. None of the $23,000,000 was incident to the Merchandise Mart because that building was put up more than 4 years ago.

Mr. ARMSTRONG. The building was put up in 1930, but the building has expanded, and we have been required, for example, to finish offices on floors that have not been finished, at a cost of hundreds of thousands of dollars.

Mr. MCKEOUGH. That was, of course, to make it available for tenants?

Mr. ARMSTRONG. With the increased facilities that brought in additional tenants.

Mr. McKeough. Have you any idea as to what proportion of the new space that was finished is occupied by various agencies of the Federal Government?

Mr. Armstrong. I do not have the figures at my fingertips; it is information that can be secured.

Mr. McKeough. It is a favorable proportion, is it not?

Mr. Armstrong. Yes; that is correct.

Mr. McKeough. And the rental that is charged for that, of course, is in keeping with what in your judgment, under good management, will earn a good return on the improvements over and above the amount sufficient to retire that cost.

Mr. Armstrong. The Federal bureaus and agencies do not sign leases over 1 year, and all improvements that were made in the building were made on a 1-year basis.

Mr. McKeough. Well, those improvements that I have seen in connection with some of the agencies that are housed in the Merchandise Mart, I am confident, would not run into very much money. In fact, just bare walls with crushed rock in them for some of the offices that are occupied by these Federal agencies.

Now, you also said that you spent about two and a half million dollars in the development of some activities in North Carolina and Virginia. Would you mind telling me what the nature of those expenditures were?

Mr. Armstrong. In the State of North Carolina we manufacture rugs.

Mr. McKeough. Rugs?

Mr. Armstrong. Yes; and blankets, sheets, bedspreads, and woolen piece goods.

Mr. McKeough. Where were they previously manufactured?

Mr. Armstrong. Those factories were started there, some of them, some years ago, but we developed them by adding machinery, adding buildings and new equipment.

Mr. McKeough. And the part that you wrote off during the 4 years was the wholesale business. Did you liquidate any departments which you now have developed in your North Carolina activities?

Mr. Armstrong. Yes.

Mr. McKeough. Would you mind telling me where?

Mr. Armstrong. The hosiery business, which had been previously in Philadelphia.

Mr. McKeough. And your management and I am sure it is very capable and shrewd, drew the distinction between your very active store in Chicago, which I think is the best department store in America——

Mr. Armstrong. Thank you.

Mr. McKeough. I never saw the one in Seattle, but I presume it was brought about that the development of the activity in production of this line was for the purpose of reducing your costs in connection with the part you were selling through your retail establishment.

Mr. Armstrong. The amount of merchandise that is sold in our retail stores that are manufactured in our mills, is not a large percentage of the total volume of the retail stores.

Mr. McKeough. No; but it is a sufficient volume to have you expend two and one-half million dollars in activities in North Carolina, and I am turning over in my mind whether or not it is typical of the

movement of the textile industry from one section of the country to another section of the country, that took place rather largely in the last 20 years in this country, and I was wondering whether or not your management reflected the same trend of thought that brought from New England the textile activities into certain sections of the South, and if that is so, if I am correct in that assumption, I am quite convinced that the purpose of that movement was to reduce the costs to finished goods by reason of such activities because they may have been making those same commodities in another section, but here could produce them at lower rates of pay than they had previously been paying in the textile industry in New England; and I wonder also if it has any bearing on the passage of this tax bill that your management is now complaining about and is going to be asked to pay taxes because the management was able to make a saving on the lower labor costs which savings are brought about by the fact that the rates in the section of the country from which the movement took place were higher than they were in North Carolina.

Mr. ARMSTRONG. I cannot explain the economic movements that took place in the country.

Mr. MCKEOUGH. But they have taken place, and my point is this: Was the change the result of the suggestion made by the well-known industrial-engineering firm, which made the recommendation to your company, to forego the activities in the wholesale field and confine its activities to the retail field; was it a part of the suggestion that this industrial-engineering firm made to Marshall Field that resulted in this change?

Mr. ARMSTRONG. No. Marshall Field & Co. acquired its interest in North Carolina in 1909 when it had previously loaned industry down there some money; had loaned substantial sums of money over a period of years. We had no interest there in mills in North Carolina up to that time. These firms went into bankruptcy. I do not have at my fingertips the details, but there were four or five companies involved, and in the payments for advances which we had made we took over the properties in North Carolina which represented, let us say, an investment at that time of some two million dollars and had expended during the years a sum in excess of $11,000,000.

Those expansion programs more or less occurred previous to 1934 or 1935 at the time of this industrial survey, but the money we had invested in North Carolina and Virginia since 1935, to which I referred, the two and one-half million dollars, was in the development of the facilities and property that had already been purchased.

Does that answer your question?

Mr. MCKEOUGH. Yes, partly; and please do not misunderstand me; I am not criticizing the management.

Mr. ARMSTRONG. I understand.

Mr. MCKEOUGH. But I merely want to point out the possibility that the profit that is now flowing back because of the shrewdness of the management may have been accumulating because of that approach. In other words, I do not think they went to North Carolina just because they wanted to develop the State of North Carolina; I think they were possibly interested in making money in North Carolina and receiving some benefits that might flow eventually to Marshall Field & Co. in connection with their merchandising efforts. I still think that is a part of their program.

Mr. ARMSTRONG. May I say this, that as far back as 1925 the profits on our mills in North Carolina were greater than they are expected to be today.

Mr. MCKEOUGH. Is that possibly the explanation why the Congress enacted the wages-and-hours law?

Mr. ARMSTRONG. I do not believe so.

Mr. MCKEOUGH. It did not have any effect on the wage structure in those mills?

Mr. ARMSTRONG. Our wages, when that bill was enacted, had an effect on the wage increase to this company, to my mind, offhand, just standing here, because I cannot be sure of the figures, but they are approximately correct, not to exceed an amount of $25,000 on the whole pay roll of an $11,000,000 investment.

Mr. MCKEOUGH. Well, I commend you; I think it is very fine for you to be able to make that statement, and I am happy to know it had a small part in the wisdom that resulted in the development of the company you have today.

Mr. ARMSTRONG. The point I am making——

Mr. MCKEOUGH. There is just one other observation I would like to make with reference to the 4 years referred to, because throughout that earning basis you showed practically no net income on which you paid any income tax to the Federal Government, or a very small sum. I take it that the losses on the wholesale activities were practically equal to the net return on your retail activities; is that correct?

Mr. ARMSTRONG. Yes.

Mr. MCKEOUGH. So you had, for the 4 years 1936, 1937, 1938, and 1939 really no cost to do business in this country by reason of your having the change which was brought about in the activities of this corporation; that is, made no contributions to the Federal Government. In other words, practically no income-tax payments of any size during that 4 years. Is that correct?

Mr. ARMSTRONG. Well, we made some income.

Mr. MCKEOUGH. No appreciable amount in comparison with the amount that would be taken if this proposal here goes through, for the program which the Government has to put into effect in order to develop an adequate defense program, only a part of the expense of which will be met.

We have appropriated approximately eleven billion in that direction and some three or four billions still to be added to that, making our activities in that direction equal to something like $14,000,000,000.

Now, obviously, the income of the Federal Government, which has been in the red, because of the situation applying in the country for the last 10 years, has not enabled it to set up any reserve with which it might approach a $14,000,000,000 defense program, so that under the pending bill under consideration by this committee we are now trying to make some approach to get the added income with which to meet this cost. And I take it that Marshall Field & Co. is wholeheartedly in favor of the defense program?

Mr. ARMSTRONG. Correct.

Mr. MCKEOUGH. And I am sure that in the event, by reason of the shrewdness of the management, there is reflected and carried into the year 1940, as Dr. Crowther has pointed out, a very fine income on which you anticipate you will be compelled to pay a substantial tax

for the calendar year 1940, they will be willing to pay a rather heavy cost.

Now naturally you would not want to be compelled to pay any more than is necessary, but I am wondering if you are willing to state for the record that even if you may have to make a serious contribution from your earnings to the national income, that Marshall Field is just as wholeheartedly in favor of that payment as it is in going into the program of preparing the country for security.

Mr. ARMSTRONG. May I add one qualifying statement?

Mr. MCKEOUGH. Yes.

Mr. ARMSTRONG. You are talking about the estimated earnings of this company for the year 1940.

If the proposed legislation, as the bill now stands, is enacted, this company will pay income taxes three times greater, a 200-percent increase in 1940 over 1939 on an estimated increase in profits of 25 percent.

Now, gentlemen, you realize that the amount of profits you can make out of a department store is more or less limited. If you raise the ceiling too high it becomes profiteering, and then of course you have to meet competition. In other words, we estimate that increase in activities will increase our income 25 percent, and we are going to pay three times as much Federal taxes.

Mr. MCKEOUGH. Are you willing to pay that in order to do business in this country for defense purposes? I am not being facetious.

Mr. ARMSTRONG. I realize that.

Mr. MCKEOUGH. I am serious about it.

Mr. ARMSTRONG. I believe you are, and I am certainly.

Mr. MCKEOUGH. Because you happen to have been in a position for 4 years where you had paid practically no income, and come down to the year 1940, it does not seem to me that there should be any complaint if it applies to the year 1940.

In other words, had you had the same thin earnings in 1940 that you had in 1936, 1937, 1938, and 1939, when you were liquidating your wholesale activities, you would not then have to pay as heavy a bill in comparison to what you will have to pay under the proposed bill.

Mr. ARMSTRONG. That is correct.

Mr. MCKEOUGH. And you would not be present today for the purpose of making any protest with respect to 1940, that you anticipate is going to be so large that you will be compelled to pay 39.34 percent of your total income for Federal tax purposes. I think that is the figure you used before for 1940.

Mr. ARMSTRONG. Yes.

Mr. MCKEOUGH. You are in the happy position of earning an income, but in the unhappy position of having to take the figures for 1936 to 1939 and that is the reason you are here protesting. The only fellows who are protesting are the fellows who are going to pay the bill, and I want to point out for the record that the corporate earnings of the Nation, according to the best estimates we can get, for 1940 will result in the Government, if this bill is enacted, receiving in excess-profits taxes approximately 190 to 225 million on an 11 to 14 billion dollar defense program. You can figure how long it will take the Government to liquidate a 14 billion dollar defense bill based on

a return of excess profits, money which the Government has to expend to secure the future of this Government.

I sympathize with you as did Dr. Crowther in that in 1940, you happen to be ready "for the kill," so to speak, but there is one other thing to be said: I think that the country by and large, certainly will have little sympathy for the corporation that may have put itself in position to have excess profits, when this Government is now asking, in the interest of security, that the Government set up a selective, compulsory draft bill to take completely 1 year out of the life of those who are going to be asked to learn how to use and develop equipment that you are going to help to pay for; and I am wondering if you will be willing to put into the record today that if it is the best judgment of the Congress that Marshall Field & Co. do so, that it is willing to pay 39.34 percent of its total net income for Federal tax purposes for the high purpose of securing this Nation for the future.

Mr. ARMSTRONG. But I do suggest that there be equality in the distribution of taxes, and if you want corporations to pay 39 percent and all corporations pay 39 percent taxes to the Government, then the company that I represent certainly is willing to do so. At the present time I am not in position to judge about the $100,000,000 that you referred to, but the increased taxes that this company will have to pay, under that rate, would mean you would only need 100 corporations like Marshall Field & Co., in 1940, to pay the total amount of increases that you have mentioned.

Mr. MCKEOUGH. I agree with you, and I want to point out that we are not setting out to pick on Marshall Field & Co.

Mr. ARMSTRONG. I appreciate that.

Mr. MCKEOUGH. I have a very high respect for that organization. It is one of the best stores, not only in the city of Chicago, but in the country, and I hope that the management of Marshall Field & Co. will not protest the application of this proposed excess-profits tax when our estimates, at best, are between 190 to 225 million dollars out of the excess-profit taxes. I do not think there could be any objection in the light of that situation.

Mr. TREADWAY. May I ask a question, just one question. Your argument is based somewhat on the fact that the retail end of the business of Marshall Field concern was profitable and the wholesale end was not.

Is there any explanation of why the wholesale part failed to show a profit?

Mr. ARMSTRONG. Yes, sir. From the information we have been able to obtain, the best of which is this report I referred to that was written in 1935, that showed that due to one thing or another—that is quite a story—that situation was brought about.

For instance, there was passing out of the crossroads department store that used to be an account of our wholesale store. In its heyday, our wholesale store had upward of 45,000 accounts on its books. That was back in the twenties, when they had the accounts of 45,000 retail merchants.

That dwindled down as the years went on. The little corner store disappeared. The automobile came along, and hard roads, which made for bigger stores in the bigger cities.

There was a further change. The time was when manufacturers would not sell to retailers, but as the retailers got bigger, eventually there were some retailers who had as big buying power as some wholesalers, so the mills had to sell to the retailers direct.

Every time that transition occurred, the wholesale store lost another customer. Probably the jumps between towns became bigger.

But at any rate, the volume fell from $100,000,000 per annum in 1919 down to $22,000,000 in 1932.

Our people expended all the ingenuity they had at their command to try to stop that trend.

In 1935 they called in outside advice, and the result of it was that they were told, "You had better recognize the facts." We did.

Therefore, after the program was completed in 1938, 1939 was the first year to get the full benefit of it, and we had no longer a retail and a wholesale store. We had just a retail store, which was a different business.

Now then we feel that you gentlemen, drafting this bill, recognize we are entitled to have the same exemptions that our competitors have. That is all we are asking for, and if we have the same exemptions Marshall Field & Co. are perfectly willing to pay their share of the national-defense-program tax bill.

But I am sure you gentlemen are anxious, and I am sure you have no reason to feel otherwise—I hope not—that this should be distributed more generally among corporations, and not put on just one corporation, and have them on a different plane than their competitors. I do not think that is an unreasonable request.

Mr. TREADWAY. Have other wholesale houses had the same experience you are speaking of as Marshall Field & Co.?

Mr. ARMSTRONG. Other wholesale houses have, one by one, gone out of business. There are not near the number of wholesale houses in the country today that there were 20 years ago. I do not happen to have the statistics at hand.

Mr. TREADWAY. It is due to the fact that retail establishments are becoming able to deal direct with the manufacturers. Wholesalers would be more or less in the nature of jobbers, would they not, getting the stock from the manufacturer and selling it to the retailer? Was that about the process?

Mr. ARMSTRONG. Yes, sir.

Mr. TREADWAY. And that is being gradually done away with?

Mr. ARMSTRONG. Yes, sir.

Mr. TREADWAY. The gentleman has answered my query, but I would like to make one observtion. I am very glad to know that a man born and brought up as a boy in a little country town in the district I have the honor to represent, the town of Conway, Mass., made such a great success in the business world as Marshall Field.

Mr. DISNEY. Is your calculation of 39 percent based on the average earnings theory or the invested-capital theory?

Mr. ARMSTRONG. On the invested capital with 4-percent minimum. We are unable to qualify satisfactorily under the first option and have to resort to the minimum provision of part 2.

Mr. ROBERTSON. When was your carpet factory located in Virginia?

Mr. ARMSTRONG. That is at Fieldale, Va.

Mr. ROBERTSON. When was it located there?

Mr. ARMSTRONG. The property was purchased in 1917.

Mr. ROBERTSON. When you built that carpet factory there, was that not the first carpet factory south of the Potomac?

Mr. ARMSTRONG. No, sir; we owned a cotton factory in North Carolina.

Mr. ROBERTSON. I was not referring to cotton factories. I said carpet factory.

Mr. ARMSTRONG. I thought you said cotton factory. I am not sure when that was opened, but it was one of the first.

Mr. ROBERTSON. Is it not a fact that there are but two carpet factories in the entire South, one of them located in the county in which I live?

Mr. ARMSTRONG. So the record may be straight, we started our carpet factory in 1924.

Mr. ROBERTSON. I do not believe you or anybody else have located a carpet factory anywhere in the South except in Virginia and North Carolina, because there are only two in the South, and we have one in Virginia. These carpet factories have paid the best wages of any plants we have, and they have the best working conditions, and whenever you have an opportunity to establish another one, I will be glad to have you establish it in Virginia.

Mr. ARMSTRONG. I thank you.

The CHAIRMAN. We thank you for your appearance and the statement you have given the committee.

The Chair has received a number of letters and telegrams from various firms, organizations, and individuals in regard to the legislation we have under consideration. Without objection, at this time I will insert in the record at this point a letter from John D. Battle, executive secretary of the National Coal Association; also a letter from G. Edward Escher, president of the White Construction Co., of New York City; a letter from Claude W. Dudley, tax counsel of the Millers' National Federation; and a telegram and letter from Mr. Karl Bishopric, president and treasurer of the Spray Cotton Mills, located at Spray, N. C.

(The letters and telegram above referred to are as follows:)

NATIONAL COAL ASSOCIATION,
*Washington, D. C., August 12, 1940.*

HON. ROBERT L. DOUGHTON,
*Chairman, Ways and Means Committee,*
*House of Representatives, Washington, D. C.*

DEAR SIR: With respect to the tax legislation under consideration by your committee, we take cognizance of the announced intention to confine the bill which the committee will report to the three main topics listed and discussed in the report of the subcommittee, and to refuse consideration at this time to any other particulars.

In the interest of saving time, may I ask that you make this letter a part of the record in the present hearings in order that the views of the bituminous coal industry may be before your committee.

First, it approves of the proposed suspension of profit limitations contained in the Vinson-Trammell Act.

Second, it approves the pending proposal of the amortization of emergency facilities in the interest of promoting national defense.

With respect to the excess-profits tax, we submit certain matters that it is hoped the committee will consider. In this connection we feel it would be helpful to point out the financial condition of the bituminous coal industry. The data published by the Bureau of Internal Revenue on the net income and income taxes of the bituminous coal-mining industry show that since 1925 the industry has operated at a substantial loss. Data compiled by the National Bituminous Coal Commission show that for the year 1936 the loss of the industry, computed on the basis of reports filed under the Coal Act, was approximately 11 cents per ton, or about $50,000,000. The losses in 1938 were greater than they were in 1937. The year 1939 was also unprofitable.

The plight of the industry was such that in 1937 Congress passed the Bituminous Coal Act for the announced purpose of fixing minimum prices and thereby bringing the industry's realization up to cost. It is announced that efforts in this direction will soon be consummated, though such is not the fact at this time. Any increases in net earnings that result from this effort will flow from the 1937 Coal Act, and not from any emergency conditions.

The bituminous-coal industry does not oppose an increase in taxes necessary to maintain sound finances. However, it believes that in any tax program based on excess earnings the bituminous coal industry occupies a unique position and is entitled to special consideration.

Considering the financial history of the industry, it is obvious that the earnings of previous years afford no basis for the ascertainment of excess profits, since as an industry it has been operating at a deficit. On an invested-capital basis, the industry goes into 1940 with its capital seriously impaired. It is respectfully suggested that very careful consideration be given to application of the invested-capital basis in this industry, which has had no opportunity to restore its capital assets.

It is suggested that any bill brought forth on this subject should not be made retroactive, but effective as of January 1, 1941. This is particularly desirable in view of the fact that practically 8 months of the present year is already gone, with many business houses making commitments throughout the year with no knowledge whatsoever of the proposal to impose this tax.

The taxpayer should be allowed an election as to the basis of the tax--that is, as to which basis is more advantageous to him. This election should continue until the final determination of the tax liability.

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.

Under method No. 2, page 7, of the subcommittee's report, 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.

Another matter of great importance to this industry on which we feel an expression should be made, though it is apparently not on the agenda of the committee, is that we strongly urge the restoration of that provision, formerly in the corporation income-tax section of the Revenue Act, 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 a situation. With the impending imposition of a heavy supertax 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, if any, of the enterprise as an entirety.

Attached is a table which shows the losses in the industry during recent years, taken from reports of the Internal Revenue Bureau.

Yours very truly,

J. D. BATTLE, *Executive Secretary.*

*Net income and income taxes of the bituminous-coal-mining industry as shown by income-tax returns*

| Year | Number of companies | Number reporting net income | Number reporting no net income | Net income | Deficit | Net income or industry | Tax | Industry's profit or loss |
|---|---|---|---|---|---|---|---|---|
| 1917..... | 1,234 | 1,149 | 85 | $204,564,196 | −$645,678 | $303,918,518 | $70,961,656 | $132,956,862 |
| 1918..... | 1,234 | 1,106 | 128 | 150,094,603 | −1,247,971 | 148,846,632 | 65,763,660 | 83,082,972 |
| 1919..... | 1,234 | 817 | 417 | 74,202,962 | −9,943,268 | 63,259,694 | 12,934,424 | 49,325,270 |
| 1920..... | 1,234 | 1,152 | 82 | 251,025,514 | −1,658,135 | 249,367,379 | 76,223,563 | 173,143,816 |
| 1921..... | 1,234 | 503 | 731 | 53,164,099 | −30,271,905 | 23,889,194 | 10,539,444 | 13,349,750 |
| 1925..... | 3,650 | 1,045 | 2,585 | 40,462,955 | −62,526,452 | [1] −22,583,497 | 4,517,057 | [1] −26,980,554 |
| 1928..... | 2,592 | 965 | 1,842 | 33,477,073 | −57,984,400 | [1] −24,508,330 | 3,441,860 | [1] −27,950,190 |
| 1929..... | 2,646 | 934 | 1,535 | 40,068,844 | −51,890,877 | [1] −11,822,033 | 4,000,019 | [1] −15,822,052 |
| 1930..... | 2,356 | 781 | 1,458 | 25,077,232 | −67,148,274 | [1] −42,071,042 | 2,637,057 | [1] −44,708,099 |
| 1931..... | 2,307 | 582 | 1,513 | 9,957,000 | −57,702,000 | [1] −47,745,000 | 1,039,000 | [1] −48,784,000 |
| 1932..... | 1,897 | 289 | 1,578 | 5,926,000 | −57,123,000 | [1] −51,167,000 | 777,000 | [1] −51,944,000 |
| 1933..... | 1,917 | 396 | 1,455 | 7,243,000 | −54,792,000 | [1] −47,549,000 | 1,029,000 | [1] −48,578,000 |
| 1934..... | 2,071 | 660 | 1,357 | 23,631,000 | −31,218,000 | [1] −7,551,000 | 3,308,000 | [1] −10,892,000 |
| 1935..... | 2,012 | 591 | 1,384 | 19,566,000 | −35,142,000 | [1] −15,576,000 | 2,750,000 | [1] −18,326,000 |
| 1936 [2]..... | 1,995 | 500 | 1,355 | 19,992,000 | −32,304,000 | [1] −12,492,000 | 3,214,000 | [1] −15,616,000 |
| 1937 [2]..... | 1,553 | 539 | 1,276 | 18,390,000 | −26,062,000 | [1] −7,662,000 | 3,208,000 | [1] −10,870,000 |

[1] Deficit.

[2] The figures for 1936 and 1937 are presented in a form directly comparable with previous years by excluding from net income the dividends received on stocks of domestic corporations and interest on Government obligations, and by adding to net income the amount of contributions or gifts. In this form the data more nearly reflect the income obtained from coal-mining operations and are comparable with other years.

NOTE.—The years included in the table are the only years for which separate figures for the bituminous coal industry are available. The data for the years 1917 to 1921, inclusive, are taken from tables prepared by Edward White, head of the Statistical Division of the Income Tax Unit, for the use of the U. S. Coal Commission. The figures are based on the income-tax reports of all companies making such reports for all 5 years. The anthracite figures for the year 1925 were furnished by the Assistant Secretary of the Treasury upon request of the National Coal Association; the bituminous figures for the same year were obtained by subtracting the anthracite figures from those of the 2 branches of the industry combined, as shown in the Statistics of Income of 1925. In 1928 the Bureau of Internal Revenue first published separate figures for the 2 branches of the coal industry, and the data shown for the years 1928 to 1937, inclusive, are taken from the yearly reports of the Bureau entitled, "Statistics of Income."

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WHITE CONSTRUCTION CO., INC.,
*New York, August 9, 1940.*

Hon. Chairman DOUGHTON,
*House Ways and Means Committee,*
*House Office Building, Washington, D. C.*

YOUR HONOR: From rather sketchy dispatches in the newspapers we understand that additional tax revenues in the form of an excess-profits tax are being currently considered in Washington. From what information we have received, it appears that in final form this excess-profits tax will be based on earnings over a certain fixed return on invested capital or earnings over an average for recent years, the corporate taxpayer possibly to be given the alternative of paying a tax based on either computation.

If the Federal Government is in need of a large amount of additional funds for the defense program, it is only natural that the country's already huge tax burden must be increased. However, we think very definitely that companies which have been operating at deficits in recent years should be allowed to offset profits against such deficits before any excess-profits taxes are paid. That seems fully justified and equitable when you consider that such corporations have in many cases raised additional capital during the past 10 years in order to continue in business and supply employment to hundreds of men. We believe they would be bearing their full share of the tax burden by paying the basic 19 percent corporate tax rate until they are able to return to profitable operations sometime during the next few years.

We would appreciate it if you would give this letter your fullest consideration and present its contents to your committee.

Very truly yours,

WHITE CONSTRUCTION CO., INC.,
G. E. ESCHER, *President.*

MILLERS' NATIONAL FEDERATION,
*Washington, D. C., August 9, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Committee on Ways and Means,*
*House of Representatives, Washington, D. C.*

MY DEAR MR. CHAIRMAN: I represent the Millers' National Federation which is a trade association, the membership of which includes flour millers producing more than 80 percent of the total commercial production in the United States. It is my understanding that hearings on the report of the Subcommittee on Internal Revenue Taxation will not extend beyond Monday the 12th. This makes it impossible for us to hold a meeting of the tax committee of the Millers' National Federation, the members of which are scattered from coast to coast. It is also impossible for the members of the federation's tax committee to make a study of the subcommittee's report in time for me to present to you their views. I do want to present at this time, however, certain reflections which have occurred to me in my 1 day's study of the report. The points which I want to make will be separately listed and discussed:

*1. The amortization of emergency facilities provision should be segregated and action taken thereon promptly, but careful and exhaustive consideration should be given to the excess-profits tax provisions in order that the best possible law may be enacted.*—I recognize the fact that there is urgent need for prompt action with respect to item II of the report, "Amortization of emergency facilities," in order to speed up the program of work essential to the national-defense program. There is not the same need for prompt action on item I, "Suspension of the Vinson-Trammell Act," or item III, "Excess-profits tax." An excess-profits tax based wholly or in part on invested capital is a very complicated tax. Assume, as most businessmen do, that an excess-profits tax is to be enacted retroactively to January 1, 1940, it is not now so important that it be enacted quickly as it is important that the best possible law be passed. To enable your committee to report out a bill designed to raise the maximum amount of revenue with the minimum of inequities and inequalities among taxpayers, time is required for your consideration of the many problems which arise in connection with the drafting of such a bill. Time is also required for businessmen to study the proposed legislation and report to you the inequalities which they see in it as related to their individual businesses. Three days is inadequate time for the preparation and presentation to you of those views which are absolutely necessary for you to consider if the best possible law is to be the result of your deliberations. I strongly urge upon your committee the segregation of item II, "Amortization of emergency facilities," and the prompt introduction of a bill covering that item alone to be followed by most exhaustive hearings on the excess-profits tax in order that your committee may have the benefit of all helpful information which can be secured bearing upon that subject.

2. *The base period used under the excess-profits tax law should be not less than 5 years.*—Your subcommittee's report proposes that the base period shall be the years 1936 to 1939, inclusive. Insofar as the milling industry is concerned it is vitally necessary that this period be lengthened so that it shall be not less than 5 years. In the year 1935 a processing tax of 30 cents per bushel was imposed on the processing of wheat. Most milling companies secured an injunction against the collection of that tax for a large part of the year 1935. The industry was forced to figure the processing tax as a part of its costs, for it did not know that the law would be declared unconstitutional and that it would be relieved of paying the tax. After the Processing Tax Act was declared to be unconstitutional many milling companies paid back to their customers as so-called reimbursements the amount which they had collected from them in 1935, representing the processing tax applicable to the flour sold to them in that year. Most of these reimbursements to customers were paid in the years 1936 and 1937, although some of them were not paid until the fiscal year of 1938. These reimbursements are allowed as deductions by the Bureau of Internal Revenue in the years in which they are paid. This results in a distortion in the income statements. A large deduction is included in the taxable year of 1936, 1937, or 1938, as the case may be, whereas the gross income to which that deduction is applicable is included in the year 1935. Let me give you two examples to show you how this works out in individual cases.

*Company A*

| | |
|---|---|
| Net income for 1935 | $129,746.15 |
| Net income for 1936 | 43,952.69 |
| Net loss for 1937 | (99,908.04) |

*Company B*

| | |
|---|---|
| Net income for fiscal year 1936 | $241,896.06 |
| Net income for fiscal year 1937 | 85,513.72 |
| Net loss for fiscal year 1938 | (223,250.68) |

I have the figures of many other companies, but will not burden you with them at the present time. These are typical. The transaction involving the sale of flour in the period during which the injunction was in force (the calendar year 1935 or the fiscal year 1936) should either be in or out of the base period data used under the proposed excess-profits tax law. If the years 1936 to 1939, inclusive, are used as the base period, the reimbursement side of this transaction (the expense side) will be in and the sales side of the transaction (the gross income side) will be out. This results in a gross distortion of the base-period income of milling companies. By increasing the base period to 5 years this distortion will be eliminated.

3. *A fixed percentage on invested capital of the taxable year should be allowed as an excess-profits credit rather than a computed percentage.*—The subcommittee's report recommends that a corporation which elects to have its excess-profits credit based on invested capital shall be entitled to deduct the same percentage of its invested capital for the taxable year as was earned on its invested capital for the base period, not to exceed 10 percent or to be less than 4 percent. 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 is a difficult administrative job. It is multiplied several fold when in each individual case the invested capital, not merely for the taxable year, but for each and every one of the base years (and for each and every day of each of the base years) is required to be computed. The excess-profits tax law of 1917 allowed an excess-profits credit of not less than 7 percent or more than 9 percent on the 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. After 1 year's experience with that law it was abandoned because of the extreme difficulty of computing invested capital and net income for the pre-war years. 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 for the taxable year. Based on previous experience with the excess-profits tax laws of these earlier years, I strongly recommend to your committee that a fixed percentage of invested capital rather than a computed percenage within a cerain minimum and maximum be allowed as an excess-profits tax credit and that the fixed percentage of 8 percent.

4. *If it is finally determined to use a computed percentage, the minimum and maximum should be 7 and 9 percent instead of the suggested minimum and maximum of 4 and 10 percent.*—This recommendation is based upon a belief that the subcommittee's recommendation results in too great an inequality between those industries which had a profitable record during the base period and those industries which were not so profitable during that period. It cannot be said that earnings of 5 percent on a corporation's actual invested capital is an "excess profit," regardless of its base period history. I am firmly of the belief that a differential of not more than 2 percent between the minimum and maximum is justified. A corporation which has a substantial earnings record during the base period will use the first alternative method in computing its excess-profits credit, that is, its excess-profits credit will be its average earnings for the base period without any regard whatever to its invested capital. A corporation which is not so fortunate as to have such a substantial record of earnings during the base period may be, and is quite likely to be, less able to pay a substantial excess-profits tax on its earnings for the taxable year than the corporation which has had a consistent record over the 5 years. By limiting the excess-profits credit of those corporations which have had meager earnings during the base period to a mere 4 percent of the invested capital of the taxable year the

pressure of the tax falls most heavily upon those least able to pay. In the event that your committee finally determines that a computed percentage of invested capital should be allowed in computing the excess-profits credit and that this percentage shall be within a certain minimum and maximum, I recommend that the minimum and maximum be 7 and 9 percent instead of the suggested rates of 4 and 10 percent contained in the subcommittee's report.

5. *The election of a corporation to have its excess-profits credit based on its average earnings for the base period or on a percentage of the invested capital for the taxable year should not be unalterably and irrevocably binding.*—The purpose of the election by the taxpayer to compute its excess-profits credit by averaging the earnings of the base period or by applying a percentage to the invested capital of the taxable year is to allow the taxpayer the opportunity to use that method which will afford to it the higher excess-profits credit. Because of the complexities in computing invested capital, as well as net income, many corporations will make honest mistakes in their returns and will choose that method which will be, upon audit of the returns, found to be the lower of the two alternative methods offered. Provision should be made so that the election made in the return is not unalterably and irrevocably binding. A corporation should have at all times available to it the higher of the two alternative methods.

6. *Nontaxable stock dividends should be included in invested capital.*—Nontaxable stock dividends are as much a part of retained invested capital as taxable stock dividends. From the standpoint of the corporation both taxable and nontaxable stock dividends represent capitalized earnings. They represent accumulated surplus which have been left in the business and which the management expects to be left permanently in the business as a part of its invested capital. I see no reason for distinguishing between taxable and nontaxable stock dividends in the computation of invested capital.

7. *Invested capital should not be reduced by an operating deficit.*—The excess-profits tax laws of 1917, 1918, and 1921 recognized that a corporation was entitled to a minimum invested capital equal to the actual investment by the stockholders in the corporation regardless of the fact that a part of that capital may have subsequently been lost in operating deficits. A corporation which started business in 1934 with $500,000 of capital paid in cash by its stockholders, which has made no distributions out of capital prior to January 1, 1940, and which has an accumulated operating deficit of $100,000 at January 1, 1940, should still be entitled to an invested capital of $500,000 at that date. As I understand your subcommittee's report, the invested capital of such a corporation would be reduced to $400,000. This appears to me to be inequitable and to operate most unfairly against those corporations least able to bear the burden of an excess-profits tax.

8. *The percentage of borrowed capital to be included in invested capital should not be dependent on the size of the borrowed capital.*—Your subcommittee's report recommends that 100 percent of the borrowed capital should be included in invested capital up to $100,000, that 66⅔ of the borrowed capital should be included in invested capital from $100,000 to $1,000,000, and that 33⅓ percent of the borrowed capital in excess of $1,00,000 should be included in invested capital. I see no reason for including a greater percentage of the smaller borrowings in invested capital than of the larger borrowings. The stockholders of corporations are those who ultimately bear the personal burden of the corporate tax. A corporation with $5,000,000 of borrowed capital may be owned by 1,000 stockholders, which would represent an average of $5,000 for each stockholder. Considering this fact, it is obvious that the stockholders of large corporations are not necessarily persons of substantial means and able to bear the burden of a high excess-profits tax. As I see it, there should be no differential and whatever percentage of borrowed capital is determined to be allowable in computing invested capital should apply to all borrowed capital regardless of the amount of the borrowed capital.

Furthermore, it seems to me that borrowed capital should either all be allowed in invested capital, in which case the interest thereon would be disallowed as a deduction in computing the net income subject to the excess-profits tax, or all borrowed capital should be excluded from invested capital, as it was in previous excess-profits tax laws, and the interest allowed as a deduction in computing the net income subject to the excess-profits tax. If the previous law is followed in this respect the computations of invested capital will be greatly simplified in that the daily computation will not be required. That is necessary only where borrowed capital is a factor in the determination of invested capital.

9. *Proper provision should be made for successor corporations to use the base period data of their predecessor corporations in determining their excess-profits credit.*—Since the beginning of the base period many corporations have been reorganized and in other cases the corporate structure has been simplified by the elimination of subsidiary corporations through merger or consolidation. Adequate provision should be made so that businesses which have been continuously in operation during all of the base period and are still in existence in the taxable year shall not be deprived of the opportunity to use their base period earnings as the basis of their excess-profits tax credit merely for the reason that the business was operated by a successor corporation in the taxable year. Permission should be granted such successor corporations to use the base period data of their predecessor corporations.

10. *The present excess-profits tax and the present capital stock tax should be eliminated.*—The present capital stock and excess-profits tax laws are inextricably bound together. They are unsound in principle. The capital stock tax is not based on any actual valuation of the corporation's property or of its capital stock, or its value as a going concern, but is based on a declared value of capital stock, which declaration may be in any amount that the executives of the corporation choose to declare. They make their declaration with one eye on the excess-profits tax which is a companion tax. The total amount of capital stock tax and excess-profits tax paid by corporations under the present laws depends not so much upon the record of the corporation, but upon the good or bad luck which the executives have in their effort to prognosticate future earnings. It is more essentially a "guess tax" than any tax with which I have ever had experience. With the passage of the proposed emergency excess-profits tax law carrying rates comparable with those contained in the previous war period excess-profits tax laws, the capital stock and excess-profits tax now on the books should be eliminated.

Respectfully,

MILLERS' NATIONAL FEDERATION,
By CLAUDE W. DUDLEY, *Tax Counsel.*

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[Telegram]

SPRAY, N. C., *August 10, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Ways and Means Committee,*
*House of Representatives, Washington, D. C.:*

Thanks for permission to appear Monday before your committee in excess-profits tax hearing as conveyed by telegram from Barron K. Grier, committee clerk, but regret will be unable to be present. I do hope, however, that it will be possible to read into the record my letter to you of July 31st, which was handed to you by Mr. Julius C. Martin, and also this telegram. In that letter I endeavored to show that many corporations made losses or subnormal profits during the base period years 1936 to 1939 because while maintaining a high wage standard themselves they had to compete with corporations which paid very low wages and worked long hours weeks. Conversely, the corporations which paid low wages made big profits, and thus have an unfair advantage over the high-wage corporations if they use their average earnings during the base period as their excess-profits credit, and the mills which paid high wages and worked their employees reasonable hours will be correspondingly penalized as a result of having done so.

It would seem fairer to use in all cases the same excess-profits credit which is permitted to corporations which were not in existence during any part of the base period; namely, 10 percent of the first five hundred thousand of invested capital and 8 percent of such capital in excess of five hundred thousand. I cannot understand why new corporations are given such an advantage over older ones as is provided in the proposed bill. I respectfully request that your committee take the necessary action to make the bill more equitable in this respect.

SPRAY COTTON MILLS,
KARL BISHOPRIC, *President.*

SPRAY COTTON MILLS,
*Spray, N. C., July 31, 1940.*

HON. ROBERT L. DOUGHTON,
*Chairman, Ways and Means Committee,*
*House of Representatives, Washington, D. C.*

DEAR SIR: This morning's newspaper informs us that among the various plans for excess-profits taxation considerable attention is said is said to be given by your committee to one which would operate as follows:

Corporations with invested capital of less than $500,000 which have during a period of years earned as much as 10 percent of their capital investment would be allowed a 10-percent deduction before computing the tax. Corporations which had earned less than 10 percent would be allowed only an 8-percent deduction. Corporations with invested capital of $500,000 and more would be allowed a 10-percent deduction if their earnings amounted to 10 percent during the specified period, otherwise they would be allowed only 6 percent deduction.

Such a provision would work a hardship on numerous corporations like ourselves which during a period of years have either made losses or low profits because of the fact that they have endeavored to maintain a decent standard of wages and have had to sell their goods in competition with firms which have paid niggardly wages and have worked their employees excessive hours.

We operate a spinning mill only, producing cotton yarn. When the N. R. A. was found unconstitutional by the Supreme Court a great many competing spinning mills soon reduced their wages to a very great degree, some of them actually going to as low as 10 cents per hour and lengthening their work week from 40 hours to 50, 55, and in some cases as much as 60 hours per week. We, however, did not do this, but maintained the N. R. A. minimum of 30 cents per hour, in fact, our minimum during most of the years since the inauguration of the N. R. A. has been considerably higher than 30 cents per hour, and at no time have we operated more than 40 hours per week per shift. As you know, during recent years the cotton textile industry as a whole has suffered greatly. You can readily understand, therefore, that having to meet such low-wage, long-hour competition as mentioned above and maintaining a higher standard of wages and a shorter workweek ourselves, we have suffered even more than most spinning mills. Our record for the 5 years ending December 31, 1939, was as given below:

| | *Gain* | *Loss* |
|---|---|---|
| 1935 | | $41,708.32 |
| 1936 | | 71,121.30 |
| 1937 | | 71,001.48 |
| 1938 | | 117,714.41 |
| 1939 | | 9,944.89 |
| | | 311,580.40 |
| 5-year average | | 62,316.08 |

You will observe that in no year did we make any gain whatsoever and that our average for the 5 years was a loss of $62,316.08 per year. While a portion of the above losses was the result of depreciation in values of stocks and bonds which we held as investments and which we had to sell along during the years in order to provide operating income, our losses were in chief measure the result of two things:

First, higher labor cost than our competitors because we maintained the N. R. A. standards of hours and wages and better. We persisted in maintaining our wage level, all the time hoping that one of the various wage-and-hour bills constantly before Congress would eventually become law and thus force our competitors to come up to something nearer our own wage level. During all these years we constantly urged our North Carolina Senators and our congressional district Representative to support these various wage-and-hour bills which were introduced from time to time. Finally our hopes were realized and the present wage-and-hour bill became law and you will observe that in 1939, the first year of operation of this Fair Labor Standards Act, our loss was only $9,944.89, even though the legal minimum wage was still only 25 cents per hour and the workweek, 44 hours, as compared with our better-than-N.-R.-A.-standard minimum wage and our 40-hour workweek.

Second, the other principal cause of our manufacturing losses was that we were an old mill built in 1896 and our machinery was worn out and obsolete

and we could not on that account compete successfully with our competitors which had newer and more modern-type machinery. Many of these mills were financially able to put in this new and more efficient machinery because of great profits which they made as a result of the low wages they paid and the long-hour workweeks at which they operated. We, ourselves, did not dare to put in new machinery until the fair-wage-and-hour bill was passed because we realized that even with the new machinery we could not hope to compete successfully with mills paying 10 and 15 cents per hour and working 60 hours per week. As soon as the Fair Labor Standards Act became law, we immediately took steps to replace our old machinery with new and by the help of large amounts of borrowed money, we have gone a considerable way in this replacement program and now can operate profitably under normal conditions provided the fair-wage-and-hour law is continued in force.

You can see, however, from the above how the proposed plan of excess-profits tax will penalize us and we will be thus penalized because we paid through the years a high standard of wages and maintained a 40-hour workweek in spite of unfair competition in these respects from other mills making our line of goods. If we make profits from now on, as we hope to do, it will be because we do not have to contend with the unfair low wages of competitors and because of the modern machinery which the Fair Labor Standards Act has permitted us to dare to purchase and not because of war conditions. In view of the foregoing we are wondering if you would not consider it fairer to let the 10 percent on invested capital deduction be applicable to all corporations regardless of their previous earnings and regardless of whether their invested capital be more or less than $500,000. It would seem fairer to treat all alike.

We apologize for taking up so much of your time with such a lengthy letter but we are sure that you and your committee want to do what is right and you can see how the plan now proposed would probably be unfair to many others besides ourselves.

Yours respectfully,

SPRAY COTTON MILLS,
By K. BISHOPRIO.

P. S.—As our invested capital is over $500,000 we would be permitted to deduct only 6 percent under the proposed plan before coming under the excessive-profits tax provision.

(Thereupon, at 5:20 p. m., the committee adjourned to meet tomorrow, Tuesday, August 13, 1940, at 10 a. m.)

# EXCESS PROFITS TAXATION, 1940

TUESDAY, AUGUST 13, 1940

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, D. C.*

The committee met at 10 a. m., Hon. Robert L. Doughton (chairman) presiding.

The CHAIRMAN. The committee will please be in order.

Mr. TREADWAY. Mr. Chairman, before starting the meeting, may I say that one of the witnesess who is unable to be here because of illness has been in communication with me about his testimony and finds he is not able to come. I request that he be allowed to file a brief.

The CHAIRMAN. Without objection, it is so ordered. There appears to be no objection.

The CHAIRMAN. The first witness this morning is Mr. Edward J. Harding, of the Associated General Contractors, Washington, D. C. Is Mr. Harding present?

(No response.)

The CHAIRMAN. His name will be stricken from the calendar.

The next witness is Mr. Henry B. Fernald, of the American Mining Congress. Mr. Fernald, will you please come around and give your name and address to the stenographer, and whom you represent?

## STATEMENT OF HENRY B. FERNALD, MONTCLAIR, N. J., CHAIRMAN OF THE EXECUTIVE TAX COMMITTEE OF THE AMERICAN MINING CONGRESS

Mr. FERNALD. I am Henry B. Fernald, of Montclair, N. J., chairman, executive tax committee of the American Mining Congress.

The CHAIRMAN. Proceed.

Mr. FERNALD. The time since the subcommittee's report became available has been wholly inadequate for full consideration of the proposals therein made. Furthermore, the brief outline in the report does not discuss many matters of definition, specification, and technical questions, which can only be fully considered when the draft of the bill becomes available. Accordingly, we shall confine our discussion to certain points of particular importance as they affect the mining industry.

We appreciate the difficulties of your committee in your desire to draft an excess-profits tax which will reach what are in fact "excessive" profits and at the same time will not work hardships and injustices on those whose profits are not in fact "excessive." We feel that the

use of the alternative methods for computing the tax, the recognition of borrowed capital, and some of the other proposals made, clearly evidence your desire to be fair to taxpayers.

The full recognition which the proposal seems intended to give to earnings of the base period will undoubtedly simplify the computations for those taxpayers who had normal earnings during the base period. Unfortunately, however, only a small percentage of the total number of corporations of the country had even fair average earnings for this period; at least that has been the case in the mining industry. That the majority of mines or other industries did not have satisfactory returns during the 4-year base period is not of course any reason why the principle of recognition of prior earnings should not be applied to those who had satisfactory years.

It is generally recognized that the mining industry is one in which there is great fluctuation of income from year to year. It looks to an average return from good years and poor years in order to obtain a satisfactory result. Profitable years must make good the losses of poor years. A mine once opened cannot readily be shut down completely in bad years, if there is any hope that in the future it may be able to make profits. If abandoned, it may fill with water, its entries and workings may cave; and in many cases it will become exceedingly difficult if not impossible ever to reopen it. Consequently the operator is likely to keep the mine pumped, at continual expense, and may operate it on a minimum scale in order that it may be available for operation in better years. Accordingly then, the maintaining of the mine in working condition during years of loss or of no income is, in effect, a part of the additional investment required to yield the future profits.

Furthermore, an operating property is usually the result of a considerable period of exploration, development, and equipment, before the mine reaches a production stage. Accordingly, the income of the years in which the mine is making profits reflects not merely the profits and the capital returns for these profitable years but also the return for the earlier years before it reached the stage of profitable production.

We cannot determine whether the income of any particular year is anything more than a fair and reasonable return for that year, unless we take into account the period of development, the years of loss and the years of low yield. A drastic, rigid excess-profits tax will therefore have an exceedingly and unjustifiably serious effect upon the mining industry.

Without attempting to discuss various details which it will undoubtedly be important to consider when the draft of the bill becomes available, we mention at the present time the following major points for your consideration:

(A) Date of incidence of the tax: The subcommittee proposal is that the excess-profits tax should apply to all fiscal years beginning after December 31, 1939. A large part of the taxable year 1940 is already behind us. We have already made a very substantial increase in the income tax for the year, which applies to the transactions of many months before the Revenue Act of 1940 was enacted. We should not aggravate this situation by the imposition of a new, complicated, difficult, unforeseen tax with retroactive application.

The estimated yield of the excess-profits tax if applied to the year 1940 has been given as $190,000,000. Only a part of that total amount would be applicable to the now remaining months of this year, which really is the only period to which the tax should apply. Certainly no material part of that amount will reflect the results of the national defense appropriations which still remain largely unexpended.

The small amount which it is estimated will be raised by this tax does not warrant the difficulties which will arise from an attempt to apply it retroactively. Greater justice will be done to taxpayers by a deferment of the application of this tax until January 1, 1941. Great disturbance to business will be avoided. It must be remembered that even after such a law as this has been enacted, some considerable time must elapse before any taxpayer can obtain an accurate understanding of the application of the tax to his particular affairs.

Many taxpayers may already have paid out dividends from earnings after setting up reserves only for the taxes heretofore imposed. Others may have used their profits for plant and equipment expenditures. In either case they may find themselves without any reserve of funds with which to pay a new heavy tax.

Furthermore, if the effective date of this tax is deferred, there will be better opportunity for consideration of the many intricate questions which arise in framing the law. If the amortization provision is separately passed, and if the act is not to be effective until the beginning of next year, there will be no occasion for the great haste in passage which is almost sure to mean gross injustices to some taxpayers which we believe your committee will join with us in wishing to avoid.

(B) Base period earnings: The proposal is to use the earnings experience of 4 years—1936 to 1939, inclusive—taking the average of the 4 years for all corporations which were in existence during that entire period.

Compelling all taxpayers to use 4 consecutive years as a base period will produce inequities which should be avoided. Special and nonrecurring expenses or losses developing in 1 year will seriously penalize a taxpayer if such year is included in the base period. Also in the mining business there are years in which adverse conditions encountered in the operations will depress the earnings below a reasonable level, or a cessation of production may result in no earnings or a heavy loss for a part of the base period.

In order to avoid these inequities we suggest the taxpayer be permitted to use any two of the four base period years in computing the average.

(C) Comparative income of base period and taxable year: In comparing the net income of the taxable year with the average net income of the base period it is essential that the incomes of all years should be on a reasonably comparable basis. Many questions involving reorganizations, consolidations, or other property acquisitions will have to be considered. Insofar as these occurred after the close of the base period they seem to be taken into account in the subcommittee's plan. Those which occurred during the base period, even in the final year of that period, will not be taken into account in any way under method (*a*). Yet there may be a material distortion of income comparison unless they are taken into account. Adequate provision (possibly such as that of sec. 330 of the 1918 act) should be made so that income of the base period will reflect the income of the

properties and businesses whose income is reflected for the taxable year.

(D) Alternative plans: It is necessary to have alternative plans. The report proposes Method (*a*) credit based on average base period income, and method (*b*) credit based on invested capital.

We believe that it would simplify the proposal and be only fair and equitable if provision were made for the computation under method (*a*) substantially as now proposed but with certain modifications herein referred to, and that method (*b*) should be a flat allowance of 10 percent of the invested capital of the taxable year. We believe 10 percent is not an excessive rate of allowance when the normal risks of investing capital in business are considered and especially is this true in a speculative industry such as mining. The subcommittee has recognized 10 percent as a fair return for new corporations for industries in general.

The allowance of 10 percent of invested capital for the taxable year will eliminate all the complications involved in computing the daily average invested capital for the 4 years of the base period.

A flat 10 percent rate could then be used without differentiation as to new money, and without the further complications which the use of several different rates of exemption introduce in the present proposal.

We accordingly urge that method (*b*) should be modified and a flat 10 percent exemption on invested capital be used.

(E) Credit based on average base period income: This method (*a*) is only available, under the proposal, to those corporations which were in existence for the entire 4 years of the base period. We believe it should be made available to corporations which were in existence for 1 full year or more of the base period.

(F) Election as to method: The report is not clear as to what "election" is given to the taxpayer. The spirit of the report appears to contemplate that the taxpayer will have the right at any time to a determination of his tax either under method (*a*) or method (*b*) as might be more advantageous to him.

Few, if any, taxpayers have yet had final determinations made by the Treasury Department of the net income for all years of the base period. Until that is done they will not know the amount of their exemptions under method (*a*). There is no probability that any taxpayer will be able in the first instance correctly to determine the amount of invested capital applicable under method (*b*). Accordingly, any computation made at the time of submitting the tax return may be subject to variation and change, one way or another, before final determination is made of tax under this law. The taxpayer will be in no position to make an intelligent election at the time of filing his tax return. The taxpayer should have the right to pay whichever tax, under method (*a*) or method (*b*), will be lower; except only that the taxpayer should have the right, if he so desires, to be taxed under method (*a*) without any requirement to make the invested capital computations.

(G) Equity invested capital: We note the following particular points for comment:

(1) Provision is made that the accumulated deficit as of the beginning of the taxable year shall be applied in reduction of invested capital. This we believe should not be done.

As to mining companies it is generallly found that a mine can best be maintained in a position for future earnings by keeping it open, and even to some extent operating, during periods of depression. This is true not merely from the standpoint of the physical mine itself but also from the standpoint of the entire mining organization. Often an entire community is wholly dependent upon the mine and its payroll, and if the mine were shut down, a large part of the labor would have to go elsewhere to find employment. When it came time for the mine to resume, it would be difficult and might require considerable time before an organization could again be developed for its operation. During depressed periods, therefore, so long as mining operators can feel there will be a future opportunity for the profitable operation of a property, they would rather keep the mine going, even at some loss, than to shut it down and abandon the entire enterprise.

Of course there is a limited opportunity given under the tax law for the carry-forward of operating losses of 1 year over 2 succeeding years, but this does not give full relief in the case of mines which may have been sustaining 5 to 10 years of loss in the hope of finally coming to years of profitable operation. In any event, however, the right to carry forward that loss does not affect the merit of the contention that the accumulated losses should not, for invested capital purposes, decrease the investment which has been made in the property.

(2) Provision is made 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. This was a provision of our prior excess-profits tax laws. Under those laws it was not an unreasonable assumption. That situation is, however, changed 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. For example, if a dividend of $100,000 were paid on February 1, and the profits earned for the entire year proved to be $120,000, the February 1 dividend would be considered, under section 115, as having been paid out of the profits of that year, even though these profits had not been earned until after the dividend date. 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.

(H) Borrowed 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 allowances for borrowed money will require exceedingly involved computations. If the full 100-percent allowance for borrowed money is made, it will greatly simplify the average computations in the case of any company, where otherwise the differential computation might become very involved.

We further suggest that it should be made optional with the taxpayer as to whether he would include borrowed money as invested capital (with the exclusion of interest thereon in computing net income) or would exclude borrowed money from invested capital and have full deduction for interest. It is quite possible that some corporations would rather avoid the extended computations which will be necessary to compute daily average invested capital based on borrowed money than to get some small advantage from the inclusion of borrowed money in invested capital. Furthermore, if the inclusion of borrowed capital is required, it may discriminate unfairly against many smaller corporations which pay comparatively high rates of interest for borrowed capital.

(I) Consolidated returns: We most strongly urge that taxable net income and invested capital, for integrated enterprises consisting of more than one corporate entity, be permitted to be determined on the basis of consolidated returns. 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.

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.

The use of consolidated returns would in itself eliminate many problems of reorganization, consolidation, and change of ownership, such as those referred to in section (C) hereof. Provisions should be made for the same basis of consolidation in the base period as in the taxable year.

(J) Excess-profits tax should be computed on an average basis: We have already referred to the great variations from year to year in income of mining companies, so that it is only possible to determine whether or not the income is "excessive" by taking into account the net results of several years.

Injustice could be avoided by providing that the excess-profits tax should be imposed on the average returns of a period of years.

Perhaps the situation could be met by providing for a deficit carry-over; whereby, if in any year the corporation failed to earn the full amount of its exemption, the excess of its exemption might be carried forward as an adddition to its credits in subsequent years. This would probably be satisfactory to companies which started in with such deficits in the first years subject to the excess-profits tax so that the deficit allowance could be carried forward to subsequent years of profits. It might not be satisfactory for those who had larger profits in the first excess-profits tax years and then later had losses, unless full and adequate provision were made for refund or credit, and so forth.

Perhaps a fairer proposition might be to provide that in no event should a company be considered to have excess profits in the first excess-profits tax year unless its income for that year were in excess of the best of its base period years. Then it would not be considered to have had excess profits in its first 2 years unless their aggregate result was better than the best 2 years of the base period, and so forth.

(K) Foreign tax credit: The subcommittee report proposes that dividends from foreign corporations should be eliminated in computations of excess-profits net income, where the invested capital method is used. According to the theory of the excess-profits tax as we understand it, namely, that it is intended to apply to the profits which may be produced directly or indirectly by our defense program, it would seem reasonable that all income derived from operations in foreign countries should be wholly excluded from excess-profits net income.

If, however, such income is to be included in excess-profits net income, then credit should be allowed against the excess-profits tax for foreign-income and excess-profits taxes, to the extent not used against the normal income tax. It would be inequitable to give no recognition to such foreign taxes or subject such foreign income to a United States excess-profits tax without relief from multiple taxation.

(L) Excess-profits tax brackets: The present proposal is to apply a 25-percent tax to a first bracket representing 10 percent of the exemption; a 30-percent tax to a second bracket representing 10 percent of the exemption; and to tax all the balance at 40 percent.

The first two brackets we feel are very narrow. The 1921 law for example, allowed an 8-percent exemption (plus $3,000), then income in excess of the exemption and less than 20 percent of invested capital was taxable at 20 percent, and income in excess of 20 percent of the invested capital was taxable at 40 percent. Thus (except for the $3,000 exemption) the income in the first bracket was equivalent to 150 percent of the exemption. Under the committee's proposal the first and second brackets are each only 10 percent of the exemption so that the 40 percent rate of tax applies on a relatively much larger proportion of income.

We believe it would be fair that each of the two lower brackets for the new tax should be equal to the amount of the exemption.

(M) Special relief: The subcommittee's proposal suggests that in view of certain other proposed provisions for the new law, there will be no occasion for special relief except in the single case where the Commissioner is unable to determine the invested capital.

If the years 1936 to 1939 could be considered as "normal" years for all corporations, there might be more merit in this contention. However, we know that for only a comparatively few of the total number of corporations of the country were these years of the base period on the average at all satisfactory. Certainly this is true as to mines. There will therefore be many corporations that will still have real occasion for special relief if they are not to be dealt with harshly and unfairly.

We therefore recommend that the special relief provision should be considerably broadened, probably under provisions similar to those of prior acts.

We believe, however, that the special relief provisions should be administered as a matter of equity by a special board, apart from the Bureau of Internal Revenue. We believe the application of special

relief should not rest in the same Bureau that has to deal with the application of the technical provisions of the law.

(N) Amortization: Many established mining companies will not be greatly concerned with the proposed amortization provision. However, numerous new mining ventures, particularly in the field of strategic minerals, and probably some established operations, will be called upon to make substantial expenditures to create necessary productive capacity for defense purposes. We understand that such mining enterprises will be covered by the amortization provisions if the new or increased facilities are certified by the Advisory Commission to the Council of National Defense as necessary or desirable for the national defense.

We recognize the urgency of immediate enactment of such special provision for amortization and there appears to be no reason why it should be delayed, as we understand there is no essential difference of opinion regarding it.

However, there is evident no good reason for such haste in the enactment of an excess-profits tax law. Accordingly, we urge that these two measures be separated and that the many complexities of an excess-profits tax be subjected to full and careful consideration before the enactment of such a law.

I would also like to state when notice of these hearings was given, the American Mining Congress made the request that Mr. Evan Just, of the Tri-State Zinc & Lead Ore Producers Association of Miami, Okla., and Mr. Donald A. Callahan, of Wallace, Idaho, representing the Idaho Mining Association, be given an opportunity to be heard on behalf of those whom they represent.

Mr. Just and Mr. Callahan arrived in Washington yesterday, the earliest possible time at which they could get here by train from their respective communities. They were greatly disappointed upon arriving to find that so specific bill was being considered and that the time for the hearings was being distinctly curtailed. They have not had an opportunity to contact the people they represent since obtaining a copy of the report of the subcommittee.

Accordingly, they ask me to state that they will not make an appearance at this time, but reserve the right to request an opportunity to be heard before the proper committee of either the House or the Senate when a bill embodying the recommendations of this committee shall be introduced.

Mr. BOEHNE. I just want to make an observation, Mr. Chairman, which does not directly deal with the testimony, except as referring to the very first sentence of Mr. Fernald's testimony, also the very last paragraph.

It is only a personal opinion of mine, but I think the press of the country has been unfair not only with this committee but with the Congress as a whole in demanding more speed on the defense program.

A number of editorials have been presented critizing Congress for their lack of haste on the defense program and then we have had men like Mr. Knudsen and others come before us and tell us that under no conditions would businessmen sign contracts for the manufacture of armament for defense purposes unless they knew exactly what kind of law Congress was going to pass.

I think it is proper to call the attention of the country to the fact that at the time the Revenue Act of 1940 was being considered by the

conferees of both Houses of Congress, when they struck out the excess-profits provision that was inserted in the Senate, an agreement was reached by the conferees that the tax experts of the Treasury would be asked to study an excess-profits tax law for presentation to Congress not later than October 1st. I think it is fair for the country to know that the Congress has been most diligent in trying to present an excess-profits tax law, particularly in view of the fact that businessmen will not sign these contracts unless they know what the law contains. I think that is entirely proper, because any businessman wants to know what is going to happen—because laws do affect the businessman's business. And I think we, at the same time, should be given the same consideration they are asking of us.

Mr. FERNALD. Mr. Chairman, may I simply say, regarding that, that I quite agree there has been unfair criticism by those who have not appreciated at all the magnitude of the program involved in national defense and those who have not appreciated at all the magnitude of the problem involved in drafting an excess-profits tax law. And what I have said is not in any spirit of or in any way criticizing your committee and what it is trying to do. What I say is that I think you will find—and I am expressing my considered opinion—that a lot of people will be delighted to sign defense contracts after the amortization provision is taken care of, and will not feel that they must wait until they can determine the exact provisions of this excess-profits tax law. That is not worrying them. It is not the question of what is going to happen in connection with the excess-profits tax, but what is worrying them is what allowance will be made, or will be made to them in computing taxes with regard to the expansion of facilities, and so forth.

Mr. BOEHNE. They would like to know what amortization schedules would be given?

Mr. FERNALD. Yes, sir.

Mr. BOEHNE. Do you not agree, also, that when they know that, they will also be interested in knowing what the Government will take away from them?

Mr. FERNALD. They are interested in knowing it, but, even after this law is passed, it will be months before they can even have the dimmest glimmer of what these complicated excess-profits tax provisions mean. I am sure that those of you who have been studying it diligently, as I know you have been studying it, appreciate that it is not an easy thing for anybody to determine under this proposed law what this excess-profits tax, as required under the law, will be.

The CHAIRMAN. If this witness is in a better position to know the attitude of the contractors with whom the Government is negotiating than is the National Defense Council, who have that obligation and duty, then we should know about it. They have, after the most concrete contact with the matter, come before us and stated positively that they are unable to get contracts signed until they know what these provisions will be. Now, you say there is no reason for haste in the enactment of an excess-profits tax bill. In that, you say that you are in a better position to know what the contractors will do than is the Council of National Defense. Your testimony is directly contrary to their testimony on that point.

Mr. FERNALD. The only suggestion I can make is that my expression to you is made after conferring with those men, and asking them if it would not be a satisfactory solution if this should be put through, and that you should have further time to consider the excess profits taxes. That is the suggestion.

Mr. TREADWAY. In connection with the remarks of Mr. Boehne, so far as Mr. Knudsen's testimony was concerned, my recollection is that when he appeared before the Subcommittee on Taxation, or the subcommittee which framed this recommendation for the full committee, in executive session, he was very positive in his statement that it was necessary to have these three provisions go along together—that is, the amortization, suspension of the Vinson-Trammell Act, and the excess-profits tax provisions. Following that session with Mr. Knudsen, Mr. Cooper, the chairman of the subcommittee, gave out a public statement which we confirmed, or which the members of the subcommittee confirmed, that we were ready and anxious to cooperate with him in preparing this bill, and we offered every assurance possible that it would be satisfactorily arranged for the contractors who are holding up their agreements with the Government in connection with the national defense. The statement Mr. Cooper made at that time seemed to give assurance to the contractors, because when Mr. Knudsen appeared later in an open meeting on this bill, or on the recommendation, he said that they were not having any difficulty with contractors at that time as they had had previously. In other words, that they were taking the assurance of ours that the whole matter would be satisfactorily cleared up.

I am very certain that our records will show that Mr. Knudsen at that time testified that they were not having difficulty. I cannot quote his exact language, but that was the idea, that the contractors were coming across and signing up with the Government on the assurance that we would expedite the legislation. We have had others who testified to the fact that the three problems could be separated, and that the one thing the contractors wanted to know was the extent of the amortization which they had been assured of. There have been speeches made on the floor which, probably, the witness has read, quoting contractors as willing to sign contracts. Now, Mr. Fernald, with his wide experience in connection with the same subject matter, comes before us and confirms the testimony that we have had, or the suggestion we have had, that the problems could be separated, and that it would be satisfactory to the interests he represents if the excess-profits tax provisions were delayed and given further and more complete study. Am I right in that?

Mr. FERNALD. Yes, sir.

Mr. TREADWAY. That is the attitude of your organization, is it not?

Mr. FERNALD. Yes, sir.

Mr. TREADWAY. Have you had occasion to make contracts with the Government?

Mr. FERNALD. Our mines generally do not have occasion to make contracts with the Government, but we are in contact with those who are using the products of the mines in their contracts with the Government, and it is on that basis that I am particularly speaking.

Mr. TREADWAY. In other words, your knowledge on the subject of the separation of these questions comes from those who are having

practical experience with people who are entering into contracts with the Government?

Mr. FERNALD. Yes, sir.

Mr. TREADWAY. And they have assured you that they would not delay their acceptance of Government contracts awaiting a final decision on the excess-profits tax?

Mr. FERNALD. You use the word "assured," but the information I have had from them is that they would rather have the amortization provision immediately enacted and gotten out of the way, if they felt that Congress was taking the necessary time to get a fair and proper excess-profits-tax bill framed. They would prefer that rather than to feel that the speed in trying to get through the amortization provision was carrying with it an incomplete and unsatisfactory consideration of the excess-profits-tax provision.

Mr. TREADWAY. You do not quite answer my question.

Mr. FERNALD. Pardon me.

Mr. TREADWAY. I am not criticizing your statement at all, but I want to get a little more specifically their attitude about agreeing on the desirability of the Government proceeding with this bill without the excess-profits tax being included.

Mr. FERNALD. I think all the expressions I have heard indicate an entire willingness to do that.

Mr. TREADWAY. I have another question: In this very complete brief that Mr. Fernald submits, he refers on page 8 to consolidated returns, and advocates their inclusion in this bill.

Mr. FERNALD. Yes, sir.

Mr. TREADWAY. When we were in executive session, which was secret, but it is not a secret now so far as the executive session was concerned, we were informed that it was a very intricate subject on which to properly frame the necessary language. We have an expert drafting force. We are, of course, dealing with various subjects, and must depend on the advice of these experts whose business it is to draft language covering all these questions. They have assured us that the drafting of language, or proper language, for consolidated returns is a very intricate and complicated task, and that it would, perhaps, cause more delay than the inclusion in the bill of the excess-profits tax. We had a witness the other day who said that the language could be prepared in 3 hours. We asked him if he would take Sunday off, that being Saturday when he testified, to prepare it. He testified in effect that there would be no difficulty at all in drafting it, and we suggested that he be allowed, in addition to his church duties, to devote some time to drafting a consolidated returns provision. However, it has not yet been presented to the committee. What is your reaction to the statement I am making about our experts?

Mr. FERNALD. Mr. Chairman, I have the greatest respect for your experts and the difficult job they have before them, and the way in which they discharge their duties. Certainly, time is required for the consideration of these matters, and it can only be drafted by giving time to it. I do think that it is possible to get such a provision drafted. I recognize that it may take a little time, just as other things will take time. It is for that reason, and in full sympathy with the difficulty of the problem of drafting the provisions, that I made this recommendation of divorcing those subjects, and giving

the necessary time to get the right kind of excess-profits-tax law prepared.

Mr. TREADWAY. I have another question about consolidated returns: Do you think that the consolidated returns provision need necessarily be an integral part of this bill here before us, in view of the fact that the next session of Congress will start during the first week in January? Of course, the subject of taxation is one thing that is always with us, unfortunately, but at that time there will be, of course, ample opportunity to study the intricacies of the problem facing us in the matter of consolidated returns. Therefore, my question is do you consider it essential that the consolidated-returns feature be included in the bill we are now worrying along with?

Mr. FERNALD. I think it ought to be included. I would hate to see a bill go through with the clear intimation that you anticipated you must start out in January with a revision of provisions which you had not had time to consider at first. If this bill is to be applicable to the year 1940, certainly consolidated returns should be provided for in it. Therefore, I think that provision should be in it at this time.

Mr. TREADWAY. Of course, the 1940 returns will not be due until March.

Mr. FERNALD. I appreciate that.

Mr. TREADWAY. So they would have from January to March to notify the unfortunate taxpayers of what they would face, even if we assume that the provision we are talking about now would be applicable to the year 1940.

Mr. FERNALD. The very few months remaining between now and March 15 will pass very quickly to those who have the immense problem of making up the computations that would be involved.

Mr. TREADWAY. You can see the difficulty that we are suffering from.

Mr. FERNALD. I thoroughly appreciate that.

Mr. TREADWAY. And we appreciate your sympathy.

Mr. REED. I just want to make one observation: We have all these editorials in the papers voicing rather severe criticism of the delay of the defense program by reason of the failure to work out this problem. If I am wrong, I want to be corrected, but it is my understanding, and has been all the time, that the administration itself has insisted that the three propositions go along together instead of separately.

The CHAIRMAN. If we have them together, it will not cause very much delay, so far as our consideration is concerned. It was the understanding that they had worked out a satisfactory excess profits tax provision. It has been the understanding all the time, and the subcommittee seemed to be unanimously convinced, that the three proposals would be combined. That was the statement Mr. Cooper, the chairman of the subcommittee, made, in which he referred to contractors relying on that in their willingness to sign contracts—that is, on the basis that the three propositions would be combined in one bill, and not carried separately.

Mr. DISNEY. I was one who thought we ought to work on the amortization feature immediately and get it out of the way, but when Mr. Knudsen, who is a great businessman, and not a part of the administration, came here before the committee, after immediate contact with contractors, and told us that he could not get this program under headway unless the amortization feature, the excess-profits tax,

and the suspension of the Vinson-Trammell Act were determined. He convinced me that we ought to incorporate the three features in the one bill. Then my position on proceeding piece-meal vanished immediately on hearing that testimony, in the light of his contact with the contractors, and knowing what they were thinking about with reference to entering into contracts.

Mr. TREADWAY. I know that Mr. Knudsen, in his testimony before the full committee, said in effect that the contractors, in view of the statement that was issued, were willing to sign contracts under that assurance. Is not that correct, Mr. Cooper?

Mr. COOPER. You are right on that.

Mr. TREADWAY. That was later than the testimony Mr. Disney referred to.

Mr. COOPER. I think you are correct about that. I think the record will also show that Secretary Stimson stated that since that statement was issued by me, as chairman of the subcommittee, the experience had been much more favorable.

Mr. DISNEY. Mr. Fernald, referring to the statement on page 4 of your statement, with reference to the consolidation of companies, I have in mind the purchase by one company of sizable proportions of another company of sizable proportions. Now, each had the same earnings during the past period as a basis of returns, but the result of the consolidation, or, rather, of the purchase, will have a tendency to, perhaps, double the earnings in the latter part of 1939, or after the purchase of the corporation. Do you have any suggestion to make as to how to meet a condition of that kind?

Mr. FERNALD. One suggestion I made was the consolidated return proposition, and the other I have advanced would be a provision probably somewhat similar to section 330 of the 1918 law. There is no question but that there should be relief in cases of that kind. The third question is whether that could be covered by broadening the special relief provision by providing equitable relief. In other words, create a board to consider those cases, if each business unit as constituted in the taxable year was not comparable with the pre-war period, and to give equitable relief. In other words, some of these are technical provisions of the law, and others would be handled through the relief provision. I am trying to answer the question as to whether I made any suggestion in regard to that.

Mr. DISNEY. That is a suggestion as to how to arrive at the average earnings for the base returns of a corporation after it was purchased by another corporation with, perhaps, equal earnings.

Mr. FERNALD. The question is whether, in that particular case, it is in any way covered here in the studies that have been made, and I am inclined to agree that it is not; but I also agree that it should be done, and I believe, that the committee should have time to consider propositions of that kind.

Mr. DISNEY. Do you have any suggestion to make on a question that was raised yesterday by one of the witnesses who testified he had transferred assets in April of this year, so that he would be cut off from any alternative so far as the average earnings for the base period was concerned, but would have to be treated on the basis of invested capital?

Mr. FERNALD. Perhaps that could be handled through special relief, through a special board to be created to do equity in special

situations of that kind. I am afraid you will have so many propositions of that kind to arise that unless there is a broad provision for special relief, equitably administered, we cannot possibly avoid some injustices.

The CHAIRMAN. If there are no further questions, we thank you for your statement.

Mr. BUCK. Mr. Chairman, I am in receipt of a telegram dealing with the gold-mining question, and I think it should appear in the record at this point.

(Said telegram is as follows:)

[Western Union]

SAN FRANCISCO, CALIF., *July 18, 1940.*

Hon. FRANK BUCK,
*Congress Office Building, Washington, D. C.*

Section 304 (c) of the Revenue Acts of 1918 and 1921 exempted incomes from gold mining from the war-profits and excess-profits tax. The same conditions which justified exemption then exist today. Gold is not a war industry; the price is fixed; no abnormal profits can be made. There can be no profiteering. No new millionaires can be created by war industry stimulation. In lieu of creating abnormal profits, gold mines will be faced with hazard of extinction from inflated costs. In last World War, gold mines could not operate and meet the wage scales developed by shipyards, steel mills, and powder factories. In times of tremendous governmental credit expansion and trends toward currency inflation production of gold should be encouraged and no laws enacted which will destroy marginal ores, discourage new exploration, reduce new discoveries, and curtail production. If advantages and disadvantages are weighed gold-mining income will be exempt from excess tax. Tax revenue from gold mining will be insignificant in amount compared with the loss of national wealth and national income directly and indirectly resulting from deterent of increased taxes on exploration and operation. Gold production is a noninflationary force, and it should be promoted not crippled.

ERROL MACBOYLE, *Grass Valley, Calif.*

Mr. TREADWAY. I have a telegram on the subject of consolidated returns that I would like to appear in the record at this point.

(Said telegram is as follows:)

[Western Union]

BOSTON, MASS., *August 12, 1940.*

Hon. ALLEN T. TREADWAY,
*House of Representatives, Washington, D. C.*

Understand that subcommittee report on proposed tax on excess profits does not provide for consolidated returns. This development seems most inequitable and will work a serious hardship on this company and its several subsidiaries, particularly those in Massachusetts. Your help in bringing about a provision for consolidated returns will be greatly appreciated.

LOUIS K. LIGGETT,
*President, United Drug Co.*

The CHAIRMAN. The next witness is Mr. Ellsworth C. Alvord.

## STATEMENT OF ELLSWORTH C. ALVORD, CHAIRMAN, COMMITTEE ON FEDERAL FINANCE, CHAMBER OF COMMERCE OF THE UNITED STATES, WASHINGTON, D. C.

The CHAIRMAN. How much time do you need, Mr. Alvord?

Mr. ALVORD. I think I can cover everything I wish to say in 15 or 20 minutes. In order to save the time of the committee, I have prepared a reasonably elaborate statement, which I ask that I may

be permitted to file, and then that I may be permitted to proceed extemporaneously and as expeditiously as possible.

Mr. Chairman and members of the Committee on Ways and Means and the Committee on Finance, I wish, first, to congratulate the subcommittee of the Committee on Ways and Means. They were faced with a Herculean, and, perhaps, an impossible task. I think that in the time available to them they have done an extraordinary job, and have done it extraordinarily well. The problems with which they dealt are probably the most complicated problems in the field of taxation. I think they have very ably analyzed the problems inherent in the excess-profits tax. Many of those problems have been answered in such a way as to avoid much of the criticism that is generally hurled at excess-profits taxes.

In my opinion, an excess-profits tax must be enacted, but I think we should first consider just what we are trying to do by the enactment of an excess-profits tax, and what the purpose of a tax of this nature is. We have heard during the earlier part of the hearings the question raised about the yield. The immediate yield of the measure now before you, in my opinion, should not be considered. Under ideal circumstances—which, unfortunately, exist only in theory—an excess-profits tax will yield nothing. The purpose of an excess-profits tax is to prevent in a period of emergency like this the creation of "war millionaires," "unjust enrichment," and inordinate profits as a result of accelerated activities attributable to the tremendous expenditures required for a national-defense program. Another way to put it is that the excess-profits tax is a very effective means of partial control over prices which otherwise would be uncontrolled. But bear in mind that inflationary prices do not always result in profits. If it is understood that that is the purpose of the excess-profits tax, then, in my opinion, it becomes reasonably simple to determine upon the provisions which should be incorporated in an excess-profits tax.

Your first problem is, naturally, how do we measure *normal* profits? If we have a measure that is designed to extract profits above that normal—(which, in my opinion, is a very proper purpose, and at this particular time an essential purpose)—then we must very carefully determine what are *normal* profits.

I think the subcommittee report very properly recommends the use of a base period experience of earnings. But, gentlemen, let me remind you that the use of earnings is subject to several considerations.

First, obviously it has no application—and the subcommittee report recognizes that—to corporations which were not in existence during the base period. I think the subcommittee report should permit new corporations which were in existence for 1 or 2 years of the base period to use that experience, if they so choose. It, however, requires the use of the invested capital method, if the corporation was not in existence during the entire period—a requirement which will result in unnecessary hardship and inequality.

Second, it obviously has no proper application to what we call low earners.

We are just at the close of a decade of a terrific depression. That, I think, all of us appreciate and recognize. There is no period within the last 10 years which properly reflects normal activities. We cannot select any of the last 10 years as a true measure of normal

profits. As a matter of fact, almost everybody who has been through the last 10 years has been hoping for larger profits, and has been hanging on in that hope.

And let me point out further that the youth of this country—of which I trust I am still one—knows of no other experience except during this 10-year period of depression. Consequently, your measure of normal profits, whether it be an earning yardstick or other yardsticks, must recognize those facts.

The subcommittee report recommends the use of the 4-year period averaged—1936-1937-1938-1939. I merely point out to you that 1938 was one of the worst years we have had in the last 10. Practically every corporation sustained losses in 1938 and corporate net income was down to $4,700,000,000.

Mr. BOEHNE. Do you mind an interruption at this point?

Mr. ALVORD. Certainly not, Mr. Boehne.

Mr. BOEHNE. You said that in the past 10 years there have been no normal years. Is not that true say of the last 20 years, more or less to an extent—say ever since the World War?

Mr. ALVORD. I do not think that is true, Mr. Boehne. Personally, I think that those who happened to pick the year 1926 as a fair measure were probably sound—1926 came after we were getting pretty well out of the depression following the last war and before we got into the terrific inflation of the 1928-29 period. But let me point out to you that prices today are away below your 1926 level. Your corporate incomes today are away below your 1926 level. Your corporate revenues in 1939, notwithstanding tremendously increased tax rates and efforts to plug loopholes to prevent evasion were below your 1926 revenues.

The solution of the question of the earning period, it would seem to me, would be to take an average of 2 or perhaps 3 of the last 4 years; or even 2 out of the last 3 years would come closer to measuring normal profits.

Let me point out to you that the rates which you are recommending—and on my principle, my theory, extraordinarily high rates are justified if you use a proper measure of normal profits—mean that you are in effect putting a very definite ceiling upon all profits in excess of normal.

Therefore I urge you to consider most carefully all the factors which properly go into a consideration of normal profits.

As I indicated, base period earnings are clearly inapplicable where they have been abnormally low. You gentlemen know the industries as well as I do; the durable goods industry, the construction industry, the finance industries, the aviation industry, upon which an essential part of our national defense rests. Many of them over the last 10 years have been constantly in the red, or just in the black for a year or so. Many of them have not earned dividends for their stockholders. Many of them have not earned dividends for their preferred stockholders.

The subcommittee report properly says, we must use in that case a different measure of normal profits. But let me examine just for a moment the alternate yardstick which your subcommittee recommends.

It says we shall take invested capital. We shall compute the return on that invested capital during the base period, 1936-39. We will consider that return as normal. But it cannot exceed 10

percent, and if it happens to have been less than 6 or 4, depending on the amount of the invested capital, we will let them earn the minimum.

To me that is merely duplication. If base-period earnings are satisfactory as a measure of normal profits; if during the base period a taxpayer has realized a reasonable return, you do not have to go through all the computations of invested capital. The base-period earnings measure applies to that taxpayer.

Bear in mind, what we are now trying to do is to find a yardstick where base-period earnings have been inadequate. But the yardstick recommended as an alternative is based again on base-period earnings. it would seem much simpler, much fairer, to use a slightly different measure.

I quite recognize that invested capital and a return upon invested capital are proper measures of an excess-profits tax. But, again, the reason we use that is to determine normal profits where normal profits have not been realized. Consequently, you have got to be arbitrary.

Unless you embark upon the general program which I have suggested for criticism and discussion, which would apply special assessment ideas to the determination of normal profits—and I will elaborate on that just a little later—if you are going to avoid unfairness, if you are going to give a true alternative base—you have got to avoid prior year earnings, and choose some specific rate of return on invested capital.

The rates of return which you have used before are well known. In the 1917 act you said that the normal profits would be not more than 9 nor less than 7 percent on invested capital. In the 1918 act, for excess-profits tax purposes, you said 8 percent on invested capital. For war-profits tax purposes, which you heaped on top of your excess-profits tax, you said 10 percent. In 1921, you said 8 percent on invested capital.

It would seem to me that under present conditions, it would be perfectly appropriate, as an alternative, to say we will not consider profits excessive, abnormal, unfair, unless they exceed 10 percent.

In fixing the rate at 10 percent, gentlemen, I have attempted to consider that during this entire 10-year period, the corporations to which this alternative applies, are those which have been almost constantly in the red or which have had very small earnings. If they cannot recoup somehow I suppose they may as well quit.

Let me apply, for example, the rates of the subcommittee report to very practical situations. Suppose a corporation had outstanding preferred stock upon which it was paying preferred dividends, or had agreed to pay preferred dividends of, say, 6 or 7 percent, or even 8 percent. That particular corporation has been one of these which during the last 10 years has not earned reasonable profits. Suppose we all agree to that.

That corporation, gentlemen, is allowed to earn 4 percent, and it must pay 6, 7, or 8 percent preferred-stock dividends. Certainly, in that type of corporation, not only should you have your rate high enough, but you should say there are no excess profits until the existing preferred-stock dividend requirements have been met.

Another normal type of corporation is one which has a long-term commitment on the repayment of an indebtedness entered into before the excess-profits tax was considered, under which, based upon its

then earnings and its anticipated earnings, it agreed to pay off say $100,000 a year; not going to the stockholders at all, but going to creditors.

It seems to me quite appropriate to say, there shall be no excess profits until that debt commitment has been met.

There are other perfectly proper measures of normal profits. I shall not attempt to discuss them. If time were available, I think that some of these other methods would be considered perfectly appropriate. The only immediate solution in view of the time element is an extension of the principle which the subcommittee appropriately and properly recommends, the principle of special assessment.

The subcommittee report does an excellent job in eliminating some four or five of the basic reasons for special assessment under the prior law. In that, as in other respects, I have indicated they have done an excellent job. But I do not think they have covered every conceivable case.

I think certainly for an experimental period you have got to give authority to some one. Based on the experience that we had under the old law, I would create an agency above the Bureau of Internal Revenue. And that agency has to have authority in individual cases, which we cannot now anticipate, or which we do anticipate and have not time to care for, to prevent—let me call it murder, because that is almost what it will be.

Let me refer next to the recommendation you have just heard from the witness preceding me, Mr. Fernald, with respect to consolidated returns. The merits of the computation of normal profits for the base period and for the taxable period on the basis of consolidated returns, I am quite confident are conceded. Consequently, I shall not refer to them unless someone wants to ask me about them. I shall apply myself to the question which Mr. Treadway asked of Mr. Fernald.

You have two choices with respect to consolidated returns. You can make them mandatory, so that every consolidated group must file consolidated returns; or you can make them permissive. I think that the statements by the experts, which Mr. Treadway referred to, related primarily to the compulsory policy. They must, gentlemen, because the drafting of a consolidated return provision which is permissive is very, very simple. You have it in the law now. All you have to do is to strike out a few provisions that are in the existing law, and add a few words covering consolidated invested capital. The drafting of that provision is very simple.

Mr. TREADWAY. May I interrupt you at that point?

Mr. ALVORD. Certainly you may, sir.

Mr. TREADWAY. My recollection is that the insistence of the Treasury is what brought about the attitude of the drafting service; that the Treasury did not consider that there should be an option in the way of a permissive return.

Mr. ALVORD. That, I think, may be right; and that is why I am referring to this matter and to one other question which I would like to dispose of very quickly.

Under the permissive policy, and I think also under the mandatory policy, you must confer power upon the Secretary of the Treasury to prescribe very detailed, technical, difficult regulations. I wrote them once and I can tell you they are tough. But even those regulations are in existence with respect to the determination of consolidated net

income. It is not going to be an impossible job to apply those regulations to your excess-profits tax.

As I indicated to you, the second policy is to make consolidated returns permissive rather than mandatory. Theoretically, I have always advocated mandatory consolidated-return provisions. And in that I think I find myself in a very distinguished, but not exclusive, group. I go back to the days of Mr. Kitchen, and Senator Simmons, and Dr. Adams, and that entire group of persons who wrote, applied, and administered our old war laws. And through every change in officials of that type, including the members of this committee, the policy of consolidated returns has been recognized as eminently sound and practical and necessary.

My solution, Mr. Treadway, for the position that the provision cannot be drafted is, put your permissive provision in for this year.

Mr. TREADWAY. You want to use the word "promptly." They do not say it cannot be done.

Mr. ALVORD. I mean during the enactment of this bill; include it in this bill. Put your permissive provision in.

In my opinion, every consolidated group practically without exception will file a consolidated return. Then, as in 1928, provide that, having once filed, they cannot change. If there are cases of consolidated groups who do not choose to file a consolidated return, then come along in 1941, when you will have ample time, and work out some form of a mandatory provision applicable to all, or at least to that group.

I think that is a practical solution and I think it will work. I can give you a draft of a consolidated return provision for your excess-profits tax by noon today. I already have it. It is not difficult at all.

Bear in mind, however, that you are delegating a tremendous amount of power to the Secretary of the Treasury. We have done that before.

Mr. CROWTHER. Another consideration that came up during the discussion was the fact that the adoption of a mandatory consolidated return or even a permissive consolidated return would lose us a lot of revenue. I think the suggestion was made that we would lose around sixty or seventy million dollars a year.

Mr. COOPER. Will the gentleman yield?

Mr. CROWTHER. Yes.

Mr. COOPER. I think that estimate of $60,000,000, Doctor, applied to a consolidated-return provision for ordinary incomes, not for excess profits.

Mr. ALVORD. I think that certainly is very true, Mr. Cooper.

Mr. CROWTHER. For the same reason it might produce less revenue if it were applied to excess profits.

Mr. ALVORD. I think the unanimous opinion is that, over a period of time, for both purposes, normal income tax and excess-profits tax, consolidated returns will make money for you and save tremendous problems of administration.

I still object very seriously—although I appreciate the practical problems which the Treasury officials are facing—to the determination of the merits of any one problem by reason of its results in the first year of application. This Government of ours I trust is going to be a long-continuing government, and, over a period of years, I am quite confident that consolidated returns will lose no revenue. We used to be convinced that it gained revenue.

Mr. BOEHNE. If you had mandatory consolidated returns, under your present plan, you would have some corporations with subsidiaries that would not have the same base period.

Mr. ALVORD. Mr. Boehne, I confess I cannot draft a compulsory provision, and I recognize the soundness of the statement of your experts that they cannot do it, in the time available. The problems are very large, and very many. But it is preferable, and I think essential, that a consolidated return provision go into this bill. I do not think it will be very far wrong if you tell Mr. Beaman to sit down and draft it. He may make a few slips, but we make many other slips in other provisions. And I suspect that there are going to be many slips in the drafting of an excess-profits tax law. There have got to be, in the time given to them to draft it.

The CHAIRMAN. Mr. Alvord, suppose the Legislative Counsel and our drafting experts come in and take a viewpoint in this matter different from the one taken by you. Which do you think should obtain with the committee? They say they cannot do it.

Mr. ALVORD. I suggest that I would be very happy to sit down with them for 2 hours—even 1 hour, and if I cannot convince them in that time that it can be done, or they cannot convince me that it cannot be done, I would say, forget it.

The CHAIRMAN. Suppose you do not come to an agreement, where would we be?

Mr. ALVORD. You have got to choose, and I am very confident that you will follow your present experts.

I do not have to tell you gentlemen that I respect the judgment, the ability, and the integrity of your experts, just as much as I trust that you respect the ability and judgment and integrity of your former experts.

They are very able. They are very honest and hard-working. You are asking too much of them in this bill. But if it is their honest opinion, despite my protestations and convictions to the contrary, that it cannot be done, then certainly you have got to follow them. You cannot follow me.

Mr. TREADWAY. I understood you very definitely to say that you would be very glad to put your time against theirs to see if one can convince the other.

Mr. ALVORD. My time is always available, Mr. Treadway.

Mr. TREADWAY. You are very generous.

Mr. ALVORD. Let me take up one more matter, and then I am almost through.

Mr. CROWTHER. May I interrupt you before you leave that subject, to clear up this situation about the consolidated returns. The argument developed that if we did not have consolidated returns—which we do not permit now except to railroads—why we should have consolidated returns here. And there was some discussion as to whether or not we ought to have it for all, ought to have it both for income-tax and excess-profits-tax purposes. It was then the statement was made we would lose around $60,000,000 a year in revenue. The question was whether we ought to have it for one and not for the other.

Mr. ALVORD. I think you ought to have it for both. Let me remind you that when you eliminated them back in 1934 you were

supposed to have picked up $80,000,000 by doing so. So if you put them back in, you are going to be $20,000,000 to the good. As a matter of fact, I do not think you picked up $80,000,000 at all. I do not know what it would cost the first year. There is no person who can tell you, in my opinion.

Now I come back to this measure of normal profits.

Senator HARRISON. Mr. Chairman, before the gentleman gets through with the subject of consolidated returns, I would like to make this observation.

We are sitting here in an effort to pass this legislation, or some legislation, to take care of this question which has been put on our doorstep.

It has been put up by the defense council that, every day this bill is delayed, the program is delayed.

Now this new question you inject concerning consolidated returns: Of course, I voted for consolidated returns.

Mr. ALVORD. Yes, sir; I know that.

Senator HARRISON. But I was not in the majority. We were whipped.

Mr. ALVORD. I appreciate that, sir.

Senator HARRISON. Now you inject the question of consolidated returns into a very complicated bill, and you are going to delay the passage of the bill that much, because there are gentlemen who do not believe in the consolidated return theory. It would prolong the discussion in the House, I assume. I do not know so much about that, but I know that in the Senate it would. I am not for delaying this proposition by bringing new questions in here.

I want you to realize that we have got to determine on a policy. We have got to pass this legislation speedily. That is why we were so courteously invited by this committee to sit with them. We are going to try to avoid hearings as far as possible in the Senate. That is why we are over here.

We do not want to take on any more than is absolutely necessary in this matter, because I doubt that it will be a perfect bill. I suppose there will be some gentlemen who will agree with you that it will not be perfect when we get through. But we are going to try to make the best job of it that we can.

Mr. ALVORD. I know you are.

Senator HARRISON. So do not hand to us a proposition that is going to inject new questions and delay the matter both in the House and in the Senate.

Mr. ALVORD. I trust that there will not be much delay, Senator. I think even if there is a delay of a day or two or three, it is much better to improve your proposed excess-profits tax than it is to get something through that no one can determine.

I may say further that I think this is probably a very appropriate time to test our proposition of adjourning politics. I do not know of any objection to consolidated returns which has ever been made by anyone except upon a political basis. I have been through those fights. I think I understand them. But even on a political basis I am confident that I have heard no objection to consolidated returns for excess-profits tax purposes.

Again, I am available to talk to anyone, whether on a political basis or otherwise, who wants to find out about consolidated returns, in an

effort to see if the objections cannot be removed by an understanding of the problems that are involved. I think they can be.

Senator KING. May I make one observation? I have always been a believer in consolidated returns. I have not found insuperable objections, which so many suppose exist, to the working out of a proposition through which consolidated returns may be incorporated in the bill. I should like to see it incorporated in this bill.

However, I shall defer to the Ways and Means Committee of the House, because they are largely the controllers of our fortunes at the present time. But it does seem to me that a bill which would provide for consolidated returns is one which would meet the requirements of the country and certainly would be in the best interest of the taxpayers.

Mr. ALVORD. I am very glad to have your views, Senator King.

Let me bring you one more matter and then I am practically through. The usual period for measuring income for tax purposes and for business purposes and for all purposes is 1 year. But certainly, gentlemen, I do not think that anyone would insist that the experience of 1 year will be at all an adequate determination of the measure of normal profits. Profits are entirely too fluctuating. I am sorry they are. I wish that were not true, and that you could eliminate losses, but they are much too fluctuating. You will have an industry that will not make a profit for more than 1 or 2 years out of 5 and they live for those 1 or 2 years. You have industries the very nature of which requires years of effort in the accumulation of income realized in 1 year. And then they go through the same process again.

I personally cannot believe that we are in a more serious financial condition than Great Britain. Great Britain, for excess-profits tax purposes attempts to average profits over a period of years. They have three or four comparatively simple devices, one of which you gentlemen have adopted in the income-tax provision and undoubtedly will apply to excess-profits taxes. That is the net loss carry-over, but Great Britain provides a carry-over for 6 years.

Mr. CROWTHER. How long?

Mr. ALVORD. Six years. Great Britain also has this principle. They say that if, in any of these years, you have a deficiency in income, that is, profits are lower than normal, we will let you recoup to your normal profits standard, out of your subsequent year's earnings, before any of the earnings of that subsequent year will be considered abnormal and excessive. They also let you take the depreciation allowance, and carry it over, until you recoup depreciation against profits. I think you might well consider that.

Mr. COOPER. How do the depreciation allowances compare in Great Britain and this country?

Mr. ALVORD. I am glad to answer that, because Mr. Sullivan in his prepared statement said that the depreciation allowances were more liberal than in any other country, and I do not believe, Mr. Cooper, that is correct.

Mr. COOPER. He did not say that; he said they were as liberal.

Mr. ALVORD. I may have misunderstood him.

Mr. COOPER. But I think they are more liberal in this than any other country in the world.

Mr. ALVORD. Well, let me tell you how it is handled in Great Britain. You claim what you think is proper on your return and in

most cases it is allowed without question. If it is questioned you are called before an administrator, or a group of businessmen, and they tell you to say what you think you are entitled to and you tell them. In practically every case they say "O. K.", because they know that from a revenue point of view, the soundest practice is to write your assets off quickly, get them off the books and out of the way; then your income subject to tax increases.

I think that back in the earlier years the fight over depreciation allowance was quite unnecessary. But as a result it is very difficult to settle your depreciation allowance under the present law. I think the British system is much better in that respect, Mr. Cooper.

Mr. McKeough. Mr. Alvord, with reference to the question of liberal allowance for depreciation, would you care to comment briefly on what now prevails in Great Britain in relation to the percentage of tax on net income?

Mr. Alvord. Yes. Naturally it is tremendous. The normal corporation rate for last year was 37½ percent.

Mr. McKeough. 42½ percent.

Mr. Alvord. 42½ percent has been proposed for the current year. I did not know that the act had passed, unless they have done so within the last few days; 42½ percent will be the standard normal corporate rate, and 100 percent of excess profits.

Mr. McKeough. It would balance up, would it not; that is, the relation in comparison to what is proposed here in the treatment of earnings by corporations? In other words I think you will agree that even they may have been, for the purpose of this discussion, as generous in carrying over their losses and in writing off amortization or depreciation, we certainly counterbalance any difficulties that you have against any benefits that flow to corporations in Great Britain, in the light of not having reached 100 percent of the excess profits and the 42½-percent normal tax.

Mr. Alvord. I still prefer to be a corporation over here.

Mr. McKeough. Yes.

Mr. Alvord. But let me just point out, Mr. McKeough, that the 42½-percent tax in Great Britain represents the total corporate tax, recouped to a very considerable extent when distribution is made to stockholders——

Mr. McKeough (interposing). If for the purpose of the discussion I grant that it might have been a little more beneficial to have had a corporation in Great Britain in prior years, yet I am quite sure there is not a single domestic American corporation that is not happy that it is an American domestic corporation today rather than in Great Britain.

Mr. Alvord. I do not doubt that.

Mr. Crowther. Is it germane, Mr. Alvord, to compare the tax rate in this country with a people that are at peace to a country that is fighting for its life?

Senator King. And that may lose all of its property?

Mr. Alvord. I would say, Mr. Crowther, that even without regard to those conditions our total corporate tax burden in this country, excluding the excess-profits tax, is in excess of that in Great Britain at the present time. The average payment of corporations in the United States, based upon taxable net income, before payment of

taxes, when you include Federal, State and local taxes, exceeds 42½ percent now.

Mr. McKEOUGH. I would like to make an observation with regard to the observation the gentleman from Minnesota has just made.

Mr. ALVORD. Yes.

Mr. McKEOUGH. As I recall the budget for Great Britain for the current fiscal year is approximately $10,000,000,000.

Mr. ALVORD. Yes.

Mr. McKEOUGH. I merely point that out with relation to what we have been called upon to do in connection with the defense program in the United States which will probably total more than $10,000,000,000, the total budget for Great Britain, and she is at war, and we all hope that we will not be at war but are appropriating a sufficient amount to make sure that no one will come over and attack us.

Mr. ALVORD. The estimated expenditures for 1941 exceed $12,000,000,000, but you must bear in mind there is quite a difference between the population in Great Britain and the United States.

Mr. McKEOUGH. Yes; 40,000,000 as against 130,000,000.

Mr. ALVORD. To summarize, Mr. Chairman, I do not think you can measure your excess profits based on the experience of 1 year. There are various devices which will permit your corporations to level out over a period of years and pay only on excess profits over that period of years. I think you should consider these various methods. I have elaborated on that in the memorandum which I have given to the committee.

With respect to the taxable year covered, it does seem to me that if the act is made applicable to 1941 rather than to 1940 it would be much fairer. I know of no immediate necessity for immediate enactment of an excess-profits tax law. Revenue should not be the consideration. I think it would be well to have the enactment of an excess-profits tax law at this session to be applicable next year.

Now just a word with respect to amortization and I am through. In my memorandum I have attempted to explain the simple policies of amortization because there seems to be a great deal of confusion and misunderstanding about it. I am confident the subcommittee has eliminated substantially all of the tremendous administrative difficulties which were in the prior law. So far as I can see the subcommittee has done an excellent job.

There are one or two matters which I assume it has already considered which I point out in the memorandum.

Amortization is based upon a simple business proposition of getting your cost back; it is not a special privilege; it is not a special allowance.

I think that the present law is adequate. The Treasury does not agree. The Treasury is in the boat, and, therefore, it requires legislation. That legislation, so far as I can see, could be enacted very promptly. I quite appreciate the discussion that we have heard as to whether excess-profits tax legislation should be coupled with the amortization provision.

The average businessman, with whom I have talked, has indicated that amortization is the only consideration he has in his mind, as between amortization and tax liability. I have yet to talk to a businessman who expects to make a profit out of Government con-

tracts. They simply say, "Keep me whole. Do not make me lose money; and I will be satisfied."

Mr. DINGELL. What is industry's thought concerning the amortization provision in this bill; is it ample?

Mr. ALVORD. I think it is ample.

Mr. DINGELL. Is it fair and equitable?

Mr. ALVORD. I think it is.

Mr. DINGELL. I appreciate the wish to have more consideration but the main idea is to help speed up the program.

Mr. ALVORD. My opinion would be that you could prepare and pass an amortization provision in 2 or 3 days.

The basis for the demand for a single bill to cover both matters, and perhaps I am taking too much for granted, is Mr. Knudsen's remark which I heard, and Mr. Stimson's, which seems to be that the businessman must know what his tax liabilities are going to be before he signs a Government contract.

Now, gentlemen, I do not know of any businessman who has ever known in the past, who will know now or who will know in the future, what his tax liabilities are going to be.

I can give you my own opinion; based on the subcommittee's report. This is far from criticism, because it is just inherent in the technical difficulties surrounding an excess-profits tax.

I cannot apply the subcommittee's report—and the draft of a bill is going to be much more difficult to analyze and interpret and apply—to any situation with which I am familiar and come close to an estimate of what the tax consequences will be. It cannot be done. And it is going to be sometime before the regulations can be drawn up. You could not put it into effect if you passed it tomorrow. I do not think that that particular position on that point is practical. It is a laudable objective but one that I think never has been attained and cannot be attained.

Thank you very much.

Mr. ROBERTSON. Mr. Alvord, do you think there is immediate necessity for the enactment of an amortization plan?

Mr. ALVORD. Inasmuch as the Treasury Department has taken the position that the emergency period cannot be considered in determining the normal life of an asset—with which I disagree—you certainly must have some legislation.

Mr. ROBERTSON. Under those circumstances if it takes 3 or 4 weeks to work out a consolidated returns provision do you think we should hold up this bill that long or put it through without the consolidated returns provision?

Mr. ALVORD. Bear in mind that in my answer I am not considering the many things you gentlemen have to consider. If I were doing it I would have put the amortization provision through a month ago and then take time to really consider the problems of the excess-profits tax, because the latter is a delicate job and the consequences are terrific.

Mr. ROBERTSON. I believe the existing law governing contract for airplanes allows a profit of 12 percent?

Mr. ALVORD. That was the Vinson Act. It was formerly 12 percent, and was then cut to 8 percent, and I believe a provision has passed the House restoring it to 12 percent.

Mr. ROBERTSON. Assuming that it is 12 percent and we pass the amortization plan, that would authorize a rate of 20 percent?

Mr. ALVORD. The amortization will not change the profit in the slightest. Amortization is merely the return of cost. That is the basic principle. If I sell this desk, which cost me $1, for $1.25, there is no one who ever dreamed that the $1 is income. It is not. If, instead of this desk costing me $1, I buy the materials and tools, and it costs me $1, precisely the same principle applies. Now this amortization provision simply means that if I buy a few tools and make one desk I have got to get back the cost of those tools. Unless I do, when I sell this desk, I will have a loss. If I sell 2 desks I must recover my costs out of 2 desks—or out of 1,000 desks, if I can sell 1,000 desks.

Mr. ROBERTSON. The proposition is, if you invest $1 in that desk and get the dollar back in 5 years, and use the desk for 20 years you have made a gain, have you not?

Mr. ALVORD. No. I do not think so, because after the 5 years the entire $1.25 is income. And I do not think that anyone is wise enough to sit here today and believe that the tax rates in the future are going to be less than they are today.

Mr. ROBERTSON. Well, as the gentleman from Illinois recently pointed out, we are appropriating for as big a defense budget as Great Britain.

Mr. ALVORD. Yes.

Mr. ROBERTSON. And the reason we are doing this is to try to get to a point where we will be properly defended.

Mr. ALVORD. Yes.

Mr. ROBERTSON. Under those circumstances do you approve or disapprove of the theory of imposing at this time an excess-profits tax?

Mr. ALVORD. Yes; I do approve. I think I said that before you came in.

Mr. ROBERTSON. I missed the first 2 or 3 minutes of your statement.

Mr. ALVORD. With respect to your question on amortization; I think I can answer you further, if I may.

Mr. Hitler adopted a very sound and I think a useful provision. In 1933 he said: "Gentlemen, we will let you write off over 3 years the plant you are going to build today." I think that provision was probably more instrumental than anything else in getting private industry built up to the point where it produced his present machine.

Mr. ROBERTSON. You realize, of course, that the period from 1936 to 1940 is not a normal period for industry in this country. And you have brought up the suggestion that possibly the years picked by the subcommittee's report as the base of determining normal income does not reflect the normal income.

Did you make any specific recommendation for some other period?

Mr. ALVORD. Yes; I did, and I elaborate on that in some detail in the memorandum which I am filing with the committee.

Mr. ROBERTSON. What was the specific recommendation you made?

Mr. ALVORD. The specific provision, with respect to the base period, was an average of two or three out of the last four, or take two out of the last three, bearing in mind, principally, that 1938 was a loss year. An average for all 4 years imposes a very high rate upon normal profits.

Again, Mr. Chairman, I hope you gentlemen succeed in your efforts.

Mr. DISNEY. Mr. Alvord, I want to get your suggestion on this feature.

Two corporations of comparable business, during the base period, we will say, and one corporation purchased the entire plant and equipment of the other. That doubles its income this year. Assuming there is no stock transfer or anything of that kind; the purchasing corporation remains the same. Have you any suggestion as to the treatment of the base period?

Mr. ALVORD. Yes. I have assumed that would be taken care of. I have referred to it in my memoranda, but have not gone into it in detail orally.

Certainly in determining or comparing earnings during prior years with earnings during the present year you have got to put taxpayers on a comparable basis: Corporate reorganizations, liquidations, and acquisitions occurring during both periods must be recognized, and adjustments made. In other words you have to make adjustments so that the earning power is on the same basis in both periods. That is inherent in the earnings base and the invested capital base. I assumed that the committee is going into that.

Mr. TREADWAY. Mr. Alvord, you wanted to make your statement a part of the record?

Mr. ALVORD. Yes.

The CHAIRMAN. Without objection the statement referred to will be incorporated in the record.

Mr. ALVORD. Thank you.

(The statement referred to follows:)

STATEMENT OF ELLSWORTH C. ALVORD PRESENTED TO THE COMMITTEE ON WAYS AND MEANS OF THE HOUSE OF REPRESENTATIVES, AT HEARINGS ON THE EXCESS-PROFITS TAX BILL, AUGUST 13, 1940

Mr. Chairman, gentlemen, I am Ellsworth C. Alvord, an attorney, of Washington, D. C., appearing as chairman of the committee on Federal finance of the Chamber of Commerce of the United States.

INTRODUCTION

The Report of the Subcommittee on Proposed Excess-Profits Taxation and Special Amortization became available on Friday, August 9. Time has not been available for adequate consideration of the proposals. The report is necessarily written in general terms. The specific provisions of the forthcoming bill will require careful analysis.

A subcommittee of the chamber committee on Federal finance has given to the proposals the most careful study that time permits. It has been unable to call a meeting of the full committee, or to ascertain its views. Although the views which I shall express must be considered to be the views of the subcommittee, I believe they also represent the position of the committee.

THE NATIONAL DEFENSE PROBLEM

The country is united in its determination to provide adequate national defense. Action is demanded. The vital need is for a sound, coordinated program which will provide:

(1) Maximum security—an adequate military and naval establishment, fully equipped and manned.

(2) Maximum industrial production—geared to provide the necessary armaments as efficiently and rapidly as possible.

(3) A sound method of financing both of the above objectives.

THE PROBLEMS OF FINANCE

We must face the ultimate problem of financing our national defense program. We must soon have estimates of the probable costs of the program. Present estimates would necessarily be tentative, subject to revision in the light of developments abroad. But estimates must be made, just as they were made

during the World War, and a financial program prepared. Defense cannot be financed on a day-to-day basis.

Answers should be sought to the following questions:

(1) What will be the total cost of the Military Establishment contemplated at the present time?

(2) What will it cost annually to maintain this establishment?

(3) What will be the cost of additions to present plant and equipment required to carry out our defense program?

### ECONOMIC PROBLEMS

The defense program also requires us to consider economic problems of far-reaching importance, which will vitally affect our financial decisions.

The immediate problem is to effect a rapid transition from a peacetime economy to an armament economy. It will be necessary to maintain a tremendous armament production for an indefinite period of emergency or war—possibly a long period. We shall then have to face the problem of sudden curtailment of armament demand, and the return to a peacetime basis.

Each of these stages involves sweeping economic readjustments. Shall we sacrifice or encourage production for the normal peacetime needs of our country? How can we best protect and encourage private enterprise not employed in national defense but essential to the preservation of peacetime activity and employment, during each of the above three stages? How can we lessen the shock of post-war collapse, in the light of our experience after the World War? Can we afford to ignore the problems of idle men, idle machines and idle funds, which still exist despite our efforts to solve them over the last 10 years?

The foundation of our whole program requires most thorough consideration and coordination. We should have some agency to consider the broad financial and economic problems as a whole, and to suggest means of dealing with them. If this cannot be accomplished within our present administrative framework, an agency should be created to do the job.

### POSSIBLE METHODS OF FINANCE

Our choice of methods of financing the defense program is limited by the possible sources of Government revenue. There are only four:

(1) Taxation;

(2) Borrowing, within limits permitting ultimate repayment;

(3) Inflation and repudiation; and

(4) Confiscation.

We can agree that the last two alternatives are unnecessary and unthinkable at the present time. Yet we may be forced to accept them, if our financing of billions of defense expenditures is allowed to proceed without adequate planning or consideration of the consequences.

### NECESSITY FOR HASTE

Consideration of the excess-profits tax and of amortization at this time has been dominated by urgent demands upon the Congress for immediate enactment. The reason advanced for unusual haste is that manufacturers will not enter into contracts necessary to national defense before provision has been made for both subjects.

Unquestionably, the method of amortizing the cost of new defense facilities is a problem requiring immediate solution. This provision, however, can be readily separated from the provisions for taxing excess profits and passed without delay.

Secretary of War Stimson and Mr. Knudsen testified before the committee last Friday that immediate action on excess-profits taxation was also desirable, in order that manufacturers might be appraised of their tax liabilities in advance of the conclusions of contracts. This is certainly a desirable objective. But will it be accomplished by the immediate passage of the pending proposals? An excess-profits tax is one of the most difficult and complicated forms of taxation with which we have ever had to deal. This was amply demonstrated by the three prior excess-profits tax laws of 1917, 1918, and 1921—with respect to the drafting of the law, its interpretation, and its administration. The proposals for determining tax liabilities under the invested capital method are complex and almost wholly without precedent. They may require hundreds of computations, involving highly technical problems of fact, accounting and law—with frequently

recurring changes and variations. Potential tax liabilities cannot be ascertained or estimated with reasonable certainty either immediately, or by next March 15, or prior to entering into a defense contract.

Simplification and improvement are more essential than speed in the enactment of an excess-profits tax.

### THE FUNCTION OF AN EXCESS-PROFITS TAX

The primary purpose of an excess-profits tax should be to prevent improper profits, primarily those resulting from uncontrolled price increases. It may also be an important revenue producer, but revenue is a secondary matter. The tax should be designed to permit "normal profits" while preventing or discouraging profits above normal, especially those resulting from war profiteering, speculation in commodities, and like activities. Under ideal conditions an excess-profits tax, if it accomplishes these purposes, should produce no revenue at all.

An excess-profits tax will be necessary when defense spending takes effect. But if price control is our primary objective, it must be obvious that there is no need for extravagant haste in the enactment of such a tax. The defense contracts awarded to date are negligible. The profits on these contracts and the effect of defense spending will not be apparent in the income of the current year and probably not until well into 1941.

Moreover, fundamental economic conditions today are far different from those of 1917 or even of 1926 (the frequently proclaimed objective for normal conditions). Commodity prices today are lower than they were at the outbreak of the war, 25 percent lower than in 1926, and 50 percent lower than in 1917. Corporate profits for 1940 will be $3,500,000,000 less than in 1917 and $2,250,000,000 less than in 1926. Under these circumstances, there is no justification for the belief that a critical price situation exists. Furthermore, it is generally admitted that many present prices are too low.

The following table shows our present situation, as compared with 1917 and 1926:

| Year | Industrial Production Index [1] | Wholesale Price Index [2] | Corporate net income [3] |
|---|---|---|---|
| 1914 | [4] | 68.1 | 3,940 |
| 1915 | [4] | 69.5 | 5,310 |
| 1916 | [4] | 85.5 | 8,706 |
| 1917 | [4] | 117.5 | 10,730 |
| 1918 | [4] | 131.3 | 8,362 |
| 1919 | [4] | 138.6 | 9,411 |
| 1926 | 108 | 100.0 | 9,673 |
| 1934 | 79 | 78.9 | 4,275 |
| 1935 | 90 | 80.0 | 5,165 |
| 1936 | 105 | 80.8 | 6,761 |
| 1937 | 110 | 86.3 | 6,914 |
| 1938 | 86 | 78.6 | [5] 4,700 |
| 1939 | 105 | 77.1 | [5] 6,700 |
| August | 103 | 75.0 | ..... |
| September | 111 | 79.1 | ..... |
| 1940 | ..... | ..... | [5] 7,300 |
| April | 102 | 78.6 | ..... |
| May | 106 | 78.4 | ..... |
| June | [6] 114 | 77.5 | ..... |

[1] Federal Reserve Board, 1923-25 average = 100.
[2] Bureau of Labor Statistics, all commodities, 1926 = 100.
[3] Statistics of Income. In millions of dollars. 1938, 1939, 1940 estimated on basis of collections.
[4] No data available.
[5] Estimated.
[6] Preliminary.

An excess-profits tax devised hastily, or designed primarily to produce revenue, will have the most unfortunate repercussions—financial, economic, social, and political. Private enterprise not employed in national defense will be irreparably damaged. National defense itself may be jeopardized.

### AMORTIZATION

(a) *The principle.*—There is much confusion and apparent misunderstanding regarding amortization of the cost of special facilities necessary for national defense. It is even referred to at times in terms suggesting "special consideration" or "gratuitous allowances."

In reality, amortization involves a simple, everyday business problem, based upon simple, well-recognized, fundamental principles:

(1) Cost must be returned;

(2) There can be no profit until cost is returned; and

(3) Cost must be returned, so far as possible, out of the proceeds of sale.

This holds true, whether we are dealing with an article purchased and sold, or produced and sold. If it becomes necessary to acquire special tools or to build a special plant to make the article, these costs, like any other production costs, must be recovered from the proceeds of sale. If only one article is produced, the entire cost must be recouped from the proceeds of a single sale. If a thousand articles are produced and sold, the cost must be recovered from the proceeds of a thousand sales. In any event, cost must be recovered over the shorter of the following periods: (*a*) Before the productive machinery wears out, or becomes obsolete; or (*b*) before the product becomes obsolete through lack of demand. Betterments, new processes, substitutes are daily developments.

(*b*) *The present law.*—The tax law recognizes and applies these simple business principles. The theory of the allowance for depreciation is precisely the principle I have stated: That the cost of an asset should be returned to the taxpayer out of the income earned by the asset, in order to avoid a tax on the return of cost. If the asset earns income only in a single year, its entire cost must be allowed as a deduction in that year. If it earns income in 2 separate years, its cost must be allocated between the 2 years, either by equal deductions in each year (straight-line depreciation) or by proportioning the cost to the income received in each year (unit production or job depreciation). If it earns income continuously, cost must be allocated and deducted over a period measured, in every case, by the useful life of the asset. In the ordinary case, this may be the period within which it becomes exhausted by physical wear and tear. But a shorter useful life may be recognized, as, for example—

(*a*) Where economic conditions will compel abandonment of the asset before it is worn out;

(*b*) Where the asset is constructed on leased property by the lessee, and the lease will terminate before the asset wears out;

(*c*) Where the asset is useful only to perform a specific contract, which will be performed before the asset is exhausted;

(*d*) Where the asset is used on mineral property which will be exhausted before the asset is worn out.

In all such cases, where a useful life shorter than the normal period of exhaustion is established, cost is returned over the shorter period, either by straight-line depreciation or by any other appropriate method.

(*c*) *Defense facilities.*—The problem of recovering the cost of defense facilities should be solved by the application of the same principles. It is the position of the Treasury Department that it cannot recognize that the defense emergency will measure the useful life of facilities employed for defense purposes. Furthermore, the present law is inadequate in the case where the proceeds received from all defense contracts are not sufficient to recover the cost of the facilities. Special legislative provision would be necessary to cover this case.

(*d*) *The subcommittee proposal.*—The subcommittee has proposed a statutory provision which would permit the taxpayer to elect a deduction, for both income and excess-profits tax purposes, of the cost of defense facilities over a period of 60 months. The facilities must be certified as necessary in the interest of national defense by the Defense Advisory Commission and either the Secretary of War or the Secretary of the Navy, and must have been constructed or acquired after July 10, 1940, and before the termination of the emergency. The election of such a deduction is in lieu of the allowance for depreciation and obsolescence in the present law, but the taxpayer may, at any time within the 60-month period, shift to the provisions of the present law. The amortization deduction may begin either with the month following the month in which the facility is completed or the taxable year following the year in which it is completed. If the facility ceases to be useful for national defense before expiration of the 60 months, upon certification of this fact by the Secretary of War or Navy, the taxpayer may recompute his deduction on the basis of the shorter period. This privilege will also be available to taxpayers who have not elected the amortization deduction. Furthermore, taxpayers who have not elected the amortization deduction and who receive payments from the Government as recoupment for the unamortized cost of a facility which is certified to be no longer useful, may deduct the amount of such payments, if the payments are also reported as gross income. The proposed provision is fair and proper, and many of the former administrative problems are avoided.

(c) *Recommendations.*—The following suggestions are submitted:

(1) The provision should not interfere with the operation of the present law. Failure to elect the 60-month deduction should not foreclose the taxpayer from recovering the cost of facilities over a shorter period than their period of exhaustion through normal wear and tear, if the facts justify use of the shorter period.

(2) A taxpayer who elects the statutory provision should not be compelled to take the deduction in equal amounts over the 60-month period. He should be permitted to write off cost against the income as it is realized from sales, by any recognized method of depreciation, just as he may do under present law.

(3) The provision should not be limited solely to facilities acquired, constructed, etc., after July 10, 1940. In view of the fact that a certificate is required showing that the facilities are necessary to national defense, the prescription of any basic date of construction seems unnecessary.

(4) Where a contract negotiated with the Government specifically provides that a portion of the proceeds shall be treated as return of cost, this determination should be accepted for tax purposes, regardless of the taxpayer's election of the amortization deduction under the statute.

(5) Where special plant and equipment for defense purposes is constructed for the taxpayer without cost to him, the taxpayer should not be regarded as receiving income, nor should any deduction for amortization be permitted.

(6) The period of limitations must not prevent refunds resulting from reallocations.

### ANALYSIS OF THE EXCESS-PROFITS TAX PROPOSAL

The proposals of the subcommittee contemplate, as a basis for the excess-profits tax, alternate methods of determining "normal profits." The taxpayer may elect to regard as normal profits either—

(a) The average earnings of the corporation for the 4 years 1936-39, increased by 8 percent of capital additions after the base period and reduced by 6 percent of capital reductions after the base period; or

(b) The average return on invested capital for the 4 years 1936-39, but not more than 10 percent or less than 4 percent, except that with respect to the first $500,000 of invested capital, the minimum return is 6 percent.

The election may be exercised independently in each taxable year, using prior earnings as the basis in 1 year, and invested capital in another. It is not indicated however, whether the taxpayer may change the basis of his election for any particular year after the return has been filed. Deficiencies asserted by the Commissioner after the filing of a return may result in a larger tax liability upon the basis elected by the taxpayer than if the alternative method had been selected. The tax should be imposed in the alternative, and should not be contingent upon the proper exercise of an election.

### EARNINGS BASIS

One of the most difficult and delicate tasks in framing an excess-profits tax is determining the yardstick for measuring normal profits. No single yardstick is adequate. Fortunately or unfortunately, there is no one group of factors which invariably produces profits. Ability, ingenuity, determination, initiative, foresight, willingness to work, a realization of, but a healthy disdain for, risks and hurdles—assisted frequently by fortuitous circumstances and something sometimes called luck—are perhaps primarily responsible. Fundamentally, it is the capacity to produce goods or services desired by someone else, regardless of the basis of the capacity. It is this capacity of the individual (whether or not profits are the result, and whether or not they are the motive), which must be encouraged and protected.

From a theoretical standpoint, the average earnings basis appears to provide one fair yardstick of normal profits. This basis has the following advantages:

(a) It has the tremendous virtue of simplicity; in drafting, in administration, and in computation by the taxpayer.

(b) It confines an excess-profits tax to profits which have increased after the defense emergency arose—which is the only proper objective of the tax.

(c) It gives effect to all sources of earnings, including the value of management services, and the contribution of intangibles to earning power.

(d) It does not discriminate among corporations or industries on the basis of size, capitalization, or risk.

Average earnings are clearly inadequate, however, in the following cases, and some other yardstick must be provided:

(1) Corporations having abnormally low earnings in the base period; and

(2) Corporations formed during or after the base period, which do not have adequate earnings (although 1 or 2 years' earnings should be accepted if the taxpayer so elects).

The most difficult problem arising in connection with the average earnings basis is the selection of a fairly representative base period. We have just ended a decade of depression. The 4 years 1936 through 1939 do not cover a period of normal profits for most corporations. For most corporations, 1938 was a severe loss year. Owing to these abnormal conditions, many corporations had widely fluctuating earnings over the period. A better basis of normal earnings would be obtained by allowing the taxpayer to select any 2, or most certainly any 3, of the last 4 years, or even any 2 of the last 3 years.

In the application of the earnings basis, provision must be made, of course, for appropriate adjustments so that the base period earnings and the taxable year earnings are on a truly comparable basis. For example, adjustments must be made for corporate reorganizations and liquidations during either of the periods.

It will also be appreciated that the earnings basis does not recognize admittedly normal profits attributable to a normally increasing and expanding business. It will, on the contrary, if applied rigidly, tend to restrict severely a trend of increasing profits from normal activities as well as the willingness to assume the necessary risks in new undertakings.

A plan similar to the special assessment provisions of the prior laws, but designed to permit appropriate determinations of normal profits might be a solution.

### INVESTED CAPITAL BASIS

As previously stated, no single yardstick is available for measuring normal profits. A return on invested capital is an appropriate alternative to an average earnings basis. In any event, a reasonable yardstick must be used for the many corporations which have had abnormally low earnings in the base period, and by new corporations.

The subcommittee proposal, however, is fundamentally objectionable in prescribing an average return on invested capital over the same base period as the alternative to the average earnings basis. The two methods tend to duplicate each other. If a corporation has normal prior earnings, it will use the average earnings method, without resorting to invested capital. New corporations are unable to compute average return on invested capital, and must be specially provided for. The only case in which invested capital will be useful, therefore, is that of the corporation whose earnings have been unusually low during the base period. For this purpose, there is no necessity for the extraordinary complications and innumerable computations required in the subcommittee proposal. A specified return on invested capital, such as was provided in the old law, is a better and more definite cushion for corporations with poor earnings records.

The subcommittee proposes to allow as a cushion a return of 6 percent on the first $500,000 of invested capital and 4 percent on the balance. This percentage, which tends to level out toward 4 percent as invested capital increases, is wholly inadequate. "Invested capital" is an arbitrary concept, difficult to determine, based on the original and accumulated investments in a corporation. It bears no relation to the investment of the present or future stockholders. And there is no logical basis for discriminating between "old" capital (which is allowed a return of 6 percent and 4 percent and "new" capital) (which is allowed a return of 10 and 8 percent). It should be recognized and admitted that all capital is entitled to earn at least a return of 10 percent.

Other factors must also be considered where the invested-capital basis is used. For example, corporations must be permitted to earn the existing dividend requirements on their preferred stock. And corporations having existing commitments based upon earnings should not be forced to face embarrassment. In both cases, there are no excess profits until after adequate profits have been realized to meet their preferred dividends and commitments.

### COMPUTATION OF INVESTED CAPITAL

The subcommittee report recommends that invested capital for any taxable year (and also for the years in the base period) be the average invested capital for the year, obtained by computing the invested capital for each day of the year. In the case of a corporation with a fluctuating invested capital—as, for example, a corporation with outstanding bank loans varying from day to day in amount, or certain forms of investment trusts, whose stockholders may draw out their investments from day to day—probably 1,500 computations of invested capital would be

required for the first taxable year under the excess-profits tax. Elimination of the base period for computing the return upon invested capital would greatly reduce the burden of computation.

"Invested capital," as defined in the report, consists of equity capital and borrowed capital.

(1) *Equity Capital.*—Equity capital consists of the following items:

(*a*) Money paid in for stock, or as paid-in surplus, or as a contribution to capital: This is similar to the provision in the old law. Generally speaking, it does not offer unusual difficulties where adequate records are in existence. Complications may arise where money is paid in for bonds which are subsequently converted into stock. Is this to be treated as borrowed capital, or as money paid in for stock, or as property paid in for stock?

(*b*) The unadjusted basis of property other than money previously paid in for stock: This provision is a decided improvement upon the old law in two respects: (1) It apparently draws no distinction between tangible and intangible property; and (2) it places no limitation upon the value of either tangible or intangible property for purposes of inclusion in invested capital.

There is a further difference from the old law, in that "unadjusted basis" for tax purposes is substituted for the value of the property when paid in. "Unadjusted basis" may be the value of the property when paid in, or its March 1, 1913, value, or its cost or other basis to the transferor if acquired in a reorganization. The use of tax basis will simplify to some extent the determination of property values for invested capital purposes, since adequate records will usually be available. "Basis," however, is an arbitrary tax concept, not at all related to actual investment. Instances of hardship will occur where the taxpayer has paid fair market value in terms of stock for property with a low basis, and is required by the arbitrary provisions of the revenue law to assume the transferor's basis.

(*c*) Taxable stock dividends to the extent they constitute a distribution of accumulated earnings and profits: This is a new provision, and a desirable one. Nontaxable stock dividends have no effect on earnings and profits, and hence do not affect the amount of invested capital. Taxable stock dividends, however, are deemed to reduce earnings and profits. If such a dividend exceeds earnings and profits of the taxable year, it reduces accumulated earnings and profits, and also invested capital, in the absence of this provision. The provision compensates for this situation by allowing taxable stock dividends, to the extent they reduce accumulated earnings and profits, to be added back to invested capital. The taxpayer is thus relieved of the serious problem of distinguishing between taxable and nontaxable stock dividends. Invested capital will not be reduced in either case.

(*d*) Accumulated earnings and profits: This provision corresponds to the provision for "undivided surplus" in the old law. As in the old law, distributions in the first 60 days of the taxable year are considered to be out of accumulated earnings and profits to the extent thereof. This is contrary to the express provision of the present law in section 115 (b) that distributions are deemed to be made out of the most recent earnings and profits. There seems to be no adequate reason for the provision, which has the effect of reducing the taxpayer's invested capital by the amount of all distributions in the first 60 days of any taxable year.

The subcommittee further recommend that invested capital, as described above, should be reduced by the sum of the following: (1) Prior distributions not out of accumulated earnings and profits; (2) deficits in accumulated earnings and profits; (3) distributions during the taxable year not out of earnings and profits of the taxable year.

The requirement for reducing invested capital by prior distributions not out of accumulated earnings and profits will work an injustice where a corporation has unrealized appreciation in the value of property and effects a partial liquidation. While part of the distribution is properly attributable to the unrealized appreciation, this adjustment would compel such part to be charged against capital. This is contrary to the Bureau treatment of such a distribution.

The requirement that deficits should reduce invested capital is also improper. Recognition should be given to the full amount of capital paid in even though the corporation has been so unfortunate as to sustain losses which have resulted in a present deficit. The investment has been made in the corporation, losses have been sustained in keeping the business going in the hope that at some future time profits could be earned which would justify maintaining the business as a going concern instead of winding up its affairs and liquidating the corporation. Deficits due to losses sustained are paid for out of the investment which has been made, and

the invested capital to be considered for future years should not be reduced by the amount of such deficits.

(2) *Borrowed capital.*—The subcommittee proposal also allows a portion of borrowed capital to be included in computing invested capital. The indebtedness must be evidenced by specified written instruments. Borrowed capital is determined at the beginning of each day of the taxable year. Until the aggregate of equity capital and borrowed capital equals $100,000, all borrowed capital may be included; when equity capital is over $100,000 and under $1,000,000, two-thirds of borrowed capital may be included; when equity capital exceeds $1,000,000, one-third of borrowed capital may be included. To the extent that borrowed capital is included in invested capital, a proportionate part of the deduction for interest in computing net income subject to the excess-profits tax is disallowed.

The complications of this method of treatment are obvious. The necessity for fine distinctions and discriminations is obscure. If the principle is recognized that borrowed funds are, in a business and practical sense, capital invested in the corporation, there is no reason why the corporation should be permitted to treat only an arbitrary portion of its indebtedness as invested capital. Nor is there any practicable distinction between "small" corporations and "large" corporations. The dividing line is impossible to draw. And all corporations, regardless of size, may be compelled to borrow for some purposes.

A simple and adequate solution would be to allow taxpayers an option, either to include all borrowed capital in invested capital and to eliminate any interest deduction on such indebtedness, or to exclude all borrowed capital from invested capital and retain the interest deduction. This option is necessary, because many corporations are still compelled to pay high rates of interest upon their borrowings. Unless invested capital is permitted to earn a higher return than the interest rate, these corporations will be penalized by the inclusion of borrowed money in invested capital. A provision designed to be a relief provision would thus become a penalty, unless the proposed option is granted.

### COMPUTATION OF NET INCOME

The adjustments recommended by the subcommittee are sound and should be approved.

Statutory net income is necessarily an arbitrary concept, having in many cases little relation to true earnings and profits. Every effort should be made, in measuring excess profits, to make the statutory concept conform as closely as possible to accepted accounting principles. Nonrecurring and unusual losses during the base period should not result in extraordinary and unjustifiable liability for the excess-profits tax. Losses upon abandonment and recognition of unamortized discount upon the retirement of bonds are examples. On the other hand, reserves for unrealized inventory losses in the taxable year (as in the 1918 act) and other similar reserves might well be recognized.

As in the case of earnings, net income must be adjusted, for both the base period and the taxable year, where reorganizations and liquidations have occurred.

### ONE YEAR AS A MEASURE FOR EXCESS PROFITS

A 12-month period for measuring excess profits is without justification. Business profits are fluctuating and erratic. Business losses are too frequent. A 12-month period measures neither excess profits nor ability to pay. In many industries years of effort are required, with substantially all the income realized in one year. The construction industry is a typical example. In the textile industry, 2 good years out of 5 are considered "normal" experience. Many industries have no better experience.

Serious consideration should be given to devices which will assist in extending the period over which excess profits are to be measured. The following are recommended:

(*a*) A 5-year net loss carry-over (In England a 6-year carry-over is permitted).

(*b*) A carry-over of "deficiency income" (i. e., income which is less than average earnings over the base period), as in England.

(*c*) Applying losses in the first year or two of the "postemergency" period against profits realized during the period when the tax was in force, as in the 1918 act.

(*d*) A carry-over of "excess profits" to the following years where "deficiency income" is realized.

CONSOLIDATED RETURNS

It is perhaps necessary that politics be adjourned to permit a reconsideration on the merits of the subject of consolidated returns. But the imposition of an excess-profits tax requires a reconsideration, from the point of view of both the Treasury and the taxpayer.

After the enactment of the profits tax of 1917, a committee, consisting of members of the Committee on Ways and Means of the Committee on Finance, and of leading experts, was engaged in the preparation of regulations to carry out the act. As a result of a very careful and nonpartisan consideration of the subject by this committee, the Treasury authorized the filing of consolidated returns by corporations which, by reason of common ownership, were affiliated—that is, although composed of several corporate entities, were as a practical matter but one corporation. The Congress adopted these regulations and wrote them into the 1918 Revenue Act. With certain amendments not of importance in this discussion, this provision was retained in every revenue act until 1934.

The statement by Senator Simmons, at that time the chairman of the Finance Committee, in his report upon the 1918 revenue bill, is still applicable:

"So far as its immediate effect is concerned, consolidation increases the tax in some cases and reduced it in other cases, but its general and permanent effect is to prevent evasion, which cannot be successfully blocked in any other way. * * *

"Moreover, a law which contains no requirement for consolidation puts an almost irresistible premium on a segregation or a separate incorporation of activities which would normally be carried as branches of one concern. Increasing evidence has come to light demonstrating that the possibilities of evading taxation in these and allied ways are becoming familiar to the taxpayers of the country. While 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 believed that the present Treasury officials, and every prior official of the Treasury responsible for the administration of our tax laws, agree that consolidated returns are necessary and appropriate. The Under Secretary of the Treasury stated a few years ago that "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 * * *. 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."

From the taxpayer's point of view, every consideration compels the conclusion that consolidated income is the only true measure of income. And most certainly, excess profits cannot be realized unless the group as a whole has aggregate earnings above normal.

SPECIAL ASSESSMENT

The subcommittee report recommends that special relief be granted only where the commissioner is unable to determine the taxpayer's equity invested capital for the first day of the first taxable year beginning after December 31, 1939. The special relief granted in such a case is to determine equity invested capital equal to the cash on hand plus the total of the adjusted basis of the property then held by the taxpayer and minus the then outstanding indebtedness.

The cases in which relief is accorded are far too limited. Under any excess-profits tax, whether based on earnings or invested capital, cases of extreme hardship will arise. These cannot all be anticipated. Special provisions should be made for all cases where, owing to abnormal conditions affecting the capital or income of the corporation, an exceptional hardship would be imposed by the general excess-profits tax provisions.

Furthermore, we might attempt a direct short-cut in many cases. The primary problem is to determine what the normal profits of the particular corporation should have been. This determination might be submitted to a special committee of experienced, practical men, authorized to consider all the relevant factors—as, e. g., the nature of the industry, the degree of risk involved, prior-year losses, debts, the "normal" earnings of representative corporations engaged in similar business, etc.

EARNINGS AND PROFITS

The final recommendation of the subcommittee is that the Internal Revenue Code be amended to provide that unrecognized gains or losses on the sale or exchange of property by a corporation be excluded from its earnings and profits account. In my opinion no attempt should be made to define in the statute the concept of earnings and profits. That would require provisions as complicated and detailed as those describing the scope of net income. But there can be no objection to the proposition that gains and losses are to be taken into account for purposes of computing earnings and profits only at the time and to the extent that such gains and losses are recognized for purposes of computing net income. While this is in accord with the present Bureau rule (sec. 19.115-3, reg. 103), it should be noted that the Board of Tax Appeals and the courts have taken the directly contrary position. (See *Susan T. Freshman*, 33 B. T. A. 394; *F. J. Young Corp.*, 35 B. T. A. 860, affirmed 103 F. (2d) 137 (C. C. A. 3, 1939); *W. S. Farish & Co.*, 38 B. T. A. 150, affirmed 101 F. (2d) 833 (C. C. A. 5, 1939); and *Dorothy Whitney Elmhirst*, 41 B. T. A. 348.)

TAXABLE YEARS AFFECTED

It is proposed that the excess-profits tax be applicable with respect to all taxable years beginning after December 31, 1939. It should apply only to taxable years after December 31, 1940.

Application of the tax to incomes of the current year assumes that profits from defense spending will be realized in 1940. Such an assumption is not warranted by the facts. Almost three-quarters of the year have already passed. The defense program is still largely in the planning and preparatory stage. It is reasonably safe to assume that "excess" profits resulting from defense expenditures will not be realized this year in substantial amounts. Industry in general, suffering from a long period of low prices and depression, has not had an opportunity to earn "normal" profits. It does not appear that any substantial amount of revenue can be obtained from the excess-profits tax for the current fiscal year. Under these circumstances, we can well afford to postpone application of the tax until 1941.

## STATEMENT OF WALTER H. COOPER, CHAIRMAN, COMMITTEE ON FEDERAL TAXATION, AMERICAN INSTITUTE OF ACCOUNTANTS

The CHAIRMAN. The next witness is Mr. Walter H. Cooper. Please give us your full name and for whom you appear.

Mr. WALTER COOPER. Mr. Chairman and gentlemen of the committee, my name is Walter H. Cooper. I am appearing here as chairman of the committee on Federal taxation of the American Institute of Accountants. I am not here representing any corporation or any industry but rather to give you the benefit of the office and experience of the accountants who have been dealing with excess-profits taxes in all of the past laws.

First as to amortization: We are in favor of the enactment of the amortization provision. If passed the law as written is ample to cover it, with the regulations of the Treasury Department covering the things that should be in the law.

We do favor extending it to cover the addition of facilities not directly required for defense production. If we are in favor of amortization being applied to excess profits taxes, in all business, and all income, why then should amortization be limited? Why limit improvements and expansion to the type that will cease when the defense program is accomplished? We want business activities to continue, but hazards of expansion must be recognized, particularly as excess-profits taxes are to apply to all business. Furthermore, to effectively accomplish the production program, expansion will be needed in

many lines of business activities not directly producing articles for defense.

With respect to consolidated returns: We believe that consolidated returns should be required and made mandatory.

I will not repeat a lot of things which Mr. Alvord said but I will say this as some of the reasons why we favor it.

First, as accountants we favor it as it is the only true basis for determing income.

There are many reasons why subsidiaries must be organized. As a matter of fact, the newspapers carried a story today of the Reconstruction Finance Corporation requiring the organization of what has been referred to as a domestic corporation. That is just another subsidiary. Now, why should there not also be required a consolidated return?

As a matter of fact, the Securities and Exchange Commission requires the publication of a consolidated statement for security registration. Now it seems improper that the Government should say you cannot sell your stock without proper regulation, without furnishing a consolidated statement, and not require the same thing for tax purposes.

Where subsidiaries have been eliminated during the base period, 1936–39, full earnings thereof would not be included in the base-period income but would be included in excess-profits-tax income. Conversely, the reverse would happen when previously losing subsidiaries were eliminated. For instance, if a certain concern has been operating during 1936 and 1937 and it is liquidated and operates under the plan of a separate corporation, for 2 years, its earnings will not be included in the parent company for the base-period income, but now under the excess-profits-tax period it will be.

Furthermore, I think if you do not have the consolidated return there will be much field for tax avoidance. Tax avoidance would be possible through the organization of new subsidiaries to increase exemptions. I have here an illustration of a corporation that now has a million and a half of capital and is entitled to, say, 6 percent, or $90,000. That is a 6-percent return on the investment, or $90,000 before excess-profits tax. It can organize three subsidiaries with a half million dollars and each of those subsidiaries will be given 10 percent, or $50,000. Their aggregate exemption will be $150,000 instead of $90,000; in other words, there will be $60,000 more for excess profits.

Now that is one of the possible means of using a separate corporation to avoid a tax that really should be paid.

Consolidation must be for both income and excess-profits taxes to avoid complications of determining income on two bases, so far as intercompany transactions are concerned, before and after January 1, 1940.

As to the method of tax, the methods proposed will result in an inequitable distribution of the burden and the strong will get stronger and the weak weaker. A company that was fortunate enough to earn 20 percent on its capital can continue to do so without paying any added tax. One that earned only 4 percent will have to pay a heavy tax if the earnings rate increases even though a 6 percent or 8 percent is really not excessive.

Applying the same low rate to the new capital in an old corporation, while new capital in a new corporation is allowed a higher rate would not be sound or fair.

Old corporations should be allowed the same minimum rates of exemption as are allowed to new corporations. Why differentiate, particularly as new corporations may be organized in many cases and where technical difficulties, already existing, prevent transfers to new corporations the taxpayer would be unjustly penalized?

If new plants are to be built in central areas for defense work the corporations in heavy industries, machinery production, and so forth, are the most logical ones to do it, they know how and have some of the needful equipment now. They, as a general rule, have low earnings for the 1936–39 period and the expansion of defense production facilities will be hampered if earnings over 4 percent are taxed at 40 percent.

The low minimum rate of exemption will defeat the purpose of including borrowed capital and will not lead to expansion of smaller corporations. For example, if 8 percent is earned on borrowed capital costing 6 percent interest (few small corporations can make long-term loans for plant expansion at a lower rate) income tax of 21.9 percent must be paid on the 2-percent difference. This is equal to 0.438 on the capital. Deduct from the 7.562 percent earnings of 4 percent as the exemption and on the remaining 3.562 percent an excess-profits tax of 39 percent (or 1.4892 percent on the capital) must be paid. This leaves only 6.0728 percent net earning before interest—which takes 6 percent. Thus on an 8-percent earnings the corporation just about breaks even. Even a 10-percent gross return, if obtainable, would net only three-fourths of 1 percent and would never justify the risks entailed.

On the other hand, a 10-percent rate of earnings on borrowed capital costing 6 percent, without the proposed borrowed capital provision, would yield a net of 1.9 percent on the borrowings—assuming a 4-percent excess-profits-tax exemption rate.

Even if capital could be borrowed at 5 percent, the results, in terms of net yield, would be: if 8 percent were borrowed on capital, under the proposed law, 0.0034 percent and, if borrowed capital be disregarded, 0.0144 percent. If 10 percent were earned on borrowed capital, under the proposed law, the net yield would be 0.0139 percent, and if borrowed capital be disregarded, the net yield would be 0.0292 percent.

Also under method (a) the profitable companies that can borrow and expand will get no benefit therefrom as borrowed capital is not recognized under method (a).

If two methods are continued with lower minimum exemption rate for existing corporations, those that were inactive should be put in same category as new companies.

If elective method (a) should be used, the 8 percent additional capital should be applied to increases over average capital during the base period—not additions after January 1, 1940. Why should capital, added, say, during December 1939, create no added exemption while capital added in January 1940 increases the exemption?

Is a taxable stock dividend to be treated as capital paid in under method (a)? It should but the report indicates no treatment.

In lieu of (a) and (b) methods, we should have only one method—that is method (b) with an 8-percent–12-percent range.

Better still no excess-profits-tax bill, now, but take time to work out a fair law, permit taxpayers and business to study a definite proposed statute, and then make it applicable January 1, 1941.

As to net income, gains, or losses on sales of depreciable assets used in business should not be excluded. They represent mainly under or over depreciation and in the light of present Bureau policies there is usually under depreciation and loss on disposition. This is a real operating loss and should be deductible, otherwise there will be much dispute regarding rates. Further, the proposed law will lead to the scrapping of assets otherwise salable—an unnecessary waste when we may need all facilities available, even if obsolete, for defense production.

The use of the 1936–39 base period will work injustice to corporations in industries that were slow to recover (or did not recover at all), such as machinery producers, construction, and heavy industries generally. I refer you to my alternate suggestion under the method of tax.

In the interest adjustment (when invested-capital basis is used) allowance should be made for interest previously disallowed because the capital is used to carry tax-exempt securities. It should not be disallowed twice.

So far as exemptions are concerned, insurance companies should be exempted. They may have little capital left after the inadmissible asset adjustment but are really using such capital in their business, and are limited by State laws in selection of investments. The company with a substantial investments in governments may be penalized with respect to net underwriting income.

What will be the equity invested capital of a mutual insurance company—apparently zero.

Now I want to discuss briefly the carry-forward of unused exemptions.

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 aggregate income exceeds aggregate exemptions.

By law, income must be computed on an annual basis—though business does not run that way. Also technicalities as to time of deduction of expense or loss, or taxation of income, requires a treatment that is not in accord with good accounting which seeks to apply expense against income produced thereby.

In many businesses fluctuations are expected so that one year a loss of little income results while in the following year substantial income results. The average may not be excessive—and the average for 1936–39 is required to be used as a base.

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.

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

When contract business is involved and profits are computed when contracts are completed the result of more than one year's business may be piled up in one year for tax purposes.

The rate bracket variations are too low.

On a 5-percent exemption the difference between the 20-percent and 30-percent brackets is only one-half of 1 percent. This should be widened particularly as, in the case of a company with a 20-percent earnings rate, under method (a) the difference is 2 percent on capital. The same as to the 30–40 percent. Disputes over years for taxation or deduction are likely because of variation in bracket rate applicable.

We suggest only one rate or a wider spread between the brackets which should be based on capital invested.

Where method (a) base earnings is used as the basis apply a fixed rate, 10 percent if an 8–12 percent spread is used, to figure the capital for bracket purposes.

In reference to the computation of invested capital, any distribution during the year should be deemed to be out of prior surplus if the year's earnings are sufficient. Use the same basis as for income-tax purposes. Distributions after the first 60 days, when the year's earnings are insufficient to cover them, should be deducted but preferably there should be no reduction for any distribution of earnings during the year. Should this lead to extra distributions the individual income and surtaxes thereon will greatly exceed the slight loss of excess-profits taxes.

Earnings or profits should be fully defined as many other questions are still open, such as the amount of earnings after depletion or depreciation based on unrecognized gain, the carry-forward of surplus upon reorganization, income-tax deductions, and so forth.

The existing excess profits and capital-stock-tax laws should be repealed.

There is no reason to have two excess-profits tax laws. If the capital-stock-tax revenue is required, then it should be replaced by a 1-percent increase in the normal income-tax rate. That is what the good guessers now pay and although poor guessers may pay more they should not be required to do so anyway.

Mr. DINGELL. You made an observation with reference to a differentiation in the tax rate applicable to old companies and new companies. Is not that going to stimulate scheming and the possible creation of some device to get away from paying higher taxes?

Mr. WALTER COOPER. I think it is quite apt to lead to the organization of new companies. I would not be surprised at that at all.

It seems to me if the old corporation is entitled to 4-percent exemption and they get an advantage by organizing a new company, it is obviously better for them to do it.

Mr. DINGELL. What effect will that have on industry?

Mr. WALTER COOPER. It adds another headache to be taken over, and there are enough of them now.

You may have a particular situation in which there is a lease which is not transferable, and that will prevent the organization of a new company, so one company gets a saving and another company does not.

Mr. DINGELL. Will that have a tendency to slow down any of the activities in connection with the defense program?

Mr. WALTER COOPER. I think it will have a tendency to slow up business.

Mr. DUNCAN (presiding). We thank you for your appearance and the statement you have given to the committee.

Mr. DUNCAN. The next witness on the calendar is Mr. D. H. Reynolds, of the Machinery and Allied Products Institute, Washington, D. C. Is Mr. Reynolds present?

(There was no response.)

Mr. DUNCAN. The next witness on the calendar, Mr. C. N. Osborne. Will you give the reporter your full name, your residence, and the capacity in which you appear?

## STATEMENT OF CARL N. OSBORNE, VICE PRESIDENT, THE M. A. HANNA CO., CLEVELAND, OHIO, AND VICE CHAIRMAN, NATIONAL ASSOCIATION OF MANUFACTURERS' GOVERNMENT FINANCE COMMITTEE

Mr. OSBORNE. Mr. Chairman, my name is Carl N. Osborne; I am vice chairman of the National Association of Manufacturers' Government finance committee, and vice president of the M. A. Hanna Co., Cleveland, Ohio.

Mr. DUNCAN. You may proceed with your statement.

Mr. OSBORNE. Mr. Chairman and gentlemen of the committee, the National Association of Manufacturers is fully aware that the heavy costs of the emergency national defense program make it necessary for the Government to raise substantial amounts of additional revenue through taxation, and we also are firmly of the belief that business concerns should carry a fair proportion of this heavy tax load. We agree with the honorable chairman of the Senate Finance Committee who in a recent radio address said:

> We must all "tighten our belts"; we must be resolved to face sacrifices. The end of expenditures for national defense is not in sight; therefore the need of additional taxation to underwrite those expenditures must be expected.

We also recognize that a new excess-profits tax (not to be confused with the existing tax levied in conjunction with the capital-stock tax) represents a possible means of raising a portion of the additional revenue required by the Federal Government.

We sincerely believe that a substantial portion of additional or so-called earnings which companies may derive from the rearmament activities of the United States should be returned to the Government.

Although we favor a carefully drawn excess-profits tax as an emergency measure, we wish to point out that the unsound nature of this type of taxation requires that we oppose it as a permanent part of the tax structure. It is unnecessary to repeat to this joint committee the remarks of Secretaries of the Treasury McAdoo, Carter Glass, and Houston in opposition to excess-profits taxation, although I ask the chairman's leave to include these remarks in the record.

Mr. DUNCAN. Without objection, it is so ordered.

(The statements above referred to are as follows:)

STATEMENTS OF SECRETARIES OF THE TREASURY MCADOO, GLASS, AND HOUSTON IN OPPOSITION TO EXCESS-PROFITS TAXATION

Secretary of the Treasury McAdoo stated to the House Ways and Means Committee in 1918 (1918 tax hearings, p. 15):

"The theory of a war-profits tax is to tax profits due to the war. The theory of an excess-profits tax is to tax profits over and above a given return on capital. * * * The excess-profits tax must rest upon the wholly indefensible notion that it is a function of taxation to bring all profits down to one level with

relation to the amount of capital invested, and to deprive industry, foresight, and sagacity of their fruits."

Secretary of the Treasury Carter Glass, now a distinguished Senator from the State of Virginia, declared in his annual report as Secretary for the fiscal year ending June 30, 1919 (pp. 23 and 24):

"The Treasury's objections to the excess-profits tax even as a war expedient have been repeatedly voiced before the committees of the Congress. Still more objectionable is the operation of the excess-profits tax in peacetimes. It encourages wasteful expenditure, puts a premium on overcapitalization, and a penalty on brains, energy, and enterprise, discourages new ventures, and confirms old ventures in their monopolies."

In the Annual Report of the Treasury for the year 1920, Secretary David F. Houston declared:

"The reasons for the repeal of the excess-profits tax should be convincing even to those who on grounds of theory or general political philosophy are in favor of taxes of this nature. The tax does not attain in practice the theoretical end at which it aims. It discriminates against conservatively financed corporations and in favor of those whose capitalization is exaggerated; indeed, many overcapitalized corporations escape with unduly small contributions. It is exceedingly complex in its application and difficult of administration, despite the fact that it is limited to one class of business concerns—corporations. Moreover it is rapidly losing its productivity."

In a letter dated March 17, 1920, to the House Ways and Means Committee, Secretary Houston declared:

"The application or calculation of the excess-profits tax is so complex that it has proved impossible to keep up the administrative work of audit and assessment."

Mr. OSBORNE. Practically every tax expert we have ever had is on record in regard to the inequities involved in excess-profits taxation as well as the tremendous administrative burden it places on the Treasury Department.

The report submitted by your subcommittee on the proposed excess-profits taxation shows earnest efforts to meet the complex and difficult problems created by this type of legislation.

The subcommittee has acted wisely in recommending that an election be given the taxpayer of computing his excess profits either on the basis of average earnings over a previous period or on the basis of capital invested in the business. For example, an examination of the authoritative data issued by the Standard Statistics Co. on the earnings records of leading industrial companies in the United States shows wide variations in income between different industries and from year to year within the same industrial groupings. We have prepared a chart from this latest available Standard Statistics Co. data covering the years 1926 through 1938, showing the abnormally low earnings of 7 industrial groups, represented by 86 individual companies, who suffered losses in the year 1938 and who will unquestionably require the equitable option of determining excess profits on the basis of invested capital. With the chairman's permission, we offer this chart for the record.

Mr. DUNCAN. Without objection, it is so ordered.

(The chart referred to appears on facing page.)

Mr. OSBORNE. The many hundreds of letters which have come into the association's offices during recent days show that a great number of business concerns whose earnings would not be affected, or at least at the most only slightly affected by the national-defense program, would be severely punished if an optional method of computing excess-profits taxes was not provided.

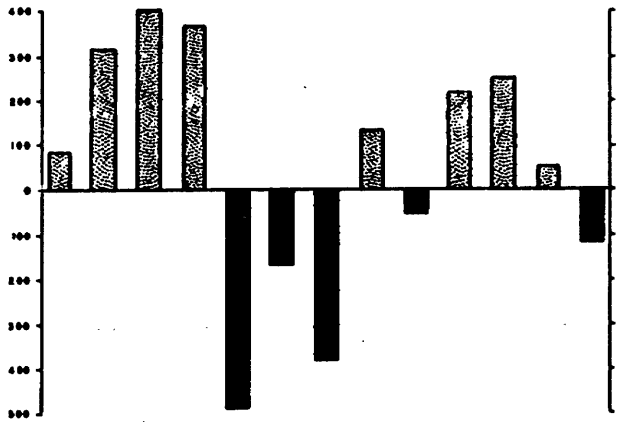
With your permission, Mr. Chairman, we should like to offer for the record typical examples of companies who have submitted facts on

# INDUSTRIES WITH ABNORMALLY LOW EARNINGS

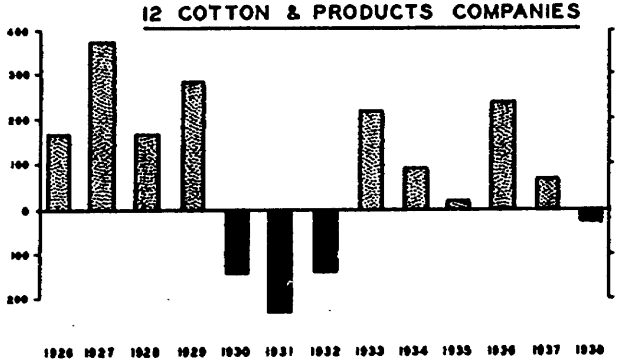
## REPRESENTED BY 86 INDIVIDUAL COMPANIES

IN RELATIVES 1926-1930=100

### 4 SILK & PRODUCTS COMPANIES



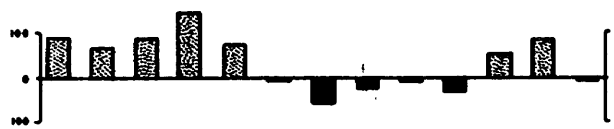
### 12 COTTON & PRODUCTS COMPANIES



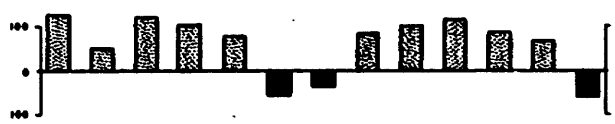

SOURCE: STANDARD STATISTICS COMPANY

### 14 METAL FABRICATORS

### 27 IRON & STEEL COMPANIES



### 7 MEAT PACKING COMPANIES



### 16 COAL COMPANIES

### 6 RESTAURANT COMPANIES


U.S. GOVERNMENT PRINTING OFFICE: 1940—O-253390

their need of an option allowing them to compute their tax on the basis of invested capital because of their record of losses or of inadequate earnings during the period 1936 through 1939. We should like to offer other typical examples of companies who need the protection of computing their taxes on the basis of average earnings because of the particular nature of the company or of the industry involved.

Mr. DUNCAN. Without objection, it is so ordered.

(The statements referred to are as follows:)

TYPICAL EXAMPLES OF COMPANIES WHO NEED THE OPTION OF AN INVESTED CAPITAL BASE

C. 1. A VALVE COMPANY

Ours is a good example of a company which, on account of adverse business conditions in the industry, has suffered through no fault of its own, a loss during the past several years. It would be most unfair to compute an excess-earnings tax based on our earnings for 1939, or on our average earnings during the period 1936–39 inclusive.

This company has built its business on valves and hydrants for the water-works market. We depend upon this market for more than 75 percent of our business and when the demand for water works valves and hydrants falls off, our business is bound to suffer. Should this business now improve along with business in general, it is necessary that we be permitted to retain a substantial part of any earnings which we make in order to make up for the losses which we have suffered during the past several years. This is more important under the circumstances than it would be if we had been enjoying a profit for these years. It is only fair that an option be given corporations to compute this tax on the basis of invested capital; and an additional consideration given to the companies which suffered a loss during the past few years, which would permit them to enjoy a larger percentage of profit instead of penalizing them. Our company showed a net loss of $34,867 for 1939 and $53,760 for the period 1936–39, inclusive. Our invested capital at December 31, 1939, was $1,163,000.

C. 2. A CABLE COMPANY

Our company was incorporated in January 1936, with an invested capital and surplus of approximately $1,750,000. We began actual manufacturing operations in the summer of 1936 and for the fiscal year ending March 31, 1937, we showed a profit of $1,616. On March 31, 1937, investment in the business was $1,762,000; profits, after taxes, for the ensuing year were $71,026. Investment in the business at March 31, 1938, $1,833,000; profits, after taxes, for the ensuing year were $243,960. Investment in the business at March 31, 1939, $2,083,000; profits, after taxes, for the ensuing year were $297,736. Investment in the business at March 31, 1940, $2,305,000.

I am glad to furnish these figures for I am very hopeful that Congress will make some allowance for a new company which started during this depression period. I hope some special treatment may be allowed new companies for it invariably takes some little time before they can show their established earning power. With the present equipment installed in our plant, we should have a normal earning power of $400,000 or more at the present time.

C. 3. A REAL-ESTATE COMPANY

This corporation was organized in 1933 for the purpose of owning and operating a group of commercial properties. At the time of its organization paid-in capital amounted to $600,000 and real estate having this value was acquired.

Our properties had all been poorly maintained and poorly operated, and at the beginning our net profits after depreciation and all other charges, were negligible. Subsequently our earnings have gradually increased until they now represent about 2 percent per annum on our capitalization. We have made large investments in the improvement of our properties, and have reason to anticipate that in future years we will be able to earn a more nearly adequate return on our investment, unless some confiscatory tax is imposed upon future increases in earnings. Certainly a net return of 5 percent or 6 percent should not be regarded as exorbitant.

C. 4. A PAPER-PRODUCTS COMPANY

This company is vitally interested at the present time in having tax computed on the basis of invested capital rather than on average earnings during the period 1936 to 1939, inclusive.

The company operated in receivership from 1932 to 1936. Immediately after it emerged from that status, it embarked on an extensive modernization program which will not be completed before the end of 1941. In the meantime, this company has made little profit and it cannot improve its earnings substantially before 1942.

Under these circumstances, if the new law should preclude this company from earning more on the average than it did during the period 1936-39, it would take this corporation completely out of the earning class and deprive the stockholders from ever participating in dividends.

There must be many other corporations now engaged in similar modernization and rehabilitation programs which were inaugurated to meet competition in normal times in their respective fields and not for the purpose of making excess war profits. The proposed law, if limited to the average profits made by such corporations during the period 1936–39 would also be unfair to them. There is no reason why the Government should punish such corporations just because their modernization programs have not been completed in time.

It is my belief that an option should be given to each company to determine its excess earnings either on the basis of invested capital or on the basis of average earnings made by other modern, up-to-date concerns operating in the same field of business during the years 1936-39. By doing so, the Government would be creating a goal which could only be reached through efficiency and modern equipment.

C. 5. AN OIL-REFINING-EQUIPMENT COMPANY

For the years 1936 to 1939, inclusive, this corporation had an invested capital of approximately $6,000,000. The result of operations for the 4 years showed a net loss; therefore, we had no average earnings for this period. We are somewhat typical of a group of corporations which would be very severely penalized by basing tax on average earnings for a period including recent years. Our only relief in this respect would be to grant us an exemption from the high tax rate based on a percentage of our invested capital.

We recognize that the enactment of tax laws presents a very difficult problem, but feel that the old principle of "ability to pay" should be kept very much in mind when enacting tax laws carrying rates so high that they may force out of existence corporations financially weakened by unprofitable years.

C. 6. A WOOLEN MILL

The average of our earnings for the years 1936-39 has been a loss rather than a profit. In 1936 and 1939 we made a small profit but this was more than outweighed by losses of 1937 and 1938, most of these losses being caused by the severe drop in wool during the latter part of 1937, and some of this had to be absorbed during 1938.

C. 7. A METER COMPANY

For approximately 6 years, that is from 1930 to 1936, our company being in the capital-goods industry, suffered repeated losses and heavy ones at that Salaries were reduced 50 percent and many weeks were run in the factory at not over 16 to 18 hours total time. By the end of 1936, the company had depleted all of its assets to keep afloat and with the upturn in 1937 was compelled to borrow substantial sums to fill orders received. The upturn in 1937 was short-lived and the year 1939 and so far this year have been the first indications of any return on the investment capital. As a matter of fact, we resumed dividend payments this year for the first time since 1930. We have not had an opportunity in any way to build back any surplus into the company, much needed for future depressions which are bound to come.

C. 8. AN AUTOMOBILE ACCESSORY COMPANY

The average annual earnings yardstick does not take into consideration the fact that a young and growing business can be expected to earn more money in future years than for the average of the years 1936-39, inclusive. In our own case we still are growing and developing. During 1939 we have been expanding plant facilities and as a result should be in a position to develop more earnings than in

previous years, even without the impetus to business brought about by the defense expenditures of the Government.

Another thing, for several years we have been doing research and development work, the effect of which has not yet been felt in our business volume or earnings to an appreciable degree. Money expended in past years for development could easily come back to us several fold in 1 year and cause us to be taxed unfairly as regards excess profits.

It is my feeling that the average earnings yardstick or the invested capital basis of measurement would not permit us to earn the amount to which we would be entitled as a result of normal growth of our business and as a result of efficiencies on which we have been working for some time and which now are just beginning to take hold.

### C. 9. A SHOE MACHINERY COMPANY

We would advise that in our case we had a rather large invested capital, but have not been showing appreciable profits during the past 4 or 5 years due to, first, comparatively slow business, and our desire to maintain as large an organization as possible throughout our plant so that they would not be thrown on to welfare, and so that our chances for merit rating would be as good as possible when this comes into effect in this State shortly.

Second, we have been confronted with a rather serious patent infringement suit which has only this year been settled after having been dragging along for about 8 years. This in itself has necessitated our spending a considerable amount of money for defense, and because of the loss of a portion of the suit we found it necessary to replace a great many of our machines in the field which has automatically increased our invested capital.

### C. 10. A METAL STAMPING COMPANY

With respect to the proposed methods of taxing the excess earnings of corporations, we feel that our company and companies in our industry would be very severely handicapped if it were based on an average of our earnings over the past years. Being in the heavy goods industry we have not had, as you well realize, what would be called good business for the past 3 years. With the exception of 1937 you might almost classify these 3 years as depression years. We feel, therefore, that it would be very unfair to have an excess-profits tax based on an average of earnings for a period that you might call depressed.

Due to the national-defense program we have built up our unfilled orders position considerably and it seems quite apparent that we will operate over the next 2, 3, or 5 years at a somewhat greater rate than we have during the last 3 years, with a consequent increase in profit. Under the method of taxing on the basis of average earnings over the past 3 years we would not be able to earn anywhere near a fair return, such as 10 percent.

Companies in the consumer goods industries have not had the depressed conditions during the last 3 years that existed in the heavy goods industry, therefore they would be permitted to earn before excess-profits tax a far greater return than companies in industries such as steel, cement, automobile, etc. I do not feel, therefore, that it is a fair basis for determining taxes on excess profits.

We in our company are in no way desirous of profiteering, as we realize that everyone must do his share in the national defense program. We believe, therefore, that a basis of taxation such as on invested capital which would permit us to earn a fair return, namely, 10 percent, would be satisfactory and would be sufficient for use to keep our plant and equipment in efficient condition so that we could in the future produce our profits and sell them in a competitive market.

### C. 11. A CLOTHING COMPANY

We do not feel that a tax based on average earnings of any number of years in the last 10 would be a just basis for taxation, as while there were some fair years, there were some poor years and the average would hence be low. We therefore feel that some basis of earnings on invested capital should be used and that a method of taxation should be worked out which would be just and equitable for all.

### C. 12. A CHEMICAL LABORATORY

I wish to advise that we are capitalized at $50,000. For the past 5 years, we have invested all of our earnings in research, hence, we have had no profits. It appears that shortly we will begin to realize on this work. If any bill is passed,

taxing an excess of earnings over the past 5 years, we would be badly penalized I assume that earnings will be judged on a percentage basis of invested capital rather than to take the earning power of a company over the preceding years.

C. 13. A SHEET METAL PRODUCTS COMPANY

In 1937 due to the unprecedented flood of the Ohio River, we had a flood loss that we estimated to be $90,000. In spite of this loss we had profits that year of approximately $60,000, but the point I am making is that we would probably have made without the flood $150,000. Should not the higher figure be considered on any basis of average, which includes such an expenditure?

C. 14. A WOOLEN GOODS COMPANY

We favor an excess-profit tax based on average earnings. During the past few years we have operated decidedly in the red.

C. 15. A BEARING COMPANY

* * * Any excess profits figured on the basis of earnings in excess of former years would work a distinct hardship on this company.

The following table indicates our earnings, 1935 to 1939:

| | Profit | Loss | | Profit | Loss |
|---|---|---|---|---|---|
| 1935 | $54.44 | | 1939 | $1,729.38 | |
| 1936 | 33.29 | | | | |
| 1937 | 1,905.45 | | Total | 3,733.56 | $4,890.55 |
| 1938 | | $4,890.55 | | | |

Our invested capital is $65,000.

Last year and the first half of this year shows a steady improvement and we hope to continue that. If, after a year of hard and intensive work, we were able to show 5-percent, or even 10-percent, profit, it would be idiotic and ruinous to tax that at excess rates.

C. 16. A LINSEED PRODUCTS COMPANY

If a law is passed basing an excess-profits tax on the excess profits of future years over the average profits of 1936 to 1939, inclusive, this company would have to pay an excess-profits tax on all future profits, as the loss during the recession of 1938 entirely offset all the earnings for 1936, 1937, and 1939.

This would be a great hardship on this company and others similarly situated, and we feel that the law should give all companies the option of basing excess-profits tax on the invested capital or the declared value on the capital-stock tax return.

C. 17. A PAPER COMPANY

Unless an option is given to corporations to compute their taxes, either on the basis of invested capital or on the basis of average earnings during the period of 1936 to 1939, inclusive, a very great hardship will be done to many corporations.

Our own experience in the 4 years 1936 to 1939, inclusive, was that we lost money in 1936 and 1938, and made a little money in 1937 and 1939. Our invested capital in these 4 years was approximately $2,500,000.

In the 10-year period 1930–39 we lost money in 7 of the years and made money in only 3, so that if our taxes are based on the excess earnings over 1936–39, and no option is given to compute returns on invested capital, we might possibly have to close down and go out of business. I think this applies to a great many other companies.

C. 18. A FURNITURE COMPANY

We are of the opinion that if this tax is settled on a basis of average earnings for a few recent years that it is going to be extremely unfair to a good many manufacturers, particularly in the furniture industry. During the last 4 years our company has operated at an average profit of less than 1 percent, due as is generally conceded in the furniture industry, to a demoralized condition in the industry.

If an excess-profit tax should be set up on this basis it would mean that concerns like ours would be paying excess-profit tax even in cases of extremely moderate

profit such as 2 or 3 percent. It seems to us the only fair way to set up this sort of tax is on the basis of average earnings in recent years or on a basis of invested capital with a manufacturer having an option as to the method of figuring the tax. It seems as though this ought to be the fairest way and ought to produce the needed revenue.

C. 19. A SURGICAL INSTRUMENTS COMPANY

As far as my company is concerned, unless earnings based upon invested capital were permitted the tax would apply to all earnings, for the reason that after paying existing taxes it has not had enough to pay its dividends for several years.

C. 20. A RAILWAY SUPPLY COMPANY

Average earnings of our company for the 4 years 1936–39, inclusive, have been, in round figures, $35,800. For this period average figure for combined capital and surplus has been $787,600.

We are in the railway supply business, which for the period taken, has been in a depressed condition and we do not think earnings have been adequate.

C. 21. AN ELECTRIC MACHINERY COMPANY

It would be essential to this company that the forthcoming excess-profits tax grant an option to compute the tax on the basis of invested capital.

This company has had occasion to make substantial write-offs in recent years, representing in part the adoption of more conservative accounting practices by a new management. In recent years we have therefore had no earnings or inadequate earnings and the above-mentioned option would be necessary in order to deal fairly with our situation.

C. 22. A HOSIERY MANUFACTURING COMPANY

We think it is most important that corporations be given an option in computing excess earnings on the basis of invested capital. Insofar as we are concerned we have sustained a net loss for every year since 1934 and if we are to be charged with excess earnings and taxed heavily on that basis there would be absolutely no incentive for us continuing in business.

C. 23. AN ENAMELED STEEL WARE COMPANY

We know it would, in very many cases, be very unfair to treat as excess profits any earnings above the average for the period 1936 to 1939, inclusive. Excess profits should be based on amount of invested capital.

Our company made no profits during the years 1936–37–38 on account of unfavorable conditions in our industry, and because of further unfavorable nonrecurring matters affecting our company.

During 1939, we had moderate net earnings and expect to have such moderate earnings each year; but, if any earnings above the average for the period 1936 to 1939 were taxed as excess, then nearly all our moderate earnings would be taxed as excess, which would clearly be unfair and a very serious injustice to companies like ours.

C. 24. AN AIRPLANE COMPANY

Our company is capitalized at $200,000. The company has sustained losses of approximately $50,000 a year, to December 31, 1939, for the 3 years of its existence.

The operations of the corporation have been largely developmental and introductory in character.

C. 25. A MACHINERY COMPANY

Referring to our general letter of August 2, our company in common with the majority of the smaller manufacturers has not enjoyed anything like satisfactory earnings during the 1936 to 1939 period. Heavy losses in 1938 nearly offset all profits of the other 3 years.

Consequently an excess-profits tax based upon earnings over our average for the 1936 to 1939 period would afford us practically no protection at all.

We prefer the use of invested capital as a basis for computing the tax, provided a reasonable allowance is made. This allowance should certainly not be less than 6 percent.

C. 26. A PACKING COMPANY

I wish to state that if this company, and I think the same holds true for all canners, had to base the tax upon its earnings from 1936 to 1939 inclusive, it would be disastrous.

In the case of this company, in the first 3 years we made moderate profits but in the fourth year made a serious loss, leaving us a net profit for the 4 years of about $4,782 per year, while our capital amounts to $400,000. In other words, slightly more than 1 percent.

We will hope that there will be some provision for allowing us to earn a percentage on our capitalization.

C. 27. A MANUFACTURER OF SOCKS AND MITTENS

We believe in our own case that it would be very unfair to determine excess earnings on the basis of our average earnings during the period 1936 to 1939 inclusive. Actually our earnings average only 2.1 percent during that period on our book value.

C. 28. A PAPER MANUFACTURING COMPANY

The proposed "excess earnings" tax of corporations, as now being drafted by the Federal legislature, is of utmost importance to some small corporations like our own, particularly as to the method of computing such excess profits. We fully recognize the need for standing heavier taxes, both for rearmament program and eventually to reduce our national debt. We feel that the alarm that some are showing, simply because taxes are increasing, is unfounded and unpatriotic. But the methods of taxation must be worked out on a reasonable basis of equality, or gross hardships will arise.

Our earnings over the past 5 years, and that of many other units in the paper industry of America, have shown approximately a no-profit basis, on a relatively high invested capital. Therefore, it is obvious that to base the new law on earnings, and not at least give the corporation the option of using invested capital as a basis, would be both unreasonable and unfair.

TYPICAL EXAMPLES OF COMPANIES WHO NEED THE OPTION OF AN AVERAGE EARNING BASE

E. 1. A PRINTING PLATE COMPANY

War taxes based on "invested capital" nearly ruined our industry during the previous war and would very likely duplicate that condition if the same methods should be used in raising future war taxes. The reason for this is that from 65 to 75 percent of our sales dollar is represented by an extremely high-priced pay roll. A very modest amount of money is necessary to start in the photo-engraving business in a small way.

We therefore hope that any new taxes to raise necessary war funds will be based upon "excess earnings" of corporations, *over* the amount they enjoy in normal years.

E. 2. A CARBURETOR COMPANY

We are one of the smaller manufacturers in the automotive industry with a capitalization showing a net worth of approximately half a million dollars and our capital stock has been continuously very closely held by the same owners for more than 25 years that we have been in business. As a result, we have always carried our book assets on a most conservative basis, so that after this long period our statement reflects a probably too modest valuation of invested capital.

We have been successful to the point that for the last 5 or more years our net earnings have been considerably in excess of a 10-percent return as based upon our net worth. We do not have nor are we seeking business arising from the war or the rearmament program. We will, of course, be glad to serve in this connection if called upon to do so, but the point we make is that we are normally making "excess profits" according to present book valuation.

We are right-minded toward contributing our share of Government expense in this emergency, but feel that as a corporation we should not be abnormally penalized for normal profits that do not arise from the war or rearmament program.

E. 3. A BOTTLING COMPANY

Our average net earnings for the 1936–39 period were $90,916, and our invested capital is only $10,000. Therefore, according to your information, practically all of our earnings will be subject to the excess-profits tax.

E. 4. A RESISTOR AND SWITCH COMPANY

Our company is a close corporation of modest size that has been in existence since 1892. As a matter of sound practice, our accounting has been conducted on an extremely conservative basis, without capitalization of values for patents, goodwill, and like items. Hence, in terms of percentage our earnings in normal times represent a sizeable amount as compared to invested capital as carried on our books.

On this account, we are only interested in that part of the contemplated legislation concerning the basis of average earnings from 1936 to 1939 inclusive. While a basis of that kind would give us some relief as compared with a straight percentage, the years on which the average is based are far from normal years.

For example, our earnings for the years 1936 to 1939 inclusive, amounted to profits of 18 percent and 31.82 percent for 1936 and 1937; a loss of 33.29 percent for 1938; and a profit of 25.67 percent for 1939. Our average for the 4-year period is 14.26 percent.

We feel that the year of 1939 comes as nearly as possible to being a normal year but from the reports received concerning the contemplated law, there does not seem to be much that can be done about it.

E. 5. A CORDAGE COMPANY

A plan which defined excess earnings as that number of dollars in excess of the average for the years 1936 to 1939, inclusive, would be unfair, I think, to this corporation. During that 4 years we had one very bad year which thereby reduces the earnings for the period very greatly. It does not seem fair nor, I might add, wise, to discourage improvement in earnings from an unsatisfactory level. It does seem sensible, however, to put some top limit on what those earnings should be which are considered normal, expressed in terms of a percentage of invested capital, and the best plan of all seems to be the option as between the two plans with, of course, no doubt some top limits being required.

To give you the facts, however, which will be more useful, our net income as shown on our United States tax returns was, for the years in question, as follows:

| | |
|---|---|
| 1936 | $1,250,000 |
| 1937 | 570,000 |
| 1938 (loss) | 1,135,000 |
| 1939 | 540,000 |

Our invested capital, measured by adding together our capital stock, surplus, and reserves, amounts to about $12,000,000.

E. 6. A METAL COMPANY

Our earnings during the past 5 years have been sufficiently good with respect to capital invested to make it appear more desirable to us to tax excess profits upon an earnings rather than an invested-capital basis. Our earnings have not in any way been due to war conditions, and are not so at present, unless to a very minor degree. It seems to us that as the purpose of the proposed law is to tax earnings due to war profits, the tax should be confined to profits arising solely as a result of war business.

Corporations whose earnings have been small or nil for some years past would naturally prefer an excess-profits tax based on invested capital but it seems to us that if the profits accrue from war business they ought to be taxed in the one case the same as in the other. Probably the fairest law would permit a choice of the two methods.

E. 7. A DIE-CASTING AND STAMPING COMPANY

It is found by analysis that in our particular case, if the "excess earnings" tax were to be computed on an invested-capital basis, the tax would be prohibitive, due to the fact that although our capital assets cost over $100,000 they have been depreciated to a value of approximately $25,000 over a period of years.

The volume of business we are capable of handling comfortably runs about $500,000 per year and average profit for the period from 1936 to 1939 will run approximately $50,000 per year.

In view of the above, we would be very much in favor of the new tax being based upon several years' average earnings.

E. 8. A WOMEN'S WEAR COMPANY

We find that an invested-capital basis will work out very badly for us because our normal earnings, or the average for the past 5 years, are large in proportion to the capital investment of our company. Our average of invested capital for the past 5 years is $4,600,000. Our average earnings for the past 5 years have been $906,000 or 19.6 percent of invested capital. The variation has been from 16.6 to 22.2 percent in this 5-year period, and for 1939 it was 20.6 percent on a capital investment of $5,272,000. If we assume that the excess tax will begin at some point below 10 percent of invested capital, you can see that we, with normal earnings, would pay a substantial excess-profits tax.

We, naturally, are very much interested in having a tax bill framed to offer the alternative of average earnings to an invested-capital basis.

E. 9. A METAL SPECIALTIES COMPANY

We feel very strongly that excess profits should be based on earnings in excess of the average of the years 1936 to 1939, inclusive. To arbitrarily state that any earnings over 10 percent, for example, on invested capital in our case would be unfair, as you will see from the figures given below. We are modestly capitalized and through hard work turn our inventory more often than we believe competitive concerns turn theirs, thereby giving us greater sales and relatively greater profits on a small investment.

Our average profit on our sales is around 11 percent, but the percentage of return on our invested capital is around 20 percent, so that the only fair thing in computing excess profits due to the current war stimulus to business is to consider those profits which are abnormal as compared with the past.

| | Invested capital | Sales | Profits after taxes | Percent on sales | Percent on invested capital |
|---|---|---|---|---|---|
| 1936 | $416,635 | $700,370 | $92,771 | 11.90 | 22.3 |
| 1937 | 448,379 | 811,535 | 91,137 | 11.23 | 20.3 |
| 1938 | 462,215 | 754,510 | 73,250 | 9.71 | 15.8 |
| 1939 | 503,728 | 899,279 | 102,936 | 11.44 | 20.4 |

E. 10. A LITHOGRAPH COMPANY

During the last 5 yeas our earnings before Federal taxes have ranged from a low in 1928 of 3.69 percent to a high in 1936 of 16.38 percent of invested capital. The average was 10½ percent. Obviously, an excess-profits tax based upon 8 percent of invested capital would not be taxing war profit, but would simply be placing an additional load on our normal earnings. If we were permitted to use an average based upon our 1936–39 earnings it would be preferable.

E. 11. A PUBLISHING COMPANY

From the viewpoint of our own company, it would be unfortunate if the tax were based solely upon a percentage of invested capital. I would very much rather see the tax based upon average earnings over a period of years, or at least have the alternate of using a basis if we wished to do so.

E. 12. A LUMBER COMPANY

We are one of those companies that would be badly affected by basing the excess-profits tax on our invested capital.

We have an invested capital of $281,000. Our annual business has been running from $800,000 to $1,000,000. We have been able to do this on a small capital because we are renting several of the buildings we use and are selling contract work where the payments are made promptly.

In our case the only real fair way would be to compute on the basis of average earnings.

E. 13. MANUFACTURERS AND JOBBERS

In our business we have found it necessary to form small corporations in various States where we do business rather than to qualify our parent company in each of these States.

These corporations were formed with only a nominal capital, and during the years when we were able to file consolidated returns, of course the income of the group was reported as one unit. Now, hereafter under this contemplated excess-profits tax, if they do not allow a consolidated return a great injustice will be done if this tax is based on invested capital alone, and if no consideration is given to the average earnings, say, for the past 3 years. To illustrate: For the year 1939 the parent's net income was 11.20 percent of its invested capital; subsidiary A net income 43.48 percent of its invested capital; subsidiary B net income 76.99 percent of its invested capital; and subsidiary C net income 54.04 percent of its invested capital. Therefore you will readily see that it will be a great injustice to these small corporations to tax them and only consider the invested capital alone.

Of course, these small companies are large borrowers from the parent company, and for subsequent years we will be able to correct this condition by putting in more capital, but as we understand the act that is now proposed, it makes the tax applicable to 1940, and then we will be penalized for absolutely no reason at all, because a mere book entry could change the amount now shown as a liability, that is, the advances from the parent company, to capital stock and paid-in surplus, thereby avoiding the tax without changing the fundamental condition of the company in any respect.

We trust that this law, if enacted, will not be based upon invested capital alone, but that it will also consider the average earnings for at least 3 years.

E. 14. A WIRE AND CABLE COMPANY

This company has been conservatively run for a great many years and therefore the book value of invested capital is very low in relation to the physical plant. Profits depend upon volume. At 100 percent volume we would expect to earn 25 percent of our present book value per year. This is in accordance with past history. Thus an alternative basis on average earnings appears very desirable to us.

E. 15. A PAPER COMPANY

An excess-profits tax based on invested capital would work a great hardship and be very unfair to our company for the reason that the earnings of this company during the years 1936 to 1939, inclusive, have averaged about 27½ percent on invested capital and will probably exceed that average by 3 percent for 1940. From this you can see that if such a law were based on invested capital that it would result in our having to pay, in Federal taxes, about 50 percent of our earnings.

E. 16. A CRANE COMPANY

An excess-profits tax based upon a moderate return on invested values will take a very considerable share of our normal earnings. It may further indicate that we have made a mistake in not increasing out invested values by increasing, our outstanding capital stock instead of borrowing from banks, as shown below, which we regularly do for the accommodation of our customers who ask for long-term credits.

| | 1936 | 1937 | 1938 | 1939 |
|---|---|---|---|---|
| Invested capital (Jan. 1) | $3,127,000 | $3,452,000 | $3,683,000 | $3,895,000 |
| Bank borrowings—average | 850,000 | 1,360,000 | 1,490,000 | 1,570,000 |
| Net earnings | 644,000 | 637,000 | 375,000 | 437,000 |

E. 17. A WIRE BRUSH AND MACHINERY COMPANY

Our average earnings for the 4 years 1936 to 1939, inclusive, would be $200,000, or 12½ percent on invested capital. If we take the 3 best years out of these 4, the average earning would be $225,000, or about 14 percent on invested capital.

If the tax is based on profits in excess of 8 percent on invested capital, such tax with us would apply on profits in excess of $130,000, or, in other words, would result in this special tax applying on about one-third of our average earnings.

To be fair alike to corporations who have shown fair earnings during past years, and also to those whose earnings have been little or nothing, it would appear that there should be an option between average earning base and a tax based on invested capital. If the basis were established wholly on invested capital, it

would appear to unduly penalize concerns which, through good management, have turned capital a maximum number of times annually.

E. 18. A PHARMACAL COMPANY

This company, like many others, has a tangible invested capital which appears to return a high rate of earnings for the stockholders. However, there is an element in its business which is of large value but which cannot be measured and reflected in the capital employed, although it is an essential factor in the continued successful operation of the business. This element is the good will built up over a long period of years by adequate service, fair dealing with customers, products of consistently high quality, and the investment of large uncapitalized sums in research and advertising. An excess-profits tax which does not recognize this intangible factor in connection with invested capital, will be an unfair burden on all companies so situated.

E. 19. A CHEMICAL COMPANY

We feel that corporations must be given option to permit basing credit on past earnings since credit based on invested capital penalizes small corporations like ours which has relatively high ratio of profit to invested capital due we believe to economical and efficient handling of capital and conservative valuation of assets.

Mr. OSBORNE. We feel that this committee would also be interested in some examples of companies who apparently need special consideration. I also ask your leave, Mr. Chairman, to include in the record some actual examples of business concerns who state that they are not protected by the proposed option of selecting either invested capital or prior earnings for the computation of excess profits.

Mr. DUNCAN. Without objection, it is so ordered.

(The statements above referred to are as follows:)

TYPICAL EXAMPLES OF COMPANIES WHO NEED SPECIAL RELIEF

[NOTE.—These are examples of business concerns who are not protected by the proposed option of selecting either invested capital or prior earnings for the computation of excess profits.]

S. 1. A DRY COLOR COMPANY

The writer is connected with another corporation in liquidation, which has had no earnings for the past 10 years, and no invested capital except a contract based on the contingent earnings of another corporation. Considerable revenue is about to be received under this contract, and unless the proposed excess-profits tax law should provide for such cases like this, the tax would be confiscatory. Some form of special relief to cover such cases should be included in the law.

S. 2. A FABRIC MILL

You will observe that our unusual loss for our fiscal year ending June 30, 1938, puts us in an extremely unfortunate situation.

| Fiscal years | Invested capital | Earnings | Fiscal years | Invested capital | Earnings |
|---|---|---|---|---|---|
| 1937 | $954,275 | $133,681 | 1940 | $785,347 | $242,177 |
| 1938 | 917,920 | [1] 327,235 | | | |
| 1939 | 759,199 | 28,148 | Averages | 854,183 | 19,188 |

[1] Loss.

You will see that under either the average earnings basis or the invested capital basis we would pay excess-profits taxes starting on very much lower earnings than our recent years' average earnings, either with or without eliminating our disaster year ending June 30, 1938.

In the last war excess-profits act there was a blanket clause for exceptional cases which in effect gave opportunity, in a case such as our present situation, for taking as a base for calculation of excess profits the experience bases of other or average companies. Would there be any great difficulty in getting a provision into the new law designed to give relief to corporations whose invested capital or earnings record is abnormal, when compared with representative concerns doing a similar business? The 1918 law contained such provisions for relief in sections 327 and 328 of that act.

S. 3. A MECHANICAL EQUIPMENT COMPANY

It is becoming increasingly apparent that an excess-profits tax which bases exemptions on a percentage of capital or an average of earnings in prior years is grossly unfair to one type of company which is essential to the defense of the country. The type of business to which I refer is engaged in inventing, developing, and manufacturing new types of highly technical apparatus for the Army and Navy. The chief asset of organizations of this type is inventiveness of their research personnel. Research departments in this type of organization often conceive of a new product from their past wide knowledge and experience and are able to perfect it with little actual research on the new product itself. The funds expended for developments on the type of new product produced in this manner are little if any. This product is, therefore, not represented by any capital. This does not mean that this wide knowledge and experience of the research workers is not acquired at a considerable expense over a long period of years but it would be impossible to resurrect and allocate these expenditures from many years back. There are also no earnings in prior years on new products developed in this way so that an exemption based on earnings would not be possible.

An excess-profits tax to be fair to this type of industry should have a special provision for exemption on products produced as outlined above before the application of excess-profits rate. This exemption could be based on a percentage of gross receipts on the sale of these products or the Bureau of Internal Revenue could be given wide discretionary power to construct a capitalization for this product based on its possible gross market and importance. Such provision in the excess-profits tax would give a manufacturer of new and highly technical equipment an opportunity to make the same profit allowed firms that have their assets in capital or have earnings in prior years and are, therefore, safeguarded by the tax bill.

To my knowledge there are a number of companies of the type outlined above and I urge that their interests be protected.

S. 4. A DAIRY COMPANY

We happen to be in the enviable position of those who are this year enjoying earnings considerably in excess of those of previous years and, as a result, I presume our tax burden will be proportionately very heavy regardless of the final form of the excess-profits tax law and even though our increased earnings cannot possibly be attributed to national-defense preparations.

This corporation was organized under the laws of the State of New York in January 1925, with an authorized capital stock of $300,000, of which $283,900 has been issued. Earnings have consistently been plowed back into the business except for very modest amounts paid out in dividends. The company has grown rapidly, especially in recent years, and because of rapid expansion it has always lacked working capital; $113,326 was invested in fixed assets in 1938 and $143,035 in 1939.

If invested capital is considered to be capital stock issued plus paid-in or earned surplus, then we estimate that our earnings in 1940 will amount to 41½ percent of invested capital. In this connection may we state that our surplus account was reduced by about $138,000 in 1936 when goodwill of that amount was marked off against surplus. This goodwill represented cash paid for businesses purchased that was in excess of assets less liabilities and it was only marked off to make our financial statement look better.

We estimate further that our earnings in 1940 will be about 262 percent of the average earnings for the last 3 years. If the year 1936 was included the percentage would be still larger and if the years 1938 and 1939 only were included the percentage would be smaller.

I have not seen it suggested anywhere that a third option be offered the taxpayer in computing excess-profits taxes, namely: An excess-profit tax only on earnings in excess of a certain percentage of the average of the declared value of capital stock for the past 3 years as reflected in the capital stock tax returns of those years including the one just filed. The latter suggestion would give us more relief than a tax based on either invested capital or average earnings and probably the same is true of any small concern with limited invested capital whose earnings have increased materially in 1940.

S. 5. AN IRON AND STEEL COMPANY

Our own company, for a long number of years, has gone through a period of continued losses, due largely to a transition in consumer demand for the manufactured product, and the inability of the old management to recognize and keep pace with new productive equipment to offset such transitions. As a result, the past 4 years continue to show an average loss, but with the ultimate objective apparent.

We therefore would be tremendously handicapped if an excess profit was established on the basis of earnings for the past 4 years, because there would be no cushion to assist us, from an earnings standpoint, in payment for new equipment which has been installed. Of necessity, indebtedness has been incurred to carry on the company to provide employment for old workers, and to attempt to revamp the productive facilities of the company.

We are also of the opinion that invested capital should not be the determining base of excess earnings. Some means other than these must be provided to allow some assistance to companies with indebtedness who are attempting to work out of a difficult situation.

S. 6. A STAINLESS-STEEL COMPANY

It so happens that it does not seem to make much difference with our company as to whether credit allowable for figuring excess-profits tax is based on 8 or 10 percent of the invested capital, or whether this credit is based on the previous 3-year or 5-year average earnings. However, these are only estimates and, if there is a decidedly different method of calculation in view, we would be very glad to have any information that you have to give us so that we can get a clear picture of the effect of such taxes.

In either of the methods which I have indicated above, the tax would be excessive considering the company's cash position by making it impossible for us to retain the cushion necessary to carry us over periods of poor business resulting in losses.

S. 7. A WOOL COMBING COMPANY

In regard to your letter asking for facts having a bearing on the position of this company in relation to the ending excess-profits tax we have the following comment. In recent years our earnings have been seriously affected by extraordinary and uncontrollable events uch as serious floods in 1936 and 1938, and also a hurricane in the latter year. Furthermore, we have experienced in recent years, labor difficulties which have adversely affected earnings. Thus it would work a hardship on this company if an excess-profits tax were based on average earnings of the last few years. There is another factor also which makes average earnings an inadequate and unsatisfactory base so far as we are concerned and that is the very wide fluctuation in the level of activity in this industry.

By and large this industry is characterized by such wide ups and downs in activity that results vary from respectable earnings in 1 year to a loss in the next. Years of small profits or even losses of course pull down the average, and such average seems like an unfair base on which to erect an excess-profits tax.

Thus in our case the inclusion of the factor of invested capital as an alternative base would seem more fair, although this criterion also would have its drawbacks as far as we are concerned because our plant is well depreciated and because we have no capital invested in inventory since we do an entirely commission business in which reputation and good will are highly important, though intangible assets.

It looks as though either base or a combination of both of them is going to hit this concern pretty heavily so far as a tax on excess profits goes.

S. 8. A GEAR AND MACHINERY COMPANY

Our invested capital would have been larger if it had not been for the undistributed earnings tax which caused us to issue, during 1936 and 1937, unsecured notes of the company to our stockholders, as dividends. We were able to pay

off one set of notes issued in 1936, in the amount of about $158,000. We have still outstanding about $478,000 worth of notes owing our stockholders. This money would have been kept in the company as needed for operations, if it had not been for the tax law mentioned above.

We feel that there should be some alternative plans upon which the excess-profits tax should be based. We do not consider that our earnings in any of the years mentioned are normal except possibly 1937 and, as mentioned, our invested capital should have been larger except for the diminution of same caused by the undistributed earnings tax.

S. 9. A GLASS COMPANY

The matter you raise is extremely important to those of us who are relatively small, employing as we do from 200 to 300 employees. These last 10 years, with the exception of a small profit in 1937 and 1939 have been difficult years and if there is any real profit to be made in the future, we certainly would not want to have the excess-profit tax based on the trivial amount that we have earned in the last 10 years.

There is another phase of the tax law which I think should be given consideration in this matter, and that is companies which have carried for a considerable time a capital debt are being handicapped in its reduction by the excess-profits tax. In other words, if and when a considerable profit is made, the excess-profits tax limits the amount of reduction in debt that can be made. I suppose this is difficult to legislate for, but it is a matter of importance to some of us who have in the last 10 years accumulated quite a debt in order to keep our pay roll going and which is a distinct burden to us, particularly in view of the fact as above stated.

S. 10. A LICORICE COMPANY

We consider, no matter how levied, an excess-profits tax very unjust, due to the difficulty in arriving at an equitable basis on which to assess the tax.

Our company has very little chance of obtaining any war orders from which to earn excessive profits, some of which might be used in amortization of additional manufacturing facilities. Without giving actual facts and figures of the affairs of our company, we might for your information, say that due to the nature of our business our profits run more uniform than most corporations, and while we feel that an option should be given to corporations to compute the excess profits either on basis of invested capital or average earnings during the period 1936 to 1939, or longer, believe the latter basis would be to our advantage. However, much would depend upon the percentage of profit permitted on invested capital, also what amount of good will would be considered as capital. Where a company's dividend record over a long period of years establishes a value for good will, that value should be recognized and taken into the calculation.

S. 11. A VALVE COMPANY

We find that as far as our company is concerned, taking our earnings for the period 1936 to 1939 inclusive, our average earnings on the capital invested for those years is 2.8 percent. It is certainly a very meager return on a manufacturing business. This company is over 100 years old and our records indicate earnings in previous years (not too far back) to show a return of 10 percent to 15 percent.

It does not seem fair to pick out certain recent years where earnings have been difficult due to taxes, raw material costs, labor increases, and shortened hours of work, and say that that average is all that can be expected, and that any earnings over are subject to heavy taxation.

It is also true that many companies in the past years have spent money, modernizing their plant, or on machinery, or in research, and in many cases have remodeled their line so that heavy charge-offs were necessary for obsolete items. That happens to be our particular case. We found that our line needed to be revamped and modernized to keep pace with the requirements of the day, and we had to go through the process of designing in the drafting room new items, making patterns, cataloging these new additions.

Any new tax law considering only average earnings for the past few years would be entirely inequitable as far as we are concerned. Also, if we assume that some companies have mortgage indebtedness or a debt which can only be reduced out of the earnings, if taxes are to take most of their earnings over an average, that is not in proper relation to the business, and debt reduction would be impossible.

S. 12. A BRIDGE COMPANY

I believe that it is in the interest of all of us to pay our just share of the new tax. It is with this thought in mind that I think that we should be careful that we do not unjustly penalize certain classes of industries.

There are certain industries in which the profits are sporadic—there may be a big profit in one year, and then practically no profits or even losses for a couple of years, and then another large year. Our own corporation is an example. Last year, we lost about $35,000, and in 1938 approximately the same amount. In 1937, we had profits of $104,000 and $82,000 the year before.

If the excess-profits tax is going to be such a large amount as is talked of in the newspapers, you can very readily see that if there isn't a chance of averaging this, a concern can very easily be driven to the wall, and hence not able to carry their share of the taxes.

S. 13. A MACHINERY COMPANY

The future tax problem can be an extremely serious one for this company, and at the present moment we are floundering around, wondering what is going to happen.

Our industry has suffered tremendous losses and serious impairment of capital in the past 10 years. Our own company has had only one profit year, 1937, in that period, and its capital was impaired to the extent that R. F. C. money was necessary to continue operations.

We have a heavy-machine shop and are in an excellent position to be of major assistance in the defense program that is getting under way.

We think under present conditions that a company that does its share in this defense program should be given a chance to rebuild a large part of that capital which has been lost during this employment depression of the last 8 or 9 years before it is obliged to pay excess-profit tax.

S. 14. A DRILLING AND MACHINERY COMPANY

In line with the other machine-tool manufacturers, we believe that an excess-profits tax would be relatively high when based upon either invested capital or net earnings over a period of the past 3 or 4 years. A number of the machine-tool manufacturers do not manufacture a strictly standard product, which can go through on a production basis, but instead have to build up the machines on special order to suit their customer's particular requirements and often there is a certain amount of special engineering work involved. Consequently, there is often a considerable amount of extra hardship involved in stepping up production to meet the demands for equipment under the national-defense program, and there certainly is no incentive to go to this extra effort if the large percentage of the profits are to be confiscated by the Government in the form of an excess-profits tax.

We believe that a fair base for figuring excess-profits tax for the machine-tool industry, at least in our particular case, would be on the basis of percentage of profit on gross business over a period of 3 or 4 years. For instance, suppose we show an average profit over a period of 4 years of 10 percent. Under present conditions, it is easy to get higher prices so that profit margin would be stepped up to 15 or 20 percent. If this is the case, the extra margin of profit would be subject to the excess-profits tax.

Working on this basis, a manufacturer could take steps to double his production without being penalized on the extra volume of business.

S. 15. A CASTING COMPANY

Due to anticipated volume of production from now until the end of this year, and to plant improvements recently made and under construction we anticipate our 1940 earnings to exceed our average earnings over the past 4 years.

There is a situation in our case and, no doubt, in a great many others, which should be taken into consideration in the discussion of an excess-profits tax. Our company was necessarily reorganized in 1932, and at that time the cost of the assets to the new company's stockholders was only about 50 percent of actual cost or replacement value. Necessarily, in figuring on an invested-capital basis we would be severely penalized if we were allowed to earn a percentage based on such cost value for the assets taken over by the new company at that time. There are, no doubt, a great many concerns which were reorganized within the past 10 years who are in the same situation and have, of course, been allowed depreciation for income-tax purposes on cost value only by the Treasury Department. It would seem only fair to such concerns to allow a reappraisal of plant and equip-

ment for the purpose of establishing present-day values in connection with the proposed tax. Perhaps this has been contemplated, although we have not been advised to that effect and we bring it to your attention at this time.

Naturally the proposed tax law would allow us the choice of one of two evils but in our position we would be severely penalized in making either choice unless we were allowed to reappraise our fixed assets as outlined above.

S. 16. A FURNITURE COMPANY

| Year | Earnings | Income tax | Earnings after tax | Invested capital |
|---|---|---|---|---|
| 1936 | $61,714 | $11,746 | $49,968 | $419,502 |
| 1937 | 14,111 | 2,500 | 11,611 | 389,513 |
| 1938 | [1] 4,469 | None | [1] 4,469 | 410,484 |
| 1939 | 14,145 | 2,659 | 11,486 | 493,406 |

[1] Loss.

You will observe that we had very poor years in 1937, 1938, and 1939, and if the tax bill goes through as proposed we will suffer quite a penalty. We sincerely trust that the lawmaking body will work out an arrangement that will fit our case much better than that now proposed.

It so happens that we, along with many other corporations, are so-called debtor corporations. We have a large debt which we are trying to retire from year to year. We think some provision should be made in the tax bill to permit retirement of debts.

S. 17. A VARNISH AND INSULATOR COMPANY

We have in mind a situation having to do with our own subsidiary company, operating in Canada, where there was a small capital invested but due to complete availability of all processes and engineering from this plant, the branch plant contemplated fairly large earnings with respect to the invested capital. However, because of an unfortunate selection of the management for the first 2 years of the plant's operations, the anticipated earnings did not materialize. Therefore, when the proper functioning was provided in 1938 and 1939 and the true picture arrived at, the average earnings were diluted by the two badly managed years of a newly formed company and one that was formed without any idea of war work and is not affected by war orders at the present time. Due to the fact that there was an inflexible provision in the Canadian law up to the present time there has been no redress available. We, therefore, think that there should be some sort of a discretionary privilege accorded to the taxing authorities when it is apparent that unusual conditions exist.

S. 18. A PACKAGING COMPANY

While we agree that an option should be given corporations to compute the excess-profits tax on either the basis of invested capital or the basis of average earnings during the period 1936 to 1939 inclusive, there may be a number of corporations on which either method would work an injustice.

We feel some consideration should be given to a method which will include net sales. If starting with 1940 a company by proper management were able to increase sales over the 4-year period of 1936 to 1939 and made only a reasonable profit on the increased sales, they would be penalized under either method. This is providing it was not necessary to either increase their invested capital by putting new money into the organization or by materially increasing fixed assets.

An excess-profits tax not considering net sales may have a definite tendency to hold down the growth of an organization. We realize that the matter now is complicated enough considering only invested capital and average earnings but we are bringing this up for your consideration merely as an expression of our opinion.

S. 19. A FURNITURE COMPANY

It looks as if we are going to be hit hard, no matter how they figure the excess-profits tax. The fact that we have reduced our capital to meet the changing conditions during the depression, now reacts to our disadvantage. Furthermore, as we had such poor earnings during the depression, that also will act to our disadvantage.

Our capital and surplus, December 31, 1929, was $3,225,884, while the capital and surplus July 1, 1940, is $2,087,893, due to the low earnings since the depression and also to the reorganization scaling down the value of our stocks, which appeared necessary in 1932.

Our earnings since 1936 are as follows: 1936, $89,435; 1937, $132,699; 1938 (loss), $7,702; 1939, $146,960.

The average for those 4 years is only about $90,000, while this year we made $165,000 the first 6 months, and if we can make a similar amount in the next 6 months, we would be hit pretty hard on the difference.

Before we met the depression, our earnings for the 4 years previous were as follows: 1926, $482,496; 1927, $394,893; 1928, $547,376; 1929, $668,779.

In 1930 we made a profit of $130,862, and then in 1931, 1932, 1933, and 1934, we had heavy losses.

Under such a set-up, if they allow us only 6 or 7 percent on our present capitalization, we certainly are going to get stuck and if they use earnings as a basis, covering 3 or 4 years, we will be stuck worse. In fact, it looks as if we couldn't escape but there ought to be some effort made to take care of these concerns in a little different way that suffered so heavily during the depression.

S. 20. A TOY AND ART GOODS COMPANY

As requested in your letter we are appending below a statement of our earnings for the years 1936-39 inclusive:

| Year | Capital stock | Earnings (less taxes) | Rate of return |
|---|---|---|---|
| | | | *Percent* |
| 1936 | $266,400 | $4,953.45 | 1.9 |
| 1937 | 266,400 | 12,604.75 | 4.7 |
| 1938 | 266,400 | 9,093.18 | 3.3 |
| 1939 | 300,000 | 13,616.69 | 4.2 |

As the prospects for 1940 show a greatly increased percentage of earnings, it looks as if we will be pretty hard hit whichever way this bill is drawn.

Mr. OSBORNE. We admit that the association has not had time to study carefully the most equitable manner of affording relief to companies who are not relieved by the optional method recommended in the report of the subcommittee but we felt that you would desire to have these additional facts before you in your consideration of the drafting of the excess-profits tax measure.

We offer eight specific criticisms and suggestions for the consideration of this committee in connection with the proposed taxation of excessive profits:

1. The method proposed under the invested capital option of determining the amount of exemption by limiting the credit to a maximum rate of 10 percent of the invested capital may work injustice on companies who are very conservatively capitalized. It also is unreasonable to assume that 4 percent should be a normal return on invested capital for companies who have earned less than that rate or have even suffered losses. In addition to the inequity of assuming that any single rate of return is proper for all companies and all industries, it certainly can be said that 4 percent is too low a rate of return when previous losses are taken into consideration—and in many industries involving more than ordinary risk 4 percent is too low under any circumstances. We note that the excess-profits tax law in effect during the World War period granted a credit rate of 8 percent.

2. The proposal to allow new corporations higher rates of return on invested capital may give them a substantially competitive ad-

vantage over old established firms and such a competitive advantage may work particular hardships in the case of smaller concerns.

3. Under the proposed option of establishing an excess-profits tax credit on the basis of average earnings over the years 1936–39 there may be a need for greater flexibility in selecting certain years in the recommended base period in order to reflect the proper normal earning power of the corporation. This committee should consider giving the taxpayer an option of using only 3 out of these 4 years and the additional privilege of eliminating from the computation of average earnings losses suffered during the base period.

We have heard from companies subject to processing taxes during the suggested 1936–39 base period which indicates that the unusual burden borne by such processors during this period makes it necessary to give them special relief in establishing their so-called small earnings.

4. We wish to point out the proposal to allow the first $500,000 of invested capital a larger rate of return than the invested capital over this arbitrary amount is unsound, for it gives no consideration to the fact that the larger corporation is practically always made up of a greater number of owners than the smaller corporation, and that the invested capital expressed in terms of the share of each stockholder will be more severely taxed in the case of a larger company than in the case of a smaller concern. In other words, this might tax the investment of a small shareholder at a higher rate than the investment of many large shareholders.

5. We agree with the subcommittee that the excess-profits tax be applicable with respect to all taxable years beginning after December 31, 1939, because of the emergency facing the Nation at this time, although it is our general position that as far as possible retroactive taxation should be avoided. We suggest for the consideration of this committee that the excess profits tax drafted at this time should continue in force only during the years 1940 and 1941, applying to taxable periods beginning in those years. If the excess-profits law proves to be generally workable and the need for this tax continues it will be an extremely simple matter to extend the application of the tax for an additional desired period at the end of those 2 years.

6. The pending excess-profits tax law should contain a provision to protect companies against future losses arising either out of the cancelation of Government contracts or the termination of defense activities. This protection is necessary to deal fairly with companies whose recorded earnings during the emergency period may actually have been only book figures and would be subject to less adjustments upon the cancelation of contracts or the termination of the defense program in order to reflect actual earnings.

7. The present ban against consolidated returns results in unjust tax burdens and represents an obstruction to the industrial expansion so vital at this time. The true income of an integrated organization composed of a number of subsidiary concerns can only be reflected in the consolidated income account and for this reason consolidated statements are considered essential for a true reflection of earning capacity by accountants, credit agencies, and by such Government agencies as the Securities and Exchange Commission. We recommend the restoration of the privilege of filing consolidated returns for Federal income tax purposes in the same manner as under the law and its administration from 1917 through 1934.

Consolidated returns furnish the most accurate picture of earnings of an integrated group of companies for all income-tax purposes; consolidated returns should at least be granted for excess-profits tax purposes. This committee will recall that the World War excess-profits tax required consolidated returns and that the La Follette amendment to the Revenue Act of 1940 required the filing of consolidated returns.

We are aware that estimates have been offered as to the amount of revenue which might be lost through the reestablishment of the right to file consolidated returns. We can understand that such a revenue loss will apply to the first year or so in which such consolidated returns were filed but we feel that any contemplation of revenue loss is a shortsighted view and ignores the stimulus both to general business and to the national-defense program which will result from the restoration of the right to permit consolidated returns for tax purposes.

8. We urge the elimination of the present normal tax on the dividends received by corporations since such dividends have already been taxed as net income earned by the distributing corporation. It is essential in many business enterprises to establish separate legal entities for industrial operations, just as it is necessary to establish separate and distinct departments within the business, and such integrated companies should be free of the double taxation imposed when the profit earned in the case of the subsidiary corporation is again taxed when received as dividends by the parent company.

We direct your attention to the fact that up until the enactment of the Revenue Act of 1935 it was recognized that dividends received by a corporation are already subject to taxation as income in the hands of the originating corporation and accordingly should be free from further taxation. We recommend a return to this accurate and fair treatment of intercorporate dividends, particularly as the provisions of present law represent an obstacle to the expansion and operation of certain companies and industries which may be essential for national defense and preparedness purposes.

We call your attention to the fact that the national defense program contemplates the location of future plants between the Allegheny and Rocky Mountains in order to create vital supply lines far from the more vulnerable coastal areas where 80 percent of crucial war industries are now located. Separate corporate entities will undoubtedly be required to meet this necessary expansion of our defense facilities even though they may represent only an extension of the integrated efforts of single operating companies. The double taxation of intercorporate dividends and the ban against consolidated returns may in some of these instances represent a handicap to this aspect of the preparedness program.

9. We assume that the contemplated suspension of the Vinson-Trammell Act shall also be accompanied by the suspension of the profit restrictions of the Merchant Marine Act.

In our efforts to prevent "profiteering" by taxing at relatively high rates earnings derived from the rearmament of the United States, we are certain that this committee wishes to avoid imposing burdens which will handicap desirable and necessary economic recovery as well as the actual progress of the national-defense program itself. We trust the committee will give favorable consideration to the suggestions we have offered in connection with the pending excess-profits

tax measure, and we trust that fundamental revisions in the general tax structure, made all the more necessary through the imposition of this additional tax, may also be given consideration in the near future.

In conclusion, we wish to emphasize again the willingness of business to foster the program for national defense and to contribute its full share to the tremendous cost of this program. We regret that you have not had the opportunity to read the cooperative sentiments contained in the great number of letters from individual manufacturers throughout the Nation which have recently come into the offices of the association. A brief quotation from one may suffice:

> We fully recognize the need for standing heavier taxes, both for the rearmament program, and eventually to reduce our national debt. We feel that the alarm that some are showing, simply because taxes are increasing, is unfounded and unpatriotic. But the methods of taxation must be worked out on a reasonable basis of equality, or gross hardships will arise.

The CHAIRMAN. We thank you for your presence and the statement you have given to the committee. There has just been a call for a quorum in the House and the committee will stand in recess until 2 o'clock this afternoon.

(Thereupon, at 12:30 p. m., the committee took a recess until 2 p. m. this day.)

AFTER RECESS

The committee reconvened pursuant to the taking of recess, Hon. Robert L. Doughton (presiding).

The CHAIRMAN. The committee will please be in order. The next witness on the calendar is Mr. Harry E. Howell, member of the National Association of Manufacturers' Government Finance Committee. Is Mr. Howell present?

Mr. HOWELL. Yes, sir.

The CHAIRMAN. Please give your name and address and whom you represent to the stenographer.

## STATEMENT OF H. E. HOWELL, COMPTROLLER, GENERAL FIRE EXTINGUISHER CO., PROVIDENCE, R. I.

Mr. HOWELL. My name is H. E. Howell, comptroller, General Fire Extinguisher Co. I am here to present the views of the National Association of Manufacturers subcommittee on the study of depreciation.

The recommendations for an amortization provision made by your Subcommittee on Internal Revenue taxation go far toward the solution of the cost-recovery problem involved in the acquisition of factories, equipment, and machinery required immediately to satisfy urgent national-defense needs. The Revenue Act of 1918, the work of your committee and the widespread interest of industry in this question of cost recovery of special facilities are a clear indication of its vital import.

There has been an extensive amount of expansion of facilities going on without waiting for the passage of this enactment, but the enactment of such a provision for amortization would relieve a considerable uncertainty and permit concentration of effort on the job of producing vital necessities. It may be true that the depreciation provisions of

the present law are adequate, but the manner in which the depreciation provisions have been administered by the Treasury Department seems to have created the demand for legislative action that would at least clarify the problem of those special facilities.

Now, the report of the subcommittee is not entirely clear to us as to whether the certifications for allowance of amortization are to be extended not only to facilities directly utilized in the fulfillment of Government contracts, but also to all other facilities directly or indirectly used to support the national-defense program. It will be remembered that the amortization provision in effect during the World War and subsequent years applied to all plant and equipment "acquired * * * or * * * constructed * * * for the production of articles contributing to the prosecution of the war." It seems that this broad interpretation is more suitable. We accordingly recommend that facilities which have been erected or acquired for the special purpose of meeting the needs of the defense program, even though they are not directly utilized in the fulfillment of Government contracts, be subject to amortization allowances from the effective date of the excess-profits tax.

We have three additional suggestions for inclusion in the amortization provision recommended by your subcommittee. The first of these is that the practice incorporated in prior rulings which provided for a computation of usable value at the end of the period should be discarded because of the difficulty in determining such values. One of the chief difficulties of arriving at amortization allowances under prior law was the involved task of determining the value of plant and equipment at the end of the emergency period and a great amount of litigation costly to both the taxpayers and the Government resulted from this attempt to establish it. The entire question of amortization largely hung on this difficult if not impossible determination, and the relief contemplated by the tax law often was not effected. If properties which have been completely amortized do actually have usable value at the end of the emergency period, no further depreciation may be taken as a deduction from income in subsequent years when taxes upon business profits will probably remain at a high level. So, in the long run, there should be no material difference in the total tax collected.

Our second suggestion for inclusion in the amortization provision is an amendment of the section of the Internal Revenue Code which aims at the satisfaction of just claims on the part of taxpayers and the Government in respect to years for which returns have already been closed. The determination of taxable income, particularly that which may arise from these unusual activities, based upon an arbitrary cutting off at the end of a fiscal year, works grave hardship and, among other things, particularly as to the inability to reopen and adjust taxable net income for such an item as the amortization deduction which must necessarily be tentative until it actually occurs. The income-tax law has recognized that the cost of capital assets may be recovered. This implies that these costs are deferred expenses and, in the case of profits subject to the excess-profits tax, at least, we believe these costs should be deducted in direct proportion to the profits subject thereto.

To the extent that it is necessary to keep open the tax year involved for an equitable adjustment of the profits arising from national-

defense activities, the utilization of defense activities for such purposes and the amortization thereof, we think section 3801 should be amended in mitigation of the effect of limitation and other provisions of the internal-revenue law to permit of the adjustment of the years involved so that the portion of the total amortization deduction taken in a given year will be in proportion to the portion of the total profits subject to excess-profits taxes reported in that year.

Now, to some extent this recommendation reflects the distaste of the taxpayer to the levying of those rates in which there are inequities and technicalities, and his willingness to accept any fair rate of tax if equitably applied.

Our third and final suggestion is that in the event a contract between the taxpayer and the Government specifically covers the question of amortization of facilities used in a manner which is not inconsistent with specific acts of Congress, the provisions of such contract should apply and supersede the general amortization provisions.

I would like to offer for the record, with the permission of the chairman, a statement of basic principles to be embodied in a sound amortization provision, representing the recommendations of the association on this cost-recovery problem; also a brief memorandum showing some of the liberal amortization and optional depreciation allowances which have been granted by foreign countries.

The CHAIRMAN. Without objection it is so ordered.

Mr. HOWELL. In closing, may we say that if the pending excess-profits tax cannot be hastened because of its complex nature, a sound amortization provision should be considered the first order of business. It is generally accepted that the recovery of capital losses on defense facilities and the tax upon excess profits will both apply to this year's earnings, so that they need not necessarily be linked together in a single bill.

I thank you.

(The following was filed for the record by Mr. Howell:)

SOME FOREIGN PROVISIONS FOR AMORTIZATION AND OPTION DEPRECIATION

As early as 1932 the British Finance Act provided an additional deduction of one-tenth in the table of official rates for wear and tear of specific machinery. Another one-fifth additional deduction was allowed by the 1938 act and additional allowances have been provided for excess-profits tax purposes where plant and machinery have been installed after the beginning of the year 1937 and the circumstances are such that these assets will be subject to exceptional depreciation and will become obsolete or redundant as a consequence of the present war.

The French decree law of May 2, 1938, offered corporations the right to establish exceptional depreciation for the extension of the means of production (these terms being interpreted in a broad sense) and for investments of a social character. This exceptional depreciation allowance allowed by France was added to the normal depreciation allowance up to 20 percent of the net profit of the fiscal year.

The experience of Germany in showing liberality in allowing the reflection of losses on plant and equipment for income-tax purposes is extremely interesting in its application. In 1934, before Germany's development into the leading military power in Europe and at a time when business activity lagged in that country and considerable unemployment existed, a provision was introduced in the German income-tax law providing for optional depreciation. This optional depreciation was permitted in the case of such productive goods, whose useful life usually did not exceed 5 years, as office machines and equipment, vehicles, tools and dies, machine tools, textile machines, and construction machinery. Under the optional depreciation provision the German taxpayer had the option to depreciate the machine fully in 1 year or to extend this write-off over 2, 3, or 4 years as desired.

This rapid write-off provision existed in Germany until 1938 when almost full employment had been reached and when the raw material shortage in Germany made it essential to curtail production of goods which involved alloys and ferrous metals. Germany, however, still allows optional depreciation in the case of such items as trucks, trailers, busses, and all productive goods which cost less than approximately $50.

STATEMENT OF PRINCIPLES WHICH SHOULD BE EMBODIED IN THE TAX LAW IN REGARD TO AMORTIZATION ALLOWANCES

1. Definition of terms: The term amortization is employed in the specific connection of designating the special loss in the value of plant and equipment acquired or constructed for the production of articles contributing to the prosecution of the emergency defense program. Such amortization should be unmistakably differentiated from all other claims for wear, tear, obsolescence and loss * * * and shall be inclusive of all depreciation during the amortization period on property subject to amortization.

2. It should be recognized that this special loss can only be actually determined at the time the national emergency defense program comes to an end.

3. While the exact amortization loss can only be determined at the termination of the emergency period it should be recognized that some tentative allowance which may be deducted from the profits of each year should be allowed.

(a) It seems reasonable to assume that with the defense program now inaugurated, a 5-year period of defense activity with concurrent excess-profits taxes will ensue, and therefore it seems that tentative amortization allowances based on a 5-year estimate of usefulness for such special facilities is fair and reasonable. This would allow a tentative amortization deduction to be taken in each year at the rate of 20 percent of the cost of the facilities.

(b) Should the actual emergency terminate prior to this 5-year period, adjustments of the 20 percent tentative amortization deduction taken in the prior years shall be made on a basis which will spread the total loss from amortization over the period during which the profits from defense operations, together with such income as may arise from cancellation or adjustment of contracts were reported for tax purposes.

4. It should be recognized as a basic principle that the entire cost of such facilities must be recovered during the period that taxes are assessed upon the profits earned from defense operations in which these facilities are employed.

5. The practice incorporated in prior rulings which provided for a computation of usable value at the end of the period should be discarded because of the difficulty in determining such values. It is pointed out that if such properties have such usable value, no further depreciation may be taken and no tax saving will result in subsequent years and that this will largely offset any saving in tax which might arise from the elimination of usable value from the computation of amortization loss.

6. Special amortization allowances should be extended not only to facilities directly utilized in the fulfillment of Government contracts but also to all other facilities used to support the national defense program.

7. Such special amortization allowances should be granted for both normal income tax and excess-profits tax purposes.

8. To the extent that it is necessary to keep open the tax years involved for an equitable adjustment of the profits arising from national defense activities, the utilization of defense activities for such purpose and the amortization thereof, Section 3801 should be amended to permit of the adjustment of the years involved in mitigation of the effect of limitation and other provisions of the internal-revenue law.

9. In the event that a contract between the taxpayer and the Government specifically covers the question of amortization of facilities used, in a manner which is binding upon the Treasury Department, the provisions of said contract will supersede the above.

Mr. TREADWAY. I notice you appear in a dual capacity, or have a dual connection?

Mr. HOWELL. Yes, sir.

Mr. TREADWAY. You are comptroller of the General Fire Extinguisher Co., and you are also a member of the National Association of Manufacturers' Government Finance Committee?

Mr. HOWELL. That is the capacity in which I am appearing, Mr. Chairman.

Mr. TREADWAY. In that capacity?

Mr. HOWELL. Yes, sir.

Mr. TREADWAY. Now, would you mind telling the committee just what that long title means?

Mr. HOWELL. Well, there is a Government Finance Committee of the National Association of Manufacturers, and the problem of depreciation and amortization seemed so difficult that we formed a committee and we have been studying it for many months.

Mr. TREADWAY. Is it purely a theoretical study, or have you had practical experience with Government contracts?

Mr. HOWELL. We have had reports from many concerns who are dealing with Government contracts, and also had the cooperation of the American Institute of Accountants—accountants experienced in the handling of amortization under the last 1918 act.

Mr. TREADWAY. You are a central body, rather than a practical group?

Mr. HOWELL. That is right.

Mr. TREADWAY. Now your members—what experience have they had with Government contracts?

Mr. HOWELL. Well, I can file a list of the people who have contributed to this particular study we have made. They represent a very large number of concerns in the United States in all fields, and I can file that.

Mr. TREADWAY. I say that have contracts with the Government. I am trying to get at the point whether or not you are speaking from experience in your remarks about amortization, and I might ask you some questions if you have had a practical experience on it.

Mr. HOWELL. You will note in the very first statement I made I say our committee was not clear as to whether this amortization provision is going to be confined to the facilities used directly on Government contracts. We felt there are many subsidiary industries—for instance, people that make taps, dies, and so forth—that will not have Government contracts, but they will be supplying vital facilities for people who do have Government contracts; and, if it does not apply to such people——

Mr. TREADWAY. Indirectly, they are supplying a Government contract, if they are subcontractors for various features going to make up the general contract.

Mr. HOWELL. They may not even be subcontractors; they may be supplying a part of the tools and equipment, and not part of the final job. For instance, an outfit manufacturing shells will require certain tools, taps, and dies that are made by independent tool makers.

Mr. TREADWAY. Yes; I understand that.

Mr. HOWELL. Now, we are not clear whether this amortization provision covers such people. If they are not covered, we believe they should be.

Mr. TREADWAY. In other words, you feel anyone that has a governmental interest in a contract should be cared for in the amortization feature of the bill, providing it has to do with the expansion of their plant; is that it?

Mr. HOWELL. Yes, sir—using the rules of the 1918 act "acquired or constructed for the production of articles contributing to the

prosecution of the war." Now, that broad interpretation we feel should be placed upon this and, upon that basis, all of our members have had a great deal of experience under the last act.

Mr. TREADWAY. Just one other idea: Should that amortization include anything having to do with expanding the plant that is not for national defense?

Mr. HOWELL. No.

Mr. TREADWAY. Or do you limit your recommendation to having to do with the national defense?

Mr. HOWELL. That is right.

Mr. TREADWAY. Which is right?

Mr. HOWELL. It is limited. The ordinary expansion is taken care of by the regular depreciation provisions of the income-tax law.

Mr. TREADWAY. Yes; but that is not nearly as liberal as the one proposed in this bill; but it is liberal enough, in your judgment, to care for any nonnational defense activity of the firm?

Mr. HOWELL. Yes, sir.

The CHAIRMAN. If there are no further questions, we thank you for your testimony.

The next witness on the calendar is the Honorable Jerry Voorhis, a Representative in Congress. Please give the stenographer your name and address.

## STATEMENT OF HON. JERRY VOORHIS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. VOORHIS. My name is Jerry Voorhis; my address is San Dimas, Calif. I am Representative from the Twelfth District of California.

Mr. Chairman, I have had the pleasure of listening to the testimony most of the time for the last 2 days and the things that I very much want to say to the committee are in emphasis of this problem from a little different angle than that to which you have been listening.

The American people are high-powered people. We want to have security; we want to have a high standard of living and we do not want, if we can avoid it, to have our lives disturbed any more than necessary. But, after all, national security is the primary consideration.

National security is going to cost money to finance, and that is the reason why the Ways and Means Committee is up against a very tough problem at the present time.

I would like to say at the outset, Mr. Chairman, that I am not a bit certain that the soundest way to raise revenue, generally speaking, is by taxing profits. I believe the income and inheritance taxes and taxes on idle accumulations of money or property should be the main sources of revenue, and I feel sure we are going to have to operate pretty drastically in these fields pretty soon. For example, I believe the taxes on my own salary are pretty small compared to our country's need of revenue.

This excess profits tax will, I am informed, produce no more than $200,000,000 of revenue. That is not very much. But the basic reason for this bill, or for any other tax on profits, so far as I am concerned, is to see that, as nearly as possible, justice is done all the way around, to see that where specially large profits are made as a result of the defense program, a portion of them must be shared with the

Nation as a whole. For, after all, the more prosperous a business is, the more that business has to lose if anything happens to our country.

I do not presume to come here to attempt to discuss in detail the bill which the committee will report on the basis of the proposal of its subcommittee on taxation. I have studied that proposal as carefully as I can in the few days since I was able to obtain a copy. But that is, of course, hardly time enough to digest in detail so important a matter as this.

I am not here to urge upon the committee the adoption of any program which would either be unfair to any taxpayer or which will stand in the way of an effective carrying forward of the national-defense program. I am here to urge that this bill be so carefully prepared that it will be fair not only to the people who will pay the excess-profits tax, but also to the American people who in the end will foot the bill for the national-defense program now being carried out. I do not believe that the American businessman asks anything from his country and his government beyond a reasonable return on his investment so long as the business he is doing is connected with the defense effort of the Nation. We have pledged ourselves that there will be no profiteering in connection with this defense effort and, since all the people of the country will be asked to bear a portion of the burden, it is important that we keep that pledge.

This excess-profits tax bill has got to be considered, it seems to me, against a certain background. First, in this bill is included repeal of the profits limitation provisions of the Vinson-Trammell Act. Second, this is an excess-profits tax bill on profits over and above normal profits and is therefore in a different category from that of a bill which applied to all profits. In the third place, one of the functions of this bill is to protect the Government and the people in connection with orders for goods which it is important to have filled just as fast as possible and where in many instances representatives of the Government are, therefore, in no position to be too exacting or to drive too careful a bargain. Under the old profits limitation program it was not so necessary or so vital, but with that provision repealed the only device that remains is this excess-profits tax program. Unless, therefore, this is an effective and fair bill from every standpoint, we will be in a position of having permitted a further growth of concentrated financial and industrial control in the United States, a development which in my judgment is contrary to the basic American principles which we are seeking to uphold in this entire effort.

Furthermore, unless the bill is an effective one, we will make possible a serious maldistribution of income not only as between the recipients of large profits on the one hand and the rank and file of the people on the other, but also as between those industries which will inevitably find themselves in a favored position on account of the national crisis, and those other industries, such as agriculture particularly, whose markets have been drastically curtailed as a result of it. The very same causes that are proving at this time a very great profit opportunity to concerns producing national-defense materials, are the ones which have restricted our agricultural exports.

It is an axiom of our economic system that if exorbitant profits are made by some and not promptly reinvested there will inevitably be less purchasing power for goods produced by other farmers or manufacturers and they must consequently suffer loss. The total purchasing

power of the Nation is always equal to the total cost of production unless new money is being injected into the system from some source. For all these reasons, but particularly for the sake of having the people of the United States know that the Congress is bending every effort to prevent unfair advantage being gained by anyone as a result of the national-defense effort, I have asked this time to appear before you.

I have two or three specific suggestions with regard to the proposals of the subcommittee. There are two plans for the determination of normal profits in the base period. Under the first plan, as I understand it, normal profits or the excess-profits credit as it is called, are determined by averaging the earnings for the 4 years in the base period. This is, of course, a plan which will be employed by corporations whose rate of earnings relative to invested capital was high in the base period. The second plan, which the taxpayer may elect to use, provides that normal profits or the excess-profits credit shall be determined by taking an average of the percentage which its earnings in each base-period year bore to its capital in that period. This, of course, would be the plan which would be chosen by corporations with large capitalizations relative to income. Under the second plan a ceiling of 10 percent of invested capital is set, and the credit cannot be more than that. In the case of the first plan, no ceiling is provided. Corporations, could, therefore, under this plan have earned very high rates of profits during the base period and still use these as an excess-profits credit. Those corporations which will be most advantaged by so doing are the great monopoly corporations of the Nation. Their excess-profits tax will only operate on very high rates of earnings.

As an example of what this may mean, I find that in the years 1934 to 1936, none of which were particularly prosperous years, earnings in excess of 15 percent were made by 1 out of 4 of a sample of 500 of the more important corporations in the country—more true in 1937 and 1939. It seems to me that under this first alternative plan there should be a ceiling to the amount of excess-profits credit which could be claimed. I would prefer to see this graduated so as to allow small corporations a greater percentage on their invested capital as an excess-profits credit than would be allowed in the case of large corporations. But I think some ceiling certainly should be set and that unless this is done certain inequalities are bound to appear and some corporations will enjoy a much more favored position with regard to the payment of excess-profits taxes than others. Furthermore, a great deal of revenue, I am certain, will be lost. I believe careful consideration of the problem of the small corporation which has enjoyed a rapid growth and added to its capital out of earnings has got to be given. I confess I do not know the answer to this specific problem, but I would urge that special consideration be given to this group and that the bill, as a whole, be kept a tight bill, rather than to sacrifice the basic provisions of the bill for the sake of taking care of those particular cases.

I would not make the ceiling too low if one were put in, but I would point out that, since 1939 is included as one of the base period years, there must be considered the fact that in some industries connected with munitions very high profits were made in the latter part of that year and that in contrast to the fact that in other lines of business the profit rate for the whole year 1939 was very modest, indeed.

The flat credit of $5,000 seems to me to be entirely proper for the reason that it will mean a great deal to some of the smallest corporations. In my own excess-profits tax bill, a credit for $10,000 was allowed. Personally, I wish a law could be drawn so that the exemption could apply only to the little fellow where it is in many cases of vital consequence, but so there would be no exemption for big concerns with earnings running into the millions where it makes little difference anyway. I realize, however, the difficulties in working this out in an equitable manner and have no objection to the proposal of the subcommittee on this point.

Now, if I may make a point about the rate of tax. If I understand correctly the subcommittee's proposal, a reduction is allowed from net income equal to the normal corporation income tax paid by the corporation. This means, of course, that on that portion of net income that has already been paid to the Government in taxes the excess-profits tax would not apply. This is obviously the only fair thing to do and it was included in my own bill on the subject. But it has bearing on the matter of rates to be imposed in the excess-profits tax.

These rates as proposed by the subcommittee reach a maximum of 40 percent on that portion of the excess profits net income which is above 20 percent of the excess-profits credit. Remembering first that the Vinson-Trammell Act is being repealed, second that this whole tax program is on excess profits over and above normal profits and, third, that the top rate applies only to that portion of profits which is far in excess of normal profits; remembering also that we are seeking to prevent undue advantage accruing to anyone in connection with this national defense program, it would certainly appear to me that, if anything, the rate in the first 10-percent bracket is too high and that at the very least a fourth bracket should be added to provide taxation at the rate of 50 or 60 percent on excess profits net income in excess of 50 percent of excess-profits credit. If there is any inequity in the determination, gentlemen, of the excess-profits credit in the first instance, that inequity will be carried over more seriously, if the rate of taxes suggested in the subcommittee's report is used, than would be the case on a basis such as I have proposed. In my own bill on the subject, it was graduated more steeply and I had 75 percent in the bracket where the excess profits ran over 50 percent in excess of normal profits.

It must be remembered that in the end the American people are paying for the increased business which causes these additional earnings to be made, and that the patriotism and sacrifice of the people is the base on which the whole thing rests. It is true we are not at war, but it is also true that our efforts should be in the direction of greater equality of opportunity and better spread of income which are and have always been fundamental objectives of the American Nation.

I notice that it is proposed to allow the inclusion of certain percentages of borrowed money as part of invested capital. I do not feel that I am prepared to discuss this proposal in detail. I can see the importance of it in the case of small corporations which have to pay a relatively high rate of interest on borrowed money and whose invested capital was necessarily small at the beginning. I assume, however, that the committee in its bill will guard against the possibility of some

of the great corporations of the Nation, whose credit advantages are such that they can borrow at extremely low rates of interest, deliberately doing so for the purpose of avoidance of taxation. I also wonder whether the graduation is as steep as it ought to be in connection with these allowances of borrowed money as part of invested capital.

I realize fully that the matter of pushing forward the defense program is of primary consideration. I trust and believe, as I have said before, that American business stands ready to cooperate in this respect on the basis of fair and just returns and that its cooperation does not have to be purchased. It is obvious that a private corporation cannot afford to construct extensive new plant facilities or to retool its plant if all it has to look forward to is the meeting of a peak demand for national-defense material over a comparatively short period of time. I am personally of the opinion that in the munitions industry itself such peak demand needs should be met by means of the construction of plants or the purchase of tools by or for the Government itself and the leasing of such facilities on a fair basis to those capable of running them. But I shall not go into this phase of the situation at this time because it does not directly concern the Ways and Means Committee in its consideration of this bill. If a private corporation is going to risk its money and construct additional plant and facilities to meet the demand of national defense, then I understand the importance of special amortization allowances to such a corporation. I would like to stress that, Mr. Chairman.

I would like, in the next place, to point out that there is another phase to this amortization question which seems to me to present an entirely different picture from that where the corporation risks its own funds. The situation I have reference to is one where the corporation takes no risk at all. For example, suppose a corporation sets up a subsidiary and secures an R. F. C. loan for the construction of a new plant, the R. F. C. having no other security than the new plant to be built out of its loan. Suppose further that the business of this new plant will be the filling of orders for the War Department so that one agency of the Government will be paying to the company through its purchases the income necessary to repay the R. F. C. loan. In such a case, the corporation has taken no risk at all itself. But as I understand it, even in such a case it would receive a 20 percent amortization credit each year. Certainly this is not equitable and furthermore the whole principle of the generous amortization provision is, as I understand it, to compensate business for risks which it may take. Under a circumstance such as I have outlined, it certainly seems to me, after the amortization is complete, that the plant should belong to the United States. Its costs would have been completely amortized and the corporation will have received the profit from the contracts given it by the Government.

I sincerely believe that democracy is on trial now as it has never been before and, believing that, I think that the Members of Congress have a responsibility which is so tremendous that it terrifies one to think of it. The consideration of this tax bill presents one phase of how this responsibility is developed and, I think, one example of how difficult it is for Members of Congress to exercise or have an opportunity to exercise and meet that responsibility. I wish to make a proposal regarding how I think we can better discharge it.

During the World War Congress adopted an excess-profits tax law and without doubt the House and Senate committees thought at that time that they had written a measure which was clear and which would involve no great difficulty for the administrators. But, as I am sure you gentlemen know, what actually happened was that bureau chiefs practically assumed the responsibility and perhaps had to assume the responsibility of writing their own excess-profits tax law by means of opinions, rules, and regulations.

For example, long after the war, in 1924, a select committee of the Senate made an investigation of the Bureau of Internal Revenue and found among other things that it was 8 years after the law was adopted before the Solicitor of the Bureau of Internal Revenue issued his opinion setting forth the principles upon which the amortization deductions were to be decided. For 8 years, the report indicates, employees in the Bureau of Internal Revenue floundered around, one group deciding it one way, and another group another way. Obviously, it is not fair either to the taxpayers or to the Government.

Railroads, for example, were denied the benefit of the amortization provisions of the law but some railroads, owned by industrial corporations, got amortization allowance. One claim of a great corporation to the effect that war orders had compelled it to build plants from 34 to 40 percent in excess of its post-war necessities was approved on the basis of statistical computation. But testimony before the Senate committee showed that at the very time the corporation was claiming it had excess plant facilities, it was before the Federal Trade Commission pleading it did not have sufficient plant capacity to meet demands.

Another corporation claimed amortization of $55,000,000. The Senate committee questioned $27,000,000 of this deduction, but the Commissioner insisted the claim was closed and could not be reopened. When the committee proved that if the Bureau would use actual production figures of the corporation instead of estimated figures, millions of dollars of the amortization claim could not be supported, the claim was reopened.

These are only examples and to a certain extent they are ancient history. But the object of my mentioning them is to prevent their happening again and to urge that both for the sake of taxpayers and the Government steps be taken to see that the same sort of uncertainty does not take place in the carrying out of the law now under consideration. For otherwise the regulations and administrative decisions adopted by the Bureau may become more important than the law itself and it will be difficult if not impossible for Members of Congress to know what is being done or to effectively carry on their responsibility to the taxpayers, the Government, and the people.

It is true that, as a result of the Senate investigation, Congress created the Joint Committee on Internal Revenue Taxation and, while that step was good, frankly I do not believe it has solved the problem. The Members of the House have little opportunity to make use of the joint committee and, in fact, I doubt that many Members of the House, aside from those on Ways and Means, know what this joint committee or its experts are doing. I would make two suggestions:

1. The Congress should require the Bureau of Internal Revenue to submit its regulations for the administration of this act, and the joint committee should be required to take responsibility for reporting

to Congress its approval of the regulations. We should develop a method of maintaining a day-by-day check on the law. I can see no other way of improving the law and of permitting Members of Congress to exercise their responsibility.

2. Congress, on a number of occasions, has voted against making income-tax returns a public record. There is no reason to believe that Congress would change its opinion if that issue were now raised. Members of Congress and supporters of secrecy insist that the income-tax payments should not be divulged by the Government. But is there any reason why we should not require the Bureau to report to the Congress the amount of deductions a corporation has claimed for amortization, for depletion, and for depreciation? Perhaps those reports might help to accomplish what I desire—to inspire interest on the part of Members of Congress in what these provisions in the tax laws mean in practice.

I would merely like to point out that, out of total deductions of $672,000,000 claimed by corporations where individual claims were in excess of $500,000, the Senate committee, on the basis of its evidence, contended that excess allowances had been made in the amount of $210,000,000. If the facts, opinions, rules, and regulations had been matters of public record, I do not think these things would have happened and I believe it would have been better for all concerned.

I hope, gentlemen, that I have made my position plain. I shall not be surprised if I am the only witness appearing to urge the tightening of the provisions of this bill in certain respects. I have done so simply because I believe it is important for somebody to emphasize and reemphasize the necessity for having Congress prove to the American people that it is going to exercise extreme care to protect the interests of the people generally at a time and in a psychology when that interest is all too easy to forget.

The CHAIRMAN. The next witness is Hon. J. Harold Flannery, Representative in Congress from Pennsylvania. Is Mr. Flannery present?

(There was no response.)

The CHAIRMAN. The next name on our list is Mr. R. V. Fletcher, vice president and general counsel of the Association of American Railroads.

## STATEMENT OF R. V. FLETCHER, VICE PRESIDENT AND GENERAL COUNSEL, ASSOCIATION OF AMERICAN RAILROADS, WASHINGTON, D. C.

The CHAIRMAN. How much time do you require, Mr. Fletcher?

Mr. FLETCHER. Ten minutes, I think, will be ample.

The CHAIRMAN. You may proceed.

Mr. FLETCHER. Mr. Chairman and members of the committee: My name is R. V. Fletcher. I am vice president and general counsel of the Association of American Railroads, a voluntary organization maintaining headquarters in Washington and representing substantially all of the class I railroads of the country. I suppose it would be a fair estimate to say that 95 percent of the entire mileage of railroads are members of the association.

I desire to express my appreciation of the opportunity of appearing again before the Committee on Ways and Means, and I shall try to sustain what I hope is a well established reputation for brevity.

In making my brief presentation of the railroad question, as applied to this excess-profits tax, I have no purpose at all of criticizing the policy of the committee or of the Treasury with respect to the principles which are discussed in the subcommittee's report dated August 8, 1940. I have no doubt that the demand upon the Treasury incident to national defense is such that an excess-profits tax is inevitable, and I have no opinion to express contrary to the subcommittee's conclusion in regard to the suspension of the Vinson-Trammell Act, and the desirability of adopting a policy of amortization of emergency facilities. As a matter of fact, my rather slight acquaintance with the subject leads me to the conclusion that such amortization is not only fair but absolutely essential to the inauguration and prosecution of an effective program of national defense.

My only purpose is to make some suggestions with respect to the application of the proposed law to railroads, themselves essential agencies in any well-considered defense program. As all the members of the committee know, the railroads have been far from prosperous in the past 10 years. Due to the industrial depression affecting all business and other adverse factors which need not here be enumerated, something more than one-third of the railroad mileage of the country is now in the hands of the courts undergoing reorganization either through the medium of receiverships or bankruptcies. In adopting plans for promoting the national defense it is important that the railroads should not be overlooked, and that language should not be written into any tax bill which would place them at a disadvantage in comparison with their competitors or which would subject them to treatment less favorable than accorded to industry generally.

May I say here, gentlemen, that while I have a more or less prepared statement, I will welcome interruptions at any time. It does not make any difference to me if anybody wants to ask a question. If you wish to ask any questions, I will try to answer them, without waiting until I complete this prepared statement.

Now, may I say at the outset that I echo the sentiment which, I believe, has already been expressed to the committee by other witnesses, to the effect that it is a little difficult to attempt to pass upon this proposed legislation without having had an opportunity to examine the bill which the committee proposes as a means of carrying out its general recommendations. All of us, of course, are familiar with the very clear and comprehensive report of the subcommittee, signed by Chairman Cooper, and my discussion of the bill is based upon that report. I realize, however, that it is of the utmost importance that a bill should be presented to the Congress and disposed of at the earliest possible moment in order that there may be no delay in getting under way a well-organized defense program. Then, when the conclusions of the committee come to be embodied in an actual bill, language may be found which will lead one who examines it to a different conclusion from that derived from reading the subcommittee's report. It is important, therefore, that those of us who are interested in the questions covered by the bill should have the advantage of examining the actual bill after it has been drafted, and the privilege of expressing our views, perhaps, not orally, but in writing. I do not know whether that would be practicable or not, but, as I have said, when a bill has been prepared and presented to Congress, from an examination of the exact language of the legislation, we might

draw different conclusions from those drawn from reading the report. It is sincerely hoped, therefore, that opportunity will be afforded to all interested in the question to submit supplemental statements in some form after the bill has been presented to the Congress and its exact language has been examined.

Now, may I mention the question of amortization, because from certain statements in the press it might appear that it would apply only to so-called industrial corporations. It is highly important that equipment purchased by the railroads for the purpose of cooperating in carrying out the national defense program should be amortized in the same way as facilities acquired for defense purposes by industrial concerns. I read from the subcommittee's report, on page 2, where I find the following language:

> Your subcommittee, therefore, recommends that a corporation be allowed a deduction for income—and excess-profits tax purposes for the amortization of certain facilities which are 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. Such facilities are land, buildings, machinery and equipment, or parts thereof, constructed, reconstructed, erected, installed, or acquired after July 10, 1940, and the construction, reconstruction, erection, installation, or acquisition of which was contracted for prior to the termination of the present emergency.

I would suppose that the statute would follow the obvious intent of that declaration in the subcommittee's report, and that it would, no doubt, include within the scope of the relief provision equipment which has been purchased by a railroad company in order to furnish transportation that is made necessary by the national defense program. That would be equipment which would not be required for the ordinary operations of the railroad at all, and I take it that such equipment would fall within the scope of the amortization provision of the law. It should apply not only to equipment, but possibly it should apply in the case of the construction of new lines. There may be occasion for the construction of new lines, as, for instance, if there should be a munitions factory located at a place that is not now served by a railroad. In that case, it would be necessary to make an extension of the railroad line solely for the purpose of serving such a plant, and I presume that that line facility could be amortized on the 5-year basis the same as a facility that might be constructed in the interest of directly carrying out the national defense program.

I want to say, however, that this date of July 10, 1940, challenges attention. I have the impression that other witnesses have explained to the committee the importance of careful consideration with respect to that date of July 10, 1940, so as not to exclude equipment which may have been ordered, or the construction of which may have been begun, prior to that date. Of course, we are not contending here that equipment purchased for ordinary commercial purposes, having no relationship to the national-defense program, should be subject to special treatment, but our contention is that the statute should not be so written as to exclude railroad equipment which may have been contracted for prior to that date, provided it is completed subsequent thereto, provided, of course, the railroad company shall furnish the certificate which the statute no doubt will require. It is a matter of common knowledge that prior to July 10, 1940, it was obvious to all well-informed, thoughful people that the Nation must embark upon a more intense and complete program of national defense, and cases

may no doubt be found where railroad companies, anticipating the need for equipment in order to discharge their obligations in the premises, made contracts for equipment which would not have been made but for the obvious necessity for speeding up and intensifying the national-defense program.

Mr. REED. Do you have any evidence, as a result of conferences with the railroad organizations that they were looking forward in their expenditures in anticipation of this emergency?

Mr. FLETCHER. I am not sure that I could cite any specific instance of that now, but I have no doubt that such instances do exist, without being able to put my finger on the particular cases at this moment. I have no doubt that if a railroad company can convince this committee, the War Department, or the Navy Department, that such instances existed, you would want to provide language in the law that would not exclude them from the benefits of the amortization program.

Mr. REED. I wondered how far they had foreseen it.

Mr. FLETCHER. I do not think there would be a great deal of that, but where there was, it should be taken care of in the amortization provision. If a railroad company can convince the Advisory Commission to the Council of National Defense, the Secretary of War, or the Secretary of the Navy that the equipment is necessary in the interest of national defense during the present emergency, such equipment should be given the privilege of special treatment in the matter of amortization regardless of any particular date.

Now we come down to the very important question of what basis should be adopted in determining excess profits, or how the excess-profits taxes are to be collected. Of course, we have here two alternative methods: We have the invested-capital method and the average-earnings method. It is probable that by far the majority of the railroads would select as preferable the invested-capital method rather than the average-earnings method. I say that by reason of the fact that for the past 10 years the railroads have had a most unhappy experience in the matter of net earnings during that depression period, and very few of them would be able to obtain any substantial credits by taking into consideration their earnings in that period. I believe it was Mr. Stam who spoke on behalf of the Joint Committee on Internal Revenue Taxation, and after explaining, with admirable clarity, the details of the average-earnings method, he used this language:

> However, it is recognized that taxpayers with very low base earnings will be unjustly treated by a tax based entirely on average earnings.

This terse statement exactly expresses the situation of the majority of the railroads of the country. The test period 1936–1937–1938–1939 was, with the possible exception of 1937, a period of profound depression in the railroad industry. Taking the railroads as a whole, therefore, it will be found that the average earnings for the 4 years are very low and in the case of many roads utterly nonexistent. It is assumed, therefore, that most of the railroads will gratefully elect to adopt the invested capital method rather than the alternative. Generally speaking, these railroads will find their protection in the credit of 4 percent upon invested capital which the proposed statute will reflect. In some cases there will be an additional credit, since not all of the railroads were without net earnings in the base period. In connection

with the determination of invested capital, which is, of course, all important, I venture to suggest that language be used in the bill which will make it clear that the so-called depreciation reserves may be included in the term "earnings and profits" which, according to the subcommittee's report, are to be included in computing equity invested capital.

I mention that, because a great many railroads have a substantial amount of money in the so-called depreciation reserves. I do not want to go into too much detail about it, but I think it is understood that under the accounting rules of the Interstate Commerce Commission railroads are required to set up annually on their books figures that will represent the depreciation of equipment. Those amounts are not kept in cash, but they are invested in property. They are put in the property investment accounts of the carriers, and in most cases they are substantial in amount. I think they should be allowed to be included in the equity invested capital, but it is not clear from the statement of the subcommittee whether they will be permitted to be so included, and we apprehend that, unless that is taken care of by express language in the statute, there will be some difficulty with the Bureau of Internal Revenue in having those particular reserves included in the term "invested capital."

Some question has arisen in the minds of the tax experts connected with the railroad industry as to whether such depreciation reserves will be recognized by the Department of Internal Revenue. Of course, these reserves represent actual earnings set aside for a special purpose and in determining in the case of a particular railroad the amount of its equity invested capital, depreciation reserves should not be excluded.

Now, we come to the question of borrowed capital, and the point I have just made is all the more important by reason of the fact that in the case of most railroads their capital structure includes a comparatively large amount of borrowed capital, which borrowings were used actually to construct the line and are included in the property investment account.

As I have previously stated to the committee in reply to questions from members, the railroad industry to a greater extent that almost any other, by reason of the low rate of interest at which money can be borrowed, has seen proper to construct very substantial portions of their lines through the medium of bond issues rather than stock issues. As I understand the proposition, in the case of a fairly large railroad company only 33⅓ percent of borrowed capital can be included in the term "invested capital." It is highly important, therefore, that these very substantial amounts which the railroads carry in depreciation reserves should not be excluded.

Now, there is one class of railroads to which I desire to call particular attention. I have reference to railroads which are now undergoing reorganization through receivership or bankruptcy proceedings. Many of these railroads will emerge from bankruptcy during the period when the excess-profits tax is in effect. Special problems arise in connection with this class of railroads. In many cases the existing stock will be entirely wiped out and the new stock will be distributed to bondholders and other creditors. There will be difficulty, therefore, in determining with respect to such railroads as to money paid in for stock. Some method will have to be worked out whereby a

valuation can be put upon the stock in order to determine invested capital. It is respectfully suggested that language be included in the new law which will provide in effect that in the case of railroads which have been reorganized the capital stock be valued at a sum approved by the Interstate Commerce Commission as the basis of the accounting for the new company. It will be necessary, doubtless, for the reorganized company to open up a new set of books and the Commission under its general duties to superintend accounts will be called upon to approve a figure on the balance sheet of the carrier representing the value of the capital stock. That figure the Treasury can very well afford to accept as the basis for the value of the capital stock in determining equity invested capital.

In this connection, technically, many railroad corporations will come into existence as new corporations subsequent to the last of the base years and, as I understand the proposition, these companies will be entitled to a credit of 8 percent upon the value of the invested capital.

Of course, those companies will have to open books. They will have to begin their career with a new set of accounts, and the Interstate Commerce Commission will supervise those accounts, because under the law all accounts are under the control of the Interstate Commerce Commission.

There has been a great deal of discussion before this committee about the desirability of applying consolidated returns for excess-profits tax purposes. I do not intend to go into that very largely, but I venture to make the suggestion, in connection with the excess-profits tax, as applied to railroads, that the privilege be extended to the railroads to make consolidated returns for excess-profits purposes. The committee will remember that under the present law applicable to income taxes railroads are permitted under certain restrictions and limitations to make a consolidated return for income-tax purposes. This policy was deliberately adopted by the Congress some years ago by reason of the peculiarities of railroad capital structures. It is not necessary to reiterate the reasons why it was necessary in order to do justice to permit railroads to make consolidated returns. Suffice it to say that the principal and controlling reason is that the laws of many States make it necessary for the railroads to maintain separate corporations in order to conform to the policy of those States. It is obvious that the same principle which controls sound policy as to consolidated returns applicable to the income tax should apply to excess-profits tax returns. There are some railroads which have as many as 49 companies in the consolidated tax returns and railroad systems with 20, 30, and 40 companies are by no means rare. Generally speaking, all these companies represent but a single investment and a single operation. From the viewpoint of simplicity as well as for obvious practical considerations, the various separate corporations making up a system should be permitted to file a consolidated return for excess-profits taxes just as they now do in the case of income taxes.

In connection with the whole subject of taxes upon railroads, I am asking the privilege to file with the committee a printed copy of some suggestions which were made to the Secretary of the Treasury in 1939, at a time when hearings were had upon the whole question of taxation by the Undersecretary of the Treasury. While some of the questions

discussed in this carefully prepared memorandum are not before the committee at the present time, yet in my opinion the committee will be interested in that discussion of the problem of railroad taxation so far as the Federal Government is concerned. One question of great importance is discussed on pages 3 and 4 of this pamphlet. I refer to the desirability of making some change in the law which would permit consolidated returns in the case of lessor corporations where less than 95 percent of the stock is owned by an operating railroad company but where under the contract the taxes levied upon the lessor corporation must be borne by the lessee. Many instances could be cited where all the property of a railroad corporation has been leased to an operating company so that this lessor property is in effect a part of the railroad system of the lessee. Under the lease contracts the internal revenue taxes imposed upon the lessor must be paid by the lessee. No good reason can be cited why in cases of this sort the lessor company should not be included in the consolidated return.

As previously stated, we respectfully ask that the privilege be extended to the railroads of the country to express further views after the text of the law is available.

Mr. TREADWAY. I notice that this pamphlet is dated November 1939. Does it represent the view of your organization today?

Mr. FLETCHER. It does as to matters therein treated. There are many matters treated there which are not involved in this bill.

Mr. TREADWAY. With a view to saving printing costs, would it not be desirable to designate the portions of the report that relate to matters we are dealing with here?

Mr. FLETCHER. I am not submitting that pamphlet for inclusion in the record, but I am simply filing it with the committee. The reason I offer it is because there is a discussion in there, more elaborate than I have time to make now, with reference to the desirability of making consolidated returns for excess-profits-tax purposes.

I thank you very much.

The CHAIRMAN. The next witness we will hear is Mr. W. W. Schneider.

Mr. Schneider, please state your name for the record and whom you represent.

## STATEMENT OF W. W. SCHNEIDER, SECRETARY, MONSANTO CHEMICAL CO., ST. LOUIS, MO.

Mr. SCHNEIDER. Mr. Chairman and gentlemen, my name is W. W. Schneider; I am secretary of the Monsanto Chemical Co., St. Louis, Mo.

I want to discuss just a few points in the subcommittee's report. The first point I want to discuss is with reference to a question Mr. Disney raised this morning. The subcommittee's report does not indicate how you intend to handle the case of a company that has acquired some other business during this base period, or a case where two companies have merged or consolidated during that base period.

We happen to have that case in our company. That is one of the reasons for making my remarks on that subject.

I might call your attention to the recommendation made by the Minister of Finance in Canada to the House of Commons, on June

26 of this year, on that very point, in connection with the Canadian excess-profits law. His recommendation is as follows:

> That in the case of a taxpayer who acquired a business as a going concern since January 1, 1938, the Minister may direct that the standard profits of the predecessor may be added to those of the taxpayer if the Minister is satisfied that the trade or business of the predecessor and the taxpayer are not susbtantially different.

I do not know whether that recommendation was adopted or not, but I put it forward as a suggestion in this case.

It seems to me offhand that where two businesses have joined, or where one company has taken over another business during this base period, that for the purpose of making a comparison between the average profits for that 4-year period and the profits of both on which the tax is to be paid, it is only fair and proper that the profits of those two companies, or those two businesses which are now one business, should be added together for the purpose of ascertaining the average profit during that 4-year period.

With respect to the second method, the invested capital method, it also seems to me that the invested capital of the two companies should be added together to ascertain the invested capital of the present enterprise for the purpose of ascertaining the percentage of return on invested capital during that 4-year period; and also add together the profits of those two enterprises during that same period to determine what is the real percentage that that present enterprise should start with as a base under this new tax law. It seems to me that is a fair and proper method of handling it. Some way has to be devised of handling it. I do not know what the opinion of your experts is on that point. I am not an expert myself.

There happens to be another recommendation from the Minister of Finance of Canada which might be appropriate to point out here. He recommends as follows:

> That the Act shall apply to the profits of the year 1940; and in the case of a fiscal period ending in 1940 prior to December 31, that the Act shall apply to that proportion or percentage thereof which the number of days of said fiscal period in the year 1940 bears to the total number of days of such fiscal period.

I know of some companies whose fiscal year ends on November 30 of this year, and they will escape the excess-profits tax for eleven-twelfths of their 1940 profit, as well as the 3 percent that you tacked on a few months ago in the Revenue Act of 1940. Perhaps that is one of the reasons why the revenue under this proposal is going to be so low for the year 1940. I just throw that thought out in passing, that you might avoid a discrimination against companies whose fiscal year starts 30 days later, as against a company whose fiscal year starts on the 1st of December of last year. Now, I have just one more point to make, and the most important one, and that is with respect to the valuation of property that has been received in exchange for stock.

On page 11 of your committee's report, you have recommended using the unadjusted basis, and I believe the thought behind that is that there have been tax-exempt reorganizations, under section 112, and so forth.

In my opinion, there is no necessary connection between the basis for figuring the income tax and for figuring what is a fair rate of return on the taxpayer's invested capital.

If I issue $5,000,000 worth of stock in exchange for $5,000,000 worth of assets, that is my invested capital and not what the seller may have paid for it 5, 10, 15, or 20 years ago. He might have paid $10,000,000 or $1,000,000 for it. In my opinion, in determining what is the reasonable rate of return on my invested capital, I should be given the value of what I pay for it; in that case, $5,000,000 worth of stock, and not what the seller might have paid for it, during some period in the past.

That is the last point I wish to make.

Mr. TREADWAY. You started out by referring to your company having been composed of two separate companies.

Mr. SCHNEIDER. That is right.

Mr. TREADWAY. And you were asking for a basis of figuring excess-profits tax on the capitalization or the earnings of the two, according to the alternate scheme.

Mr. SCHNEIDER. That is right.

Mr. TREADWAY. When your companies consolidated, does the new capitalization represent the total of the two capitalizations of the subordinate companies, or did you change your form of stock in some way or other? My point is this, that I think very frequently when that sort of thing is done, there is something put in the capitalization perhaps reducing the total represented by the stock of the two companies.

Is your stock today identical with what it was when the companies were separate, before consolidation?

Mr. SCHNEIDER. No; we issued common stock in exchange for their business and assets. We did not acquire the other company's capital stock, if that is the point you have in mind.

Mr. DISNEY. You refer to a question that I asked. The illustration that I had in mind was a different one, where there was no corporate change in the purchasing company.

Mr. TREADWAY. Does not that weaken your argument a little bit, that you should now go on the basis of the value of the capital stock of the two companies?

Mr. SCHNEIDER. I do not believe it does, because in ascertaining my investment, I think I am entitled to what I paid for the property and not what somebody else paid for it. He might have paid a whole lot more. It works both ways. He might have paid a whole lot more than I am now paying him for it. In that case, I would get a much higher base under that other theory; or he might have paid a much lower figure. It works both ways.

The CHAIRMAN. How can you keep up with what that value is; some people pay less for a stock than it is worth and others pay more. Some one else might have paid more for the stock than you did. How do you equalize it?

Mr. SCHNEIDER. I do not think any man is going to pay any more than he thinks the property is worth. That is a matter that they have to prove to the satisfaction of the Commissioner of Internal Revenue, in any event.

The CHAIRMAN. Suppose he woke up and found that he had paid more than he thought it was worth?

Mr. SCHNEIDER. If that were so in my case, that would still be my investment.

Mr. MCKEOUGH. You merely approach this, as I see it, on the basis of some consideration being extended for your new set-up that is

interrupted by reason of the four test years that are proposed in the report, either on the basis of earnings or on the basis of your capital investment.

Mr. SCHNEIDER. That is correct.

Mr. MCKEOUGH. In other words, if you changed your operations while the period of the 4 test years is involved, you merely seek a consideration for that change in connection with the proposed report as it applies to your tax for 1940.

I think you have got an approach that is worthy of very sympathetic consideration.

Mr. SCHNEIDER. In other words, there are two businesses now united in one. If you want to make a proper comparison, you have to take the investment in both companies and the earnings of both companies, to figure the future tax and profits.

Mr. MCKEOUGH. Otherwise, you would be manifestly unjustly treated, if you were posed with a situation where you had no relief because of that 4-year period being interrupted by a new set-up.

Mr. SCHNEIDER. That is correct.

The CHAIRMAN. If there are no further questions, we thank you for your appearance and the information you have given the committee

Mr. SCHNEIDER. Thank you, Mr. Chairman.

## STATEMENT OF CHARLES H. MYLANDER, VICE PRESIDENT, HUNTINGTON NATIONAL BANK, COLUMBUS, OHIO

The CHAIRMAN. The next witness on the calendar is Mr. Charles H. Mylander, of the American Bankers Association.

Please give your name and address to the reporter, Mr. Mylander.

Mr. MYLANDER. Mr. Chairman, for the record, my name is Charles H. Mylander. I am vice president of the Huntington National Bank, of Columbus, Ohio. I am a member of the committee on Federal legislation of the American Bankers Association and chairman of its subcommittee on taxation.

I want to say first that on behalf of the American Bankers Association I think we should commend the committee and the Congress for its efforts on this bill to place the defense program, to some extent at least, on a pay-as-you-go-basis. We have been advocating that basis for a good many years, as you know.

I think also that we ought to thank the Ways and Means Committee for the consideration that it has given the banking business in the draft of past tax laws.

In the 7 or 8 years that I have been coming down to Washington this is the first time, I think, that I have been able to understand the report of a subcommittee. And, I think the committee which prepared the report should be commended because it has had to deal with a very difficult subject.

We assume, of course, that because there is no special mention of the banking business in the report of the subcommittee, that it is intended that the banks shall pay taxes on their excess profits on the same basis as any other corporation and that they will be allowed the same option as to whether they use their earnings over a base period, or the invested capital method as other corporations are allowed.

When we come down to the details of the computation of the invested capital in the banking business I find one place here where the subcommittee was not as clear as we would like to have it. On page 5 of the subcommittee's report, under the definition of "invested capital" we find that the report states:

> Your subcommittee recommends that the invested capital of the taxpayer should consist of equity invested capital and borrowed invested capital, and that borrowed invested capital should be defined as borrowed capital of the taxpayer which is evidenced by written promises to pay.

Then, when we go over to page 12 we find another definition of borrowed capital, which should consist of indebtedness of the taxpayer, evidence by a bond, note, bill of exchange or debenture, certificate of indebtedness, mortgage, or deed of trust.

Banks issue none of the items which I have listed, but banks have in addition to equity capital a tremendous amount of borrowed capital which is represented by deposit liabilities. And, we feel that the bill should state definitely that the deposit liabilities of the bank should be included in the invested capital of the institution, since that deposit liability represents money which the banks have borrowed from the public, and which is evidenced by the promise of the bank to repay those deposits, either upon demand or upon certain definite dates, and evidenced by a certificate of deposit or savings passbook, or what have you.

If we do not have the admission of our borrowed capital, the invested capital of the bank, as defined by the bill will be reduced considerably by the provision in paragraph 5 of the report, that is, the ratio which certain inadmissable assets bear to the total assets being taken away from the invested capital.

As you know, banks are confined in their investment to certain definite types of investments, by the National Bank Act, the Federal Deposit Insurance Act, and so on. A large part of those admissible assets which banks may buy, may be inadmissible for the purpose of computing invested capital under the proposed bill.

We have not had time to make computations of the typical case, but for banks as a whole it would mean a reduction of about one-third of the equity capital in the banks of the United States by reason of this inadmissible asset.

We have one further point to make and that is in the determination of net income, as defined on page 13 of the report: Net income as computed for excess profits-tax purposes, for any taxable year, including taxable years in the base period, shall be the normal tax net income plus income tax payable, and less the amount of gains or losses realized by the sale or exchange of any asset, depreciable or nondepreciable held for more than 18 months.

Until the passage of the Revenue Act of 1939, corporations generally, including banks, had no reason to keep records as to the length of time an asset was held in gain or loss computation. Consequently, I think you will find that in most corporations it will be rather difficult, in the case of certain intangible assets, to determine what length of time that particular asset was held. For instance, a bank buys a Government bond, or did back in that period, bought a Government bond, and put one bond on its books at so many dollars but it did not identify that bond by number, so that some 10 or 12 months later, when it sold the bond, the bank sold one of the Government bonds for so many dollars

it might have been a bond which was purchased 10 months before or it might have been a bond which was purchased 20 months earlier.

And, I feel that is true in the case of a number of corporations who deal in intangible assets, that is, that the distinction between gain and loss for 18 months of the tax year, in the base years 1936, 1937, and 1938, will be very difficult of attainment.

To summarize: We feel that banks, and we ask that banks be treated exactly as other corporations are to be treated under this bill, and that is, that they be allowed to include in invested capital the same proportion of borrowed capital, namely, their deposit liability, that other business corporations include.

Then, this last point which I have made about the difficulty of ascertaining the length of time certain assets were held; we asked that that be cleared up in some way.

Thank you.

Senator KING. Do I understand you to mean that the capital would consist of deposits, whether those deposits are time deposits, or whether they are deposits in which you are acting as an agent for others, or deposits on which you pay interest?

Mr. MYLANDER. Senator King, you have two kinds of capital defined in this bill: Equity capital and borrowed capital. We feel that the deposits are borrowed capital, the same as the borrowed capital of a manufacturing concern from a bank. We have borrowed that money from our depositors, the same as the manufacturing concern borrows money, comes and signs a note to the bank to borrow money. We have entered into the same kind of contract.

Senator KING. Many banks now receive deposits upon which they pay no interest, or a negligible amount of interest.

Mr. MYLANDER. Yes.

Senator KING. They receive the deposits only because the depositor comes in, some patrons who have been doing business with the bank for some years; it represents no advantage to the bank; in some instances it is a liability rather than a benefit. Would you treat that as capital?

Mr. MYLANDER. I would treat it as borrowed capital as defined under this bill, because the deposits of a bank, the deposits of these individuals, while the individual may derive no benefit and the bank itself may derive no benefit from it for the moment, nevertheless the bank must keep as a reserve in cash, idle, earning no money, an amount equal to its equity capital.

The CHAIRMAN. Would not the borrowings, which you have described as capital, fluctuate so much that it would be very hard to determine what your capital was? The other concern does not have to keep a reserve which would fluctuate.

Mr. MYLANDER. Very much so, Mr. Chairman, just the same as the ordinary corporation borrows money.

The CHAIRMAN. I do not think it is analogous. You are bound to keep a reserve, under the law, and if your deposits run down, then the only way you can keep the reserve is to borrow money, or collect in notes.

Mr. MYLANDER. Yes.

The CHAIRMAN. A corporation is under no obligation to keep a certain reserve. I do not think the two are analogous.

Mr. MYLANDER. That is all the more reason, Mr. Chairman, why we feel that banks are entitled to treatment accorded other corporations, because they do have to keep a reserve; we have to keep a very large fund of idle money in reserve, earning nothing.

The CHAIRMAN. It would be very difficult, I think to tell just what your borrowed capital was because it would fluctuate so much.

Mr. MYLANDER. Of course, there is one difference between the banking business and the ordinary corporation: The bank must balance its books every day and keep records so we can tell exactly what our deposit liabilities are each day. And, we have to furnish that information to the Federal Deposit Insurance Corporation; we furnish them a statement showing the amount of deposits each day, because it is on that basis that our premiums for deposit insurance are computed.

Senator KING. I suppose that upon a lot of such borrowed capital you would not make any money; that they have money of depositors in the banks on which they pay no interest to their customers; nevertheless they have a fiduciary relationship.

Mr. MYLANDER. That is correct, yes.

The CHAIRMAN. We thank you for your statement.

Mr. MYLANDER. Thank you.

The CHAIRMAN. The next witness is Mr. Byerly.

## STATEMENT OF F. P. BYERLY, NEW YORK, N. Y.

Mr. BYERLY. Mr. Chairman and gentlemen of the committee, my name is F. P. Byerly. I am a partner in the accounting firm of Price, Waterhouse & Co., certified public accountant of New York, Pennsylvania, Illinois, and other States; a member of the American Institute of Accountants and a number of State accounting societies; former chairman of the special committee on Federal taxation of the New York State Society of Certified Public Accountants, having served in that capacity for 2 years. I am here as representative of Price, Waterhouse & Co., and do not represent any of the State accounting societies or the American Institute of Accountants.

The suggestions I wish to offer are limited to certain ones that seem to me of prime importance following a perusal of the subcommittee report transmitted to your committee August 8, 1940. In the absence of a revenue bill no attempt will be made at this time to go into matters of detail or phraseology.

Both proposed alternative methods of computing the excess-profits credit for corporations are based upon earnings of the base period 1936 to 1939, inclusive, with which the earnings of the year 1940 and subsequent excess-profits tax years are to be compared. It seems obvious, therefore, that the bill should provide for computation of the earnings of the base period on the one hand, and of the taxable year on the other in such a manner that they shall be fairly comparable. The subcommittee report proposes to eliminate from the earnings of both the base period and of the taxable year any long-term capital gains or long-term capital losses, but there are in many cases a number of other extraordinary items of the sort commonly described as nonrecurring. Nonrecurring does not mean items of a nature that may never recur but items of major importance which do not recur annually or at longer intervals with some regularity.

Examples of such items as I refer to are:

1. Substantial gains or losses realized from sale or exchange of capital assets (including depreciable assets) that may have been held for not more than 18 months (the subcommittee report having already proposed to eliminate gains or losses with respect to items held for more than 18 months).

2. Losses on abandonment or destruction of property.

3. Taxable profit realized upon the purchase at a discount by a corporation of its own bonds or other outstanding evidences of indebtedness.

4. Deductible loss incurred upon purchase at a premium (or at an amount in excess of the principal amount less the related balance of unamortized discount at the time of purchase) by a corporation of its own bonds or other outstanding evidences of indebtedness.

Items such as those under 3 and 4 above are liable to be of substantial amount when a corporation carries out a refunding operation. Such extraordinary profits or losses, if any, realized by a corporation during the base period or the excess-profits taxable year I think should be eliminated in determining the excess-profits credit and the excess-profits income, but not for normal tax purposes.

The subcommittee report fails to provide for the determination of excess-profits taxes on the basis of consolidated accounts. The profits tax laws in effect for the years 1917–20, inclusive, made consolidated returns mandatory. The privilege of filing consolidated returns extended by later revenue acts was withdrawn by the Revenue Act of 1934.

The business of a considerable number of corporations is conducted on such a scale that it is often necessary or desirable, because of State laws, temporary exigencies of financing and sometimes for other special reasons, to have some of the departments, operations, or geographical divisions of the business conducted by subsidiary corporations. From the economic standpoint, however, the enterprise is a unit and the interest of the investing public is wholly or principally in the securities issued by the parent company.

Under an excess-profits tax law, whereby the tax is determined in part by reference to invested capital, artificial duplications of invested capital will exist to the injury of the revenue in a group of affiliated companies if the accounts are not made up on a consolidated basis. In consolidated accounts the investment of the parent company in the stock and securities of the subsidiary companies is eliminated, but in the absence of consolidation no such elimination occurs and the same net operating assets may be represented in the equity securities of two or more corporations, subsidiaries and parent. The provision in the subcommittee's report for an adjustment in respect to "inadmissible assets" would not serve to cure such duplication, since such adjustment is reduced by application of the ratio which the equity or invested capital bears to the total assets.

Furthermore, consolidated accounts are more equitable to the taxpayers in that the operating results of the whole enterprise, regardless of artificial corporate divisions, are combined in arriving at the amount of net income.

On the basis of consolidated accounts the ratio of income to invested capital is weighted average for all the separate corporations of the affiliated group and the artificial peaks and valleys that may exist in

such ratios for the separate corporate divisions are leveled off. Under the system of a separate return for each corporation, it would be quite possible for the effective tax rate on one enterprise to be more than 100 percent under a law which asserted a maximum nominal rate of only 40 percent.

Without consolidation ambiguities would often be encountered as to the status of intercompany open accounts. Questions would arise as to whether such accounts represented indebtedness or capital and how they should be treated in determining statutory invested capital.

Such complications might put taxpayers under temptation to rearrange their corporate structures and relationships so as to minimize duplication of taxes and thus might tend to retard progress in the direction of simplification of corporate structures.

Senator KING. I understand you regard the consolidated return as indispensable to a fair appraisement of the activities and successes or failures of the corporation, and therefore very desirable in any revenue legislation?

Mr. BYERLY. Yes; particularly when the rates become as high as profits taxes it is more important than on normal taxes.

The CHAIRMAN. We thank you.

Mr. BYERLY. Thank you.

SUPPLEMENTARY STATEMENT OF F. P. BYERLY, NEW YORK CITY, REPRESENTING PRICE, WATERHOUSE & CO.

Supplementing the brief statement which I made before your committee August 13, 1940, I wish to direct attention to the following related points which I did not specifically mention in that statement.

BASE PERIOD EARNINGS

In line with my recommendation that the bill should provide for the computation of earnings for the base period, on the one hand, and for the taxable year, on the other, in such a manner that they should be fairly comparable, provision should be made for the inclusion in earnings or losses of the taxpayer corporation for the base period of the earnings or losses of going businesses or companies which the taxpayer acquired by a transaction on which gain or loss was not recognized (under the income tax law in effect at the time) between the date of commencement of the base period and the date of commencement of the excess-profits taxable year. Lacking such a provision the income of the taxable year and of the base period would in many cases not be fairly comparable.

For cases where consolidated tax returns are permitted or required, it should be similarly provided that the base period earnings would include those of subsidiary companies acquired by the affiliated group during the above-mentioned interval between the commencement of the base period and the commencement of the excess-profits taxable year.

Consistent provisions should, of course, be included with respect to the determination of invested capital for the base period years where that factor is pertinent to the computation of the excess-profits credit.

INVESTED CAPITAL

The subcommittee report transmitted to the Ways and Means Committee August 8, 1940, concludes with a recommendation that earnings or profits should not include unrecognized gain or loss upon the sale or exchange of property. The tax law, commencing with the Revenue Act of 1936 (sec. 112 (b) (6)), has provided that under specified conditions the complete liquidation of a subsidiary company does not result in recognized gain or loss to the parent company. A parallel provision of the law stated that the basis of assets so acquired by a parent company should be the same as the basis to the subsidiary. The subcommittee report also recommends a general rule that assets be included at their income-tax basis in conformity with this sound principle. It should be made clear in the bill that this general rule applies to assets acquired by a parent company upon liquidation

of a subsidiary company under section 112 (b) (6) regardless of whether such liquidation resulted in an unrecognized gain or loss.

Corollary to this provision, the rule to be included in the bill with respect to the determination of undistributed earnings and profits for the purposes of invested capital should explicitly recognize the principle established by the Sansome decision (*Commissioner* v. *Frederick A. Sansome*, 60 Fed. (2d) 931 (C. C. A. 2d, 1932) certiorari denied) and consistently applied since that time in the administration of the income tax laws, viz, that earnings or profits should include the amount of the earnings or profits of a predecessor company acquired by a reorganization, merger, or liquidation which was a tax-free transaction effective for the year in which it occurred.

August 14, 1940.

The CHAIRMAN. The next witness is Mr. Connally. Please give your full name and address for the record.

## STATEMENT OF JOHN L. CONNALLY, SECRETARY AND GENERAL COUNSEL, MINNESOTA MINING & MANUFACTURING CO., ST. PAUL, MINN.

Mr. CONNALLY. Mr. Chairman and members of the committee: My name is John L. Connally. I am secretary and general counsel of the Minnesota Mining & Manufacturing Co., St. Paul, Minn., which is and has been for the past 30 years engaged exclusively in the manufacturer of coated abrasives, which is sandpaper, scotch adhesive tape, rubber cement, roofing granules, and other related products.

While Minnesota Mining & Manufacturing Co. has had certain contracts with the United States Government, none of them were subject to the limitations of the Vinson-Trammell Act. We are therefore in this discussion not dealing with the amortization provisions of the proposed excess-profits tax law. This discussion will deal only with the excess-profits tax provisions.

I have read the report of the subcommittee of the Committee on Ways and Means on the proposed excess-profits taxation of certain corporations. As I understand it, the report proposes the allowance of two alternative bases for credit against income before excess profits are subjected to tax. The first credit is, in substance, average earnings for a base period, which is the 4 years prior to the first excess-profits tax year. The second credit is inapplicable to our company for the reason that its average earnings for the base period were more than 10 percent of its invested capital for the same period.

The first credit, based on average earnings for the base period, is the credit applicable to our company. It is not, however, in our opinion comprehensive enough because it does not permit increasing the credit by the amount of earnings retained in the business, and therefore does not recognize expansion financed through the sale of stock, paid-in surplus, or other contributions to capital. The failure of the proposal to recognize as a part of the credit of a percentage of earnings retained and used for the purpose of expansion penalizes small companies which finance their growth out of reasonable undistributed earnings.

It is believed that the subcommittee's proposal respecting a 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 subcommittee's proposal 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 periods 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. This suggestion is based on the recognition that abnormal conditions may exist in a year or years in the base period, which should be recognized to avoid hardship.

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 year 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.

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 be best 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. 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.

If the subcommittee's proposals are 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 like companies.

The CHAIRMAN. Any questions? If not, we thank you.

Mr. CONNALLY. Thank you.

The CHAIRMAN. The next witness is Arthur S. Bowes, of Chicago. Will you give the reporter your full name, your address, and the capacity in which you appear.

## STATEMENT OF ARTHUR S. BOWES, REPRESENTING UNIVERSAL PRODUCTS CO., CHICAGO, ILL.

Mr. BOWES. Mr. Chairman, my name is Arthur S. Bowes, and I appear as an officer of a relatively small new company, the Universal Products Co., of Chicago.

The effect of the proposed law on us is probably similar to its effect on most of the other small new companies.

We do not and cannot make war materials. Consequently we are interested only in the excess-profits provisions. We are only 3 years old. Consequently, in establishing our base for excess profits we have no alternative. We must use the invested capital base, on which there is a ceiling of 10 percent. Actually, in our case, the base works out at between 8 and 9 percent of our invested capital. Because our capital is not large, the dollar figure is quite low.

Now that figure does not seem like enough when we see that the largest automobile manufacturer, using the 1936–39 earnings base, will be allowed 22.2 percent. It seems even more inadequate when compared with the 12 percent which one of the large soft-drink manufacturers will be allowed to use as his base.

Our largest competitor, using the 1936–39 earnings base, will be allowed 17 percent on his invested capital—about twice what we are allowed. That is in the face of the fact that one of the reasons why we started this business was that we felt that we would be able, through technical advancement in our way of making the product, and through the elimination of slow-moving items, to double that competitive return on invested capital.

We were to be able to do that by requiring less capital per dollar of sales. Our machines are several times as fast. Consequently our investment in machines could be lower. That speed also meant that we could carry lower inventories. We did not have to build up big stocks for the busy season. We could just put a few more machines to work.

Our capital was not so much in money as it was in a better idea for making the product, a lot of nerve, knowledge of the business, and a willingness to work hard. Those factors cannot be put into the balance sheet to arrive at a fairer base for excess profits but those are the factors that are putting our business over. This year we will make a nice profit. But that profit is not an excess profit. It is the result of several years of hard work. It is certainly independent of the proposed rearmament program. It is certainly a more normal profit than the meager earnings we were able to show during the first 3 years, when we were getting our business started.

But now we face this situation. If we are able to get the earnings of our little company up to only one-tenth of the base earnings of our largest competitor, the combined income and excess-profits taxes will take away about half of our earnings. Obviously that places us at a distinct disadvantage in competing with a big well-entrenched competitor, who, because he is so much older, has been able to show, during the base period, a high level of earnings which are exempt from excess-profits taxation.

Frankly, under these conditions, if the question of starting our business had come up today, instead of 3 years ago, the business now giving employment to 75 people, would probably never have been started. But the choice is more difficult now. We have started the business. We have severed our past profitable connections. Now, facing a law that severely taxes us, while protecting our big competitor, we cannot quite figure a course for the future.

It would seem as though, in the case of new companies like ours, what is meant to be an excess-profits tax becomes a very stiff tax on normal income.

A business like ours needs money for many purposes. Our investment in patents, for example, is virtually compulsory. The cost of

acquiring new patents and defending our old ones against competitors who would like to eliminate us by patent litigation, in itself abosrbs the greater part of our exempted profits under the proposed law.

Where do we get the money to see us through the next period of bad business? With what we believe to be an unfair application of the principle of this law, you make it difficult for us to earn and save a reserve fund.

We could not sell stock, even to our freinds, because this law would place obstacles in our path that would make the stock unattractive.

We could not borrow money. A small concern usually pays relatively high interest rates, and can borrow for relatively short periods of time. The additional excess profits exemption for borrowed funds is so low that we could not repay a loan in any reasonable time even if proceeds of that loan actually produced—before taxes—a nice return on the funds.

Similarly, if you make it so difficult for us to retain earnings or to borrow money, where will we get the funds or the incentive for making other items to complete our line? We have already spent money developing a few new products and the machinery for making them. Two of these items are now in a State where we should begin building the production machines. In the face of the competitive tax handicap and the risks involved in marketing any new product, is it wise to go ahead?

That type of question confronts not only us, but any other relatively new ambitious business. Similar questions may prevent the formation of many new businesses that might otherwise be started, become profitable, and pay taxes in the next few years. This law protects the big fellow.

The subcommittee has recognized that relatively new businesses are due some special consideration, but we do not believe that they have gone far enough in providing relief.

I do not pose as a tax authority. I believe that once the problem is pointed out to them the House committee, the Senate committee, and their experts can find the answer. Perhaps giving any new company the alternative of using the best of its first 4 or 5 years' profits as its excess-profits base, might give you a more equitable solution. But whatever the answer is, I hope that the bill will not take form until you have devised some means of giving the relatively small new concern an opportunity to compete with big well-entrenched competitors on an equitable basis.

Senator KING. Have you suggested any form of an amendment to the bill that would reach the small companies such as yours?

Mr. BOWES. No; I have not.

Senator KING. It seems to me there is very much merit in your position, and I would be glad to have you point out or suggest some amendment to the bill that would fully protect the small company and the new company, because obviously we need new companies even though they are small companies, because small companies sometimes emerge into much larger companies.

Mr. BOWES. I am entirely unfamiliar with things of this sort, but I will be glad to be helpful if I know how to be.

Mr. DISNEY. What do you manufacture?

Mr. BOWES. We manufacture paper drinking cups.

The CHAIRMAN. We thank you for your presence and the statement you have given to the committee.

e next witness is Mr. A. A. Miller, of Bridgeport, Conn.

Will you give the reporter your full name, your address, and the capacity in which you appear?

**STATEMENT OF A. A. MILLER, REPRESENTING MANNING, MAXWELL & MOORE, INC., CHRYSLER BUILDING, NEW YORK, N. Y.**

Mr. MILLER. Mr. Chairman, my name is A. Amasa Miller; my address is 1 Wall Street, New York, N. Y. I am representing Manning, Maxwell & Moore, Inc.

Mr. Chairman, I am here this afternoon speaking in behalf of Mr. R. R. Wason, president of Manning, Maxwell & Moore, Inc., who would have liked to have been here and spoken to you himself. But he is busy in producing goods and could not be here.

Manning, Maxwell & Moore produce heavy machinery of various sorts, such as cranes, hoists, and large safety valves for high-pressure marine boilers and other boilers, line gages, and things of that sort.

The principal problem that I would like to discuss, with your permission, is one that has already been discussed in general by several other witnesses.

I think our company presents a rather special instance of that problem.

In the middle of 1937, which came during the suggested base period for determining average earnings, this company, which has been in business during the entire base period itself, absorbed two wholly owned subsidiaries. That is not exactly the same as a company which purchases another independent company.

I think it is a special case, and for another reason, namely, that the parent company, which is the company existing, and which would have to pay the excess profits tax, was not the most profitable unit of the three companies.

The three companies were operated, as a practical matter, as a branch of one business. And the three companies did make a profit during the years in the base period, when Manning, Maxwell & Moore, which is the parent company, realized a loss on its own operations.

Obviously, it would be extremely unjust to this company to compel to use only its own earnings prior to the time it absorbed the subsidiary companies as a base for determining its average or normal earnings, now that it is running the entire business, including the business of the subsidiaries.

It has, in fact, absorbed all the assets of the business of the subsidiaries, the profits it will make this year and future years and on which its excess-profits tax will be based, will be the result of the operation of the entire properties, including the assets and business of the subsidiaries, but nevertheless during the base period there would be a year and a half, under the exact language of the report of the subcommittee, which says:

> In determining the portion of the corporate profits to be considered as "excessive" to which the tax will apply, your subcommittee recommends that in the case where the taxpayer corporation was in existence during the whole of the base period it be given an election of either of the following methods of securing the excess profits credit—

and then it says:

> It may take as a credit against its net income for the taxable year its average earnings for the base period.

Whatever question there may be about handling this as a general proposition, I do not think there is any question at all that there should be an appropriate provision of law which, to meet a situation like this could be a very simple one, to the effect that where the company has, during the base period absorbed its wholly owned subsidiaries, it should be permitted for the purpose of computing its average earnings during the base period to take in the earnings of those wholly owned subsidiaries prior to their absorption.

Mr. BUCK. You speak of absorbing the other companies.

Mr. MILLER. Yes, sir.

Mr. BUCK. Did the parent company buy the interest of the two subsidiaries, or did it buy the stock and take over all of the assets?

Mr. MILLER. It was technically a merger, and, prior to the absorption the parent company, which is still in existence, owned 100 percent of the stock of the subsidiary companies. What it did was to take over all of the assets of the subsidiary companies and the business and good will of those companies which had been previously conducted as branches of one business, anyway, and in return it delivered to those companies their stock for cancellation, and the subsidiary companies were absorbed and went out of business.

Mr. BUCK. There might be a slight difference in the treatment under the subcommittee's report, according to which method was used.

Mr. MILLER. That is true. What I would particularly like to emphasize and bring to the attention of the committee is the fact that although there may be difficult problems in connection with the handling of this general question, which several people have discussed, I do not think there is any difficulty in handling just the particular sort of case about which I do not believe there is any serious question. It should be taken care of in order to avoid an unjust result.

There is one other thing I would like to discuss very briefly. In our particular industry, and I think it will be found to be true almost unanimously of all other branches of the industry, the base period of 1936 to 1939 inclusive might give you a fair normal basis of earnings if you permitted a company to take its best year of the 4 years.

I do not believe you would find, as a practical matter, anybody in that business who would say that the average of those 4 years were normal earnings in any fair sense, even taking the best year. It is true of our company, and I think that is true of all other companies in that industry, so far as concerns what could fairly be called normal earnings, and I would seriously urge that serious consideration be given to that matter.

I do not have any concrete suggestion to make, because that would be very difficult to work out as a practical matter.

Mr. Chairman, I have here a letter by the president of Manning, Maxwell & Moore, addressed to the chairman of this committee and the chairman of the Finance Committee of the Senate, which, with your permission, I would like to file for the record.

The CHAIRMAN. Without objection, it is so ordered.

(The letter above referred to is as follows:)

MANNING, MAXWELL & MOORE, INC.,
*New York, August 12, 1940.*

Hon. PAT HARRISON,
*Chairman of the Finance Committee of the Senate.*
Hon. ROBERT L. DOUGHTON,
*Chairman of the Ways and Means Committee of the House of Representatives, Washington, D. C.*

DEAR SIRS: In connection with the consideration by your committees of the proposed excess-profits tax, we respectfully request that you give us an opportunity to be heard before your committees, through Mr. A. Amasa Miller of the firm of Littlefield, Abbott & Marshall, of New York City, our counsel, whom we have authorized to represent us for this purpose.

Our company, Manning, Maxwell & Moore, Inc., in July 1937 absorbed by merger all the business and assets of two other corporations, which prior to that time had been wholly owned subsidiaries, namely, Consolidated Asheroft Hancock Co. and Shaw Box Crane & Hoist Co.

In the act, as now proposed, as I understand it, the excess-profits tax credit is to be calculated on the basis of the average earnings and/or the average return on invested capital for the period from 1936 to 1939, both inclusive. During part of the period in question, a part of the present operations of this company was being carried on by the two subsidiaries, above named, and the major part of the profits consisted of profits earned by these companies.

Before, as well as after, the merger which took place in July 1937 the entire business of Manning, Maxwell & Moore, Inc., and the two subsidiaries was carried on as one business, the subsidiaries being 100-percent owned, and being managed by substantially the same officers and directors, and being in fact operating branches of one business.

The earnings, prior to the merger, of Manning, Maxwell & Moore, Inc., especially if, as is proposed, those earnings did not include dividends on stock of subsidiaries, would give an entirely unfair picture of the operations during 1936, and the first half of 1937, of the entire business. Since the excess-profits tax will be calculated on the earnings of the entire business, the earnings of the entire business during the base period should be used rather than the earnings of only a part of the business.

For these reasons it is respectfully urged that the committees give careful attention to the situation described above, and that appropriate provision be made in the draft of the act so that Manning, Maxwell & Moore, Inc., as well as any other corporation similarly situated in this respect, which during the period between 1936 and 1939 absorbed wholly owned subsidiaries, can use the earnings of such subsidiaries prior to their absorption as well as the earnings of the continuing parent corporation in calculating the average return on invested capital, or the average earnings, as the case may be, for the base period.

Yours very truly,

MANNING, MAXWELL & MOORE, INC.,
By ROBERT R. WASON, *President.*

Mr. CROWTHER. Mr. Chairman, I desire to offer for the record, on behalf of Representative F. J. Douglas, of New York, a telegram and letter.

The CHAIRMAN. Without objection, it is so ordered.

(The telegram and letter referred to are as follows:)

ROME, N. Y., *August 13, 1940.*

Representative F. J. DOUGLAS,
*House Office Building.*

Proposed excess-profits tax based on invested capital allowing exemption of 4 percent seriously inadequate because it does not allow a fair return on invested capital considering the risk involved in business enterprises and there is no guarantee against losses. An exemption of 8 percent should be allowed. Tax base on earnings in excess of pre-war years should allow taxpayer to use any 3 of the 4 years and loss years during 4-year period should be disregarded. Effective date of excess-profits tax should be September 1, 1940. Adequate deduction for amortization of the defense facilities should be allowed. As one of your constituents I respectfully request you show consideration to the above recommendation.

L. A. WIGGINS.

ROME CABLE CORPORATION,
*Rome, N. Y., August 12, 1940.*

Hon. F. J. DOUGLAS,
*House of Representatives, Washington, D. C.*

MY DEAR DOCTOR: I am enclosing herewith copy of letter I have today written to the Senate Finance Committee regarding the proposed excess-profits tax bill.

May I hope that you will use your influence to get certain modifications of this bill so that it will be more favorable to new companies?

With very warm regards,

Sincerely,

H. T. DYETT.

AUGUST 12, 1940.

SENATE FINANCE COMMITTEE,
*Washington, D. C.*

GENTLEMEN: I am taking the liberty of presenting to you my thought that the situation of the new industry has not been given, so far as I am aware, fair consideration in the proposed new excess-profits tax bill.

Our company was incorporated in January 1936.

| Fiscal year ending— | *Net earnings after taxes* |
|---|---|
| Mar. 31, 1937 | $1,616 |
| Mar. 31, 1938 | 71,026 |
| Mar. 31, 1939 | 243,960 |
| Mar. 31, 1940 | 239,736 |

It is our expectation that as our business develops, earnings should somewhat increase this year and future years above the latest year above reported. We have at the present time an investment in our business of approximately $2,400,000 in addition to which we are constant borrowers at the bank, present bank loans totaling $800,000.

It would manifestly be unfair to figure the average of the last 4 years earnings on a company that started 4 or 5 years ago. Should they not either be given the privilege of taking the last 1 or 2 year's earnings as a basis of computation, or, if the 4-year earnings are taken, would it not be possible to adopt a plan to weight the first year's earnings by multiplying by one, the second year period to be multiplied by two, the third year by three, and the fourth year by four? This would give a somewhat truer picture of present conditions.

I also hope that average bank borrowings may be taken into consideration and added to capital and surplus in figuring the invested capital. In the case of our business, we look for larger earnings this year and in future years, due to the growth of our business.

I think any company that had the courage to start a new business during this depression period should be given consideration and the fairest kind of treatment. New enterprise should not be discouraged but should be encouraged in every possible way.

I hope that this phase of your proposed tax measure will be carefully studied. Relief to new enterprise would not seriously affect the amount of taxes collected and would certainly encourage and stimulate small industries.

Respectfully,

ROME CABLE CORPORATION.

The CHAIRMAN. Without objection, the Chair offers for insertion in the record a letter from Mr. John E. Walker, attorney, of Washington, D. C.; and also a letter, accompanied by a statement, from Mr. Raymond Beebe, of the firm of Davies, Richberg, Beebe, Busick & Richardson, of Washington, D. C.

(The letters and statement above referred to are as follows:)

JOHN E. WALKER,
*Washington, D. C., August 13, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Ways and Means Committee,*
*House of Representatives, Washington, D. C.*

DEAR SIR: On behalf of Mack Trucks, Inc., Long Island City, N. Y., and its affiliated companies, I am directed to submit to your committee the attached memorandum showing the effect of applying section 45 of the Revenue Acts to certain of its subsidiary companies, as a result of the elimination of consolidated income-tax returns.

This group of companies has always been operated as a single entity and in fact the subsidiary companies are merely incorporated branches of the parent. The selling companies only sell the company products, and the service companies only service the company products, and, with the exception of the Mack Acceptance Corporation, all the profits or losses are reflected in the books of the International Motor Co. (the manufacturing company).

The only way the correct income of a group of companies that are in fact operated as a business unit can be reflected is through a consolidated return. If consolidated returns are not permitted with the enactment of an excess-profits tax, this group will be severely penalized by the application of section 45 of the Internal Revenue Code, and the group will never know what its ultimate tax liability is until the Commissioner has made his final tax determination for each year in question.

The Senate Finance Committee in 1918, in recommending that consolidated returns be permitted, declared:

"While 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."

For the aforesaid reasons, we urge the privilege of filing consolidated returns shall be allowed corporations for the purpose of determining income and excess-profits taxes, in the manner provided in section 141 of the Internal Revenue Code in the case of railroad corporations. Such a provision would permit the privilege of filing consolidated returns only to those affiliated groups which consent to all the Treasury regulations issued under the consolidated return section.

Respectfully submitted.

JOHN E. WALKER.

## MACK TRUCKS, INC.

### MEMORANDUM SHOWING THE EFFECT OF APPLYING SECTION 45 OF THE REVENUE ACT TO SUBSIDIARY COMPANIES, AS A RESULT OF THE ELIMINATION OF CONSOLIDATED INCOME-TAX RETURNS

#### ORGANIZATION

At December 31, 1934, Mack Trucks, Inc., and subsidiaries consisted of the following companies:

| | Organized | | Stock owned by parent |
|---|---|---|---|
| | State | Date | |
| | | | *Percent* |
| Mack Trucks, Inc. | New York | Nov. 11, 1916 | ---- |
| 1. International Motor Co. | Delaware | Oct. 13, 1911 | 99+ |
| 2. Mack Acceptance Corporation | New York | Mar. 27, 1925 | 100 |
| 3. International Brunswick Motor Co. | Delaware | Nov. 17, 1919 | 100 |
| 4. Mack Trucks Real Estate, Inc. | do | July 26, 1925 | 100 |
| 1. International Motor Co. owns: | | | |
| Mack Bros. Motor Car Co. | Pennsylvania | Jan. 2, 1905 | 100 |
| International Plainfield Motor Co. | New Jersey | Feb. 8, 1911 | 100 |
| Mack-International Motor Truck Corporation | New York | Dec. 29, 1915 | 100 |
| Mack Motor Truck Co. | Massachusetts | Jan. 20, 1910 | 100 |
| Mack Trucks of Canada, Ltd. | Canada | | 100 |
| Mack Trucks of Cuba | Cuba | | 100 |
| Mack Service Building Corporation | Illinois | Jan. 26, 1926 | 100 |
| 4. Mack Trucks Real Estate, Inc., owns: | | | |
| Mack Service Stations, Inc. | Massachusetts | July 9, 1925 | 100 |
| Do. | New York | July 13, 1925 | 100 |
| Do. | Florida | July 20, 1925 | 100 |
| Do. | Maryland | Dec. 31, 1925 | 100 |
| Do. | Wisconsin | Jan. 20, 1927 | 100 |
| Do. | New Jersey | Apr. 1, 1926 | 100 |
| Do. | Delaware | July 8, 1925 | 100 |
| Do. | Connecticut | Jan. 20, 1927 | 100 |

#### HISTORY

International Motor Co. was organized in 1911 and acquired all of the stock of Mack Bros. Motor Car Co., and International Plainfield Motor Co., both of which were manufacturing companies, and subsequently organized or acquired

the stocks of Mack-International Motor Truck Corporation, Mack Motor Truck Co., Mack Trucks of Canada, Mack Trucks of Cuba, all of which are selling companies and Mack Service Building Corporation, a real estate company.

On January 2, 1931 Mack Bros. Motor Car Co. ceased operations and became a real estate company, leasing its entire plant and property to International Motor Co. According to the lease the International Motor Co. was to maintain the property, pay all taxes and assessments and a rental equal to the depreciation on the plant at rates to be mutually agreed upon by the officers of the two corporations. This lease is still in effect.

The International Plainfield Motor Co. has, since its acquisition in 1911, sold its entire output at cost to the International Motor Co.

The Mack-International Motor Truck Corporation and Mack Motor Truck Co. are selling subsidiaries of the International Motor Co., operating on a nominal capital of $15,000 and $25,000, respectively. It has always been the policy of absorbing the book losses of these companies (they have never shown a profit) each year in the operations of the International Motor Co.

The Canadian and Cuban companies are operated as selling subsidiaries in accordance with the laws of their respective countries, and their operations are not considered in connection with income taxes in this country.

The Mack Service Building Corporation owns our Chicago service station. This company was acquired by us in June 1934. This company leased a building in Chicago to the Mack-International Motor Truck Corporation for use as a service station.

Mack Trucks, Inc., was organized in 1916 and acquired all of the stock of International Motor Co. It is a holding company only and finances operations of International Motor Co.

International-Brunswick Motor Co. was organized in 1919 and acquired all of the physical property of the Wright-Martin Aircraft Corporation, at New Brunswick, N. J. On January 3, 1920, this company entered into a lease with the International Motor Co. for this New Brunswick property. According to the lease the International Motor Co. was to maintain the property, pay all taxes and assessments, and a rental equal to the depreciation on the plant at rates to be mutually agreed upon by the officers of the two corporations. This lease is still in effect.

Mack Acceptance Corporation was organized in 1925 to act as a collection agency for installment paper received by International Motor Co. in payment for its sales. The Acceptance Corporation received a portion of the interest collected for its services.

Mack Trucks Real Estate, Inc., was organized in 1925 as a holding company for all of the stocks of the various Mack Service Stations, Inc.

Mack Service Stations, Inc., built service stations in the various States and leased these stations to the selling subsidiaries of the International Motor Co. This rental was a guaranteed 10 percent net return per annum on the cost of the building and real estate (guaranteed by Mack Trucks, Inc.). These leases were deposited with Mack Trucks Real Estate, Inc., for moneys advanced to buy and build these service stations. Mack Trucks Real Estate, Inc., issued to the public 6-percent gold notes backed by these leases to secure the money for such financing. All of these gold notes had been called and redeemed prior to 1934; there being no further need of these large rentals, the International subsidiaries maintained the properties, paid all taxes and assessments, and a rental equal to the depreciation on the buildings at rates mutually agreed upon by the officers of the two corporations. The original leases were not formally canceled.

TAX SETTLEMENT—1934

In the year 1934 the Internal Revenue Department under section 45 took exception to our method of paying rent to the Mack Service Stations, although we had stopped paying or accruing rents in accordance with the leases mentioned above in December 31, 1933. The first assessment made against us reinstated the rentals according to the leases mentioned above, but was finally settled on the basis of an arbitrary income based on the book value of the property.

TAX SETTLEMENT—1935

In this year 1935 the Internal Revenue Department, under authority of section 45 not only adjusted Mack Service Stations rents according to the formula established for 1934 (although some of the companies had been dissolved or were in process of dissolution) but also reallocated profits to the selling subsidiaries Mack-International Motor Truck Corporation and Mack Motor Truck Co. This

allocation was arbitrary in that it had the effect of divorcing all new unit sales from our branches and leaving them with nothing but a straight service business. It also had the effect of establishing a profit in these companies at the expense of increasing the loss in the parent company—International Motor Co.

TAX SETTLEMENT—1936 AND 1937

The same comments for 1935 apply to the years 1936 and 1937.

EFFECT

The general effect of these readjustments of taxable income is to increase the income of companies having either none or a nominal capital stock value, thus increasing the excess-profits taxes, but the profits established by the Internal Revenue could never be declared as dividends, thus rendering these companies subject to severe surtaxes, at the same time reducing taxes in the parent company where the directors and officers had provided management to keep income in the low brackets.

The years 1934 and 1935 were examined by one field auditor of the Internal Revenue Department who questioned the intercompany leases. The years 1936 and 1937 were examined by another field auditor who threw out the working arrangement that had been in effect for over 20 years between the parent company and its selling subsidiaries, but who did not question the leases that had been questioned by his predecessor.

This group of companies, while having numerous corporate entities, was really only one company with incorporated departments. The selling companies sold nothing but the products of the manufacturing companies and the real estate companies owned and leased only the manufacturing and servicing facilities of the rest of the group.

It is also contended that legislation cannot produce a profit where profit sold not exist. In 1934 the group as a whole had a consolidated loss of $842,863.45 and paid taxes on a profit of $200,918.79. In 1935 the group as a whole had a consolidated loss of $535,859.96 and yet paid taxes on a profit of $194,827.28. In 1936 and 1937 the increases in consolidated income of the group is caused primarily by adjustment of depreciation rates, but by redistribution of income the taxpayer was penalized by a much greater tax bill than had been anticipated.

It must be borne in mind that all of the intercompany arrangements that were questioned had been in effect many years before the 1934 law became effective and were not set up at that time in order to effect a lower tax assessment.

EXHIBIT A.—1934 TAXABLE INCOME

| | Taxable income | |
|---|---|---|
| | As reported | As determined |
| Mack Trucks, Inc. | $4,678.73 | $4,678.73 |
| Mack Acceptance Corporation | 112,632.20 | 112,632.20 |
| International Brunswick Motor Co. | | 10,819.23 |
| International Motor Co. | *958,411.87* | *1,097,863.61* |
| Mack Bros. Motor Car Co. | | |
| International Plainfield Motor Co. | | |
| Mack International Motor Truck Corporation | | |
| Mack Motor Truck Co. | | |
| Mack Service Bldg. Corporation | 2,009.10 | 2,009.10 |
| Mack Trucks Real Estate, Inc. | 7,156.91 | 7,156.91 |
| Mack Service Stations, Inc.: | | |
| Massachusetts | 24.60 | 50,569.49 |
| New York | 46.68 | 46.68 |
| Maryland | 158.16 | 11,292.53 |
| Wisconsin | 7.95 | 1,062.47 |
| New Jersey | 61.35 | 2,540.35 |
| Delaware | 9.16 | 1,728.99 |
| Connecticut | 30.44 | 1,036.84 |
| Consolidated income | *842,863.45* | *842,863.45* |
| Taxable income | 122,126.55 | 200,918.79 |
| Losses | *964,990.00* | *1,043,782.24* |

NOTE.—Italic indicates red figures.

EXHIBIT B.—1935 TAXABLE INCOME

| | Taxable income | |
|---|---|---|
| | As reported | As determined |
| Mack Trucks, Inc. | *$10,088.34* | *$10,088.34* |
| Mack Acceptance Corporation | 32,532.05 | 32,532.05 |
| International Brunswick Motor Co. | | |
| International Motor Co. | *557,048.13* | *720,473.83* |
| Mack Bros. Motor Car Co. | | |
| International Plainfield Motor Co. | | |
| Mack-International Motor Truck Corporation | | 55,757.45 |
| Mack Motor Truck Co. | | 51,256.13 |
| Mack Service Bldg. Corporation | *1,317.96* | 19,181.58 |
| Mack Trucks Real Estate, Inc. | *188.09* | *188.09* |
| Mack Service Stations, Inc.: | | |
| Massachusetts | | |
| New York | 24.60 | 24.60 |
| Florida | 46.68 | 46.68 |
| Maryland | 111.16 | 6,028.78 |
| Wisconsin | | |
| New Jersey | | |
| Delaware | | |
| Connecticut | | |
| Consolidated income | *555,859.96* | *555,859.96* |
| Taxable income | 32,714.49 | 194,827.28 |
| Losses | *568,574.45* | *730,687.24* |

NOTE.—Italic indicates red figures.

EXHIBIT C.—1936 TAXABLE INCOME

| | | |
|---|---|---|
| Mack Trucks, Inc. | $1,331,177.56 | $1,331,177.56 |
| Mack Acceptance Corporation | 45,980.78 | 45,980.78 |
| International Brunswick Motor Co. | | |
| International Motor Co. | 857,458.81 | 632,868.24 |
| Mack Bros. Motor Car Co. | | |
| International Plainfield Motor Co. | 5,450.86 | 39,275.39 |
| Mack International Motor Truck Corporation | | 260,541.91 |
| Mack Motor Truck Co. | | 72,503.67 |
| Mack Service Bldg. Corporation | | |
| Mack Trucks Real Estate | *1,015.98* | *1,015.98* |
| Mack Service Stations, Inc.: | | |
| Massachusetts | | |
| New York | 22.55 | 22.55 |
| Florida | 42.79 | 42.79 |
| Maryland | 67.98 | 67.98 |
| Wisconsin | | |
| New Jersey | | |
| Delaware | | |
| Connecticut | | |
| Consolidated income | 2,269,155.41 | 2,381,464.95 |
| Taxable income | 2,270,201.33 | 2,382,480.87 |
| Losses | *1,015.98* | *1,015.98* |

NOTE.—Italic indicates red figures.

EXHIBIT D.—1937 TAXABLE INCOME

| | | |
|---|---|---|
| Mack Trucks, Inc. | $1,512,698.50 | $1,512,698.50 |
| Mack Acceptance Corporation | 17,574.83 | 17,574.83 |
| International-Brunswick Motor Co. | 0 | 0 |
| International Motor Co. | 1,010,405.67 | 1,013,322.13 |
| Mack Bros. Motor Car Co. | 0 | 0 |
| International Plainfield Motor Co. | 71,901.64 | 104,253.82 |
| Mack-International Motor Truck Corporation | 0 | 65,901.08 |
| Mack Motor Truck Co. | 0 | 13,712.83 |
| Mack Service Building Corporation | 1,021.68 | 1,021.68 |
| Consolidated income | 2,613,602.32 | 2,728,484.92 |

DAVIES, RICHBERG, BEEBE, BUSICK & RICHARDSON,
*Washington, D. C., August 15, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Committee on Ways and Means,*
*House of Representatives, Washington, D. C.*

SIR: Our client, Universal Pictures Co., Inc., has forwarded to us the enclosed statement relative to the "proposed excess-profits taxation and special amortiza-

tion," with the request that it be presented to your committee to be made a part of the current hearings on this subject.

We respectfully request that the enclosed statement be made a part of the record of the hearings now being conducted on the above subject.

Respectfully,

DAVIES, RICHBERG, BEEBE, BUSICK & RICHARDSON,
By RAYMOND N. BEEBE.

PROPOSED EXCESS-PROFITS TAX IN RELATION TO UNIVERSAL PICTURES CO., INC.

In a national emergency of the kind now confronting this country, every true American should willingly assume his share of any burdens which fall on its citizens. National defense is obviously of vital importance today and we must appreciate that the cost involved will be staggering. Universal Pictures Co., Inc., is desirous of doing its share. The bill as now proposed, however, might very well ruin this company, which has no possible connection with defense activities.

The Congress of the United States is currently studying a so-called excess-profits tax and is hopeful of agreeing on a bill which will be fair to all corporations and their security holders. People are questioning the apparent haste which is being pursued on this vital measure; however, that still seems to be the present intent of Congress. Even though this haste is continued, the company is confident that Congress will want to enact a just and proper bill which will equitably distribute the excess-profits tax burden upon those receiving some benefit from the current situation and certainly not penalizing those companies which cannot possibly receive any share of such benefits.

The very nature of an excess profits tax is an attempt to place a tax on abnormal profits arising from Government and defense contracts; in simple words, to take the profit out of war. While the aim is clear, great care must be exercised to avert an unjust burden falling on companies which do not participate in such profits or on those who are actually hampered by the existing conditions.

One of the industries which has been seriously damaged by the war and cannot possibly profit therefrom is the production and distribution of motion pictures, which relies on world-wide markets to be able to make a small percentage of profit on its turn-over, averaging less than 8 percent. Since the commencement of the war, the foreign markets have been disappearing one after the other, foreign currencies have depreciated extensively, many countries have placed embargoes on the export of currency and domestic costs have been rising. As a result, the picture is very uncertain, both from the point of view of reasonable profits and from the point of view of securing sufficient dollars to operate the business and continue the employment of the vast numbers currently employed in the industry. The figures for last year show that approximately 35 percent of the gross revenues of such companies were derived from sources outside of the United States, a great part of which has already been eliminated.

The proposed tax, if enacted without certain modification, will place a completely unjustifiable and unbearable burden upon Universal Pictures. The company is certain that the Congress of the United States has no desire to so unjustly discriminate against it and the other companies in the country similarly situated, of which there are a large number.

The production and distribution of motion pictures is primarily a creative industry. Its assets are composed primarily of manpower, the value of which is impossible to appraise. Investment in plants and inventories is comparatively small in relation to the gross business. However, a huge investment of dollars must be made in each important picture which is manufactured, of which there must be a great many each year.

For a good many years this company has operated at a loss. Operations of the company and its subsidiaries (including foreign subsidiaries), as reported by Price, Waterhouse & Co., for the last 8 years were as follows:

| Year | Profit | Loss | Year | Profit | Loss |
|---|---|---|---|---|---|
| 1932 | | $1,250,283 | 1936 | | $1,835,419 |
| 1933 | | 1,016,893 | 1937 | | 1,084,999 |
| 1934 | $273,068 | | 1938 | | 591,178 |
| 1935 | | 677,155 | 1939 | $1,153,321 | |

Such losses used up the working capital of the company and compelled it to resort to extensive borrowings to continue in business and keep its thousands employed. For obvious reasons, the only credit available was short-term credits

and this was available only because the lenders felt that by certain changes in operations and management the company would again be placed on a profitable basis. Such changes were made, and credits obtained. The results of such changes are just beginning to show—too late, however, to be used in the compilations proposed by the new bill. At the end of its fiscal year in 1939, the company had so-called current obligations amounting to approximately $7,015,000, and there had accrued $1,012,293 of unpaid dividends on its first preferred stock and $1,796,667 of unpaid dividends on its second preferred stock.

It was anticipated that as profits were realized they would be available for the retirement of the debt previously incurred and for replenishment of its working capital, and in due course be available to care for the accumulated dividends owed to its preferred-stock holders. The company, a short time ago, created a mortgage on its studio and equipment which requires an amortization payment of $312,000 a year. It also has a revolving credit with certain banks, secured by a lien on motion pictures, amounting at the present time to $1,140,000 (which amount may need to be increased in the immediate future), which matures within 14 months. These obligations must be met.

In applying the proposed excess profits tax to its situation, the company is confronted with wholly unexpected and unjustifiable difficulties. Assuming that the business and profits of the company were to continue at the same level as in its last fiscal year (at which time there could be no profits as a result of defense activities), it would be required to pay, under the present income tax law and the proposed excess-profits tax bill, the sum of $462,600, or 40.2 percent of the total profits of the company. This, with other taxes payable, comes close to confiscation. The balance remaining would be insufficient to meet its obligations contracted prior to the proposed act, and it is highly questionable whether the company would have sufficient dollars available to it to carry on its business. As operations come closer to a normal volume, such percentage would become increasingly more onerous. The result to the company is not a great deal unlike the results of the former undistributed profits tax. The company does not believe that this is the intent or desire of Congress.

This is in contrast to those companies which have had 4 years of normal operations and profits or whose business requires a large investment in bricks, mortar, and machinery, who would only have to pay the current tax of 20.9 percent based on a continuation of their 1939 rate of earnings.

Application of the tax as proposed would have a disastrous effect on the ability of the company, or any other companies in a similar position, to obtain banking credits. It will make it impossible to replenish its working capital and, of course, to pay any returns to its stockholders.

Universal Pictures does not expect nor want to avoid its proper share of any tax burden. It does not object to the rates proposed to be established, so long as the basis for such a tax will treat all companies equitably. It is apparent, however, that many companies, including Universal Pictures, will, under the proposed legislation, be seriously discriminated against.

It is obviously unfair to compel a company which has turned the corner in the last year of the 4 years in question to use its results during such 4-year period (during part of which it sustained losses) as a basis for taxing earnings, predicated on a theory of unjust enrichment which could never happen to the company in question.

It is obvious from the foregoing that some modifications of the proposed excess-profits tax bill are imperative. It is suggested that consideration be given to the following:

(1) A corporation should be permitted to select any one or more of the 4 years in question to be used as a basis for determining the earnings base of such corporation.

(2) A corporation which is in no manner benefited by defense activities should be allowed a refund or credit to the extent of 33⅓ percent of such excess-profits tax.

(3) Whatever rate is established as a fair rate to be allowed on invested capital should apply to both old and new invested capital. There is ample precedent to establish that a reasonable and fair rate would be 8 percent. Allowance should also be made where there has been an impairment of capital.

The CHAIRMAN. That completes the list of witnesses to be called this afternoon, and the committee will adjourn until 10 o'clock tomorrow morning.

(Thereupon, at 4:45 o'clock p. m., the committee adjourned to meet tomorrow, Wednesday, August 14, 1940, at 10 o'clock a. m.

# EXCESS PROFITS TAXATION, 1940

AUGUST 14, 1940

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, D. C.*

The committee met at 10 a. m., Hon. Robert L. Doughton (chairman) presiding.

The CHAIRMAN. The committee will be in order.

The first witness this morning is Mr. W. H. Ogg, director of the American Farm Bureau Federation, Washington.

(Mr. Ogg did not come forward.)

The CHAIRMAN. The next witness is Mr. Alger B. Chapman, representing the Controllers Institute, New York City.

Mr. Chapman, give your name and address, and state whom you represent, for the record.

## STATEMENT OF ALGER B. CHAPMAN, 40 WALL STREET, NEW YORK CITY, REPRESENTING CONTROLLERS INSTITUTE

Mr. CHAPMAN. Mr. Chairman, on behalf of the Controllers Institute, I ask to submit a brief and merely summarize the institute's recommendations at this time.

Briefly, the modifications which the institute recommend in the subcommittee's proposal are as follows:

(1) An exemption of at least 8 percent should be allowed in order to permit a fair return on invested capital. The propriety of at least an 8-percent return was recognized in the earlier excess-profits laws, and in the subcommittee's proposal in the case of new corporations. The age of the corporation should not determine the rate of normal return.

(2) For the purpose of the tax based on earnings in excess of those for a prior representative period the taxpayer should be permitted, at his election, either to use any 3 of the 4 years 1936 to 1939 or to exclude loss years during the period.

Base-period earnings is certainly the more practicable method of determining the excess-profits credit. A modification of this type is more apt to reflect normal earnings, considering the shortness of the base period and its proximity to the depression.

(3) A more adequate relief provision in the form of special assessment should be incorporated in the law. This provision is to take care of the unanticipated cases and, consequently, the relief should be general and left to the discretion of the Commissioner, or some administrative body. Each abnormal case cannot be taken care of in the statute separately.



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(4) Foreign income and excess-profits taxes should be allowed as credits against the aggregate United States normal and excess-profits taxes and not against the normal tax alone. This is necessary in order to avoid more than a 100 percent tax where the corporation uses the base earnings method rather than the invested capital method.

(5) Borrowed capital should be included in invested capital in full.

(6) Stocks of other domestic 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. Apparently the reason for excluding stock is that the dividends are excluded from income.

(7) Consolidated returns should be allowed for both income and excess-profits-tax purposes. The sentiment is overwhelmingly in favor of such a measure and difficulties in drafting have apparently been offered as the only real objection. These difficulties can be taken care of if the permissive method of the 1928 and subsequent acts is employed.

(8) A deficiency in earnings should be applied for excess-profits-tax purposes against earnings for subsequent years. This principle has been recognized in the Vinson Act.

(9) The losses for the first year or two after the emergency period should be applied against the earnings during the period the excess-profits tax is in effect. This policy was recognized in the 1918 act, and

(10) Losses after the emergency period due to drop in value of inventory held at end of such period should be offset against income for the prior period. This policy was also recognized in the 1918 act.

The brief submitted herewith on behalf of the institute presents in more detail the reasons why the institute feels that the above modifications are desirable and therefore urges their adoption by this committee.

I ask permission to file this statement as part of the record of the hearings.

The CHAIRMAN. Without objection, the statement may be made a part of the record.

(The statement referred to is as follows:)

STATEMENT OF CONTROLLERS INSTITUTE OF AMERICA

[Presented to the Committee on Ways and Means of the House of Representatives, at hearings on the excess profits-tax bill, August 14, 1940]

The Controllers Institute of America appreciates this opportunity for the presentation of its views relating to the excess-profits-tax law proposed by the subcommittee of the Ways and Means Committee of the House of Representatives. The comments contained herein are based on a hurried review of the subcommittee report which was not available until Friday of last week.

The members of the institute in their capacity as accounting officials of all sizes and kinds of business enterprises all over the country have been closely associated with the workings of the 1917, 1918, and 1921 excess-profits and war-profits tax laws and also of our income and other tax laws. These experiences have been drawn upon in making the suggestions which follow.

At the outset, the institute wishes to make it clear that it agrees 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 is also in sympathy with the announced policy of Congress of preventing excessive profits on business arising out of the defense program.

The subject of an excess-profits-tax law is so important from the standpoint of the defense program and the well-being of the country that it should be carefully

considered by Congress before enactment even though this would mean some delay in its adoption. A hastily devised excess-profits tax is likely to result in very serious repercussions, financial, social, and economic. Ample consideration is most essential in order to avoid the economic disturbances which resulted from the inequities in the old excess-profits-tax laws and the difficulties experienced in the administration of these laws. 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 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 pe enacted until Congress has had sufficient time to make the careful study which this important legislation should have.

In considering a workable excess-profits-tax law under present conditions, the following changes in the situation since the last war should not be overlooked:

In the first place, the corporation-income-tax rates in 1917, 1918, and 1921 were 6, 12, and 10 percent, respectively. Under the Revenue Act of 1940, this tax is 20.9 percent. In other words, over one-fifth of corporate income is turned over to the Government through the Federal income tax alone. During the last war, corporations were not subject to unemployment and social security taxes which they now have to pay. In addition, many of our States now impose heavy taxes on income.

In the second place, the business situation today differs materially from that during the last war. Then, industry was operating at capacity. At present, unemployment is very large and few industries are operating at a satisfactory level. Capital funds are idle because the investor is hesitant to assume business risks where only a small rate of return is indicated. We are convinced that a heavy excess-profits tax unless discriminately imposed would tend to reduce business activity, employment, and investment.

The institute is in accord with the principle that the excess-profits tax shall be the lesser of (1) a tax computed on the excess of earnings over the average of the earnings for a representative prior period, or (2) a tax on earnings in excess of a fair return on invested capital. The institute is not in accord, however, with some important provisions of the excess-profits-tax bill as proposed, and it is of the firm conviction that modifications are required in order to impose the excess-profits tax on a sound basis and without too great discrimination among taxpayers.

The revisions and additions which the institute recommends in the subcommittee's proposals are as follows:

(1) For the purpose of the tax based on invested capital, a minimum exemption of 6 percent on the first $500,000 of invested capital and 4 percent on invested capital beyond that amount is seriously inadequate. An exemption of at least 8 percent should be allowed in order to allow a fair return on invested capital.

(2) For the purpose of the tax based on earnings in excess of those for a prior representative period, the taxpayer should be permitted, at his election, either to use any 3 of the 4 years 1936 to 1939, inclusive, or to exclude loss years during the period.

(3) An adequate relief provision in the form of special assessment should be incorporated in the law.

(4) Foreign income and excess-profits taxes should be allowed as credits against the aggregate United States normal and excess-profits taxes and not against the normal tax alone.

(5) Borrowed capital should be included in invested capital in full.

(6) Stocks of other domestic corporations should not be included among inadmissible assets if no dividends are received thereon during the taxable year or if the taxpyer elects to treat the dividends as income subject to excess-profits tax.

(7) Consolidated returns should be allowed for both income and excess-profits tax purposes.

(8) The deficiency of earnings (the excess of the excess-profits-tax exemption over the earnings) should be applied for excess-profits tax purposes against earnings for subsequent years.

(9) The losses for the first year or two after the emergency period should be applied against the earnings during the period the excess-profits tax is in effect.

(10) Losses after the emergency period due to drop in value of inventory held at end of such period should be offset against income for the prior period.

### I. RATES OF EXEMPTION BASED ON INVESTED CAPITAL

The subcommittee proposes that in the computation of the tax based on invested capital, the minimum exemption allowed in addition to $5,000 shall be 6 percent on the first $500,000 of invested capital and 4 percent on invested capital beyond that amount.

This exemption is not sufficient to permit a fair return on invested capital. Surely, an expected return of only 4 or even 6 percent would be inadequate to justify risking capital in a business venture. Even the interest rate on much of corporate indebtedness today is more than 4 percent.

It is the opinion of the institute that a corporation should be permitted at least an 8-percent return on its invested capital and the institute recommends such a minimum exemption from the excess-profits tax.

It is understood that under the subcommittee's proposals there would be exempt from excess-profits tax in case of new companies earnings of 10 percent on the first $500,000 of invested capital and 8 percent on the balance. There would seem to be no justification for making the exemption less in the case of old companies.

It must be remembered that even on normal profits the corporation will be taxed at the rate of 20.9 percent as compared to the 6, 12, and 10 percent normal tax rates prevailing in 1917, 1918, and 1921, respectively. In the opinion of the institute, corporations not earning more than 8 percent on their invested capital should not be called upon to pay a tax of more than 20.9 percent on such earnings. An additional tax on any part of such earnings at excess-profits-tax rates of 25, 30, and 40 percent is in conflict with the ability to pay principal and further reduces the inadequate return on the corporation's capital.

### II. 1936–39 EARNINGS

It is assumed that the purpose of the subcommittee in exempting earnings up to the average for the years 1936 to 1939, inclusive, was to free from excess-profits tax what might be considered normal earnings.

In 1936, we were only emerging from a long depression and for many industries earnings for the period 1936 to 1939, inclusive, was on the average far below normal. This is especially true of the railroads, construction, aviation, and heavy-goods industries. As a matter of fact, many industries sustained losses during one or more of the years in this period.

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 1936–1939 as a yardstick, the taxpayer be permitted, at his election, to use any 3 of these 4 years or to exclude loss years within this period.

### III. SPECIAL ASSESSMENT

In spite of the fact that the subcommittee is proposing 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 1936–1939 period and in invested capital. 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.

### IV. CREDIT FOR FOREIGN INCOME AND EXCESS-PROFITS TAXES

The institute recommends that foreign income and excess-profits taxes shall be allowed as credits against the aggregate United States normal income and excess-profits taxes. Otherwise, some corporations might be called upon to pay in United States and foreign income and excess-profits taxes more than 100 percent of their income.

Where the invested capital method of computing the excess-profits credit is used, dividends from foreign corporations are not, under the subcommittee's proposal, subject to excess-profits tax. There is no specific exemption of dividends from this tax, however, where the average earnings method is used. The same is true with respect to income from foreign branches.

Therefore, we urge the allowance of a credit for foreign income and excess-profits taxes in those cases in which the foreign income is subjected to excess-profits tax here—as in the two cases mentioned above.

### V. BORROWED CAPITAL

The institute urges that a corporation should be permitted to include borrowed capital in invested capital in full. There is no apparent justification for any limitation.

In case of some corporations, a large part of their capital is obtained from bonds and other borrowed funds while other corporations rely entirely or for the most part on stock issues. In case of many corporations, borrowing is not a matter of choice but is unavoidable due to their inability to sell additional shares. The inclusion of only part of borrowed capital in invested capital discriminates against the corporation which has to borrow.

Although the institute is of the opinion that there should be no limitation on the inclusion of borrowed capital, it is submitted that its inclusion should be optional with the corporation. To the extent borrowed capital is included in invested capital, the subcommittee report quite appropriately provides that the interest on such borrowed capital will be added back to income for excess-profits tax purposes. Many corporations, especially the weaker ones, still pay more than 5 percent interest on their indebtedness. With the minimum 4 percent and 6 percent exemption on invested capital proposed by the subcommittee, the corporation which is required to pay higher interest rates on its indebtedness may be penalized by the inclusion of borrowed capital in invested capital. Accordingly, unless the rates of exemption proposed by the subcommittee are increased as recommended in point I above, the inclusion of borrowed capital in invested capital should be made optional and not mandatory. Otherwise, the provision which it was understood was intended to give relief to the corporation which must borrow may actually penalize such a corporation.

### VI. INADMISSIBLE ASSETS

The purpose of the deduction for inadmissible assets in the old excess-profits tax laws was to eliminate invested capital to the extent it was used for assets, the income from which was not subject to excess-profits tax. However, it worked out inequitably in many cases because the Commissioner held that in computing the deduction for inadmissible assets, all the inadmissible assets must be deducted even those which yielded no income during the year. This resulted in a departure from the ability-to-pay principle in case of companies with a large part of their capital invested in stocks which did not yield any income during the year.

It is recommended, therefore, that stocks of other domestic 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.

### VII. 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 cannot be properly or equitably determined except on the consolidated-return basis.

The abolition (except in case of railroads) in 1934 of the provision for consolidated returns which had been in our revenue acts since 1918 (and for excess-profits-tax purposes since 1917) was a retrogressive step. In 1939, the consolidated return privilege was restored to pan-American trading corporations. The reason these two groups of corporations were excepted was that under the laws of the States or foreign countries in which they do business the maintenance of subsidiaries, instead of operating in the name of the parent company, is unavoidable.

This is indeed a justifiable ground for permitting consolidated returns but the institute wishes to emphasize that nearly all of the subsidiary corporations in existence today are maintained because of either governmental or business requirements. Two obvious examples are public-service companies which are compelled to operate through subsidiaries under various State laws and American companies conducting a part of their business in foreign countries which find it impossible or almost impossible to comply with the governmental requirements of these countries except by maintaining separate subsidiaries for this business.

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 wherever it was practicable to do so. The institute believes that generally where the subsidiary has been retained its dissolution has been found impracticable either because of 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 return has complicated the preparations 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.

Accordingly, the institute recommends that consolidated returns be permitted for both income and excess-profits tax purposes.

### VIII. CARRY-OVER OF DEFICIENCY IN EARNINGS

If a heavy excess-profits tax is to be imposed, its determination on an annual basis is clearly unjustifiable even if an adequate 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 earnings for subsequent years. This principle was recognized by Congress in the determination of tax under the Vinson-Trammell Act, with respect to aircraft.

### IX. 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 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.

### X. 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 resulting 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.

Respectfully submitted,

CONTROLLERS INSTITUTE OF AMERICA.

The CHAIRMAN. The next witness is Mr. Prew Savoy, representing the Auto-Ordnance Corporation of New York.

## STATEMENT OF PREW SAVOY, REPRESENTING THE AUTO-ORDNANCE CORPORATION OF NEW YORK

Mr. SAVOY. Mr. Chairman and members of the committee, I represent, as one of its attorneys, Auto-Ordnance Corporation of New York. This corporation, in 1919, began the production of a machine gun for war and emergency purposes. It expected during the period of development, that is from the last war to the next emergency, to have annual operating deficits and to make up its patent and development costs when the next national emergency or war arose.

From 1919 through 1939 the corporation has had an annual deficit in every year. While writing off its patents it had no tax benefit except a small amount in 3 years, for the reason that operating deficits existed in all but 3 years, exclusive of patent write-offs.

During that period this corporation developed an efficient machine gun essential to our Army, particularly the mechanized units and air forces, and in this respect their expectations have been fulfilled.

Thus, while organized prior to the emergency, the corporation has nonetheless been engaged in developing an article expressly for the present emergency, just as much as a corporation organized today to produce and sell an article needed in this emergency.

Because of its history, the present proposals for a credit based on invested capital or average profits leave that company, and any like company, in a very unfair position. Unless recognition is given to the peculiar situation this company can never recover its patent or development expenses.

As it has had a deficit in every single year since 1919 it cannot use average profits in the base period. There were no profits.

Its equity invested capital, being the patents acquired, will be wiped out by the accumulated deficit. Its only invested capital will be borrowed capital.

This company cannot benefit from any special assessment, because other companies developing implements of war during peacetimes manufactured other articles in addition from which profits were derived.

The only treatment which would give this company fair and equal treatment would be to allow it to capitalize patent and development expense and to allow the deduction thereof, to the extent that no tax benefit was previously derived from the writing off of patents, over a 60-month period, in the same manner as is proposed for new equipment and facilities.

In view of the purpose for which this company was organized and of its history, there is no real difference between this corporation, which voluntarily, over a period of years, developed a gun to meet the present emergency, and a corporation which voluntarily only now enlarges its plant for the same purpose. The same equities are present.

I would like to suggest two possible methods of meeting this and other similar situations.

On Monday there was testimony to the effect that, as to new plants and facilities established to meet conditions of emergency or war,

July 10, 1940, is a date too late to cover all such corporations. January 1, 1940, and even September 1939 were suggested. Any date may leave out some corporations, and particularly the one I represent, unless general authority is given someone to include it. To meet all situations, I suggest that the National Defense Council could be given authority to certify all corporations that have established plants and developed patents to meet war or emergency conditions, irrespective of the date. It could then be provided that all such corporations be allowed to capitalize plant and patent costs and development expense and to amortize or depreciate them, to the extent to which they have previously derived no tax benefit, over a period of 60 months.

Another method of meeting the problem I have raised would be by a provision that 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, and the sum so determined be treated in the same manner as investments in new facilities. This matter has been discussed with the experts of the Joint Committee on Taxation, who understand the problem thoroughly.

Finally, with respect to this corporation, which has a base period of recurrent deficits, a minimum of 6 and 4 percent on invested capital is rather low, when it is proposed to give new corporations, who likewise have no base period, a minimum of 10 and 8 percent. The proposals penalize a corporation required to lose money preparing for an emergency or war. We suggest, as a fair rate, so that they may make up some of the deficits before paying the high excess profits tax, a rate of 8 percent. It should be at least on an equal footing with a new corporation.

The CHAIRMAN. If that completes your statement, we thank you for your appearance and the information you have given the committee.

The next witness is the Honorable Charles Hawks, a Representative in Congress from the State of Wisconsin.

## STATEMENT OF HON. CHARLES HAWKS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Mr. HAWKS. Mr. Chairman and members of the committee, I have a letter here from the Kohler Co., of Kohler, Wis. It brings up a very interesting point, in my opinion, in the consideration of this proposed excess-profits tax legislation. I would like to read that letter into the record, if I may.

The CHAIRMAN. Without objection, the letter may be read.

Mr. HAWKS. The letter is addressed to me, and reads as follows:

> The special House Ways and Means Subcommittee's proposed excess-profits tax bill has just come to our attention, and both alternatives suggested by the committee are based on the erroneous assumption that the years 1936–39 were normal years for all companies. This assumption is particularly vicious as it relates to durable goods industries such as ours.
>
> Our company's sales depend largely on residential building, shown on the accompanying chart.

I would like to file that chart as a part of my remarks, Mr. Chairman.

The CHAIRMAN. Without objection, it is so ordered.

(The chart referred to will be found at the conclusion of the letter.)

Mr. HAWKS. Continuing with the letter:

The United States Bureau of Labor Statistics customarily uses the year 1926 as its base year for comparative statistics, presumably upon the assumption that that represents a "normal" year. At least, that year represents the sales volume to which our industry is geared. Residential building in 1939, the best of the years used as a base in the subcommittee's report, was only 50 percent of the 1926 volume, and the year 1936 was only 29 percent of 1926. The annual average residential building for the years 1936-39, inclusive, was only 37 percent of 1926. Thus, the proposed bill arbitrarily assumes that our earnings in those low-volume years were normal, and that any higher earnings are excessive and should be subject to an excess-profits tax.

The following figures show how unfair either basis proposed by the subcommittee would be in our case:

| Ratio, earnings to invested capital: | *Percent* |
|---|---|
| 1936 | 2.1 |
| 1937 | 5.5 |
| 1938 | 3.3 |
| 1939 | 8.7 |
| Average | 4.9 |

From 1931 to 1935, inclusive, this company suffered heavy losses every year because of the fact that residential construction during those years averaged only 15 percent of the average volume of 1926, 1927, and 1928. In each of 2 of those years we lost more money than we have made in any year since. Obviously, this is a highly cyclical business, and unless we are permitted substantially higher earnings in some years than those shown above we cannot offset the loss years or even hope for any net profit averaged over an entire building cycle.

The following illustration demonstrates the unfairness of the proposed bill: If we had been in a consumer goods industry, such as food production, we might have earned 10 percent, 15 percent, or 20 percent regularly throughout the depression without sustaining a loss in any year. In that event the bill would have allowed us earnings of 10 percent before the excess-profits tax would apply, although our need was less. As it is, we will be allowed only 4.9 percent (6 percent on the first $5,000 of profit) before the excess-profits tax applies, and in view of our critical depression losses, we greatly need substantial unpenalized earnings for some years to come.

The average earnings shown above for 1936-39, moreover, are less than 30 percent of the actual earnings of the company in the more nearly normal years of 1925-28, despite the fact that the company has since greatly expanded its facilities, entered new enterprises, and greatly improved its trade position. From this it will be seen how unreasonable it is to call any profits higher than the 1936 to 1939 average "excessive."

It seems to us that the only fair basis for taxing durable goods or other highly cyclical industries, in view of their continued depressed condition, is to permit them to deduct a flat 10 percent of invested capital before the excess-profits tax applies, or to use the earnings of a more normal period, such as 1925-28, as a base. Even the basis prescribed for new companies would be reasonably fair. This percentage may seem excessive to theorists who assume that profits are the normal, regular experience of all industries. However, that is a very modest percentage of earnings for a company which is still trying to recoup depression losses.

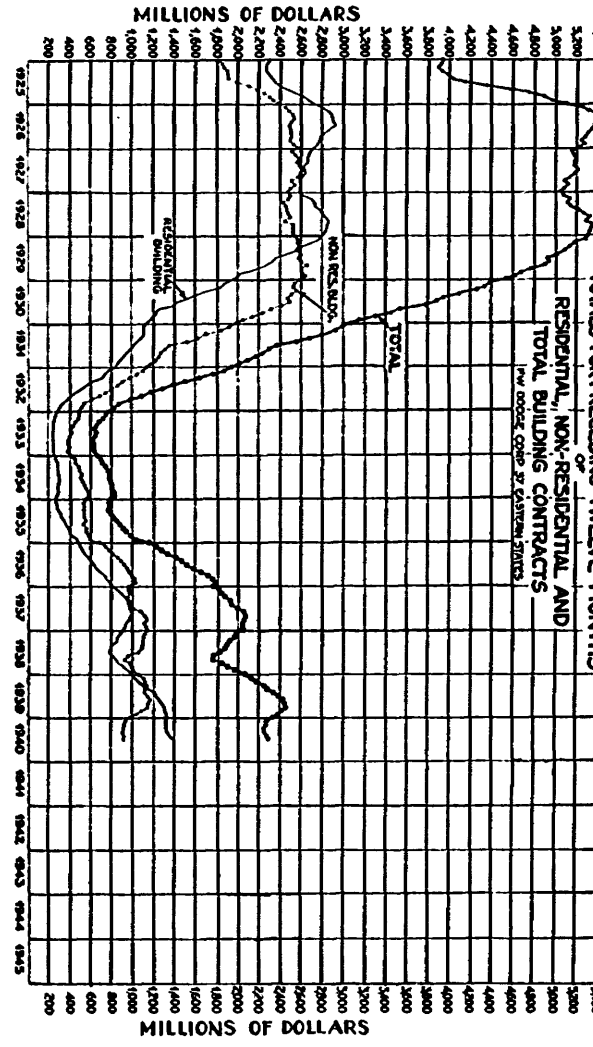
Another erroneous assumption of the drafters of this bill is that all profits now being made in excess of the profits of recent years are due to the defense program. This, however, is not true of our company. We have no war contracts, and any increase in our business is merely a continuation of the tendency of residential construction to approach a normal volume, a tendency which is quite marked because new building fell far short of current housing demands for a long period of time.

The point we want to leave with you is that in a company such as ours somewhat larger earnings in 1940 than in 1936-39, inclusive, are not, by reason thereof,

"excessive" but merely represent a normal experience in a highly cyclical business. Consequently, they should not be subject to this grossly unfair, arbitrary, and discriminatory tax.

Very truly yours,

KOHLER CO.
Per LUCIUS P. CHASE, *Attorney.*



Mr. KNUTSON. In the beginning of the letter that you read, did I understand the writer to say that the building construction in this country was only 15 percent of normal?

Mr. HAWKS. No. He says that from 1931 to 1935 inclusive, this company suffered heavy losses every year because of the fact that residential construction during those years averaged only 15 percent of the average volume of 1926, 1927, and 1928.

The CHAIRMAN. Are there any further questions? If not, thank you, Mr. Hawks.

Mr. HAWKS. Thank you, Mr. Chairman.

## STATEMENT OF BENJAMIN C. MARSH, EXECUTIVE SECRETARY, PEOPLES LOBBY, WASHINGTON, D. C.

The CHAIRMAN. The next witness on the calendar is Benjamin C. Marsh. Mr. Marsh, will you please give your name and address to the reporter, and tell us who you represent.

Mr. MARSH. My name is Benjamin C. Marsh, executive secretary of the Peoples Lobby with offices here in Washington.

The CHAIRMAN. Mr. Marsh, will you tell us about how much time you will need after we get started?

Mr. MARSH. Well, I would like about 15 minutes, although if I can convince the committee how it has got to change this bill in less time than 15 minutes, I will quit before then. But I would like 15 minutes.

The CHAIRMAN. The Chair would like first to request a little information without any thought of discussing any questions. You indicated you wanted to tell us about this measure. You say you represent the Peoples Lobby and the Chair is not fully informed what the Peoples Lobby is.

Mr. MARSH. I will be glad to inform you.

The Peoples Lobby wishes that the Congress of the United States would adopt the resolution before it for many years, and along the same line this year, put in over here by Mr. Lemke, bearing right on this bill, requiring a public record of the stock and bond holdings of all members of Congress and the same things of all Federal employees getting $3,000 a year or over; and also the land they own.

The CHAIRMAN. I am not trying to argue the question, but just to get information.

Mr. MARSH. I think I have all the information you want.

The CHAIRMAN. Do I understand you to say that Mr. Lemke is a member of the Peoples Lobby?

Mr. MARSH. Mr. Lemke is not.

The CHAIRMAN. You referred to him.

Mr. MARSH. He is not a member of the Peoples Lobby. He is a member of Congress.

The Peoples Lobby is incorporated; it is a nonpolitical organization of which Bishop Francis J. McConnell of the New York area of the Methodist Church is president, with about 2,250 members all over the United States and some four or five hundred subscribers to the monthly bulletin.

The CHAIRMAN. Do you have State organizations as a part of this body?

Mr. MARSH. No; we work only on Congress, and apparently Congress is going to have to adopt a different program or change its complexion. Of course, we do not have enough money to scare anybody.

The CHAIRMAN. I was only asking for information about what constitutes the Peoples Lobby.

Mr. MARSH. I will be glad to give it to you.

Our total budget being around $11,000 a year we cannot attempt to buy up votes. We have to rely upon the merits of the measures we propose and the wrath of the voters when Congress does not carry out our suggestions.

The CHAIRMAN. That is certainly most commendable.

Mr. MARSH. It is a highly democratic procedure.

The CHAIRMAN. Just one other statement I would like to make before you begin.

At the outset of these hearings it was agreed that the testimony be confined to the three propositions: The excess-profits tax, amortization, and the suspension of the Vinson-Trammell Act.

The hearing will be confined to those, and we will be glad to recognize you for 15 minutes.

Mr. MARSH. Thank you. I hope you will let me read this statement which I think bears upon the proposed measure, and I think the committee will admit that when the Treasury receipts are inadequate and the measure presented is inequitable it ought to be considered, and I hope today to give you some figures to substantiate it.

This bill should be called a bill to give free play to profiteers who profit on war activities.

At least $3,000,000,000 additional revenue should be raised through such a measure instead of the paltry amount that is contemplated by the pending bill.

The national income this year will be about, it is estimated, $75,000,000,000, some $6,000,000,000 more than last year. And, if the millionaires of America really feared that Hitler would invade this country they would be down here asking for heavy taxes on themselves. We have heard much, during the course of the discussion on this bill, but not that in Great Britain they are taking 100 percent of the income of corporations above their average pre-war income. I do not know why we could not do that.

And we have heard discussion about the $3,000,000,000. It is anticipated that the national deficit will be around $5,000,000,000 this year. Of course that does not mean much to the people who believe in free and unlimited coinage of deficits with nontaxable interest-bearing bonds, but it means a lot to the mass of people because the interest on the national debt is about $1,100,000,000 this year—approximately one-fourth of what is actually payable for defense.

The provision for the amortization of plant expansion for defense purposes over 5 years means that these wealthy owners do not think there is any danger of a military invasion of the Western Hemisphere, otherwise they would want to get it in 1 year. They want to get it while they can, possibly for election contributions.

Now while the Government is here trying to work out a plan to conscript men, industry is——

Mr. McLEAN (interposing). Mr. Chairman, I make the point of order that the witness' testimony is not directed to what we have under consideration, and that his observations have no constructive value whatever.

The CHAIRMAN. The Chair sustains the point, and will ask you to confine your statement to the issues before us.

Mr. MARSH. Well, who is to judge of whether a discussion of a tax measure is a discussion of the tax measure?

The CHAIRMAN. The Chair suggests, Mr. Marsh that other witnesses have confined themselves to the matter before us, apparently without any difficulty.

Mr. MARSH. Then, Mr. Chairman, I would like to read one or two articles which I think do discuss the proposed bill before you.

The CHAIRMAN. The Chair is asking the witness, if he wants to continue, to please confine himself to the three propositions contained in the report.

I want to be just as fair to the witness as possible, but it is a little embarrassing for a witness to come here and secure the attention of the committee and then violate the regular order adopted by the committee.

Mr. MARSH. All right.

The CHAIRMAN. Nobody has complained about the committee procedure, so far as I know, and each witness has confined himself to the subjects under consideration without criticizing the committee or the Congress. Of course that is the privilege of everyone, but it has no connection with the discussion of the pending measure.

Mr. MARSH. Then, Mr. Chairman, I would like to discuss the overcapitalization of corporations upon which it is proposed to let them earn this ungodly rate in the name of defense.

I am going to quote figures of a labor economist, W. Jett Lauck, who stated:

> A purchaser of 100 shares at $100 of stock of General Motors in 1908 when it was organized would at present hold 25,095 shares, and would have received stock dividends up to 1936 of $819,081.

Now, you propose to amortize the plant, as I understand it—and please correct me if I am incorrect, because this report has been about as stiff a dose of differential calculus as I ever had in college, but as I understand it you are going to let these corporations earn this return on their present capitalization.

Then, let us take the United States Steel Corporation.

> From 1901 to 1936 the United States Steel Corporation had declared dividends of 227 percent on the preferred stock, aggregating $811,360,875, all of which is "water."

Now this bill, as I understand it, proposes to say that on this watered stock you are going to allow them certain returns and you have got to assume, in this bill, that you cannot get any defense contracts until these men get their profits. They are the "fifth columnists." Why pass such a bill in their favor?

And Mr. Lauck continues with regard to United States Steel as follows:

> During this same period, dividends of 164½ percent were declared on the common stock, totaling $927,951,253, which is also "water."

Considering the whole period 1901–35, the corporation actually paid out in dividends from earnings on these fictitious securities the enormous sum of $1,-972,633,128.

Mr. TREADWAY. Mr. Chairman, the gentleman's remarks do not seem to me to relate to the bill under consideration. I am asking for information.

The CHAIRMAN. The Chair is of the same opinion.

Mr. TREADWAY. I make that point of order.

The CHAIRMAN. The point of order is well taken. I think we ought to be fairly liberal with witnesses and to let them state their position, but I do not think this is the proper time to cover all matters relating to the Government and its affairs. I am sure Mr. Marsh is an intelligent man and can appreciate the committee's efforts to solve this complicated problem. I am going to ask you to confine your statement to the issues before us.

Mr. MARSH. Mr. Chairman, I am discussing the basis upon which you propose to guarantee returns to a lot of corporations. And I think it is fair to discuss the watered stock of these corporations, which should have been squeezed out in considering their genuine investment.

And it seems to me that in the very beginning, and I have an opinion that in the election this feeling will be shared by the voters, that these corporations should bear their proper share of the tax burden.

I would like to read into the record this article in yesterday's Star by Jay Franklin, favoring conscription of wealth. It was in the Congressional Record, read in on the floor of the Senate under their free discussion, by Hon. Josh Lee, of Oklahoma, and I think it has a bearing on this subject.

Mr. Lauck reported that during the 35-year period the United States Steel Corporation paid for debt retirement additions and betterments, dividends on watered stock, "plus the $150,000,000 paid for the underwriting syndicate at the time of the formation of the company," a total of $4,441,247,347.

Now, I would like to discuss some of the profits which the airplane corporations have made, those of Douglas, Fairchild, Curtis Wright, United, and Glen L. Martin, the five aircraft companies.

The profits for the first quarter of 1940 were $4,699,258, and in the same quarter in 1939, $8,970,874, an increase of 91 percent, in round figures.

They probably want to receive over 100 percent before they are willing to enter into contracts.

And for three automobile concerns, Chrysler, General Motors, and Studebaker, the profits were $64,873,000 in round figures, $65,000,000 in the first quarter of last year and $83,282,352 in the first quarter of 1940, or an increase of 28.4 percent.

For seven steel companies, Inland, National, United States, American Rolling, Bethlehem, Youngstown, and Republic, profits for the first quarter of last year were $9,064,000; and for this year, $40,445,000, or an increase of 348.70 percent. And you propose to give a guaranty which will return a profit on anything like that.

For the two electrical-equipment giants, General Electric and Westinghouse, profits for the first quarter of last year were $9,700,000 and for the first quarter of this year, $15,992,000, an increase of 64.6 percent. And you propose a guaranty on such a return.

Mr. Chairman, I simply cannot understand how these concerns will persistently demand to be allowed to get their pounds of flesh from Uncle Sam, before they are willing to enter into a contract with the Government.

The National City Bank of New York, in its April bulletin—it has assets of $2,775,000,000—reports that in 1938 the net profits of 2,480 companies were $2,119,000,000; and in 1939, $3,456,000,000, an increase of 63 percent.

The American Federation of Labor in its current bulletin points out that the estimated profits of 400 leading corporations for the first half of this year are 59 percent larger than they were for the first half of last year.

The steel companies are doing pretty well up to date.

The Wall Street Journal, in discussing what the bill would do to U. S. Steel, says that a computation under the least expensive of the excess-profits-tax methods shows it would retain only 60 percent of any profits in excess of $67,000,000 remaining after the payment of normal income taxes.

Mr. Chairman, here I must ask a question: I cannot understand the proposal, but if I understand it correctly you propose to give these corporations—as a price for not striking against the Government in time of its national defense—you propose to let them receive a guaranteed return on their investments and stocks to apply to the debts which they hold. And they may have borrowed at 2 or 3 or 4 percent; rates vary. As I understand, that is correct.

Now, let me point out that back in 1935, the corporations with $50,000,000 of assets, 742 of them, had a debt of nearly $28,000,000,000 and their liabilities were nearly $56,000,000,000.

The CHAIRMAN. The time of the gentleman has now expired, but inasmuch as we took up perhaps 2 minutes of your 15 minutes, we will extend your time 3 more minutes.

Mr. MARSH. I appreciate that courtesy, Mr. Chairman, and I hope the last 3 minutes will be like the last 3 minutes of a good sermon—it will result in converting a lot of you.

I understand the Government is to permit the corporations this return, and if that is true, I ask if it is true, as stated in this week's United States News, that under this bill 90 percent of the corporations in America are exempt. If they are, why? Maybe it is because they are not important enough to be considered.

I have not meant to be captious, Mr. Chairman, but I think it is about time we realized that the American people are wondering why we do not start the program of national defense. Why is it that these new profiteering interests are being built up and yet the Government cannot get airplanes?

I would like to read an excerpt from a book by a Wall Street analyst on the aviation business, which tells the story "Of the $40 that grew into $5,000,000." This is what it says:

> As long as transport and manufacture of aircraft are in private hands, profits must be the first consideration.

Then, I want to quote another excerpt from that same writer:

> The only American-made machines that the industry managed to get to the Army on the front were 196 Dell "Flaming Coffins."

And again:

That the country should be at the mercy of private industry for this arm of defense is dangerous. It is particularly dangerous in view of the aviation-industry's history.

I thank you for your courtesy. And from my personal regard for the members of both committees, let me hope that it will not report out such a measure as this if you expect to grace us with your presence, after election.

The CHAIRMAN. Any questions?

We thank you.

Mr. MARSH. I thank you.

## STATEMENT OF T. J. PRIESTLY, JR., PHILADELPHIA, PA.

The CHAIRMAN. Mr. Priestly is the next witness on the calendar. Will you give your full name, address, and for whom you appear?

Mr. PRIESTLY. J. T. Priestly, 321 South Juniper Street, Philadelphia, Pa.

The CHAIRMAN. How much time do you want?

Mr. PRIESTLY. About 6 minutes.

The CHAIRMAN. You are recognized for 6 minutes.

Mr. PRIESTLY. Mr. Chairman, I am president of the Priestly Printers and a charter member of the National Small Business Men's Association.

I listened to the National Forum on the air last Sunday evening, and I felt it was my duty to come here at your request and try to explain what I believe to be the solution of our tax problem.

It seems to me that the excess-profits tax is just one more abuse of the instruments of democracy, and since it is estimated to bring in but $200,000,000 it will cause more confusion and it will make it necessary for the manufacturers of war materials to charge the Government an additional five or six hundred million dollars in order to assure themselves of no loss, while corporations producing nonessentials for war will be crucified by the tax.

The Government will lose about $300,000,000 by the imposition of this tax.

Since corporation and personal taxes are high, it appears to me that it would be better to drop the excess taxes and collect it at these points; if you fail, then you will get it anyway in the death tax.

I want to call your attention again to equitable taxation as a true instrument of democracy and show wherein a graduated gross business tax—that is, a transaction tax—based on fair amounts in each line, will return a sufficient amount to more than balance a normal budget, while at the same time eliminate the necessity which compels our Government to appropriate its citizens' savings to keep millions of the unemployed from starving.

The object of the graduated gross tax is to make it possible for the smaller corporation to exist and put back into legitimate employment all of the unemployed and pay wages more in keeping with wages paid by the larger corporations.

Government statistics prove that corporations increase their profit advantage very materially in direct proportion to their increased volume of sales.

It is evident that taxes should be paid on gross sales in accordance to the wisely established principle that taxes should be levied in proportion to the ability to pay.

Government statistics prove that progressive taxation on gross sales is the only logical, fair, and honest method of taxation; but if we should fail to comprehend the importance and necessity for establishing the base, or fair amount, of business in each line of enterprise for the purpose of progressive taxation, our present chaotic conditions would not be improved. Therefore the total amount of business done in each different line of business throughout the Nation should be divided by the number of enterprises or corporations following each line, and the quotient should be used as the base or fair amount in each line for the purpose of taxation.

This tax should be one-fourth of 1 percent of the gross receipts not in excess of the base amount; and one-half of 1 percent of the gross receipts in excess of the base amount and not in excess of twice the base amount; and three-fourths of 1 percent of the gross receipts in excess of two times the base amount and not in excess of three times the base amount; and one-fourth of 1 percent for each additional base amount taxesd progressively and cumulatively.

By this method of taxation the larger corporations will pay less in taxes than they will eventually have to pay if some such equitable tax plan is not soon enacted into law.

Sixty percent of this tax should be returned to each State in proportion to that received from each State, so that but one tax may be levied on business.

While my idea of a graduated gross tax would be to eliminate all other Federal and State taxes on business, I believe you have a wonderful opportunity to use this tax method to pay for "preparedness" without further depressing the Nation. The smaller fraction of percent for each "fair amount" could be determined by the Treasury Department for this purpose.

The CHAIRMAN. We thank you for your statement.

Mr. PRIESTLY. Thank you.

The CHAIRMAN. The next witness is Mr. Richard Pass.

## STATEMENT OF RICHARD PASS, PASS-SEYMOUR, INC., SYRACUSE, N. Y.

Mr. PASS. Mr. Chairman and gentleman of the committee: We are manufacturers of electric-wiring devices. We employ about 450 people and are located in Syracuse, N. Y.

I have made here, in the very short time at my disposal, some notes bearing on the serious effect which the excess-profits tax would have on our company and companies similarly situated if the bill were to be enacted in the form as proposed, and if I may I will follow the notes in order to cover the ground in the minimum length of time.

The excess-profits tax, in the form proposed, would prove extremely serious to the company which I represent and it would make comparatively little difference whether the tax were to be figured on the average earnings basis or on the net invested capital basis by the means which have been proposed by the subcommittee as alternative or optional methods of computing the excess-profits tax.

We have worked it out on both bases and as far as we are concerned it is practically a toss-up, and both of them, would be, to us, disastrous

and work extreme hardship on this company as on many other companies similarly situated. The reason for the seriousness to us of the proposed method of levying excess-profits taxes has to do with the history of this company's earnings during the recent years which have been proposed by the subcommittee as the base period for calculating the tax, namely, the years 1936, 1937, 1938, and 1939. During those years the average net earnings of this company were about 4.9 percent of the average net invested capital, calculated in accordance with the method proposed in said committee's report.

To explain the situation properly it is necessary briefly to review our recent history and I will do so very briefly.

The company has been in business for 50 years. Due to a number of factors which it is not necessary to discuss here, the company found itself in a difficult competitive position prior to the years of the recent severe economic depression in this country. We experienced substantial and increasing operating losses in the early years of the depression, until the situation became so critical that in 1932 the stockholders seriously considered liquidating the business and distributing the cash reserves which were still on hand. The only reasonable alternative to that course was to invest a large sum of money in new products in the effort to open up additional markets and to obtain a sufficient volume of reasonably profitable sales to sustain continued operations.

Since the new products under consideration were necessarily untried and business conditions generally were at an extremely low level, it was apparent that the large investment involved would be made at great risk. The decision to continue operating and to proceed with the development program was very largely due to our desire to keep the company employees working at a time when they would have been unable to find other employment. By that year the company's surplus had been wiped out and the shares of capital stock were reduced in order to create a book surplus.

In the development program which we undertook, over $135,000 was spent, not including the cost of continuing to operate at a loss. The new lines of products were only partially successful at first and our operations continued in the red for 2 more years. It was not until 1935 that we were able to improve our competitive position sufficiently to break even and in that year a very small net profit was earned.

As stated in the beginning the net earnings after Federal income tax for the 4 years of 1936 to 1939, inclusive, averaged only 4.9 percent of the average net invested capital during that period. Although none of these years showed an actual operating deficit, the earnings in the earlier years of this period were small.

That, of course, is the basis of our difficulty.

During these 4 years it was necessary to do much maintenance work, after the years of severe depression. Moreover, we applied as large a part of our increased income as possible to wage increases, believing that the interest of the employees should have first consideration. Only one small dividend was paid to the stockholders in the years from 1930 to 1939. The balance of the earnings were plowed in. Even at present, we feel able to spare only enough for a small dividend on the capital stock.

The financial reserves which had been accumulated during the years prior to the depression, were used to finance the losses in the early period of the depression and also to finance, as already pointed out, the development and promotion of new types of products. Therefore, it became necessary to borrow substantial sums of money to finance increasing volume, larger inventories, and for the purpose of purchasing necessary new equipment in order to proceed with an orderly program of plant modernization. The money borrowed has now been repaid, but it has not been possible as yet to accumulate a sufficient reserve to provide such additional equipment as is needed in the continuance of our modernization program and at the same time to give a reasonable financial reserve with which to operate during a future slump in the business cycle.

In other words, gentlemen, these 4 years you are speaking of were years in which we were just getting back our strength, after a very serious illness. We are now just beginning; to be able-bodied again.

We have not got the reserves necessary to carry the business on a sound basis for the future, but we are in a position where now we can accumulate those reserves if we are allowed to do so.

The CHAIRMAN. Suppose every company which would have to pay any additional taxes or excess profits taxes were to be allowed to recover in that way? Do you think we could ever raise enough money to finance the Government and meet this emergency program for national defense if we waited until those companies had recovered and reimbursed themselves for the years when they did not make any money?

Mr. PASS. I think I have a practical suggestion to make in connection with that.

The CHAIRMAN. You have given us a very fine statement and I am asking for information.

Mr. PASS. Yes; I think I have a suggestion to make along that line, and it is predicated on past experience in this country.

In this connection, we wish to emphasize that had we not accumulated financial reserves prior to 1930, this company would have been forced out of business early in the depression and would have had to throw out of employment hundreds of people who in all probability would have been unable to obtain employment elsewhere. Unless we now are allowed to build up our reserves again, it is altogether likely that in any future prolonged recession, we shall be obliged to curtail employment drastically, if not to cease operations altogether.

That is partly because in our type of business there are large fluctuations in rate of volume. We are largely dependent on building operations, and our volume goes up and down with the building cycle. Therefore we have to plow back our earnings in the good years to have enough to keep our organization together in the bad years.

Therefore, it is imperative that we continue to plow earnings back into the business if we are to put ourselves on a sound basis to meet probable future business developments.

We feel sure that the conditions described herein as applying to our own business, apply equally to a great many other companies and especially to the smaller companies, which, generally speaking, have much greater difficulty than do the large companies in obtaining new capital. If your committee has not yet heard from a great many companies who are in the same situation as are we, that is due,

we feel sure, solely to the fact that the great majority of these companies are not yet thoroughly familiar with the proposal now under consideration, or have not had time to present to you the extreme seriousness and, as we believe, unfairness in the proposed method of levying an excess-profits tax.

May I say in this connection that the first I knew about this—and I do not mean to criticize, but the fact is that the first I knew of the proposition was when I saw it in the paper over the week end. On Monday morning I tried to find if anybody in Syracuse had an official report of what was proposed, but nobody in Syracuse had, so far as I could find out.

So our accountant got to work with what we had gotten out of the papers and figured out what would happen to us, and, when I saw that we would be practically skinned alive, I had the figures checked to see if that was correct. It was only yesterday afternoon when I was sure where we stood. So I telephoned here and made arrangements for this hearing, came down on the train last night to New York, and flew into Washington, getting here just a few minutes ago.

So I want to point out there has scarcely been time for a great many of us who are involved to adequately present the extreme seriousness of the situation which will result if the excess-profits tax were enacted in the form proposed.

We wish to emphasize that the improved earnings of this company in the year 1939 as well as the continued improvement in our earnings this year, have been little affected by war conditions abroad or by defense spending in this country. In fact, it is my opinion that our business today would be better than it is were there no war activity abroad and no necessity for a defense program at home. The improvement in our volume of sales and earnings in 1939 and 1940 is simply the culmination of our efforts and large expenditures during the past decade to improve our competitive position by the creation of new and improved products and also to a large extent the improvement is due to increase in residential building, in which type of construction our products are largely used.

Therefore, since the improvement in our situation has to date no important relation to Government purchases under the defense program, we feel that it would be very unfair to our company and to other companies similarly situated, if we were to be prevented from building up necessary financial reserves by the application of an excess-profits tax calculated on either of the bases which have been proposed by the subcommittee.

We note under the proposal that for new corporations the allowable return on invested capital before the application of the excess-profits tax is 10 percent on the first $500,000 of invested capital, and 8 percent on the balance, compared with much lower rates of return on invested capital allowed older corporation before application of the proposed excess-profits tax. We cannot see why a company like this, which would have been liquidated in 1932, had only financial considerations been controlling, should be allowed a credit of a much smaller return on invested capital than the credit allowed to a new corporation. Also in this connection, we wish to call attention to the credit of 10 percent and 8 percent allowed on new invested capital.

The fact of the matter is that in actual practice, the alternative method of computing the excess-profits tax on the basis of invested

capital, as proposed in the report of the subcommittee, does not actually give the relief which we believe the subcommittee intended it should give to those companies which happened to have subnormally low earnings in the base years recommended by the subcommittee. As previously stated, in the case of our own company, it makes little difference whether the tax is figured on one or the other of the two bases proposed by the subcommittee, both methods of calculation resulting in a dangerously, and, as we believe, unfairly high excess-profits tax on current earnings. A far more equitable plan would be to establish a fixed percentage of invested capital as a credit to be applied uniformly to all corporations before application of the excess-profits tax, irrespective of what a given company's earnings may have been in previous years. Such a plan is more nearly in line with the principle of the excess-profit taxes levied in connection with the last war.

We believe that this method, establishing for all companies a credit based on a fixed percentage of invested capital, which credit we would suggest at 10 percent of the net invested capital, would be far more equitable than the present proposal, since it would treat all companies alike, whereas the present proposal seriously discriminates against those companies which for reasons possibly entirely beyond their control experienced subnormal earnings in the 4 base years from 1936 to 1939, inclusive. In our opinion, the present proposal is particularly unfair and unjust to the companies in that group whose improved earnings at present, as in the case of the company which I represent, are not due primarily or substantially to war conditions abroad or to the defense program in this country or to defense orders from the United States Government.

The CHAIRMAN. How would the Government determine that? How would the Government determine whether increased profits were due to improved conditions or to the national-defense program? How would that matter be settled?

Mr. PASS. I want to make myself clear in regard to that, if I may. That is the reason why I think that to base this on net earnings in past years is quite unjust, because it——

Mr. DISNEY. It seems to me, Mr. Chairman, that the witness is assuming an erroneous premise. Do you not understand that the corporation has its option to either work on a basis of average earnings for 4 years, or upon invested capital?

Mr. PASS. Yes; I do, sir; but may I point out that that does not give substantial relief to companies that had subnormal earnings in the 4 years used as a base.

The reason it does not give substantial relief—and I am sure I am right about this, because I have worked it out in numerous ways—the reason it does not give substantial relief is because it again is predicated on average earnings in those 4 years, except as those earnings were less than 6 percent on the first $500,000 of invested capital, and less than 4 percent on the balance of the invested capital, or unless said earnings were in excess of 10 percent.

In other words, taking our own case, it makes practically no difference whatever way we figure, because your second method, the one that is supposed to be predicated on invested capital is likewise tied in with earnings.

Mr. COOPER. May I inquire there? Mr. Pass, what would you say would be a fair return on invested capital?

Mr. PASS. I think, sir, that for a small company——

Mr. COOPER. Never mind about the size. Take any company, and take its invested capital, that is, money that men have put into the business. What do you think would be a fair return on that money?

Mr. PASS. In normal years I believe that the return should average not less than 10 percent. I mean by that not the return to the stockholders, because no wisely operated company pays out all of its earnings, or it could not survive the depressions we have in this country from time to time.

Mr. COOPER. To get back to my question, what do you think is a fair return on the amount of money men put into business organizations or companies?

Mr. PASS. I think in normal years it should average at least 10 percent on the invested capital.

Mr. COOPER. All right. Let me ask you one other question.

You have referred several times to the fact that as you understand it, your company will not benefit any by the national-defense program. Do you think $14,000,000,000 can be put out by the Government without some benefit flowing to your company?

Mr. PASS. May I say, I tried to emphasize the fact that up to date we have not been substantially benefited.

Mr. COOPER. But the $14,000,000,000 has not been spent up to date.

Mr. PASS. No; but your tax is retroactive to January 1, 1940, is it not?

Mr. COOPER. It applies to the calendar year 1940.

Mr. PASS. Yes.

Mr. REED. That is, this particular tax?

Mr. PASS. Yes.

Mr. ROBERTSON. Aside from the question of what is a proper return on invested capital, this committee, I assume, does not want intentionally to recommend passage of a law that would enable one company to make a larger return on invested capital than another company, and we have had some hardship cases pointed out during these hearings.

We had before us yesterday a Chicago manufacturer of drinking cups. He said he had been in business only 3 years, and of course those 3 years would be the only 3 years he would use as a basis for average earnings. But he had the expense of getting started and competing against established firms. He said that one of those established firms would be permitted a normal return of 17 percent, where a small competitor, under this proposed law, would not be permitted a return of anything like that amount.

Only this morning I received a letter from the representative of a flour mill who said that a report of the earnings of the 3 years mentioned would cut down the net earnings of 1 of those years and would not reflect the normal average earnings, because of the necessity of reporting nonrecurring items.

Various other representatives have indicated in specific instances that the proposed tax would not apply equally.

I would like to know whether the witness has some definite recommendation as to how that could be avoided.

Mr. PASS. Yes, sir; I think I have something to suggest which will be very helpful in that direction, and may I point out that our situation is very similar to the one you have mentioned.

During these 4 years we have just been getting back on our feet again, just been getting back our strength. We have not been able to build up our reserves.

Other companies, certain large ones, have been able to carry on during this period with relative high earnings. They can base their excess-profits tax on average past earnings and in that way will have to pay very little excess-profits tax. But we who need the reserves more than they do because we are just getting back on our feet again will have to pay out most of what we earn, or a large portion, in excess-profits tax.

Answering your question specifically, sir, I think the principle established in the excess-profits laws of 1917, 1919, and 1921, was far more equitable and fairer than the present proposal.

I have in mind specifically that at least there should be an option whereby a credit would be allowed, based on a percentage of invested capital, irrespective of past earnings.

Mr. COOPER. What would you suggest that percentage should be?

Mr. PASS. I think it might wisely be a somewhat sliding scale, following the principle which you have already developed in your proposal, as between smaller companies and the larger companies. But I do not consider I am in a position to speak of that without prejudice, because I am connected with a company that has only 450 employees.

I would say there should be a credit of 10 percent of the net invested capital, and that excess profits should be applied to all earnings in excess of that credit, and would be applied, presumably, on a progressive, or sliding scale, which would be in accordance with the principle which you have set forth in your proposal.

I want to make that point clear, because we went through it in the last war.

I was not intimately connected with it myself, because I was in the service, but I have learned since that time what the company's experience was, and what the experience of other companies was under the excess-profits tax of the last war.

I feel quite sure that it is a much fairer method than the present proposal, which certainly discriminates against companies which had unusually poor earnings in those 4 years from 1936 to 1939.

That may have been due to conditions over which those companies had no control.

In particular, gentlemen, and in conclusion, this proposal, if I may say so, with all respect, reminds me of one of the Biblical quotations which, if I remember correctly, runs somewhat as follows:

> For he that hath, to him should be given: and he that hath not, from him shall be taken even that which he hath.

The CHAIRMAN. You are quoting the Bible now?

Mr. PASS. Yes, sir.

The CHAIRMAN. Do you think that is susceptible of comparison? Who is trying to take anything away from anyone who has not got anything? We are not trying to take anything away from you that you have not got. How does your illustration fit in?

Shakespeare said that even Satan could quote Scripture to prove his point. Of course, I am not comparing you with Satan, but I cannot see how the Scripture is applicable in this case.

Mr. PASS. I am connected with two businesses, Mr. Chairman. I am an officer and director in two companies, and this is one of them.

The other one is in a different line of business. But I have had figured out the application of this present proposal to those two companies, and the difference is enormous, because one of the two companies had good normal earnings in the 4 years you are taking as a base, and this company I am speaking for here had subnormal earnings in those years. The percentage of tax is double in one company what it is in the other company. I say that is not equitable.

Mr. CROWTHER. We had a witness yesterday who presented some hypothetical cases to us of low earnings in the base earning period of 4 years. In one instance he showed that if the figures in 1940 did not reach the base level the Government would get no money at all, but if it went up then they would get a large slice of it.

I want, Mr. Chairman, without unduly wasting the time of the committee, to read half a dozen lines from Mr. Alvord's testimony that has a bearing on this subject. He says:

> The subcommittee proposal, however, is fundamentally objectionable in prescribing an average return on invested capital over the same base period as the alternative to the average earnings base. The two methods tend to duplicate each other. If a corporation has normal prior earnings, it will use the average earnings method, without resorting to invested capital. New corporations are unable to compute average return on invested capital, and must be specially provided for. The only case in which invested capital will be useful, therefore, is that of the corporation whose earnings have been unusually low during the base period. For this purpose, there is no necessity for the extraordinary complications and innumerable computations required in the subcommittee proposal.

Then this last sentence in that paragraph refers especially to what you have been discussing:

> A specified return on invested capital, such as was provided in the old law, is a better and more definite "cushion" for corporations with poor-earnings record.

You made reference to an alternate proposal, that we be guided somewhat by the provision in regard to invested capital in the 1917, 1919, and 1921 acts.

Mr. PASS. In principle, sir; yes.

Mr. CROWTHER. Yes; in principle.

Mr. PASS. That does express exactly what I have in mind; the alternative that has been suggested does not furnish the relief which I think you intended it to furnish.

The CHAIRMAN. Your company, as I understand your testimony, is on a sound basis, and is in a prosperous condition now. If that is true, would it not be better, in view of the Government's needs in this emergency, for your company to sell more stock if you need additional capital; or, if you do not want to do that and your credit is good, there should be no trouble borrowing additional capital at a low rate of interest. That would be taken into consideration in figuring the rate of tax and, as your company is in a prosperous condition and making good returns, you would be able to pay the Government some money. This condition is an extraordinary one, you understand.

Mr. PASS. May I answer that, sir?

The CHAIRMAN. That is why I ask the question.

Mr. PASS. It is very difficult to find people who wish to invest money in small enterprises today. They consider the future far too uncertain and business management today is hesitating to borrow very heavily for capital expenditures, because of the grave uncertainty as to what is going to happen to this country if things continue to go very badly abroad.

The CHAIRMAN. Are not your present stockholders able to increase their investment? If not, have you tried to sell additional stock?

Mr. PASS. No; we have not, sir.

The CHAIRMAN. You are so prosperous you do not want any more in the business?

Mr. PASS. No; it is not that. I think we possibly are overlooking a little the issue here. I am merely trying to say, sir, that I want to be treated only the same as others are being treated.

This present proposal is, unintentionally I know, but none the less surely, discriminatory against me and other companies similarly situated, because in those 4 base years we happen to have had quite subnormal earnings.

The CHAIRMAN. The conclusion that I draw from your testimony is that you are not being treated too harshly but other companies are being treated too favorably. If other companies were not getting along so well you would not be complaining.

Mr. PASS. May I point out, sir, that this works out to practically 40 percent—that is to say, the Federal tax would be practically 40 percent of our net income.

The CHAIRMAN. Suppose it is; if you have good returns left? Suppose it should be that much in this emergency?

Mr. PASS. Well, sir; it does not leave a sufficient amount to build up the reserves that we need for the future. It does not leave a sufficient amount to finance the additional equipment that we need and it is twice as much, in relation to our net profits—almost twice as much as certain other companies will have to pay, merely because those other companies, even in the same line of business, happen to have good earnings in those 4 years, and we happened to have poor earnings in those 4 years.

So I say, sir, in all sincerity, that I am not speaking entirely from a selfish point of view; that there is a principle involved here, and that what is proposed is not equitable. I am quite sure that you could accomplish your purpose equally well without any more complication, in fact, I believe with less complication and more effectiveness, if you would base your credit on a percentage of invested capital and then apply the excess-profits tax on all earnings in excess of that credit.

The CHAIRMAN. That would not fulfill the definition of an excess-profits tax, would it? That would be a normal-profits tax. We are now talking about excess profits over those earned during a certain base period. That does not have any relation to excess profits. That is what would be considered a reasonable and normal tax.

Mr. PASS. May I say, sir, that I evidently have not made myself clear, because what I am proposing——

The CHAIRMAN. I think I understood you fully. I do not want to take up too much time of the committee.

Mr. COOPER. Mr. Pass, how much is the invested capital of your company?

Mr. PASS. About one million and a quarter.

Mr. COOPER. What has been your average return on that? I believe you said 4 percent and something?

Mr. PASS. That was on the averaged invested capital, which is slightly lower, because we have been putting money back into the business—what we could. It was 4.9 percent.

Mr. COOPER. Over the base period you have made 4.9 percent on $1,250,000?

Mr. PASS. It was 4.9 percent on $1,100,000, about.

Mr. COOPER. I believe you said you would regard 10 percent as a fair return on capital.

Mr. PASS. In normal years.

Mr. COOPER. We have to take things as they are.

Mr. PASS. If you do not make it in the normal years, you cannot pay it out in the subnormal years.

Mr. COOPER. You talk about plowing money back into the business. Of course, you can put your money where you want to. If you let that money go through the tax mill, just as the rest of us have to let our money go through the tax mill——

Mr. PASS. I do not think I understand what you are saying, Mr. Cooper.

Mr. COOPER. All that you make, aside from what you pay in taxes, you can put back into your company, can you not, if you wish?

Mr. PASS. Yes; and that is what we have been doing, practically. But unfortunately, under this present proposal, there is not going to be much left. And may I try to make clear again—because I do not think I did—this proposal as to how this could be handled——

Mr. COOPER. I think we understand that fully.

Mr. PASS. It is essentially the same as it was before in the old excess-profits tax.

Mr. COOPER. You have stated no less than half a dozen times that you prefer the old method.

Mr. PASS. Have I made it clear, sir, the reasons why I do prefer it?

The CHAIRMAN. What is that?

Mr. PASS. Have I made it clear why I prefer it? I think it is much more equitable to base the excess-profits tax, not on past earnings, but on all earnings in excess of a credit to be allowed on invested capital.

The CHAIRMAN. The Chair thinks you have made your position clear.

Are there any further questions?

Mr. MCKEOUGH. Just to complete the record, I would like to ask the gentleman, what your average earnings were for the 4-year period?

Mr. COOPER. 4.9 percent. He said that several times.

Mr. MCKEOUGH. I understand his invested capital fluctuated during that 4-year period.

Mr. PASS. Somewhat.

Mr. MCKEOUGH. As nearly as I am able to figure it out, your average earnings then were something of the nature of $40,000?

Mr. PASS. It would be 4.9 percent on $1,100,000, which would be a little over $50,000.

Mr. MCKEOUGH. That is all.

Mr. TREADWAY. You are complaining, as I understand it, of this fact; two companies have practically the same invested capital during the 4 base year. One of those companies is fairly prosperous and makes normal profits. The other one makes, as you describe it, subnormal profits.

Now, using those 4 base years as the period on which we must make up our figures, for purposes of taxation, the subnormal profit company

would be very much more penalized than the other that had had average profits.

Mr. PASS. Yes, sir.

Mr. TREADWAY. That is your contention, is it not?

Mr. PASS. It is the fact. I have worked it out. I just cited that as an illustration.

Mr. TREADWAY. In other words, you are not complaining of the taxation feature so much as you are of discrimination?

Mr. PASS. Yes, sir. I believe that the same amount of money can be raised without bringing in that discrimination.

Mr. TREADWAY. The element of discrimination is the basis of your argument here.

Mr. PASS. Yes, sir; I feel that the present proposal is unfair to companies that happen to have subnormal earnings in those 4 base years.

Mr. TREADWAY. As a practical businessman, you are just explaining to us your difficulty in meeting the proposition that is before this committee at the present time.

Mr. PASS. Yes, sir.

Mr. TREADWAY. You say you represent a company with something over a million dollars capitalization.

Mr. PASS. Yes, sir.

Mr. TREADWAY. Have you any idea how many companies there are similarly situated in the country? I suppose we have a record of that, but I do not have it in my own mind.

Mr. PASS. There are a very great many.

Mr. TREADWAY. I realize that.

Mr. PASS. How many I would not want to say. Mr. Brooks, have you any idea as to how many there might be?

Mr. TREADWAY. Never mind that now. There are a great many of them. Has your experience with other businessmen shown you that this same discrimination applies to numerous concerns other than your own?

Mr. PASS. Yes, sir; it does.

Mr. TREADWAY. Yours is not an isolated case at all?

Mr. PASS. Not at all, sir.

Mr. TREADWAY. You feel that a very large number of companies similarly capitalized as yours, which are regarded as small corporations, could come here, if the opportunity were given them, and give the same testimony that you are giving to us in corroboration of your statement?

Mr. PASS. I feel sure of it, sir; yes.

Mr. TREADWAY. And I also understood you to say—of course, this report of the subcommittee has only been out a very short time. But I understood you to say that you did not know of this matter until you read of it in the Sunday or Monday paper, is that right?

Mr. PASS. Until I read it in Saturday's paper.

Mr. TREADWAY. I do not recall what day the report was made public. I was informed it was made public on August 8. Today is the 14th. The report has not been public but 6 days, and, therefore, undoubtedly there are a great many businessmen situated as you are who, in the brief time that they have had, have not had an opportunity to analyze this very complicated report.

Mr. PASS. I feel sure of it. There was no official copy in the city of Syracuse on Monday of this week, that I could find.

Mr. TREADWAY. Your information, then, came through the press?

Mr. PASS. Yes, sir; I checked it subsequently.

Mr. TREADWAY. But your first intimation was the information that you received from the newspapers, which, of course, must have been a synopsis of this report. I do not imagine that a Syracuse newspaper, even as enterprising as they are, would have printed the entire report that we have before us at the present time.

Mr. PASS. What I saw was in a New York paper, sir.

Mr. TREADWAY. Did it have this complete report?

Mr. PASS. I have not seen the official report yet. This copy that I have in my hand—this is the first time I have had one.

Mr. TREADWAY. Well, I think you are entitled to have one in view of your interesting testimony. Could you tell whether or not the paper that you saw contained more than a synopsis of these 14 pages which make up the report?

Mr. PASS. Yes; it did. It was a fairly complete report. I had it checked after I arrived by plane, here in Washington, and my information was correct. Therefore, my figures are substantially correct. I had them checked before I came here, so that I would be sure that I knew what I was talking about.

Mr. TREADWAY. I am particularly impressed, Mr. Pass, with your statement that, as a practical businessman, you are very confident that there are a great many other businessmen that would corroborate your testimony.

Mr. PASS. I am very sure of it, if time were given to them to present their case, and if they were properly informed. Of course, you all realize that we businessmen, especially those of us who are in comparatively small companies, do not have very much time to keep closely in touch with all these developments.

This is, in my opinion, an extremely serious matter to thousands of companies.

Mr. TREADWAY. That is all, Mr. Chairman.

Mr. MCCORMACK. What part does good management play in a successful business?

Mr. PASS. Well, sir, I think it plays a very important part.

Mr. MCCORMACK. I know that; I have some idea of it myself, and I wanted to get your opinion. Would it contribute 75 percent to the success of a business?

Mr. PASS. I should say that figure would be quite reasonable.

Mr. MCCORMACK. I picked that out because I wanted to get the value of your experience. My own views are along that line. Take two companies in the same line of business. One makes money and the other does not make money. You say, in your illustration, that the company with subnormal earnings is discriminated against. Now, with reference to the company that has good earnings as a result of effective management, would you not think, if you eliminated average earnings, that that company would be sharply discriminated against?

Mr. PASS. Generally speaking, such companies would be in a far better position to pay high taxes.

Mr. MCCORMACK. Unless you have something along the line of average earnings as a basis of consideration, you are penalizing good management.

Mr. PASS. No, sir; because I am simply saying that if we follow the principle that was set up before, then all companies will be treated alike, and then there will be no discrimination.

Mr. McCORMACK. Do we not treat all companies alike now? If a company wants to elect the invested-capital theory, if they have earnings of less than 6 percent on the first $500,000 and 4 percent above that—and I am not necessarily wedded to 6 and 4 percent, but we have got to have a percentage, some arbitrary point to start from—you agree to that, do you not?

Mr. PASS. Yes.

Mr. McCORMACK. Whether it is 6 or 8 percent, or 5 or 7 percent—whatever it is. In this recommendation it is 6 percent on the first $500,000 of invested capital, and 4 percent above that. Companies that earn less than 4 percent—6 percent on their first $500,000 or less than 4 percent on their $20,000,000 of invested capital—that provision helps them, does it not?

Mr. PASS. If their earnings are less than 6 percent and 4 percent; yes. But my thought, sir, is that your question is answered to a large extent in the suggestion of your subcommittee that in the case of new corporations those figures be 10 and 8 percent.

Mr. McCORMACK. I am not sure whether you are right on that or not. But we are talking about corporations that have a base period experience. Do you think there should be any consideration shown to new corporations in order to induce the investment of capital?

Mr. PASS. I think, sir, that all corporations should be treated alike under the law. I think that involves the method of assessing an excess-profits tax that I have outlined here, and which is predicated upon past experience in this country.

Mr. McCORMACK. We are not passing on the question of old or new corporations now. We are discussing the two basic theories involved in the bill. Let us take the corporation that gets less than a certain exempted percentage, whatever the percentage is. It would probably be advisable for that corporation to take the invested capital theory as their basis of computation, is that right?

Mr. PASS. I did not quite understand that.

Mr. McCORMACK. Take a corporation that has earned, during the base period, less than the percentage of earnings that is exempted. That corporation, it would be advisable to them to take the invested capital theory?

Mr. PASS. Yes, sir.

Mr. McCORMACK. Take the corporation that in the average years has made more, if they applied it on a percentage basis, than what the exemption would be. It would be better for them to take the average earnings in dollars, would it not?

Mr. PASS. Yes, sir.

Mr. McCORMACK. You have said that management comprises about 75 percent of the success of a business. Take two companies in the same line of business. One does not make money during the base period. Four percent is the exemption. The other one makes 8 percent. If you apply the same percentage to all companies, are you not really penalizing good management?

Mr. PASS. No, sir; because the tax is not based on what happens in those years. The tax is based on earnings in the current year.

Mr. McCORMACK. I know, but good management applies whether it is in past years or in the current year, does it not?

Mr. PASS. May I say, sir, that if one reviews the history of any corporation that I know of that has been in existence a considerable

number of years, it is quite clear that in the life of practically all corporations except possibly the very largest ones in recent years, there is a sine curve of business. Their business is not static. They have their tides, their periods of relatively less success and periods of greater success.

Mr. McCORMACK. You do not have to argue that with me, except that if there are two companies in the same line of business, they are following that general curve. If one has good management, and the other has poor management, the well-managed company will be more successful within the general trend than the company with poor management.

Mr. PASS. May I point out, sir, if you take 4 years, those may be the 4 years in which one of those companies will be at the node of its sine curve and the other one will be at the loop.

Mr. McCORMACK. If you allowed a corporation to elect 3 out of the 4 base years, would not that tend to meet that situation in part?

Mr. PASS. I think it would, sir.

Mr. McCORMACK. Do you think the rates proposed by the subcommittee should be increased? You know what the rates are, do you not?

Mr. PASS. The rates of exemption, the rates of credit, or the rates of tax?

Mr. McCORMACK. The rates of tax; do you think they should be increased?

Mr. PASS. It starts at 25 percent, then goes to 30 percent, and then goes to 40 percent?

Mr. McCORMACK. Yes.

Mr. PASS. I do not think they should be increased. I do not know just what would be most equitable. As I say, I am not a tax expert.

Mr. McCORMACK. Do you think the rates proposed by the subcommittee to the full committee should be increased—the rates of tax?

Mr. PASS. No, sir; I do not.

Mr. McCORMACK. I agree with you personally. I was just interested to get your answer, because I knew the views of some others. That is all.

The CHAIRMAN. Any further questions?

Mr. KNUTSON. Would it improve the bill if we were to give those making returns the option of selecting say 3 out of the 4 years?

Mr. PASS. I do not think it would do away with a legitimate charge of discrimination; no, sir, I do not.

Mr. KNUTSON. Would it ease the burden any?

Mr. PASS. Very slightly.

Mr. KNUTSON. If we took more years than that, with an opportunity to go back, say, for the last 10 years—well, the last 10 years have been abnormal in all lines of business.

Mr. PASS. Yes, sir.

Mr. KNUTSON. I mean subnormal.

Mr. PASS. Yes, sir.

Mr. KNUTSON. It is going to be pretty difficult to frame an excess-profits law that will not work a hardship and that may not put a number of concerns out of business.

Mr. PASS. May I say, if you based your tax, your excess-profits tax, on all earnings in excess of a fixed percentage of invested capital,

you would take care of the situation completely and would treat all alike under the law.

The CHAIRMAN. If a taxpayer were permitted the option of selecting as a base period any year that would relieve him of all taxes, that would be ideal, would it not?

Mr. PASS. I do not think so. I am not trying to escape taxation.

The CHAIRMAN. I did not say that; I was just wondering if that wouldn't be ideal.

Mr. PASS. May I say, sir, that what I am proposing is not to decrease the Federal revenue by one penny; it is simply that the revenue be raised in a way which will be fair to all who have to pay the tax under the law.

The CHAIRMAN. As a basic proposition that is very fair and I think we would all agree with you. But I suppose we could argue over here until doomsday on how to accomplish that and not agree. Each member of this committee may have a different opinion.

Mr. PASS. May I ask, sir, why the principle or the method used in the last war was not fair?

The CHAIRMAN. We are trying to write a bill with a view to present conditions, at the same time getting the benefit of the experience that we had with the excess-profits tax in 1917, 1918, and 1921.

If there are no further questions, we thank you, Mr. Pass.

The next witness is Mr. Ralph H. Miner, representing the Ohio Manufacturing Association.

(Mr. Miner did not come forward.)

The CHAIRMAN. The next witness is John Pleyhan, of Detroit, Mich.

(Mr. Pleyhan did not come forward.)

The CHAIRMAN. The first witness on the calendar this morning was Mr. Ogg, representing the American Farm Bureau Federation. I understand that Mr. Ogg did not know he was scheduled to appear first on the calendar, and if there is no objection, the Chair will now recognize Mr. Ogg.

Mr. MCCORMACK. Mr. Chairman, I have received a letter from David Broude discussing the pending bill, for which I would like permission to insert in the record.

The CHAIRMAN. Without objection it is so ordered.

(The letter referred to follows:)

DAVID BROUDE,
*Boston, Mass., August 8, 1940.*

Hon. JOHN W. MCCORMACK,
*House of Representatives, Washington, D. C.*

DEAR MR. MCCORMACK: Thank you for your prompt reply to my letter concerning your proposal for consideration of the principle of the undistributed earnings tax in connection with the excess profits tax. Like you, I feel that the undistributed profits tax was undesirable in the normal corporate tax program, and I also have a feeling that if it could be employed in connection with the excess-profits tax in such a way as to eliminate the question of "invested capital," "pre-war average earnings," and the accompanying "special relief provisions" including even "special amortization," many inequities could be eliminated and protracted litigation with its incident burden on both taxpayers and the Government avoided.

I am sure that if you have not already seen a very recent decision written by Circuit Justice Clark of the third circuit on June 29, 1940, emphasizing your point, you will be interested in a short quotation from it:

"*Pittsburgh Can Company, plaintiff-appellant* v. *United States of America, defendant-appellee*, United States Circuit Court of Appeals for the Third Circuit, No. 7272, October term, 1939, filed June 29, 1940

"By coincidence this is the third case arising out of World War No. 1 considered by this Court at this term. * * * In one case [apparently not a tax case] we held that those profits may have "disappointed" the United States, but had not "deluded" them in the sense of the rule permitting relief. In another *we did not permit a manufacturing company to ascribe its expansion to patriotism and so minimize its tax liability for excess profits.* In the case at bar we are upholding the right and intention of the Congress to enlarge the limitation period for the very same tax. * * * The *elapsed time, twenty-three years, is, we may observe, rather staggering.*"

I think the last sentence just quoted is perhaps the most eloquent indictment that could be made of the old World War excess-profits-tax law, and as you know, there is still much more pending litigation.

I wonder if you have any statistics readily available that would show the amount of excess- and war-profits taxes originally collected under the 1917 and 1918 acts, the amount of additional assessments, and the amount of excess- and war-profits taxes, plus interest, that have had to be refunded thereunder. Please, however, do not trouble to get these statistics if you do not have them at hand. I feel certain that the net result would show a much smaller net return from the war- and excess-profits tax than was anticipated.

It does seem to me that a formula could be evolved which would compel the distribution of excess business profits among the shareholders to be included by them in their returns. The recently increased individual tax rates applied to the increased-dividend income resulting would undoubtedly yield all that any excess profits tax law patterned after those of World War I would, with much less disturbance to business and much less likelihood of diminution by subsequent allowances of refunds with 6 percent interest running for years pending ultimate determination of questions such as "invested capital," "special relief," "amortization," "average earnings," etc. Such distribution of additional earnings would allow the shareholders to determine whether to reinvest in the same companies or in other companies, thus relieving the directors of the responsibility which they seem to fear of determining whether to enlarge plant facilities unless assured of liberal amortization allowances.

Thank you for mentioning that Mr. Dewey has shown a great interest in your proposal. I shall endeavor to get to get together with with him soon for an exchange of views.

If I should like to appear before the Committee advocating this proposal, could you arrange for a hearing?

Very truly yours,

DAVID BROUDE.

DB:EH

## STATEMENT OF W. R. OGG, DIRECTOR IN CHARGE OF RESEARCH, AMERICAN FARM BUREAU FEDERATION

The CHAIRMAN. The next witness is Mr. W. R. Ogg. Please give your full name and for whom you are appearing.

Mr. OGG. Mr. Chairman and gentlemen of the Committee: I am director of research in charge of the Washington office, American Farm Bureau Federation.

The CHAIRMAN. You may proceed.

Mr. OGG. Mr. Chairman and gentlemen of the committee: I have a statement which I am authorized by telephone from President Edward A. O'Neal of the American Farm Bureau Federation to present to the committee.

The American Farm Bureau Federation commends the prompt action of the Ways and Means Committee and the Finance Committee in undertaking to formulate legislation with respect to excess-profits taxation and special amortization provisions. We recognize the great importance of such legislation to the national defense program.

As spokesmen for farmers representing a large and important part of our citizenship, we feel it is timely to express some fundamental

convictions with respect to taxation and profits which we believe are basic to our national security in this time of great emergency.

We are 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 contracts unless this or that assurance is given to industry.

There have also been a few strikes and threats of strikes on the part of minority groups in labor engaged in essential defense industries.

Every reasonable person recognizes that some special provision should be made for an equitable amortization of new or special plant equipment that will be required for defense purposes, and that such action together with excess-profits taxes, should be settled as soon as possible in order to relieve business uncertainty and enable it to plan more intelligently. It is further recognized that this emergency should not be used by selfish groups as an excuse for oppression of labor.

But the American people will not tolerate, at a time of such grave emergency, any group, in effect, pointing a pistol at the Government and saying they will not produce guns or airplanes or other supplies needed for national defense in this hour of grave emergency unless they are given this guaranty or that guaranty and unless the restrictions are kept off their profits.

National Guard men have been called from their jobs or schools to do their part in special training, and if pending legislation is approved, will be called for a year's special service. Congress also has under consideration additional legislation for the conscription of manpower for military training. If we are going to conscript our manpower to serve our country at $21 a month to train them to shoot guns, operate tanks, and fly airplanes, it is equally essential that the industries which manufacture guns, tanks, planes, and other military equipment be willing to do their part in the national-defense program.

In such emergency, no industry or groups has any vested right to demand not only their normal profits, but in addition to demand that the Government help underwrite their capital risks, take off restrictions upon profits, and let them keep the 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 or fatal delays. If everyone will do his part, this should not become necessary.

At such a time as this, it is imperative that our people as a whole support the defense program without selfish stipulations. The attitude of every patriotic citizen and group should be: "How can I help promote the national defense?" instead of "What am I going to get out of it?"

American agriculture does not ask for any special preferred position or extra profits out of the war. Farmers are ready to do their part; they are not going to refuse to produce essential food and fiber unless they are guaranteed their normal profits and a liberal share of excess profits as well. Farmers have produced and are continuing to produce an abundance of food and fiber. The fact is, our agriculture is going to suffer tremendously, at least large parts of it, as a result of the present war. Already surpluses are accumulating due to the curtailment of our export markets. We have confined our requests to repairing the damage done by these trade dislocations and to maintaining a parity relationship between agriculture, industry and labor.

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.

With respect to the "Proposed Excess-Profits Taxation and special amortization—1940," contained in the report of the House Ways and Means Subcommittee, we respectfully submit the following recommendations:

1. We endorse the general principles of the proposed legislation with some qualifications and exceptions, hereinafter referred to. As a safeguard to industry during the 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.

2. The enactment of an equitable excess-profits tax to prevent war profiteering and to recapture excess profits to help finance the national-defense program, should also be speedily enacted as a part of this legislation.

3. In the formulation of excess-profits taxes, there should be some ceiling, above which all profits would be considered excess profits. One important weakness in the pending proposal is that it will permit inordinate profits by corporations which enjoyed a favored position during the period 1936–39, while corporations which were making only modest earnings during that period will be much more rigidly restricted in their profits. In other words, the company which profiteered on the public due to lucky circumstances or to monopolistic controls, during this base-period, will be allowed to continue to profiteer up to the same level before it is subject to excess-profits taxes during this emergency.

This situation is permitted under the so-called "average earnings" option, wherein a corporation is allowed to take as a credit against its net income, an amount equal to its average earnings for the base-period, 1936-39. The other option allows a credit equal to the percentage of its invested capital for the taxable year which its earnings

during the base-period bears to its invested capital for the base-period, but not to exceed 10 percent or be less than 4 percent.

The unequal effect of these two options as applied to some of our leading industrial corporations, is illustrated in the attached analysis which was published in the Wall Street Journal on August 8 (exhibit 1).

In order to correct this defect, it is suggested that the average earnings option be safeguarded by adding a reasonable over-all limitation on earnings, above which all earnings, would be considered excess profits. The average rate of earnings for 1936–39 is not a satisfactory limitation. It is an open invitation to the exploiter to continue to exploit in the name of national defense. It should be borne in mind also that many corporations which do not obtain national defense contracts will profit from the increased purchasing power which will result from large defense expenditures.

4. The proposed rates for excess-profits taxes are too low and should be increased, in the first place, very liberal exemptions are provided before any such taxes are levied; then the rate begins at 25 percent and the maximum to be levied is 40 percent, no matter how great the profiteering on national defense.

Thus, a corporation is allowed 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 avrage earnings during 1936–39, 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 40 percent of all excess profits no matter how great they may be.

Clearly, the public is entitled to greater protection from war profiteers than this. Surely, every patriotic industry should be content with reasonable profits, in this time of grave emergency, and not demand the opportunity to make extortionate profits. This is a time which calls for sacrifice instead of profiteering.

5. It is further recommended that Congress instruct the Treasury 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. The committee and experts who have assisted it are to be commended for the progress made toward the solution of some of these problems.

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, immediately undertake a thorough study and revison 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.

Mr. OGG. Mr. Chairman, I will not take time of the committee to read the figures but offer for the record the exhibit referred to.

The CHAIRMAN. Without objection it will be made a part of the record.

(The statement referred to follows:)

## EXHIBIT I

[From Wall Street Journal, Aug. 8, 1940]

*Effects of new profits tax plan*

AVERAGE EARNINGS OPTION

| Company | (a) Income before taxes | Normal tax (20.9 percent) | Balance before excess-profits taxes | (b) Excess-profits tax exemption | Excess profits | (c) Excess-profits tax | Ratio of normal and excess-profits taxes to income | Net after normal and excess-profits taxes | Actual net reported for year under consideration |
|---|---|---|---|---|---|---|---|---|---|
| Chrysler | $76,110,543 | $15,907,103 | $60,203,440 | $42,134,469 | $18,068,971 | $6,174,225 | 29.01 | $54,029,215 | $62,110,543 |
| General Motors | 262,312,820 | 59,033,379 | 223,309,441 | 180,104,813 | 43,204,628 | 12,770,230 | 25.42 | 210,330,211 | 228,482,425 |
| General Foods | 18,396,263 | 3,842,729 | 14,543,534 | 13,040,597 | 1,502,937 | 385,678 | 22.99 | 14,157,856 | 15,118,063 |
| Texas Corporation | 61,674,319 | 12,889,933 | 48,784,386 | 37,220,124 | 11,564,262 | 3,695,200 | 26.89 | 45,089,186 | 54,574,319 |
| Westinghouse Electric | 25,788,344 | 5,389,704 | 20,398,580 | 14,598,210 | 5,800,370 | 1,980,662 | 28.58 | 18,957,888 | 20,129,408 |
| United Aircraft | 11,287,768 | 2,359,143 | 8,928,625 | 5,151,106 | 3,777,519 | 1,481,229 | 34.02 | 7,447,396 | 9,375,437 |
| Glenn L. Martin | 5,097,606 | 1,065,400 | 4,032,207 | 2,089,367 | 1,942,840 | 724,903 | 35.12 | 3,307,304 | 4,110,606 |
| U. S. Steel | 124,444,358 | 26,008,871 | 108,435,487 | 44,737,549 | 63,697,938 | 24,630,737 | 40.69 | 83,804,780 | 94,944,358 |
| Bethlehem | 38,087,486 | 8,085,685 | 30,001,801 | 18,907,396 | 11,094,405 | 4,205,115 | 31.76 | 26,396,686 | 31,819,506 |
| Montgomery Ward | 34,310,645 | 7,170,925 | 27,139,720 | 21,521,136 | 5,618,584 | 1,709,397 | 25.88 | 25,430,323 | 27,010,645 |
| American Can | 23,404,685 | 4,891,579 | 18,513,106 | 16,776,285 | 1,736,821 | 437,165 | 22.76 | 18,075,941 | 18,294,964 |
| N. Y. Shipbuilding | 1,005,356 | 209,682 | 795,982 | 121,714 | 672,268 | 265,865 | 47.29 | 528,117 | 928,264 |
| Eastman Kodak | 27,933,232 | 5,838,045 | 22,095,187 | 20,037,675 | 2,057,512 | 517,065 | 22.75 | 21,578,122 | 22,347,345 |

See footnotes at end of table.

*Effects of new profits tax plan*—Continued

RETURN ON INVESTED CAPITAL OPTION

| Company | (a) Income before taxes | Normal tax (20.9 percent) | Balance before excess-profits taxes | Average return on invested capital 1936-39 (percent) | (d) Excess-profits tax exemption | Excess profits | (c) Excess-profits tax | Ratio of normal and excess-profits taxes to income | Net after normal and excess-profits taxes | Actual net reported for year under consideration |
|---|---|---|---|---|---|---|---|---|---|---|
| Chrysler | $76, 110, 543 | $15, 907, 103 | $60, 203, 440 | 28. 6 | $17, 182, 502 | $43, 020, 938 | $16, 778, 813 | 42. 94 | $8, 242, 125 | $62, 110, 543 |
| General Motors | 282, 312, 280 | 59, 003, 379 | 223, 309, 441 | 18. 03 | 104, 776, 295 | 118, 533, 146 | 44, 793, 851 | 36. 76 | 178, 515, 590 | 238, 482, 425 |
| General Foods | 18, 396, 263 | 3, 842, 729 | 14, 553, 534 | 19. 1 | 7, 981, 740 | 6, 561, 794 | 2, 425, 173 | 34. 09 | 12, 118, 361 | 15, 118, 063 |
| Texas Corporation | 61, 674, 319 | 12, 880, 933 | 48, 794, 376 | 8. 4 | 41, 831, 204 | 6, 953, 182 | 1, 876, 709 | 23. 95 | 46, 907, 587 | 54, 574, 310 |
| Westinghouse Electric | 25, 788, 344 | 5, 389, 754 | 20, 398, 850 | 7. 55 | 14, 537, 678 | 5, 860, 902 | 1, 980, 918 | 28. 58 | 18, 957, 092 | 20, 126, 408 |
| United Aircraft | 11, 287, 708 | 2, 359, 143 | 8, 928, 625 | 21. 54 | 3, 252, 183 | 5, 676, 442 | 2, 197, 772 | 40. 22 | 9, 730, 853 | 9, 375, 437 |
| Glenn L. Martin | 5, 097, 606 | 1, 065, 400 | 4, 032, 207 | 22. 25 | 1, 800, 620 | 2, 231, 587 | 847, 719 | 37. 52 | 3, 184, 488 | 4, 110, 606 |
| U. S. Steel | 124, 444, 358 | 26, 008, 871 | 108, 435, 487 | 2. 89 | 56, 004, 863 | 52, 430, 624 | 19, 572, 127 | 36. 62 | 88, 893, 360 | 94, 944, 358 |
| Bethlehem | 38, 687, 486 | 8, 085, 685 | 30, 601, 801 | 3. 87 | 19, 312, 895 | 11, 288, 916 | 4, 032, 744 | 31. 32 | 26, 569, 057 | 31, 819, 596 |
| Montgomery Ward | 34, 310, 645 | 7, 170, 925 | 27, 139, 720 | 11. 7 | 21, 118, 195 | 6, 021, 525 | 1, 880, 655 | 26. 38 | 25, 259, 065 | 27, 010, 645 |
| American Can | 23, 404, 685 | 4, 891, 579 | 18, 513, 106 | 10. 44 | 10, 029, 605 | 2, 483, 501 | 664, 902 | 23. 74 | 17, 848, 204 | 18, 284, 904 |
| N. Y. Shipbuilding | 1, 003, 264 | 209, 682 | 793, 982 | 1. 81 | 306, 529 | 487, 453 | 187, 318 | 39. 57 | 606, 664 | 928, 264 |
| Eastman Kodak | 27, 933, 232 | 5, 838, 045 | 22, 095, 187 | 12. 46 | 18, 860, 470 | 3, 234, 717 | 876, 113 | 24. 03 | 21, 219, 074 | 22, 347, 345 |

(a)—Largest for recent years. For Chrysler and General Motors, 1936. For United Aircraft, Glenn L. Martin, General Foods, American Can, and New York Shipbuilding, 1939. For Montgomery Ward year ended January 31, 1940, and for Texas Corporation, Westinghouse Electric, U. S. Steel, Bethlehem Steel, and Eastman Kodak, 1937. (b)—Average earnings, 1936-39, plus $5,000. (c)—25 percent on net income not in excess of 10 percent of the excess-profits-tax credit; 30 percent on net income in excess of 10 percent of the credit, but not in excess of 20 percent of the credit, and 40 percent on net income in excess of 20 percent of the credit. (d)—$5,000 plus maximum of 10 percent on invested capital and minimum credit of 6 percent on first $500,000 plus 4 percent on remainder or invested capital. Between those maximum and minimum limits a corporation receives credit equivalent to its average rate of return for the years 1936-39.

The CHAIRMAN. Does that complete your statement?

Mr. OGG. Yes.

The CHAIRMAN. Any questions? If not, we desire to thank you for your very excellent statement, Mr. Ogg.

Mr. OGG. Thank you.

The CHAIRMAN. There has just been handed to the chairman a letter which I believe the committee would be interested in, and without objection, the Chair will read it into the record.

LICKINGVILLE, PA., *August 12, 1940.*

WAYS AND MEANS COMMITTEE, TAX DIVISION,
*United States Congress.*

DEAR SIRS: The President can start a march of dimes. Congress should start a march of dollars for defense. Dollars given today help keep the invader away. If you live freely then give freely.

The enclosed dollar is for safety and security.

That is signed by John L. Krane, and here is the dollar attached. The Chair will be governed by the legal staff as to what disposition is to be made of the dollar.

Mr. MCCORMACK. The intention of the writer is certainly patriotic.

The CHAIRMAN. The sentiment is splendid, and I hope the press makes use of it.

Mr. Phillip W. Haberman would like very much to be permitted to make a brief statement; and without objection, we will hear him.

## STATEMENT OF PHILLIP W. HABERMAN

Mr. HABERMAN. Mr. Chairman, for the record, my name is Phillip W. Haberman. I am vice president and general counsel of the Commercial Investment Trust Corporation, 1 Park Avenue, New York City.

I have read the reports that have been made from day to day covering the testimony given before the committee, and I am impressed considerably by the fact that there is such a vast diversity of opinion as to the construction of this kind of a measure and its impact on different industries.

A suggestion occurred to me which I want to submit to the committee. As I recall now, Mr. Sullivan, of the Treasury Department, on the first day of the hearings, said that the estimated revenues for the year 1940, arising out of this measure, would be approximately $190,000,000, which, of course, is not a large sum in view of the emergency.

The matter of profits arising out of the prepration for defense under contract will be small this year undoubtedly, although they will be much more next year.

It would be my suggestion, if it is not out of order in view of the problems of this committee, that the excess-profits tax be not made applicable to the year 1940 but that in lieu thereof the normal corporate rate be increased from 19 percent to 22 percent.

The revenues received from corporations in the year 1939, I understand, were something like $1,500,000,000, at 19 percent, and one-nineteenth of 1 percent would be seventy-nine million. Therefore if you have an increase of 3 percent in the normal corporate rates for the current year you would receive approximately two hundred and thirty-six million; and then, by adding to that the surtax of 10 percent, you would yield to the National Treasury from that source in excess of two hundred and sixty million without giving effect to

the fact that on the basis of the half-year's earnings as shown in reports of corporations of the country for the midyear, and it is obvious that the net earnings of corporations, by and large, for the country as a whole, are going to be much more than they were in the preceding year. Therefore the $260,000,000, which is the minimum, will undoubtedly be much exceeded if that principle can be adopted, and it can readily tie in with the amortization provision and give us a constructive tax bill without the added burdens incident to this difficult problem and in addition raise revenue for the Government. That will allow proper time for formulating the provisions of an excess-profits tax bill, which are complicated, at best; and it would seem to be desirable under present circumstances to follow that procedure and thereby formulate a bill under which industry, by and large, can operate with fewer discriminations and with fewer burdens than under various phases of bills that have been considered up to this time.

That is my first suggestion.

My second suggestion bears on the question of consolidated returns.

I want to strongly urge upon the committee that if and when an excess-profit-tax bill is enacted it carry a provision for consolidated returns by corporations and their 95-percent owned subsidiaries. In doing this there is no distortion of earnings, such as falls on integrated groups, where some of them have normal or more earnings and others are in the deficit position. And if you assemble the separate returns and find the results of operation in groups of that kind, you will find that the impact of the tax is not within the philosophy of equitable taxation.

I am impressed on this point after reviewing the situation in a number of industries where there are affiliated corporations of different kinds. In our own group there are a number of sibsudiaries being what is really a single enterprise but by reason of diverse laws forced to operate in separate units.

We have undertaken to simplify the corporate structure as much as possible but have not been successful as far as we would like to have gone by reason of the fact that we operate all over the United States, and we have been obliged to maintain separate corporations by reason of diversity of State laws in many areas. And also the function of the different corporations in this group are such that they cannot be carried on under a single entity.

We have, for example, one corporate subsidiary, 100 percent owned, which will present quite a problem if we cannot file a consolidated return. We acquired this corporation just prior to the beginning of 1939, and 1939 was the first year's operation of that particular unit. Prior to that time it has been an absolutely dormant corporation, for a number of years, with small capital and negligible earnings.

We acquired it by reason of the fact that certain corporations that we owned, which had been doing a somewhat similar function, had to be dissolved by reason of changes in the New York State law. Therefore, we acquired the company. We cannot relate our earnings of the other companies; which have been dissolved, these 4 years, for to this particular company and normal earnings of the kind that we previously enjoyed in similar operations arising in this company, contracted with the 3 prior years of dormancy and no profit to speak of, would result in a distinct hardship.

I merely cite that to you as one of the many examples that might be called to your attention as to the needs and propriety for allowing a company, if an excess-profits-tax bill is enacted, to file a consolidated return.

I have a very short memorandum covering these points.

The CHAIRMAN. Would you like to submit that for the record?

Mr. HABERMAN. Yes; I would like to do so.

The CHAIRMAN. Without objection, it is so ordered.

(The statement referred to follows:)

AMORTIZATION AND TAXATION

The amortization measure should be separately passed, as it is simple compared with an excess-profits tax.

For 1940 the Treasury is said to need $300,000,000 from corporations in excess of returns at the 19-percent rate for 1939. This can be met by a simple increase in the corporate rate, plus 10 percent supertax. It would avoid accounting difficulties and fall proportionately on all profits.

In fact, additional revenues can be produced by further increases from time to time, as high as may be necessary. Treasury forecasts and calculations would thereby be simplified.

If the amortization plan must be tied to a revenue measure and if the foregoing formula is followed, it will handle both the defense and revenue needs constructively.

Excess-profits taxes are complicated and fall unevenly on comparable corporations with identical capital and profits. Discriminations can be disastrous, particularly to corporations which have no profits from the defense program.

The national economy ought not to be prejudiced by hurried legislation. Careful study is necessary. A sound bill, following adequate studies, can be prepared to apply to 1941 profits.

| | |
|---|---|
| 1939 corporate tax (19-percent rate) | $1, 500, 000, 000 |
| 10-percent supertax | 150, 000, 000 |
| Total revenue if 1940 returns no larger | 1, 650, 000, 000 |
| Each one-nineteenth of the collections (1 percent) is | 79, 000, 000 |
| Hence, a 3-percent increase over the 19 percent is | 237, 000, 000 |
| Add 10 percent supertax | 23, 700, 000 |
| Total additional revenue at basic 22-percent rate plus 10-percent supertax | 260, 700, 000 |

Mr. CROWTHER. With regard to the suggestion you have made, Mr. Haberman, I think it is a very practical one, but you realize there is a little psychological condition that has to be taken into account here. The general public is sold on the fact that we are not going to make any war millionaires and therefore we are going to have an excess-profits tax.

I think your figures are about correct. I think we have figured out that normally 1 percent of the corporate income brings in about $70,000,000.

Mr. HABERMAN. Yes.

Mr. CROWTHER. So that your figures are correct as to the rate; but it seems to me that having advertised that we are going to have an excess-profits tax so extensively to the country, carrying the implication that it will stop the creation of new millionaires, there would be considerable objection to the adoption of your plan at this time.

Mr. HABERMAN. Of course, we cannot be carried away by slogans if we can accomplish a better job for the Treasury.

And my suggestion, as you will note, applies only to the year 1940.

Mr. CROWTHER. Yes.

Mr. HABERMAN. This same principle would apply. It will thereby give you an opportunity to work out the problem of an equitable excess-profits-tax measure to be applied from January 1, 1941, but in this year, 1940, the matter of creating millionaires out of war endeavors is a fiction; there is no such thing.

Therefore, by increasing the corporate tax rate it will give corporations which use the alternatives that have been presented here the obligation to pay one tax.

Also, there are companies whose income over a period of years would be such that they would not come under the brackets of this tax, and yet who may desire to pay, as they should, a part of the cost of the national-defense program, and if you increase the normal rate by 3 percent, which will mean a very heavy increase, but it will give many of them an opportunity to pay a tax, even though under the provisions of the excess-profits tax they might not otherwise have to pay a tax.

Mr. CROWTHER. Is not the corporate tax rate now figured at about 20.9 percent?

Mr. HABERMAN. Nineteen plus the 10 percent.

Mr. Crowther. Yes.

Mr. HABERMAN. I am suggesting that it be increased to 22 percent plus the 10 percent now in effect.

Mr. COWTHER. Retroactively?

Mr. HABERMAN. Retroactively for 1940, which in effect will mean that 24.2 percent tax, and I think that industry as a whole would welcome that kind of a solution for the year 1940 to the present measure, since they are not prepared to meet the situation for the current year, and it will result in many controversies if adopted, and yet this will raise the money sought to be raised from the pending measure.

The CHAIRMAN. Any questions? If not we thank you for your appearance.

Mr. HABERMAN. I thank you, Mr. Chairman.

Mr. McCORMACK. Mr. Chairman, I suggest that the members of the Finance Committee and of Ways and Means be permitted to include in the record letters and communications which they may receive up to the time the record is going to print.

The CHAIRMAN. Without objection that suggestion will be followed.

So far as the Chair knows that concludes the hearings. There are no further witnesses scheduled.

The chairman would like to make a brief statement before we adjourn. I am sure that I express the feeling and sentiment of the members of the Ways and Means Committee when I say that we have appreciated and enjoyed very much the cooperation of the members of the Senate Finance Committee. Since I have been a member of the Committee on Ways and Means, which dates back sometime before I became chairman, I have never witnessed a hearing where there has been as fine a spirit of cooperation and harmony in working out a difficult problem. I am sure that the joint hearings of the Finance Committee and the Ways and Means Committee have not only been interesting but will prove helpful in working out a joint bill and we appreciate very much having had the members of the Finance Committee and the fine cooperation and assistance they have given since the hearings began.

Senator HARRISON. Mr. Chairman, of course, the Finance Committee is very appreciative of the invitation to sit with your committee during these hearings.

Members of the Finance Committee have been tied up in the consideration of another difficult question in reference to conscription, and they could not therefore be here as often as they would like to have been.

I hope that these hearings will be printed as soon as possible so that members of the Finance Committee may have copies of them. We will have some conferences to see whether we cannot expedite the legislation.

I cannot say at this time whether we will have further hearings by the Finance Committee; that is up to the members of that committee. But personally, I see no necessity for any further hearings.

I know that we are going to continue to cooperate as much as possible with the Committee on Ways and Means, as we have done heretofore, in connection with the matter of taxes, so that this program may get under way as quickly as possible.

Senator KING. May I express the hope that the Committee on Ways and Means will report such a perfect bill that the Committee on Finance will have little to do except to O. K. it.

The CHAIRMAN. There being no further witnesses to be heard, the Chair declares that the hearings are now closed.

(Thereupon, the committee adjourned, subject to the call of the chairman.)

(The following were submitted for the record:)

"LETTER OF W. J. KELLY, PRESIDENT OF THE MACHINERY AND ALLIED PRODUCTS INSTITUTE, CHICAGO, ILL."

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
*Chicago, August 14, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Committee on Ways and Means,*
*House of Representatives, Washington, D. C.*

DEAR SIR: In a report entitled "Capital Goods Industries and Federal Income Taxation," presented to the members of your committee late in July, the Machinery and Allied Products Institute discussed certain discriminating effects of Federal tax laws which relate intimately to the phase of income taxation on which your committee is now holding public hearings. We attach another copy of this report, and respectfully request that it be included with this communication in the record of your current hearings.

The report of your Subcommittee on Proposed Excess Profits Taxation and Special Amortization makes recommendations on the matter of amortization with which we are in substantial agreement. Indeed, we believe, and we have urged on the Treasury Department for several months, that this subject should be given separate consideration, and that legislation adequately covering it be passed promptly by the Congress and without reference to excess-profits taxation. We believe that your committee should promptly assume the leadership in accomplishing the enactment of such legislation now.

The subcommittee's report recommends further an excess-profits tax to be levied on either of two alternatives, election of the alternative to be left to the taxpayer, the base period in each instance being 1936–39.

As the afore-mentioned report proves beyond question, 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. Moreover, we invite your committee's attention to the fact that the results of 1938 ranged from minor profit to substantial loss for most of the companies in the capital-goods industries, whereas consumption-goods companies as a group made near-normal profits. To include the year 1938 in averaging profits is therefore without justice to the manu-

facturers for whom we speak. To require, when either the average earnings alternative or the so-called invested capital alternative is used, the earnings of the 4-year period, 1936–39, to be taken as the base, would be grossly unjust.

We realize your committee wishes to be fair and insofar as possible spread the Federal tax load equitably. We want to help you attain this end. However, we believe the manner in which the proposed excess-profits tax legislation is now being rushed is entirely unnecessary and unwise; we feel that unless certain provisions are changed, equity cannot be accomplished, and we reluctantly conclude that the present proposals will certainly lead to greater rather than less discrimination, with the capital-goods industries again the principal victims.

Under these circumstances we ask for time in which our taxation committee may further canvass the effects of the present proposals. The provisions recommended by your subcommittee are complex. Only this week have individual companies received the details, and projection of the recommendations to their individual situation is daily bringing numerous questions and revealing new implications. We ask that your committee allow us the privilege of appearing before you at a later date so that we may discuss with you the conclusions reached by our members. To proceed to enact new tax legislation without this kind of careful study is not prudent, and in our judgment may impede seriously the national-defense production we are all seeking to stimulate. As well as the relatively small number of prime contractors, there must be considered the opinions of the very many more subcontractors.

Meanwhile, we trust that your committee will find it possible, before reporting your recommendations on the subject of excess profits, to make such changes in the subcommittee's plan as will more nearly restore Federal income-tax equity to capital-goods manufacturers. In this connection, any approach to the solution of this grave problem assuming the two alternatives outlined by the subcommittee are to be retained in principle, cannot be sound so far as the capital-goods industries are concerned, unless it includes among others such considerations as:

(1) Provision which will assure against taxation of profits which are less than a 10 percent return on capital.

(2) 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.

(3) 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.

Respectfully submitted.

WM. J. KELLY, *President.*

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TELEGRAM OF INTERNATIONAL MILLING CO.

MINNEAPOLIS, MINN., *August 14, 1940.*

HON. JOHN G. ALEXANDER,
*Washington, D. C.*

Understand excess-profits tax contemplates base period 4 years from 1936 to 1939, inclusive. 1936 was year in which we refunded flour customers approximately million and half dollars money recovered account supreme court invalidation of processing tax, Treasury Department instead allocating these refunds to years in which processing taxes were collected as allocated them all to 1936, thus creating enormous loss in our income-tax computation for that year. If proposed base period is used will completely distort our earnings for base period and Government will confiscate large part of our earnings during the next 5 years under guise of excess-profits tax. Urge proposed law be amended to eliminate 1936 taxable year from base period.

INTERNATIONAL MILLING CO.

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STATEMENT OF R. H. MINER, OF AKRON, OHIO, REPRESENTING THE OHIO MANUFACTURERS ASSOCIATION

This statement is submitted by the chairman of the taxation committee of the Ohio Manufacturers Association on behalf of that association.

1. It is recommended that a provision permitting consolidated returns for the purpose of the excess-profits tax be incorporated in the bill now being drafted. As a matter of fairness to stockholders of business enterprises, comprising a number of affiliated corporations, these enterprises should be taxed as a unit rather than having separate levies made upon various divisions of the enterprises at variable rates resulting in comparatively higher taxes on the equities of some stockholders as compared with similar holdings of others.

2. It is urged that in many cases earnings above 4 percent of invested capital are not "excessive." The 4-percent exemption tends to tax excessively concerns which may have had a series of poor years as compared with enterprises which have had profitable years even though in the taxable year their earnings may be comparable. The exemption is in direct proportion to the prosperity of the corporation in the base period. Among competitors in some cases the tax will bear most heavily on those least able to pay.

The 4-percent exemption tends to penalize the pioneers in industry who may spend a number of years developing processes at no profit and who finally after much expense begin to make money.

It further tends to discriminate between old companies, limiting them to 4 percent when new enterprises are to be granted an 8-percent exemption.

It seeks to determine what is "excessive" on the same basis for both financially hazardous and financially safe types of enterprises.

It is recommended that with respect to more hazardous enterprises involving long periods of research and development that an exemption of not less than 8 percent be granted.

3. It is suggested the taxpayers be permitted to choose 3 out of the 4 years in the base period for calculating the exemption.

Many concerns have years in which unusual circumstances arise such as refinancing, protracted labor trouble, and periods of retooling which make these years abnormal and not representative of normal conditions. These corporations should be allowed to eliminate 1 year of the 4 to take care of these situations.

4. It is recommended that credit for income, excess-profits, and war-profits taxes levied by foreign governments upon income earned in foreign countries be allowed against the new proposed excess-profits tax as is now already allowed against the normal corporation income tax.

We know of instances where the combined foreign and American taxes on the upper brackets of income will be more than the amount of income unless such credit is allowed.

We approve of the proposed provisions of the bill providing for the amortization of new facilities and granting the taxpayer the optional methods of computing its exemption under the tax.

Realizing that the proper drafting of an excess-profits tax law should normally take a number of weeks or possibly months, it is suggested that it might be well for the Congress to proceed with the amortization provisions and take more time for mature consideration of the excess-profits tax portion of the bill.

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TELEGRAM OF EDWARD L. STANTON, GENERAL MANAGER OF THE GENERAL CONTRACTORS ASSOCIATION OF NEW YORK, N. Y.

NEW YORK, N. Y., *August 12, 1940.*

Hon. ROBERT L. DOUGHTON:

Members of General Contractors Association of New York strongly urge exemption in excess-profits tax bill of construction contracts entered into prior to 1940. Many contractors file tax reports on completed-contract basis and would be unfairly dealt with if such exemption were not included in this proposed law.

EDWARD L. STANTON, *General Manager.*

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BRIEF SUBMITTED BY D. E. CASEY, VICE PRESIDENT AND SECRETARY OF THE AMERICAN TAXPAYERS ASSOCIATION, INC., WASHINGTON, D. C.

INTRODUCTION

When the pending excess-profits tax was proposed, it was stated that its enactment would prevent the creation of new "war millionaires." It was argued, also, that since the tax upon individuals was recently increased, it is unfair not to impose an excess-profits tax on corporations. Such statements utterly disregard the facts.

Corporations are not the ultimate beneficiaries of corporate income. Corporations receive income for the benefit of their stockholders. Under existing laws, corporations no longer dare accumulate any substantial part of the net income remaining to them after the payment of normal taxes; except such portion as is reinvested in plant facilities, expansion, etc. Examination of the conduct of the large corporations in this country in this respect over the last 5 years—that is, since January 1936—will disclose that the income retained by them and not dis-

tributed to stockholders is relatively a very much smaller percentage of their total net income than in any preceding period.

If you make the comparison with the period, say, from 1916 to 1929, it is almost startling. In a large measure, this is the result of section 102 of the Internal Revenue Code as now revised, which penalizes a corporation's accumulation of profits with the purpose of preventing the imposition of surtax on stockholders.

The result under existing income-tax law is that substantially all corporate income, remaining after the normal corporate tax, is distributed to stockholders. The stockholders then pay tax upon all the corporation's distributed income. This is double taxation. It penalizes individuals—stockholders—who receive their income that way.

### NEW TAX SETTING TODAY

The excess-profits tax in the period from 1917 to 1921 operated in an entirely different atmosphere. The personal holding company law had not been passed; the unlawful accumulation section of those acts was ineffective; corporations in some instances were withholding distribution to prevent taxes against the stockholders. The excess-profits tax upon corporations in that setting might have been necessary, but the setting has been entirely changed.

The tax under section 102 is substantially as high upon undistributed income as the proposed excess-profits tax. Considering that corporate net income is substantially all distributed to stockholders and taxed against them at the very high rates under the 1940 law, there is nothing unfair in omitting to impose higher taxes upon the corporation.

If, as has been claimed, corporations will benefit from the increased expenditures due to the defense program, generally they cannot retain the benefit because they must distribute it and it will then be taxed with the high rates which are imposed upon individual income. Again, double taxation.

Under existing law it would be interesting to have someone point out how new "war millionaires" can be created.

### WE WANT NO PROFITEERING

The majority of our people are sincere when they say they do not wish to make any profit out of war. We want no profiteering, but profiteering must first be defined before the term can be applied. On the other hand, recognition of high returns for hard work and genius is a necessity.

The proposed bill is a drastic tax measure; it is capable of a stifling effect upon industries not sustained by the national-defense program. Taxes in themselves are no complete cure for profiteering. They do not prevent inflation—and inflation makes costs mount and presents opportunities for the making of increased profits.

The anxiety of businessmen today, however, does not arise from the expectation of making large profits out of national defense, but rather from a wish to avoid losses. They know, too, that if the risks of investment are made too great, new capital will be difficult to obtain through the normal channels; hence not only impeding the development needed to maintain employment and increase the national income out of which additional taxes might flow, but also retarding the now vitally necessary expansion of the defense industry.

If excess-profits taxes must be levied to provide funds for the defense program—and we do not concede this necessity—they should be applied with extreme care. There is such a thing as being penny-wise and pound-foolish. Normal business operations will suffer the heaviest tax drain. We do not question any objective which seeks to get money to pay for armament. Our only concern is how to increase tax receipts and still keep normal business from being demoralized.

To draft an equitable excess-profits tax suitable for peacetime is practically impossible. It is a good deal like asking a fellow which way or by what method he would like to have his leg cut off. It cannot be denied that an excess-profits tax is a major surgical operation on the profit system as a whole.

### CORPORATE TAXES A HEAVY BURDEN TODAY

The proposal for a new excess-profits tax comes at a time when corporate taxes and corporate income generally are far different than when the war excess-profits tax was originally imposed in October 1917, 6 months after our entry into the World War. At that time, corporate incomes were relatively high, the normal Federal income taxes were relatively low, and all other taxes (State, local, and miscellaneous Federal) were likewise low. At the present time, however, all three of these conditions are reversed.

Corporations at that time were subject to a flat rate of 12 percent; reduced to 10 percent in 1919. Today, corporations are subject to a tax of 20.9 percent: and, in addition, they are paying a tax of 3 percent of their pay roll under the Social Security Act.

All taxes consumed then only 7 percent of national income and Federal taxes took only 2 percent of national income; today, all taxes consume 22.4 percent of national income, and Federal taxes take up 9.5 percent of national income.

According to Statistics of Income, published by the Treasury Department, the net income before taxes of all corporations in 1937, the last complete year for which official figures are available, was about 23 percent below the 1929 all-time high. However, the total of corporate taxes in 1937 was the largest ever paid, with the result that net income after taxes in 1937 was less than half that of 1929.

Although the aggregate net income before taxes of all corporations in 1937, best business year since 1929, was 10 percent less than the average of the 3 years 1917–19, nevertheless the total of corporate taxes was 44 percent greater, notwithstanding the inclusion of wartime excess-profits taxes in the former period. As a result, the net income after taxes in 1937 was 40 percent less than the 1917–19 average.

Stated in another way, the official Treasury statistics show that the portion of corporate income absorbed by taxes rose during the period from 35 to 56 percent. The relation of total taxes to the net income, after taxes available to the corporations and their shareholders, rose from 54 to 128 percent.

These figures mean simply this: Both individuals and corporations are already bearing extremely heavy burdens; tax rates have been advanced to levels never before reached. This should convey a warning as to the dangers of legislation that may add to these burdens in such a manner as to actually stop the processes upon which we are dependent for success of the whole defense plan.

### REPORTS OF VARIOUS SENATE COMMITTEES

The inherent difficulties and injustices involved in any excess-profits taxes have been disclosed by our previous experience with this form of taxation. Some of them are suggested in a Senate report of September 26, 1921, on the excess-profits taxes then in effect. The report states:

"The time for discussion (of the excess-profits tax) is passed; and the time to repeal the tax has arrived. It may be mentioned, however, that further investigation has only accentuated the conviction that the inequalities of this tax make necessary its early repeal. Whatever may be its theoretical merits, it penalizes business conservatism, and places upon the Bureau of Internal Revenue tasks which are beyond its strength."

The War Department has only one attitude with regard to profit taxation. It has always maintained that tax measures must not impose so much of a burden on industry that the production of war munitions and materials might thereby be hampered or even destroyed. It has recognized that excessive taxes might result in a failure to produce sufficient munitions when needed, and this would be paid for not in dollars and cents but in lives and the consequences of a possible defeat.

In his testimony before the Nye committee, Bernard Baruch said: "In all solemnity, let me say that there is such a thing as taking the profits out of war at the cost of losing the war. Wars are never won but they can be lost. Let us at least avoid self-imposed defeat."

The Senate Finance Committee recognized these principles in its report on H. R. 5529, "A Bill to Prevent Profiteering in Time of War." The Committee said: "A tax law devised to yield revenue sufficient to run a war, should, in addition, be constructed so as not to hinder the production of war materials or curb the incentive for continuous economic activity." Uninterrupted output in most fields of industry is essential for any proper defense program.

The Senate Munitions Committee also declared: "If the absolute rate of any wartime tax is so severe as to discourage investment required for reconditioning idle plants, converting plants from nonessential to essential production, building new facilities, financing larger purchases of raw materials, and increased pay rolls * * * it cannot be permitted."

We want to expand our industrial machine to properly build this defense and insure against an industrial collapse when the job is finished. Our industrial plant has shrunk almost 25 percent since 1929 and no inclination for further investment is at present manifest. Taxes have contributed largely to this lethargy.

HOW PRODUCTION MAY BE INCREASED

As pointed out by one large corporation, it should be plain that if our defense program is to succeed, either the industries must be made more productive or some of the wants must be denied, either in whole or in part. It is impossible to consume, or have, more than can be produced. Unless we can produce more, the defense program must be curtailed or the standard of living lowered, and we do not want to do either.

We believe the people of this Nation do not wish to see the standard of living lowered further; they do not wish to see the defense program slowed up; they undoubtedly want to increase production. This can be done in two ways:

(1) By putting idle men and idle machines to work, and (2) by increasing the productivity of labor and capital already employed.

It was Germany's recognition of the principle of work and production that largely explains her amazing success in the field, while the failure of France was foretold in the following paragraphs from the Daladier-Reynaud report submitted to the President of France in November 1938:

"The gravest failure, from which the others follow, has been the persistently low level of production. * * * If production is insufficient it is primarily because its possibilities of development have been paralyzed. * * * The idea of a reduction in the length of the working day had been entertained on the assumption that, as a result of increased efficiency of labor and more intensive use of machinery, the same output could be obtained with fewer hours of work. But the efficiency of labor has not increased and the hopes founded on technical improvement have not been realized. How could it have been otherwise, when the majority of factories and shops were closed 2 days out of 7? All the efforts at reorganization that have been tried have failed. Sometimes it has been the authorities themselves who have intervened to prevent the introduction of new methods designed to lower costs. In every field where activity might be reborn enterprise has been restricted and discouraged. The creative spirit, and the willingness to take risks have been weakened. This—let us not fear to say it—is the root of the evil, for it adds a sort of moral abdication to the material difficulties."

HOW REVENUES CAN BE OBTAINED TO MEET DEFENSE REQUIREMENTS

If it were true that the United States had reached a condition of full employment of men and machines, it is obvious that the possibilities of meeting defense needs out of expanding production would be limited, and the primary problem then would be of curtailing consumption of nonessentials in order to release men and machinery for supplying necessary materials for the armed forces. But this is not the condition in the United States today.

We have large reserves of unemployed manpower and capital that can and should be brought into use. Commercial banks are not only ready to finance plant expansion, but are positively anxious to do so.

However, the very essence of a capitalistic system is that profits shall be permitted and that consideration should be given to the degree of risk. The risk is very great when investment is for defense and all these specialized plants may be rendered useless at any time by peace or political decision.

This fact was very forcibly stressed by Secretaries Morgenthau, Stimson, and Compton; as well as Mr. Knudsen, in their testimony before your committee several days ago.

It is against this general background that proposals to further increase the already high level of taxes should be viewed. It may be pointed out that on the basis of present rates the amount of additional revenue that the Government would realize, if the economy were operating under full steam, would be extremely large. If our national income could be increased to $90,000,000,000 or even $100,000,000,000, our present tax rates would produce sufficient revenue to take care of our entire defense program and also enable the Government to balance its Budget for the first time in many years.

One of the outstanding lessons to be learned from the official Treasury statistics is the way in which tax collections steadily increased during the 20's, even though the tax rates were being steadily reduced.

On the other hand if taxes are advanced too rapidly or at the wrong points there is grave danger that not only will the expansion of the defense industries be impeded, but, because of the check upon investments and consumption generally, production, employment, and the national income may be frozen at the existing sub-normal level. In such case, all that will have been accomplished will be a shifting of production from peacetime to defense industries, and a corresponding reduction in the standard of living.

CHANGE IN POLICIES NECESSARY

Within the past few months we have increased taxes to the extent of approximately a billion dollars a year. Before subjecting industry and the people to new taxes at the risk of impairing efficiency and drying up the source of capital, we ought to weigh carefully the possibilities that exist not only for increasing tax yields through an expansion of the national income, but also for effecting economies outside of the arms budget.

For the past 7 years the Federal Government has been spending billions of dollars for pump-priming and relief, justified on the ground that there were not jobs enough to go around and that but for these expenditures, millions of people would starve. With so much work now urgently needed to be done for the defense program, it ought to be possible, as the program proceeds, to dispense with most of this "made" work, thus relieving the budget and making available additional funds for arms spending.

Here again it is a question of the general policies pursued toward industry. If these are of a kind to encourage and stimulate industry, it should be possible to make this shift. Otherwise, we are likely to find ourselves saddled with a huge defense cost and a big relief bill besides.

The problem, in other words, is a broad one of making the economy strong as a whole, and of seeking the highest possible productivity of men and machines. Thus, the sum total of work and income would be increased, and the proportionate burden of defense costs thereby diminished.

EXCESS PROFITS TAX SHOULD NOT BE DEVISED IN HASTE

In view of the foregoing facts, we see no reason to incorporate in one bill (1) excessive profits taxation, (2) special allowance for amortization of emergency national defense facilities, and (3) the suspension of the Vinson-Trammell Act.

The Secretaries of the Treasury, War, and Navy and members of the National Defense Advisory Commission all have testified before your committee that special amortization legislation must be provided without delay covering the investment of funds for new plants, equipment, and the expansion of existing facilities for defense purposes. Their testimony disclosed that important contracts are now held up pending definite action on the part of Congress to this end. We respectfully submit that this difficulty could be removed in a few hours by suitable action on the part of the Congress.

It is our belief that the provisions of the Vinson-Trammell Act should be suspended. We see no reason why two types of producers (airplanes and ships) should be subjected to treatment different from that accorded to other corporations. As in the case of amortization, Congress can pass the necessary legislation without delay.

The far-reaching effects upon the economy of the Nation of a bill such as this excess-profits tax warrants most careful study. Undue haste in the enactment of such a measure cannot be justified. There is certainly ample time during the next 6 months to give this subject the careful and considered study it deserves. According to testimony of Treasury officials, revenue is not the primary purpose of this measure. Furthermore, returns will not be made by taxpayers until next March 15.

EXCESS-PROFITS TAX CREDIT

The statutory credit as proposed in the recommendations of the subcommittee appears to grant to new corporations organized in the year 1940 an advantage over corporations organized during the 4-year basic period 1936-39 and those corporations organized before this period. The fair rate of return proposed by the committee appears to be an arbitrary rate and was probably based upon statistics obtained from the Department of Commerce, the Bureau of Internal Revenue, or the Treasury Department. If this 10 percent represents a fair return to new corporations organized in the year 1940, then why should not this same rate be applied to all corporations?

It is a well-known fact that only in rare and exceptional cases do corporations earn a profit in the year of incorporation or even in the first full year of operation succeeding the year of inception.

Information obtained from the corporate membership of our association shows that a vast number of corporations organized prior to January 1, 1936, sustained net losses or had subnormal earnings during this basic period. When such subnormal earnings are compared with the average earnings of such corporations for the past 20 or 25 years, it is shown that these corporations organized prior to January 1, 1940, are penalized with a low-earnings credit under method B. Most

of these corporations due to the loss years and subnormal earnings during the basic period would obtain less relief through the use of method A (average earnings for basic period).

It is recommended that under method A the basic period be broadened to a 5-year period with the option of the taxpayer to select any 3 of those 5 years, eliminating loss years, as representing its normal earnings for the statutory excess-profits tax credit.

It is our further recommendation that under method B a flat rate of 10 percent of the equity invested capital be used as a credit against the net income of all corporations, regardless of date of incorporation.

### INVESTED CAPITAL—INTANGIBLE VALUES

The subcommittee in its report with reference to special relief provisions states that under the proposed excess-profits-tax law the need for special assessment is much less than it was under the excess-profits tax of the World War period for certain reasons, one of which is contained in item 3, "the omission of any percentage limitation upon the value of intangible property paid in for stock that may be included in invested capital."

There are many corporations which during the past years have spent large amounts of money in creating good-will. These expenditures represent substantial investments and have created assets of intangible value. Such corporations should be permitted to include this intangible value in their invested capital. Unless its net income during the basic period represents a fair return on the monies expended and used in the building up of such intangible good-will value, it is penalized with a low excess-profits credit. The special relief provisions suggested by your committee do not aid or help these corporations; therefore we recommend provisions similar to those contained in sections 327 and 328 of the Revenue Act of 1918 and 1921 be incorporated in the new law.

### INVESTED CAPITAL—BORROWED MONEY

There appears to be an unfair discrimination between large and small corporations in the amount of borrowed money that a corporation will be permitted to include in its invested capital. The statements contained in the detailed discussions of the subcommittee on this subject give no basic reason for the use of arbitrary percentages in determining the amount of borrowed money to be included in the equity invested capital. There is no practicable distinction between small corporations and large corporations. All corporations regardless of size are compelled to borrow at certain times for some purpose. Therefore, it is our recommendation that the law provide for the inclusion of all borrowed money in invested capital.

### REPEAL EXISTING CAPITAL STOCK AND EXCESS PROFITS TAXES

If a new excess-profits tax is enacted, the present capital stock and excess-profits taxes should be repealed. There is no justification for subjecting corporations to two separate and distinct excess-profits taxes at the same time. Inasmuch as the present excess-profits tax is determined by the capital stock declaration and is, therefore, an integral part of the capital stock tax, it would seem only just that these two taxes should be repealed upon the enactment of a new excess-profits tax.

Furthermore, any capital stock taxes paid pursuant to returns for the year ended June 30, 1940, were the result of values directly connected with minimizing 1940 excess-profits taxes under the present law. Since these excess-profits taxes will now be levied on an entirely new basis, it is only fair to merge the payments so closely connected with the old law with those to be made under the new law by allowing credit therefore against the tax due under the new law.

### CONSOLIDATED RETURNS

In the recommendations submitted by this association for consideration by the subcommittee, we stressed the point of having this law contain a provision granting corporations the privilege of filing consolidated returns for income and excess-profits tax purposes. We believe it essential to a correct determination of true income and invested capital of all closely affiliated corporations.

This privilege was allowed to corporations under the Federal law from 1917 up to 1924. The abuses on the part of certain corporations which resulted in the

elimination of the general privilege of filing consolidated returns in the 1934 Revenue Act have now been removed. The denial of this privilege since that act has unfairly burdened many corporations.

This problem has a very direct relationship to the preparedness program. It is going to be necessary for some plants to spread their operations, or to establish new departments or operations of an existing company, and under laws of various States under which a corporation should either qualify or be incorporated, many corporations have found that it is necessary to incorporate and form legally separate corporations. The burden which is placed upon such expansion of operations as the result of the ban on consolidated returns is a substantial one and permission to file consolidated returns is essential to sound industrial operation.

CAPITAL GAINS AND LOSSES

There does not appear to be any reason for determining net income subject to excess-profits tax on one basis and net income subject to the normal income tax on a different base. It is, therefore, recommended that all gain or loss realized upon the sale or exchange of any asset be excluded in the determination of income subject to both the normal income and excess-profits taxes, regardless of the length of time the asset is held.

INVENTORY LOSSES

Provision should be made permitting taxpayers to file claims on inventory losses where such losses occurred in goods, materials, etc., purchased for use during the emergency period if, at the end of such period, there occurs a serious deflation in prices of such goods and materials.

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LETTER OF JOHN P. LEYHAN, DETROIT, MICH.

JOHN P. LEYHAN,
Detroit, Mich., *August 14, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Ways and Means Committee,*
*Washington, D. C.*

DEAR SIR: The few comments that I desire to make, can be expressed in this letter. They represent views of owners of about 50 small companies capitalized in amounts ranging from $5 000 to $100,000.

All owners or executives interviewed expressed objection to excess-profits tax based on capitalization of enterprise. These people have conducted their businesses on conservative basis, they did not go through recapitalizations, stock splitups, appraisals, or any other methods of watering of investment, consequently their capital structures remained conservatively low. To the best of my knowledge there are several thousands of establishments of this type in the State of Michigan alone.

The majority of those conferred with favored an excess-profits tax, if there must be one, based on average earnings for normal 3- or 4-year period, say 1936–39, inclusive, with earnings in years subsequent to 1940 in excess of the average being subject to excess-profits tax. Practically every one expressed a view that a new business starting up should be given an equal chance, with excess-profits tax based on average profits of similar established businesses or capitalization, at the election of the taxpayer. In connection with this thought, Treasury Department has compiled studies of average earnings of various types of businesses, which are fairly accurate and can be used to establish an equitable basis.

Although none of my clients are directly engaged in defense work now, a number of them will be, once the defense program is fully under way. The problem of amortization of facilities acquired for defense work was discussed with those who will be affected in time and all of them expressed an opinion that amortization over a period of the program should be permitted. All concerned agreed that where defense work facilities are permitted to be amortized over a period shorter than normal life of them and are disposed of at the end of amortization period the amounts realized should naturally constitute a taxable income. When the facilities are held and used by the taxpayer after the complete amortization, an amount equal to normal annual amortization charge should be added to taxpayers income each year for a period of normal life of asset. To illustrate: A concern acquires machinery for defense work costing $100,000 having an estimated useful life of 12½ years. The entire amount is amortized in 4 years and taxpayer retains

and uses the machinery for other purposes. The normal annual depreciation of $8,000 should be added to taxpayers income each year for 8½ years or until the machinery is disposed of, whichever occurs earlier. This method would tax profits deferred by abnormal amortization and would place new concerns just starting in business on equal footing with those established as far as depreciation is concerned.

Realizing that your committee is burdened with great deal of work, I have tried to condense all views obtained to a minimum of essentials and hope that you may find something of value herein.

Please accept my sincere thanks for the courtesy extended me in this matter by your committee.

Respectfully yours,

JOHN P. LEYHAN.

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LETTER AND STATEMENT SUBMITTED BY H. GERRISH SMITH, PRESIDENT OF THE NATIONAL COUNCIL OF AMERICAN SHIPBUILDERS

NATIONAL COUNCIL OF AMERICAN SHIPBUILDERS,
*New York, August 14, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Committee on Ways and Means,*
*Washington, D. C.*

MY DEAR CONGRESSMAN: In the report of a subcommittee of the Committee on Ways and Means (House of Representatives) on proposed excess-profits taxation and special amortization, transmitted to you on August 8, 1940, by the chairman, Subcommittee on Taxation, the subcommittee recommends:

" * * * that those provisions of the Vinson-Trammell Act, as amended, which relate to limitation of profit upon the construction or manufacture of naval vessels and Army and Navy airfcraft be suspended as to contracts or subcontracts for such construction or manufacture which are entered into or completed during the taxable years to which the excess-profits tax will be applicable."

Section 505 of the Merchant Marine Act of 1936 is similar to the profit-limitation provisions of the so-called Vinson-Trammell Act.

The same shipyards and their subcontractors construct and furnish material and equipment for the merchant marine as well as for the Navy program; and as the subcommittee report states:

"Since the proposed excess-profits tax will apply to all corporations, including corporations now subject to the special profit-limiting provisions * * * it is felt that such special provisions should not apply while the excess-profits tax is in force. Uniformity will thereby be achieved in the treatment for tax purposes of all abnormal profits resulting from the national-defense program."

We can see no reason why the said merchant-marine program should be treated differently from the Navy program and respectfully request that in the event an excess-profit law is passed and the profit-limitation provision of the Vinson-Trammell Act is suspended that the excess-profit provisions (secs. 505 (b), (c), (d), and (e)) of the Merchant Marine Act of 1936 be also suspended.

Respectfully yours,

NATIONAL COUNCIL OF AMERICAN SHIPBUILDERS,
H. GERRISH SMITH, *President.*

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EXCERPT FROM REPORT OF A SUBCOMMITTEE OF THE COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, SEVENTY-SIXTH CONGRESS, THIRD SESSION, ON PROPOSED EXCESS-PROFITS TAXATION AND SPECIAL AMORTIZATION

I. SUSPENSION OF THE VINSON-TRAMMELL ACT

Your subcommittee recommends that those provisions of the so-called Vinson-Trammell Act, as amended, which relate to limitation of profit upon the construction or manufacture of naval vessels and Army and Navy aircraft, be suspended as to contracts or subcontracts for such construction or manufacture which are entered into or completed during the taxable years to which the excess-profits tax will be applicable.

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, it is felt that such special provisions should not apply while the excess-profits tax is in force. Uniformity will thereby be achieved in the treatment for tax purposes of all abnormal profits resulting from the national-defense program. It is not believed that the limited types of businesses affected by the

Vinson-Trammell Act should be treated, during the period in which the excess-profits tax applies, differently from the way in which other businesses engaged in production for the national defense are treated.

EXCERPT FROM MERCHANT MARINE ACT OF 1936

SEC. 505. (b) No contract shall be made for the construction of any vessel under this Act unless the shipbuilder shall agree (1) to make a report under oath to the Commission upon completion of the contract, setting forth in the form prescribed by the Commission the total contract price, the total cost of performing the contract, the amount of the shipbuilder's overhead charged to such cost, the net profits and the percentage such net profit bears to the contract price, and such other information as the Commission shall prescribe; (2) to pay to the Commission profit, as hereinafter provided shall be determined by the Commission, in excess of 10 per centum of the total contract prices of such contracts within the scope of this section as are completed by the particular contracting party within the income taxable year, such amount to become the property of the United States, but the surety under such contracts shall not be liable for the payment of such excess profit: *Provided*, That if there is a net loss on all such contracts or subcontracts completed by the particular contractor or subcontractor within any income taxable year, such net loss shall be allowed as a credit in determining the excess profit, if any, for the next succeeding income taxable year: *Provided*, That if such amount is not voluntarily paid, the Commission shall determine the amount of such excess profit and collect it in the same manner that other debts due the United States may be collected; (3) to make no subdivisions of any contract or subcontract for the same article or articles for the purpose of evading the provisions of this Act, and any subdivision of any contract or subcontract involving an amount in excess of $10,000 shall be subject to the conditions herein prescribed; (4) that the books, files, and all other records of the shipbuilder, or any holding, subsidiary, affiliated, or associated company, shall at all times be subject to inspection and audit by any person designated by the Commission, and the premises, including ships under construction, of the shipbuilder, shall at all reasonable times be subject to inspection by the agents of the Commission; and (5) to make no subcontract unless the subcontractor agrees to the foregoing conditions: *Provided*, That this section shall not apply to contracts or subcontracts for scientific equipment used for communication and navigation as may be so designated by the Commission, nor to contracts or other arrangements entered into under this title by the terms of which the United States undertakes to pay only for national-defense features, and the Commission shall report annually to Congress the names of such contractors and subcontractors affected by this provision, together with the applicable contracts and the amounts thereof.

(c) The method of determining the shipbuilder's profit shall be prescribed by the Commission: *Provided*, That in computing such profits no salary of more than $25,000 per year to any individual shall be considered as a part of the cost of building such ship, and the Commission shall scrutinize construction costs and overhead expenses to determine that they are fair, just, and not in excess of a reasonable market price for commodities or goods or services purchased or charged.

(d) The Commission may, with the consent of the Secretary of the Treasury, utilize the services of Treasury Department employees engaged in similar functions in the determination or collection of shipbuilder profits in naval construction.

(e) If the shipbuilder whose bid has been approved by the Commission and accepted by the applicant, as provided in section 502 of this title, shall refuse to agree to any of the requirements of this section, the Commission is authorized to rescind its approval of such bid and to advertise for new bids, or, in its discretion, the Commission may have the vessel or vessels in question constructed in a United States navy yard.

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TELEGRAM OF JAY IGLAUER, CHAIRMAN OF THE TAX COMMITTEE, NATIONAL RETAIL DRY GOODS ASSOCIATION

CLEVELAND, OHIO, *August, 15 1940.*

Hon. ROBERT L. DOUGHTON,
*House of Representatives:*

Taxation committee, National Retail Dry Goods Association, sees no objection to proposed excess-profits bill. Suggested choice of any 3 of 4 years 1936 to 1940 would improve bill by tending to equalize the alternative bases of invested capital and average earnings.

JAY IGLAUER, *Chairman.*

LETTER OF HARRY L. LOURIE, EXECUTIVE VICE PRESIDENT OF THE NATIONAL ASSOCIATION OF ALCOHOLIC BEVERAGE IMPORTERS, INC.

NATIONAL ASSOCIATION OF ALCOHOLIC BEVERAGE IMPORTERS, INC.,
*Washington, D. C., August 13, 1940.*

Hon. ROBERT L. DOUGHTON,
*Chairman, Committee on Ways and Means,*
*Washington, D. C.*

MY DEAR MR. CHAIRMAN: The excess-profits-tax proposal now pending before your committee has been given consideration by the members of my association. We have, of course, been forced to rely on details carried in the report of the subcommittee, and we are familiar with the two methods proposed for the computing of excess-profits taxes.

We most respectfully request the committee to give consideration to a problem which we believe may be unique for the import trade in general and particularly for importers of alcoholic beverages.

The European war at first had little effect on the operations of the import trade in alcoholic beverages. From September 1939 until May 1940 it was possible for the trade to import alcoholic beverages from the principal shipping countries of Europe with the exception of Germany, Poland, and the Scandinavian countries. Since then, however, the situation has changed materially. We are now limited in our imports from Europe to the United Kingdom, Portugal, and Spain.

As a result, the trade realizes that it is entirely possible that 1941 will find the industry virtually out of business.

The extension of the war, and its obvious effect on the import business, has resulted in a greatly increased demand by the general public, as evidenced by orders filed with importers by wholesale distributing companies as well as by State governments which maintain their own State store systems. Available statistics indicate that in 1940 the import trade will have done an unusually large business, but that in 1941 the stocks in the United States of various European wines and spirits will have been reduced so materially that many importers of such articles may be forced to cease doing business.

The trade is anxious to avoid, if possible, the discharge of employees and the breaking up of existing companies. It views with fear the possibility that the surplus-profits taxes due under the proposed bill for business done in 1940 may prove unusually large and that in 1941 deficit operations will be the rule rather than the exception.

I am instructed, therefore, to inquire if there is any possibility of the law being so drafted as to permit consideration of this obvious and difficult problem. Can an arrangement be made whereby deficit operations in 1941 can be used to offset surplus profits obtained in 1940? The attention of the committee undoubtedly has been called to the provision found in section 234 (a) (14) of the Revenue Act of 1918, which permitted the filing of amended tax returns where certain types of losses were incurred in 1919 as against profits subject to the excess-profits tax incurred in 1918.

Respectfully submitted.

HARRY L. LOURIE,
*Executive Vice President.*

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TELEGRAM OF HENRY J. GUILD, BRIGHTWATER PAPER CO., NEW YORK, N. Y.

NEW YORK, N. Y., *August 15, 1940.*

Hon. JOHN MCCORMACK,
*U. S. House of Representatives.*

I am heartily in favor of Bradley Dewey's proposal as outlined before Ways and Means Committee Monday that any excess-profits-tax law contain 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. Such a credit would be purely optional and would remove many inequities of proposed excess-profits-tax bill as well as bad features any such bill.

HENRY J. GUILD,
*Brightwater Paper Co.*

LETTER OF THE TANNERS' COUNCIL OF AMERICA, NEW YORK, N. Y.

NEW YORK, *August 13, 1940.*

CHAIRMAN, COMMITTEE ON WAYS AND MEANS,
*House of Representatives.*

SIR: The Tanners' Council of America, on behalf of its member companies, wishes to call to the attention of your committee a possibly serious injustice in the proposed excess-profits-tax plan.

As outlined in the report of the subcommittee, two alternatives are provided for the computation of excess-profits-tax credits. The first is based directly on average earnings during the period 1936-39; the second is based on the ratio of average earnings to invested capital for the base period applied to invested capital for the taxable year. Under the latter option, a maximum ratio of 10 percent and a minimum of 4 percent may be taken. Both methods, however, involve the average net income of a limited base period, and, therefore, corporate-tax payers may be seriously affected by the nonrepresentative nature of the base period net income.

In the case of corporations with reasonably stable earnings, or whose income during 1936-39 was representative, the proposed plan may not offer any discrimination or hardship. That is not true, however, in the tanning industry where:

1. Turn-over is very slow.
2. Raw-material prices fluctuate sharply.
3. Annual earnings are extremely erratic.
4. Substantial losses have been incurred for a number of years.

Earnings in the tanning industry are notoriously volatile because both raw material prices and business volume fluctuate sharply. The coincidence of a sharp price rise and expanded sales in a given year may inflate income sharply, and far beyond the average or long-term earnings of the tanner. Furthermore, in many instances such earnings would represent income which is not realizable and will be completely offset by subsequent losses when raw material prices decline. Hence, a very serious possibility arises if either of the alternative credits deriving from the 4-year base is neither a representative measure of income nor of adequate rates of return. For example, a tanning company has earned 2 percent upon its invested capital during the base period. That average, however, may represent such varying rates of return for individual years as: 3 percent profit, 12 percent profit, 8 percent loss, 1 percent profit.

Whether the average earnings or the ratio of such earnings to invested capital are used as excess-profits tax credit, the tanner would be severely penalized in comparison with other industries where earnings are more stable. In the example used, a tanner could apply only a little more than 4 percent of invested capital as a credit against the excess profits tax. Actual net income in a single year, as the result of price and volume changes, might be substantially greater than 4 percent. Such a year might be exceptional, the high earnings would either offset previous losses or be offset by subsequent losses. Yet from 25 to 40 per cent of such income, after the allowable credits, would be payable as tax.

It is submitted that the use of an arbitrary 4-year base period for all industries is contrary to the intention that a normal earnings base be used for the determination of excess-profits-tax credit. Such a normal earnings base for tanning companies may not coincide with the normal base of other industries. A corporation with average or high earnings in 1936-39 would have a maximum allowable credit of 10 percent, while a tanner might be limited by low rates of return in the base period to a credit of little more than 4 percent. This minimum credit would not be commensurate with tanners' ability to pay taxes, with true average income, nor would it take account of the erratic nature of tanners' earnings. A limitation of 4 percent upon invested capital can certainly not be considered a normal measure of income for a given year in an industry subject to violent price and income fluctuation.

The suggestion is made, therefore, that relief provisions be incorporated in the bill to avoid tax injustice, hardship, and discrimination for corporate taxpayers with erratic annual net income such as the tanning industry. Such relief provision should:

1. Increase the allowable credit ratio of invested earnings to capital to a flat and nondiscriminatory basis of, say, 10 percent. There is no reason why corporations which through coincidence, market fluctuations, or other reasons beyond control, show low earnings or low rate of return on invested capital in the suggested base period, should be penalized and discriminated against.

2. Extend the base period to comprehend more representative years.
3. Offer a maximum base period of 6 years with the option of using any 3 successive years, within the maximum period, as the normal net income base.
4. Permit the adjustment of normal tax net income by the net operating loss carry-over in arriving at excess-profits tax income.

These relief provisions are required because the incidence of the contemplated tax would be unjust for tanners regardless of conditions created by national emergency. Violent fluctuations in raw material prices and earnings have always characterized tanners' operations and net income. Hence, emergency tax legislation will affect tanners seriously and dangerously unless it takes account of the foregoing conditions.

Respectfully submitted.

TANNERS' COUNCIL OF AMERICA.

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BRIEF SUBMITTED BY EMMETT F. CONNELY, PRESIDENT OF THE INVESTMENT BANKERS ASSOCIATION

The Investment Bankers Association comprises over 700 investment banking firms scattered throughout the country. The members of the association handle the major part of the private financing done for American industry. In the course of their everyday work, these members have seen at first hand the impact of Government policies upon industry and the private investor. Their committee on Federal taxation has asked me to present this brief to the Committee on Ways and Means, on behalf of the association, believing that it represents the views of its membership.

(1) *Defense program essential.*—The United States is faced with a grave emergency. In a war-minded world, its defenses are sadly inadequate. A vast program of national defense is necessary. None of us know just how far that program must go. All of us are determined that it shall be fully adequate to protect us from any conceivable attacks, and all of us know that the carrying out of even a minimum program will require a tremendous national effort and sacrifice.

(2) *Productive capacity insufficient.*—We are all aware that the productive capacity of industry is unfortunately far from sufficient for the job to be done. We need new plants, new equipment, new machinery, new trained employees, new facilities of all kinds. Capital investment in industrial facilities has lagged seriously in the past 7 years. It has been estimated that as much as $25,000,000,000 must be invested to place the country on an adequate defense basis. Most certainly several billion are required immediately.

(3) *Financing of expansion.*—A great issue presents itself, and it must be decided at once. How shall the necessary expansion of our productive capacity be financed? Shall it be done by the Government, or by private investment? If the Government does it, it will have to borrow the people's savings, either by voluntary loans or forced loans, or both, and then invest the money itself. The facilities will then be owned by the Government, and controlled and operated by Government employees, not only during the emergency, but also after it has ended. That is the totalitarian way. If it is done by private financing, those facilities will be owned, controlled, and operated by private individuals, both during and after the emergency. That is the democratic way.

(4) *Private financing possible.*—We believe there would be no dissent from the view that private investment must do the job if it can. We submit that it can. There are millions of potential private investors, large and small, in this country, and they have a vast store of idle funds. They are ready to put those dollars to work for the defense program. Those dollars are not waiting to be commandeered, they are merely awaiting a word of encouragement.

(5) *What does private investor want?*—The potential private investors in this country are not "timid." They are not afraid to take risks. They want only—

(*a*) First, reasonable safety for their principal: Reasonable assurance that their investment will be returned to them in a reasonable period of time. By this they do not mean that they will take no risks that their principal will be lost. They are willing to take all normal risks.

(*b*) Second, reasonable liquidity: If necessity arises, requiring the disposition of investments, they want to know that a reasonably fair and active market will be available.

(*c*) Third, a reasonable profit, commensurate with the risk.

(6) *Government relation to capital.*—The investment banker is the conduit for the flow of capital into industry. In that capacity he knows what has dammed up this flow. He knows that it has been the stagnation of capital moving into

new and expanding enterprise that has prolonged the depression in America and halted the creation of new jobs to relieve unemployment.

We believe that the breaking of this dam is the most important problem facing Government, business, and finance. New capital flowing into industry at this time will be the most effective stimulant to the program of armament for national defense. The same expansion, devoted to peacetime effort, means a resumption of America's economic progress.

(7) *What can Government do?*—Government can help end this stagnation by modifying, or repealing where necessary, laws and administrative rulings which have contributed to confusion and fear within industry. For example, modification of the law governing the issue of securities could be accomplished in such a way that unnecessary and burdensome restrictions upon legitimate financing would be removed while real abuses could still be corrected. It is gratifying to note that the Securities and Exchange Commission is working with interested parties in the hope that something can be done along this line. Also, much can and should be done in the labor field to permit the more effective use of the labor resources of the country, without infringing upon the rights of labor. In addition, a sound, long-range tax program should be prepared and enacted, so as to enable the businessman and the investor to plan for the future.

(8) *What can business do?*—American business must be prepared to work hard, to make many sacrifices. It must be prepared to cooperate with a willing Government to proceed promptly, energetically, and enthusiastically to make the defense program a success, and to place our national economy on a sound basis for the future in other respects. We know that American business is ready to do these things. It needs only the signal. Private capital is eager to make the immense contribution it is capable of making in the interests of all of us.

(9) *The alternatives.*—We have two alternative roads that we can travel in strengthening America either for war or peace.

If we so restrict the profit from doing business as to make private investment a bad risk we drive into hiding not only large investment capital but the savings of the small investor. It has been these investments seeking a legitimate return on capital that have financed the growth of America.

The only substitute for this flow of private capital is Government credit through which business comes under the domination of Government as in the totalitarian states.

Drastic measures at this time by Government intended to strengthen our democracy will have the reverse effect if they so burden private enterprise that it cannot function.

The other road is for Congress to declare its intent to encourage in every way the flow of private capital into industry and to discourage the competition of Government credit.

A strong virile industrial system is a definite bulwark of national defense and peacetime prosperity.

(10) *The subcommittee report.*—We congratulate the subcommittee on its accomplishments in the short time available to it. With respect to the subcommittee's three main recommendations, our position is as follows:

(*a*) *Amortization.*—We recommend the immediate enactment, as a separate measure, of the amortization provisions proposed by the report. The provisions are important because they constitute a degree of assurance to the investor that to the extent that he recovers his capital, he will not be taxed. The proposed provisions will eliminate doubts and uncertainties, and remove serious obstacles to the defense program. They will constitute a real encouragement to private investors. They should be made retroactive to January 1, 1940, instead of July 10, 1940.

(*b*) *Excess-profits tax.*—We do not oppose the enactment of an excess-profits tax at a relatively early date. However, there is no necessity for undue haste, and Congress should give the matter extended and careful consideration. Such a tax can have serious and unforeseen effects. Many questions must be considered and decided. If they are not properly decided, the tax would do more harm than good.

The only legitimate object of an excess-profits tax is the prevention of excessive price increases, which result in profits in excess of "normal." It is a legitimate device for the control of prices. The ideal excess-profits tax would, of course, effectively control prices, and produce no revenue. Unquestionably, the present price level is still too low. A "runaway" increase would be disastrous, but none is presently in prospect, and a moderate increase would be a helpful stimulant to our economy.

The revenue to be produced by the pending measure is relatively unimportant, at least in the first year. Postponement of enactment until prices have shown some improvement would stimulate business, and increase the national income. In that event, the revenues would also be increased, undoubtedly by at least as much as the amount expected to be produced by the tax.

(c) *Vinson-Trammell Act.*—The profit-limitation provisions of the Vinson-Trammell Act should be suspended while any excess-profits tax is in force, in accordance with the subcommittee's recommendation.

(11) *Excess-profits tax.*—In its specific recommendations relating to the excess-profits tax, the subcommittee's report represents a long step in the right direction. The plan proposed makes substantial progress toward eliminating the defects of previous excess-profits taxes. Much more remains to be done, however. We submit the following specific recommendations for modification of the proposal:

(a) *Determination of excess profits.*—The use of the average of earnings for all 4 years of the 1936-39 period would work a severe hardship upon many corporations which had abnormally low earnings during one or more of those years. We recommend permitting taxpayers to adopt the best 3 years of the period. Most certainly it is unfair to use base-period earnings as the measure of the return to be allowed on invested capital, as the subcommittee's proposal does. We accordingly recommend that no rate under 10 percent on invested capital be considered a fair return in any event.

(b) *Protection of junior issues.*—Under the committee's proposal, many concerns would find that the requirements of senior issues constituted as much as, or more than, their entire excess-profits credit. We recommend that junior issues be permitted to earn a minimum of 10 percent without imposition of the tax.

(c) *Borrowed capital.*—Borrowed capital represents capital risked in the business just as much as equity capital. We recommend that the full amount of borrowed capital be permitted to be included in invested capital.

(d) *Carry-over of losses.*—It is unjust to consider a single year only when determining whether profits are "excess", for too many accidental circumstances can operate to produce an uneven income record. We recommend that losses be permitted to be carried over for 5 years.

(e) *Consolidated returns.*—A single business unit, such as an affiliated group of corporations, should be permitted to treat itself as a single unit for the purpose of determining whether it has, as a whole, earned "excess" profits. We therefore recommend that consolidated returns be permitted.

(f) *Special relief.*—It would be impossible for the Congress to consider and provide for all the cases which might arise in which some adjustment might be absolutely necessary. We recommend that provision be made for administrative relief in cases of undue hardship.

(g) *Termination.*—The excess-profits tax should be treated as an emergency measure, and not made a permanent part of our revenue system. We recommend that a definite date be fixed for its termination.

The views expressed herein are not presented in the selfish interest of this association or its members. They are presented as considerations which are vital to the maintenance of free enterprise in the investment of private capital. This is one of the essentials of a democracy.

EMMETT F. CONNELY,
*President, Investment Bankers Association.*

AUGUST 15, 1940.

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TELEGRAM OF H. N. GOODSPEED, PRESIDENT OF THE A. C. LAWRENCE LEATHER CO., PEABODY, MASS.

PEABODY, MASS., *August 15, 1940.*

Hon. JOHN W. MCCORMACK,
*House Office Building:*

Regarding proposed so-called "excess profits tax," tanning industry during past 4 years has earned substantially less than 4 percent. Many large concerns having net loss for total period. New proposed law which under such conditions permits maximum earnings of 4 percent before application of extra taxation will work extreme hardship on Massachusetts tanning industries. During years when inventories appreciate rapidly profits should be much over 4 percent to compensate for corresponding decline in inventory values during other years. These unusual profits therefore are fictitious in that they are lost when markets decline and consquently should not be taxed so drastically. Application of such a plan to this type of industry will ultimately break the entire industry. In view

of the fact that our raw materials fluctuate more widely than any raw materials known in any industry, leather manufacturers should be entitled to a maximum of at least 8 percent before excess tax is applied.

H. N. GOODSPEED,
*President, A. C. Lawrence Leather Co.*

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STATEMENT SUBMITTED BY THE COMMITTEE ON LAWS OF THE NATIONAL BOARD OF FIRE UNDERWRITERS

*Excess profits tax.*—In the use of the word "capital" in such an act, the terminology should specifically provide, or be broad enough to permit, the inclusion of all stockholders' money actually used in the business of fire, marine, or casualty insurance companies.

The business of insurance is peculiar in that the actual capital, as capital is generally known, paid in by the stockholders, does not represent the entire investment of the stockholders in the business.

To illustrate: The companies are required to keep and maintain what is known as a reinsurance reserve for the protection of claimants and policyholders. For instance, in the fire, marine, and casualty insurance business, one-half of all annual premiums is transferred to the reinsurance reserve and earmarked for the purposes above mentioned. On a policy to run for 5 years, 90 percent of the premium is transferred to reinsurance reserve the first year, and proportionately less during the ensuing 4 years of the contract, and there held until the contract is terminated.

It is quite obvious that where a 5-year policy is written, the premium received is not sufficient in amount to provide for the statutory requirements, nor the rules of good underwriting. If 90 percent of the premium is placed in the reinsurance reserve, a commission paid to the agent, provision made for current taxes and general company expenses, there will be needed a substantial sum in addition to the premium. This additional amount cannot be taken from the *capital* of the company paid in by the stockholders. There are provisions in the laws of all of the States forbidding any impairment in capital and if the capital of a company actually becomes impaired, companies must immediately cease operations until any deficit is made good.

There are other reasons why the cushion of surplus is needed to prevent impairment. Severe losses due to conflagration or catastrophe, unfortunate underwriting or like experiences are illustrative. Shrinkage in the market value of securities in which funds are invested to occur.

For this reason, the laws of practically all of the States provide, that in addition to capital, a company must, on organization, be possessed of a "surplus" from which may be taken the additional amounts required for the proper conduct of its business. No company may be organized without a capital and a surplus, regardless of statutory provisions. No discreet group of underwriters would organize an insurance company without an adequate surplus.

Surplus may be acquired either by an actual payment to the organization by the subscribing stockholders at the time of organization, or by an accumulation of profits transferred to surplus, rather than paid out as dividends. Generally speaking, no insurance company pays any substantial dividends to its stockholders over the first years of its existence. Such dividends, being in fact stockholders' money, are placed in surplus for the purposes mentioned.

Capital and surplus together constitute the working "capital" of the companies. To all intents and purposes they are inseparable.

Attention is called to a bill now before the Congress (H. R. 9722) being an act to provide for the regulation of business of fire, marine, and casualty insurance. There is here quoted sections 7 and 13 of that act as illustrative of the requirements generally found in all of the States in this regard. The minimum requirements may vary but the general provisions are substantially the same.

"SEC. 7. *When capital or surplus of company deemed impaired.*—Any company whose capital has been reduced to an amount less than that required by this Act, or whose surplus of admitted assets in excess of all liabilities is less than the amount required by this Act, shall be deemed to be impaired in capital or surplus, and may be proceeded against as provided in this Act.

"SEC. 13. *Minimum capital and surplus requirement.*—Every stock company authorized to do business in the District shall have and shall at all times maintain a paid-up capital stock of not less than $150,000, and a surplus of not less than $150,000. Every domestic mutual company and every domestic reciprocal

company shall have and shall at all times maintain a surplus of not less than $150,000, and every foreign or alien mutual company and every foreign or alien reciprocal company shall have and shall at all times maintain a surplus of not less than $200,000."

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STATEMENT OF THE COMMITTEE ON TAXATION OF THE NATIONAL ASSOCIATION OF CREDIT MEN ON PROPOSED EXCESS-PROFIT TAXATION AND SPECIAL AMORTIZATION

The committee on taxation of the National Association of Credit Men, which comprises a membership of approximately 20,000 manufacturers, wholesalers, banks, and insurance companies located throughout the country, desires to submit the following observations concerning the report of the Subcommittee on Ways and Means on proposed excess-profits taxation and special amortization.

Because of the limited time available to study the report, the committee is forced to restrict its comments to certain suggestions which appear to be necessary to prevent the proposed tax from operating in a manner detrimental to sound credit conditions. The committee realizes that there may be other aspects of the tax which may adversely affect credit conditions. It intends, therefore, to observe carefully the actual operation of the tax in that regard and be prepared later to submit to the Congress further information derived from such observations.

The committee desires to make a general observation with regard to the need for the proposed legislation. The committee understands that the annual revenue which will be derived from the proposed excess-profits tax is likely to be much less than the estimated $300,000,000 which is generally supposed to be the expected annual revenue. Much greater revenue could obviously be raised more easily through other means of taxation which would be less productive of the difficulties and inequities which will probably result from the proposed excess-profits tax. The revenue-producing aspect of the tax appears, therefore, to be relatively unimportant and the legislation must be regarded from the standpoint of its primary purpose—to recapture undue profits which companies may earn as a result of participation in the defense program.

The proposed legislation may accomplish that obviously desirable purpose to some extent but it may fairly be asked whether, in doing so, it will not operate to the detriment of many companies whose activities are not related in any way to the defense program. The committee believes that a more selective form of taxation so designed as to recapture excess profits realized by companies producing materials for the defense program would more effectively attain the desirable objectives of the proposed legislation and would, at the same time, not cause difficulties and probable hardships for other companies.

The committee believes, after a review of conditions that existed under former excess-profits tax laws, that it is virtually impossible to have an equitable excess-profits tax, and feels that this form of tax legislation should not be enacted. The inherent complications and inelasticity of an excess-profits tax, and the high rates of such a tax, inevitably result in inequities and frequently cause serious injury to many types of business organizations.

The committee also desires to comment concerning the association of the proposed amortization legislation with the excess-profits tax proposed. It is generally understood that enactment of an excess-profits tax has been set 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. 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 an excess-profits tax. That approach would have made possible a more deliberate study of the problems of taxing excess profits as equitably as possible 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 committee does not oppose the alternative methods of arriving at the exemptions from the excess-profits tax which are proposed in the subcommittee report but does suggest the consideration of some effective relief provision in the legislation which would prevent the operation of the tax from working any unnecessary hardships against any company, large or small. It is specifically suggested that the law contain a provision that, in cases where because of present deficiencies in average earnings or invested capital, or because of other abnormal

conditions affecting capital and income, a hardship is worked on the taxpayer as a result of the excess-profits tax, the income of such taxpayer should be subject to an excess-profits tax which bears the same ratio to its net income as the average tax of representative corporations engaged in a like or similar trade or business bears to their net income.

With the addition of this relief provision the law would contain three bases to be employed in arriving at the tax: (1) Invested capital, (2) average earnings, and (3) the special relief provision.

The committee also desires to make the following specific recommendations:

Change the base period, to be used in determining average earnings, from the present proposal of the years 1936-39 inclusive, to any 3 of those 4 years. The proposed 3-year base period would tend to eliminate abnormalities which will exist if the average of the 4 years must be used.

Permit corporations to file consolidated returns. Unless the filing of consolidated returns is permitted, substantial inequities will result in the reflection of true income and true invested capital.

Eliminate stock dividends in the computation of equity invested capital. Stock dividends paid by a corporation do not add to or detract from the amount of money that the shareholders have invested in the business. The increase in the capital stock account is offset by a like decrease in the surplus account, resulting in no change in invested capital.

In connection with the determination of "borrowed invested capital," permit the taxpayer to use an average of the capital borrowed during the taxable year. This could be accomplished by totaling the amount of borrowed capital at the end of each month of the year and dividing the total by 12. This is suggested because of the established practice of many firms of reducing their borrowed capital at the end of the calendar year. If the amount of borrowed capital should be computed as of that time, substantial inequity might result which would be eliminated by striking an average for the year.

Make the excess-profits tax applicable to 1941 instead of 1940. The amount of excess profits whose recapture is sought in the proposed legislaton during the current year is likely to be small compared to the advantage of permitting corporations to adjust themselves to the new tax by extending its date of application to next year.

The committee desires to emphasize that, even with the changes suggested above, the proposed excess-profits tax is likely to produce many difficulties and hardships. It believes, however, that the proposed changes will reduce somewhat the complications which would otherwise be caused by the tax.

The committee clearly recognizes 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 have to 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 those 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 by:

Committee on Taxation of the National Association of Credit Men: John L. Redmond (Member Ex Officio), Vice President, Crompton-Richmond Co., Inc., New York, N. Y., President, National Association of Credit Men; Bryant Eusick, Essick Machinery Co., Los Angeles, Calif.; H. E. Kay, The Teachout Co., Cleveland, Ohio; H. J. Miller, San Juan Fishing & Packing Co., Seattle, Wash.; S. Graham Nelson, Wolf & Co., Chicago, Ill.; Thomas W. Peck, Kalamazoo Vegetable Parchment Co., Kalamazoo, Mich.; Paul A. Pflueger, Max I. Koshland & Co., San Francisco, Calif.; Andrew B. Trudgian, S. D. Leidesdorf & Co., New York, N. Y.; F. S. Walden, Strevell-Paterson Hardware Co., Salt Lake City, Utah.

## Memoranda Submitted by the Retail Trade Board of the Boston Chamber of Commerce

### Changes Suggested in Excess-Profits Tax Proposal

Unless some modifications are made in the report of the subcommittee of the Committee on Ways and Means for the computation of the excess-profits tax it is rather clear that it will result in serious discriminations against some companies and also serious inequalities in the levying of this tax. Two or three slight changes in the proposal would tend to relieve a substantial amount of these discriminations and these changes can be made without doing any violence whatsoever to the principles announced in the report. To illustrate our position we have selected companies whose income will not be derived from war contracts.

#### YEARS OF BASE PERIOD

The report suggests that the base period be fixed to cover the 4 years, 1936 to 1939, inclusive, and would require a taxpayer to use all 4 years if it were in existence during the entire base period.

We recommend that this base period be increased to 5 years, or 1935 to 1939, inclusive, and that the taxpayer be permitted to use the average of any 3 of the 5 years for computing his excess-profits credit. If the 4-year base period is retained, then we recommend that the taxpayer be permitted to use the average of any 2 of the 4 years. In either case, the taxpayer should be permitted to exclude from the base period any year or years in which a loss is sustained and use the average of the remaining years.

#### MINIMUM CREDIT PERCENTAGE

The report proposes a minimum credit of 4 percent on invested capital in excess of $500,000. It is obvious that such a return is inadequate and that it cannot be reasonably said that profits in excess of 4 percent of invested capital are "excessive."

Such a limitation would impose serious hardships on many companies, particularly those that have had a struggle for existence in recent years. Even the war revenue acts of 1917 and 1918 imposed no such hardships. In the case of the 1917 act a 7-percent credit was allowed and the 1918 act allowed an 8-percent credit.

We, accordingly, submit that the 4-percent credit should be increased to at least the credit allowed in the 1917 act.

The report of the subcommittee apparently attempts to rectify this severe limitation by allowing a certain percentage of borrowed money to be included in invested capital but it is obvious that a company with no borrowed money will be penalized in comparison with a company having borrowed money. Such inequality should be corrected.

#### CONSOLIDATED RETURNS

We submit that a sound provision in the proposed revenue bill would be one permitting the filing of consolidated returns for excess-profits tax purposes. Such a provision would accord with prior revenue acts where excess-profits taxes have been imposed and would aid in removing inequalities for some companies which will occur if the report is unchanged.

### Some Examples of Inequalities That Will Result if the Report of the Subcommittee is Unchanged

I

Company A had average net earnings of about 4 percent on invested capital for the base period (1936 to 1939, inclusive). One of its chief competitors earned about 9½ percent on its invested capital during the same base period.

An examination of the record of company A will disclose that its earnings during the base period were subnormal. For example, for the 4-year period 1932 to 1935, inclusive, it had average net earnings of about 12 percent on its invested capital. It made some recovery in 1939 and for 1940 the trend continues toward normal earnings. Consequently, it would be required to pay high excess-profits taxes on all earnings in excess of the 4 percent minimum credit whereas its aforesaid competitor would probably be required to pay little if any excess-profits taxes.

It is clear therefore that if the proposed bill does not depart to some extent from the report of the subcommittee, company A will be bearing an unfair portion of

the excess-profits tax and will be placed at a serious disadvantage in the competitive field. Indeed, company A would be seriously handicapped in its effort to regain its normal position in the industry.

II

Company B is in the same industry as company A given in the previous example but is located in a different section of the country. During the base period (1935 to 1939, inclusive) it had an aggregate net loss, whereas one of its chief competitors earned about 20 percent on its invested capital during the same period. For the year 1940 indications are that company B will be "in the black" as compared with having been "in the red" during the base period. Company B during the 4 years 1932 to 1935, inclusive, earned in excess of 5 percent on its invested capital and it is clear that its experience during the base period is subnormal. Unless some relief is granted this company it is clear therefore that it will be discriminated against as will company A in the above example.

AUGUST 2, 1940.

MEMORANDUM

To: The Executive Committtee of the Aeronautical Chamber of Commerce of America, Inc.
From: The Accounting Committee.
Subject: Excess-profits Taxes and Amortization of Excess Facilities.

The purpose of this memorandum is to present the comments and recommendations of this committee with regard to excess-profits tax and to amortization of excess facilities. It should be clearly understood that in expressing such views it is contemplated that the Vinson-Trammell Act, as amended and supplemented, insofar as it applies to profit limitation and amortization of facilities, will be suspended.

The recommendations contained herein are further based on the belief that the aviation industry is entitled to such treatment that will take into consideration its rapid expansion and growth over the past several years. By providing an alternate basis for excess-profits tax purposes, hereinafter reviewed, this can be accomplished.

As to amortization of excess facilities, the clarification of this question is of immediate necessity, both as to facilities already acquired and those to be acquired.

These subjects are covered in more complete detail as follows:

EXCESS PROFITS TAX

It is the consensus of this committee that any basis of excess profits tax for the aircraft industry based on invested capital or past dollar profits is inequitable. For the past few years the industry has been rapidly expanding and further extraordinary expansions are necessary to provide the aircraft required under the defense program. In view of the increasing risks involved with the increasing volume and the necessity of the industry being on a firm footing at the end of the emergency it is necessary that fair treatment be accorded if the industry is to be able to do its full part in the national defense program. The exemption base for the purposes of excess-profits tax determination must take into consideration the growth of the industry which is being experienced each year. The volume of sales for the year 1935 was $41,000,000; 1936, $76,000,000; 1937, $114,000,000; 1938, $130,000,000; 1939, $225,000,000. For the year 1940 it is estimated sales will total $500,000,000, of which only a small portion is attributable to the national defense program. In order to equitably take into consideration the foregoing condition, the recommendation of this committee is that with the enactment of an excess-profits tax this industry be accorded an alternate method, such as one of the following:

1. That an exemption base for excess-profits tax be established as a deduction from taxable income (before excess-profits tax) in an amount equal to a specified percentage of the sales in the taxable year.

2. That the exemption base for excess-profits tax determination take into consideration the composite average of three factors—sales, pay rolls, and gross investment in facilities for 3 of the 4 years 1936 to 1939, inclusive.

To illustrate the working of this latter suggestion the following example is given:

| | Sales | Pay rolls | Facilities (gross value) | Together | Earnings before Federal taxes |
|---|---|---|---|---|---|
| 1936 | $1,000,000 | $350,000 | $500,000 | $2,150,000 | $100,000 |
| 1938 | 1,700,000 | 600,000 | 850,000 | 3,150,000 | 200,000 |
| 1939 | 3,000,000 | 910,000 | 1,500,000 | 5,410,000 | 450,000 |
| Total | 5,700,000 | 1,860,000 | 3,150,000 | 10,710,000 | 750,000 |
| Average | 1,900,000 | 630,000 | 1,050,000 | 3,570,000 | 250,000 |
| | | | | (c) | (b) |
| 1941 | 10,000,000 | 2,500,000 | 3,000,000 | 15,500,000 | 1,300,000 |

Weighted normal earnings ratio, (b)÷(c)=7 percent.
Normal earnings ratio, 7 percent.
Exemption base (7 percent of $15,500,000), $1,085,000.
Earnings subject to excess-profits tax, $215,000.

For those contractors who because of losses during the 1936–39 period are unable to apply the above formula, it will be necessary to provide an equitable exemption base for excess-profits-tax determination, and possibly a provision such as that of section 328 of the 1918 act (a comparison with representative corporations engaged in a like or similar trade or business) would have to be provided.

If in any year during the imposition of an excess-profits tax, the exemption base should exceed the taxable earnings, the contractor should be granted the privilege of carrying the unused exemption forward to future years to the end that no excess-profits tax will be imposed until the accumulated earnings exceed the accumulated exemptions.

## AMORTIZATION

Equipment and facilities acquired or to be acquired to facilitate the manufacture of aircraft and the parts and equipment therefor, during the national emergency declared by the President on September 8, 1939, to exist, fall into the following two general classifications, both of which require full amortization during the emergency period.

(a) Excess equipment and facilities already acquired and which will be used in the performance of contracts with the United States Government or others during the period of the national emergency;

(b) Excess equipment and facilities required for further expansion, whether in connection with United States Government contracts or other contracts.

Equipment and facilities already acquired have to a great extent resulted from contracts entered into with certain foreign governments which phase of expansion was coordinated through the United States Army Air Corps. Substantial additional equipment and facilities have also been acquired in anticipation of increased volume. In view of the fact that such facilities will have no further use upon the termination of the emergency period, it is necessary that the cost thereof be amortized over their actual useful life.

Specifically as regards the period for amortization it is the view of this committee that a maximum period of 5 years should be provided by statute, with the provision that the contractor, at his discretion, take the deduction in the year or years desired within the 5-year period, except that during the first year not more than 20 percent amortization may be taken, by the end of the second year not more than 40 percent of the amortization may be taken, etc.

In the event of the termination of the emergency before the end of the 5-year period it is necessary for the proper protection of the contractor, to provide (a) that such excess facilities and equipment be amortized over a 5-year period from date of acquisition or over the shorter period resulting from the termination of the national emergency, and (b) the right to amend income and excess-profits tax returns already filed in order that the amortization charges can be properly reapportioned.

AUGUST 8, 1940.

MEMORANDUM

To: The Executive Committee of the Aeronautical Chamber of Commerce of America, Inc.
From: The Accounting Committee.
Subject: Excess-profits Taxes and Amortization of Excess Facilities.

This committee met last week and prepared under date of August 2, 1940, the attached memorandum relative to excess-profits taxes and amortization of excess facilities. The purposes for which this memorandum was prepared are explained therein. Since its preparation, proposed legislation on the subjects now being considered by the House Ways and Means Subcommittee has been released for publication. In view of the information disclosed in these releases the committee has again met to study the subjects and now wishes to take this opportunity of supplementing its memorandum of August 2, 1940.

EXCESS-PROFITS TAXES

The proposed legislation would give corporations the choice between two alternatives with the same graduated scale of rates to apply in either case. Under one plan the tax base would be determined by the excess of profits, in 1940 for example, over the average for the 4-year period 1936-39, inclusive. Under the alternative the base would be invested capital, with a minimum exemption of 6 percent on the first $500,000 of such capital and 4 percent on capital above that figure and a maximum exemption of 10 percent. Between these minimum and maximum credits a corporation would be given a credit determined by its average rate of return on invested capital during the 4-year 1936-39 base period.

The rates under both plans are understood to be as follows: On excess profits of not more than 10 percent of the credit the rate is 25 percent; on the next 10 percent the rate is 30 percent; and on the remainder the rate is 40 percent. A $5,000 specific exemption for excess profits would be granted under either tax plan.

In the previous memorandum of this committee, hereto attached, reference is made to the fact that during the past few years the industry has been rapidly expanding and it is believed that in view of the risks involved due to the further extraordinary expansions required it is necessary that fair treatment be accorded to the industry if it is to be able to do its full part in the national-defense program, and emerge therefrom on a firm footing.

In the belief that the excess-profits taxes to be enacted will probably follow the general pattern of the proposed legislation, this committee believes that in recognition of the conditions above referred to a ceiling should be placed on the excess-profits tax. This could be accomplished by providing an additional alternative beyond that contemplated in the legislation now proposed. A tabulation in the Wall Street Journal of August 8 shows that the average aggregate tax (income and excess profits) for a selected number of companies falls generally below 30 percent. This committee believes it would be equitable to establish a ceiling for excess-profits taxes in an amount equal to 12 percent of income subject to normal tax which, after taking into consideration the 20.9 percent rate now in effect, would indicate a tax of 32.9 percent as compared with the aforementioned average aggregate tax which was less than 30 percent.

AMORTIZATION OF EXCESS FACILITIES

The same proposed legislation carries a provision of amortization for new plants required for the national-defense program. The provision indicates that the costs of such plants be amortized over a period of 5 years at the rate of 20 percent per year.

Based on the White House release of July 10 relative to this subject, it was understood that the 20 percent amortization could be taken as not more than 20 percent the first year, not more than 40 percent by the end of the second year, etc. It was further understood that all plant expansions since September 8, 1939, the date of the declaration of the national emergency, would be the subject of amortization during the 5-year period if such facilities were necessary in the interests of national defense. The proposal of the House Ways and Means Subcommittee indicates that these two items are not being accorded the treatment that was expected and the aircraft industry feels that it is essential and important to obtain proper and full amortization for all special facilities to be used in the interests of national defense.

*Effects of new profits tax plan*

AVERAGE EARNINGS OPTION

| Company | Income before taxes [1] | Normal tax (20.9 percent) | Balance before excess-profits taxes | Excess-profits tax exemption [2] | Excess profits | Excess-profits tax [3] | Ratio of normal and excess-profits taxes to income | Net after normal and excess-profits taxes | Actual net reported for year under consideration |
|---|---|---|---|---|---|---|---|---|---|
| Chrysler | $76,110,543 | $15,907,103 | $60,203,440 | $42,134,309 | $18,068,971 | $8,174,225 | 31.61 | $54,029,215 | $62,110,543 |
| General Motors | 282,312,820 | 59,003,379 | 223,309,441 | 180,104,813 | 43,204,628 | 12,779,230 | 25.42 | 210,530,211 | 258,482,425 |
| General Foods | 18,396,263 | 3,842,729 | 14,553,534 | 13,060,597 | 1,502,937 | 385,678 | 22.59 | 14,157,856 | 15,118,093 |
| Texas Corporation | 61,674,319 | 12,889,033 | 48,785,286 | 37,220,124 | 11,564,262 | 3,095,380 | 25.80 | 45,089,186 | 54,574,319 |
| Westinghouse Electric | 25,708,344 | 5,369,764 | 20,338,580 | 14,338,210 | 5,860,370 | 1,980,692 | 28.58 | 18,957,888 | 20,126,408 |
| United Aircraft | 11,267,708 | 2,350,143 | 8,928,625 | 5,151,108 | 3,777,519 | 1,401,229 | 34.02 | 7,417,396 | 9,375,437 |
| Glenn L. Martin | 5,097,696 | 1,065,400 | 4,032,297 | 2,089,957 | 1,942,840 | 724,903 | 35.12 | 3,307,304 | 4,110,606 |
| United States Steel | 124,444,358 | 26,009,871 | 108,435,487 | 44,737,549 | 63,697,938 | 24,630,737 | 40.69 | 83,804,750 | 94,944,358 |
| Bethlehem | 38,687,486 | 8,085,685 | 30,601,801 | 18,997,396 | 11,604,405 | 4,205,115 | 31.76 | 26,396,686 | 31,819,596 |
| Montgomery Ward | 34,310,615 | 7,170,925 | 27,139,720 | 21,521,136 | 5,618,564 | 1,709,397 | 25.98 | 25,430,323 | 27,010,645 |
| American Can | 23,404,685 | 4,891,579 | 18,513,106 | 16,776,285 | 1,736,821 | 437,165 | 22.76 | 18,075,941 | 18,284,904 |
| New York Shipbuilding | 1,093,264 | 209,692 | 783,992 | 121,714 | 672,268 | 265,865 | 47.39 | 528,117 | 998,264 |
| Eastman Kodak | 27,933,232 | 5,838,045 | 22,095,187 | 20,037,675 | 2,057,512 | 517,065 | 22.75 | 21,578,122 | 22,347,345 |

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*Effects of new profits tax plan*—Continued

RETURN ON INVESTED CAPITAL OPTION

| Company | Income before taxes [1] | Normal tax (20.9 percent) | Balance before excess-profits taxes | Average return on invested capital 1936–39 | Excess-profits tax exemption [2] | Excess profits | Excess-profits tax [3] | Ratio of normal and excess-profits taxes to income | Net after normal and excess-profits taxes | Actual net reported for year under consideration |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | *Percent* | | | | *Percent* | | |
| Chrysler | $76, 110, 543 | $15, 907, 103 | $60, 203, 440 | 28.6 | $17, 182, 502 | $43, 020, 938 | $16, 778, 813 | 42.94 | $26, 242, 125 | $32, 110, 543 |
| General Motors | 282, 312, 929 | 59, 003, 379 | 223, 309, 441 | 18.03 | 104, 776, 295 | 118, 533, 146 | 44, 508, 851 | 36.76 | 178, 515, 590 | 238, 482, 425 |
| General Foods | 18, 599, 263 | 3, 842, 729 | 14, 543, 534 | 19.1 | 7, 981, 740 | 6, 561, 794 | 2, 425, 173 | 31.09 | 12, 118, 361 | 15, 118, 063 |
| Texas Corporation | 61, 674, 319 | 12, 889, 033 | 48, 781, 286 | 8.4 | 41, 831, 204 | 6, 953, 182 | 1, 876, 790 | 23.95 | 46, 897, 587 | 54, 574, 319 |
| Westinghouse Electric | 25, 788, 344 | 5, 389, 764 | 20, 398, 580 | 7.35 | 14, 527, 678 | 5, 870, 902 | 1, 980, 918 | 28.58 | 18, 977, 662 | 20, 126, 408 |
| United Aircraft | 11, 287, 768 | 2, 358, 143 | 8, 929, 625 | 21.54 | 3, 292, 183 | 5, 696, 442 | 2, 197, 772 | 39.22 | 6, 730, 853 | 9, 375, 437 |
| Glenn L. Martin | 5, 097, 606 | 1, 065, 400 | 4, 032, 207 | 22.38 | 1, 840, 020 | 2, 231, 587 | 847, 719 | 37.52 | 3, 184, 488 | 4, 110, 606 |
| United States Steel | 124, 441, 358 | 26, 008, 871 | 108, 435, 487 | 2.89 | 56, 044, 863 | 52, 430, 624 | 19, 572, 127 | 36.62 | 86, 963, 360 | 94, 944, 358 |
| Bethlehem | 38, 687, 186 | 8, 085, 085 | 30, 601, 801 | 3.87 | 19, 312, 895 | 11, 288, 916 | 4, 032, 744 | 31.32 | 26, 509, 057 | 31, 819, 596 |
| Montgomery Ward | 34, 310, 645 | 7, 170, 225 | 27, 139, 720 | 11.7 | 21, 118, 195 | 6, 021, 525 | 1, 880, 655 | 26.38 | 25, 259, 065 | 27, 010, 645 |
| American Can | 23, 401, 685 | 4, 891, 579 | 18, 512, 106 | 10.44 | 16, 029, 605 | 2, 483, 501 | 664, 902 | 23.74 | 17, 848, 201 | 18, 284, 965 |
| New York Shipbuilding | 1, 065, 264 | 209, 082 | 778, 182 | 1.81 | 396, 529 | 487, 453 | 187, 518 | 79.57 | 606, 664 | 928, 264 |
| Eastman Kodak | 27, 914, 232 | 5, 838, 045 | 22, 065, 187 | 12.46 | 18, 860, 470 | 3, 234, 717 | 876, 113 | 24.03 | 21, 219, 074 | 22, 347, 345 |

[1] Largest for recent years. For Chrysler and General Motors 1936. For United Aircraft, Glenn L. Martin, General Foods, American Can, and New York Shipbuilding 1939. For Montgomery Ward year ended Jan. 31, 1940, and for Texas Corporation, Westinghouse Electric, United States Steel, Bethlehem Steel, and Eastman Kodak 1937.

[2] Average earnings 1936–39 plus $5,000.

[3] 25 percent on net income not in excess of 10 percent of the excess-profits tax credit; 30 percent on net income in excess of 10 percent of the credit but not in excess of 20 percent of the credit, and 40 percent on net income in excess of 20 percent of the credit.

[4] $5,000 plus maximum of 10 percent on invested capital and minimum credit of 6 percent on first $500,000 plus 4 percent on remainder of invested capital. Between those maximum and minimum limits a corporation receives credit equivalent to its average rate of return for the years 1936–39.

BOSTON CHAMBER OF COMMERCE COMMITTEE ON FEDERAL TAXATION AND EXPENDITURES

RE PROPOSED EXCESS-PROFITS TAX AND AMORTIZATION OF FACILITIES PROVIDED FOR THE NATIONAL DEFENSE

I. EXCESS-PROFITS TAX

(*a*) *Form of tax recommended.*—It is obvious that the extraordinary expenditures required by the present emergency in order to provide for the national defense call for additional taxation and that although abnormal profits are not likely to be as common as they were in the last World War, public sentiment demands and the public necessities require the immediate enactment of some form of excess-profits tax. The problem therefore is to devise an excess-profits tax that will be as productive of revenue as possible without making it too difficult for private enterprise to devote its energies to best advantage in behalf of the national defense, and that will be as free as possible from the inequalities and injustices and the difficulties in administration which led to the abandonment of the previous excess-profits tax by universal consent.

An excess-profits tax, strictly so called, is imposed whenever the net income of the taxpayer exceeds a certain proportion of its invested capital, even if the proportion is no greater than during normal times. A war-profits tax is imposed when the profits of the taxpayer exceed those earned by him in normal times even if taken by themselves they are not excessive in relation to invested capital or by any other measure. An excess-profits tax and a war-profits tax were both included in the Revenue Act of 1918, the taxpayer being assessed on whichever tax was the greater.

There are gross inequities in either of these methods of taxation taken by itself. It is believed, however, that these two methods of taxation can be combined in a single revenue measure in such a manner as to avoid some of the inequities unavoidable in each method.

We recommend that a tax be levied on every corporation when its profits are in excess of those of the preemergency period in their relation to its invested capital as it then stood, and at the same time exceed a fair return on its invested capital of the taxable year.

(*b*) *Determination of invested capital.*— As a matter of abstract theory the invested capital used in the computation of an excess-profits tax should undoubtedly be the true invested capital. Experience in the years 1917 to 1921, when the former excess-profits tax was in force, indicated such almost insuperable practical difficulties in determining the true invested capital of almost all corporations that the tax was abandoned, although the relation of net income to invested capital constitutes the only equitable measure of a graduated corporation income tax. As the controversies over invested capital dragged their way through the courts for 20 years after the excess-profits-tax law had been repealed, it was almost the unanimous opinion of persons familiar with tax problems that the attempt ought never be made again to determine the true invested capital of all the corporations in the United States.

It is true that since the last World War accounting practices of corporations have greatly improved. Nevertheless, so many questions of policy and judgment are involved in determining whether and to what extent expenditures shall be charged to capital that an elaborate reexamination of the accounting of almost all corporations from the time when they started operations would be necessary if they are all to be treated on an equal basis. It is true that in the case of all corporations that have been in existence for 20 years or more, the invested capital was finally determined for the previous excess-profits tax either by the courts or by agreement and that this determination might be taken as a starting point. But in many, if not most, cases, this determination was an arbitrary figure arrived at as a compromise to avoid further litigation in a particular case, and it would be most unfair to treat such determination as binding on either party for any other purpose. We believe that true invested capital is as elusive as the pot of gold at the end of the rainbow and should not be used as a measure of taxation except as a last resort.

The arbitrary determination of invested capital as is permitted under the present combined capital stock and excess profits tax law would be impracticable under the conditions which the proposed new tax is designed to meet. The use of a corporation's own computation of its own net worth as carried on its books would be inequitable in the case of an excess profits tax at a uniform rate measured wholly by the relation of income to invested capital as corporations which had

habitually used a conservative policy in capitalizing expenditures would be penalized. If, however, profits are not "excess" unless they exceed the ratio of preemergency profits to preemergency invested capital, any difference between corporations due to different methods in computing invested capital will wash out. Fortunately all of the figures necessary to determining invested capital as computed by each corporation are disclosed in the corporation income tax returns.

We recommend that for invested capital at the date when the tax goes into effect there be taken the net worth of each corporation, that is, its capital stock and surplus, or capital stock less capital deficit, as the case may be, as disclosed in the Federal income tax return for the year ended on that date, increased in either case by the addition of any surplus reserves as of that date, the provisions for which have not been claimed or allowed as deductions from taxable income.

The invested capital thus determined should be taken as a starting point, and invested capital should thereafter be computed by adding to the invested capital thus determined all contributions of capital and taxable income, and deducting therefrom all Federal income and profits taxes paid, losses as determined under Federal income-tax laws, and distributions to stockholders.

The invested capital for each taxable year should be the average of the invested capital at the beginning and the end of the taxable year.

(c) *Base and rate of the tax.*—The excess-profits tax should be a tax on profits determined in accordance with the provisions of the Federal income tax law, which should be amended to provide for a deduction for amortization of defense facilities. This income necessarily constitutes a certain percentage of invested capital, determined as above set forth. From this percentage there should be deducted the proportion which the average annual taxable income for the base period of the 5 years 1935 to 1939, inclusive, less Federal income taxes, bore to the average of invested capital at the beginning of the base period and at the end of each year thereof, invested capital being determined in each instance in the same manner as it is to be determined as of the date when the tax goes into effect. To protect corporations which made small earnings or none during the base period, 8 percent of present invested capital should be taken as the minimum credit for base period profits.

From the percentage of profits to invested capital in the taxable year there should be deducted the percentage of profits to invested capital in the base period, and the percentage remaining should be applied to the invested capital of the taxable year, and the profits subject to excess-profits tax thus established.

The taxable profits thus determined should be subject to a tax graduated in proportion to the relation of such profits to invested capital; but in our opinion even in the highest bracket the rate should not exceed 50 percent of the profits.

As few corporations have made consistently large profits over the years of the base period, a maximum credit allowable for percentage of profits to invested capital in the base period is probably not necessary and in any event would impair the flexibility of the proposed tax method. If figures in possession of the Treasury Department or developed in the first year of administration indicate that a maximum credit is necessary, it could be added, either now or later.

The following table will show how the foregoing excess-profits tax would work out in the case of two corporations with the same invested capital, one making a moderate and the other a great increase in profits over the base, or preemergency, period, assuming the rate of tax was the same as in 1921, namely 20 percent on taxable income in excess of the credit but not in excess of 20 percent of invested capital; and 40 percent on taxable income in excess of 20 percent of invested capital:

| | A | B |
|---|---|---|
| Average invested capital in base period | $800,000 | $800,000 |
| Average income in base period | $80,000 | $80,000 |
| Ratio of income to capital in base period ..... percent | 10 | 10 |
| Percentage used for credit ..... do | 10 | 8 |
| Invested capital in taxable year | $1,000,000 | $1,000,000 |
| Net income in taxable year | $150,000 | $450,000 |
| Credit for income in base period | $100,000 | $80,000 |
| Subject to excess profits tax | $50,000 | $370,000 |
| Taxable in lower bracket | $50,000 | $200,000 |
| Tax in lower bracket | $10,000 | $40,000 |
| Taxable in higher bracket | | $170,000 |
| Tax in higher bracket | | $68,000 |
| Total tax | $10,000 | $108,000 |

Corporation B, having a little over twice the net income of corporation A, and the same invested capital, pays nearly seven times as great an excess-profits tax as corporation A.

### II. AMORTIZATION OF DEFENSE FACILITIES

The necessity of an immense expansion of manufacturing plants for the production of ships and materials necessary for the national defense, with the probability that when the defense program is completed the new buildings and machinery will no longer be needed, has raised a serious tax problem. Money used for plant expansion is a capital expenditure, and is not a legitimate deduction from current gross income for tax purposes. Deductions for depreciation and obsolescence may be claimed only as the property becomes physically worn out or its design has become out of date. No deduction is allowed for the cost of a sound and modern plant merely because the demand for its output has ceased. If under the present law a corporation should spend a large sum for plant expansion for national defense and the plant was no longer needed after a short term of years, and if the corporation included the cost of the plant in the amount charged the purchaser for the materials or vessels produced, though the corporation may have in truth made a very moderate profit, its income-tax returns would indicate a prodigious but fictitious income, upon which it would be obliged to pay not only income tax but doubtless a very substantial excess-profits tax.

It is therefore universally recognized that there must be some means provided by which the cost of the expansion of plants for defense purposes may be deducted from gross income for tax purposes if the facilities thus provided cease to be useful when the present emergency passes. The best method is to allow a deduction from gross income similar to the deductions now allowed for depreciation, obsolescence, or destruction by flood, fire, or other calamity of capital assets, under the heading of amortization of defense facilities.

We favor the immediate enactment of an amendment to the revenue acts now in force allowing such a deduction, since no corporation can safely expand its defense facilities until it is certain that whatever gain it may make on contracts for the production of defense facilities will not be turned into a loss by a huge tax on a fictitious income.

We recommend that the deduction for amortization be subject to the following provisions:

(*a*) Amortization should be allowed only with respect to the cost of facilities, the acquisition of which is certified by the National Defense Commission as necessary for the national defense.

(*b*) To avoid a multiplicity of small claims, amortization should be allowed only when the cost of the facilities acquired exceeds a specified proportion of the value of the existing plant. This proportion should be not more than 10 percent and might be as small as 5 percent.

(*c*) The amortization allowed in any year should not be more than 20 percent of the cost of the facilities, and the taxpayer should not be required to deduct in any year amortization in excess of the profits for such year otherwise taxable. Amortization should be allowable until the entire cost of the facilities has been covered.

(*d*) If facilities in use at the time of the effective date of the amortization provision are abandoned in favor of facilities acquired thereafter, with respect to which full amortization is allowed, depreciation at the existing rates only should be allowed on the facilities so abandoned.

While manufacturers capable of providing materials and vessels necessary for the national defense are fairly entitled to know the entire tax program before they enter into contracts with the Government, it is vitally necessary that the amortization provisions be enacted without delay. Accordingly, if it appears likely that the most desirable form of excess-profits tax law cannot be agreed upon and enacted without substantial delay, we recommend that the provision for amortization of defense facilities be embodied in a separate statute, and be enacted without awating the outcome of the deliberations on the excess-profits tax.

### III. CARRY-OVER OF LOSSES

Apart from questions arising out of the problem of amortization of defense facilities, there are likely to be great irregularities in the income of corporations engaged in producing materials and vessels for the national defense, so that in the case of a single long-term undertaking, which shows a moderate profit as a whole, the strict division of income into years as required by the revenue acts might indicate heavy losses in certain years and prodigious profits in others. We

recommend therefore that, in the case of such corporations, unlimited carrying over of losses into subsequent years be permitted as long as the present emergency exists.

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MEMORANDUM ON THE EXCESS-PROFITS TAX, SUBMITTED BY ELISHA M. FRIEDMAN

15 BROAD STREET, NEW YORK.

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 3 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 to 1918—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. 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 percent 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 (p. 449). 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. Per-

haps 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 legislation. 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 1939, 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 goodwill, 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.

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MEMORANDUM ON PROPOSED EXCESS PROFITS TAX

I. NORMAL EARNINGS WHICH SHOULD NOT BE SUBJECT TO THE TAX

While it must be recognized that the proposed excess-profits tax law is designed to be a source of substantial additional revenue to the Government, it must further be recognized that this form of raising revenue (rather than an increase in ordinary corporation tax rates) is adopted for a special reason, i. e., that those corporations which will profit "excessively" as a result of the national-defense program should as a matter of fairness contribute to the national defense on a higher basis than others. Thus the only earnings which are justifiably subject to such a special tax are those which are actually in excess of a normal or fair rate of return (under normal circumstances) on the "venture capital" which has been risked in the business. The profits which a company has been able to earn during the last several years, when conditions generally have been below normal, have certainly

been no more than normal earnings. Accordingly that part of the proposal by which profits not in excess of the average for the last several years may be claimed as exempt from the tax, is reasonable and proper, except that it would be a considerable improvement to adopt the suggested change by which the taxpayer may take the average earnings of any 3 of the last 4 years. An earning capacity demonstrated in 3 out of 4 years, prior to the defense program, should be considered normal, not excessive, and should not be penalized by the losses or lower earnings of a single year, which may have resulted from a single misfortune, or from very special and abnormal conditions.

But during this same period many companies, with large invested capital, have been unable to earn any return on it, or any substantial and reasonable return. Indeed, during these years many corporations have lost large sums and some have consumed in losses not only their entire surplus but have used up a part of, that is "impaired," their venture capital. In cases where losses instead of profits have occurred, it should not be considered that the earnings for 1940 and future years are abnormal, or constitute excess profits, if they merely amount to a reasonable return upon the original invested capital.

In the report of the subcommittee of the Committee on Ways and Means, dated August 8, 1940, this latter point is recognized, but only partially, as a company which has not been earning more than 4 percent on its invested capital during the last several years (6 percent on the first $500,000), is not to be permitted to earn more than that, without making the excess subject to the proposed tax. This would be an undue hardship on some companies. When stockholders have received little or nothing for several years, but have had their money invested, waiting for the day when a return of normal business activity would bring about a sufficient demand for their company's products to give them some reasonable return, they should not be penalized by having a tax assessed against earnings in excess of 4 percent. This might well mean that the average earnings for the last 4 years, and for the year 1940, would not exceed about 1 percent, or indeed be less than nothing, i. e., a loss, if substantial losses have occurred in the years prior to 1940, yet the excess-profits tax might be levied in a considerable amount.

This hardship on companies with large invested capital, but which are engaged in those industries which have been especially affected by the long continued depression, will no doubt result in numerous proposed amendments, and possibly some changes in the bill, and these may be considered with a view to reaching an equitable compromise between the two concepts of the excess-profits tax referred to on page 3 of the subcommittee's report. The point which is urged by this memorandum is that the situation is not one calling for compromise, but for a free and fair option on the part of the taxpayer to take either one of two alternative methods, each of which should be fair and neither of which should have limitations imposed because of the existence of the alternative method. No corporation should be subject to what amounts to a penalty tax against its defense program profits, unless the defense program has contributed "excessively" to those profits. If the corporation has been able to earn profits, during a depression period, without the benefit of the defense program, certainly it should have a right to have the past rate of return considered normal. This is recognized in the proposed bill, and in the subcommittee's report. There may, however, be some tendency to minimize this basis, or place restrictions or limitations upon it, in return for concessions which may be made to those companies which have large invested capital, but which have been unable in recent years to earn any reasonable return upon it. Such restrictions or limitations should not be made. The proposition that the rate of earnings for the last several years cannot in any case fairly be deemed to have been better than normal, and hence that earnings up to that rate should not be subject to any excess tax, is 100 percent sound, and should be retained. If it is deemed proper to grant a more liberal definition of normal profits to companies with large invested capital, that should be done without penalizing those companies which have been able, in spite of unfavorable general conditions, to earn more liberal returns upon their capital.

Many companies, with large investments, necessarily have plants that are idle a part of the time. When there is a demand for the products of those plants, some reasonable opportunity ought to be given to make up for the lean years, before assessing an excess profits tax upon the increased earnings. It might well be said that the stockholders of those companies have suffered enough, without being made subject to heavy additional taxes, because they have kept available and in working order inactive plant facilities which are now found valuable and useful in the preparedness program. A minimum of 8 percent, or certainly 6 percent, would seem to be much more reasonable than the proposed minimum of 4 percent,

and this minimum, as well as the average earnings basis, should fairly be based upon any 3 of the last 4 years, rather than on an average of all 4 years, which may include 1 year of abnormal losses, and thereby take away much of the benefit of the provision. But this is a matter which, like the basis of average earnings in recent years, should stand upon its own merits. It is submitted that the two concepts of "excess" earnings are independent of each other, that no earnings are properly to be considered "excess" unless they are excessive from both standpoints, and that no taxpayer should be subject to the proposed excess profits tax unless its income exceeds its past demonstrated earning capacity, and also exceeds a reasonable return upon its investment. There is no necessity for compromise, because it is entirely fair and equitable that the taxpayer should have the full measure of reasonable protection under both bases.

2. PROVISIONS AFFECTING CORPORATIONS WITH IMPAIRED CAPITAL

Corporations which have suffered substantial losses, so that their capital accounts are impaired, should be permitted to restore their original capital from earnings, before becoming subject to an excess-profits tax. With the existing impairment, under numerous State corporation laws such companies are not permitted to pay dividends to shareholders, so that until the lost capital is restored, the shareholders have no chance of getting anything. If the restoration of the lost capital is delayed by the imposition of excess-profits taxes, the day when such shareholders will have an opportunity to salvage at least some return on their investment is unduly postponed.

If all venture capital which has been risked in a certain business is still intact, it is reasonable enough that excess earnings upon such capital, resulting from the national-defense program, should be subject to special taxes. If much of the capital embarked upon an enterprise has been lost, but it is found that the facilities of that enterprise are valuable in the defense program, with the result that substantial current earnings can be achieved, it is no more than fair that the losses which the stockholders suffered should be restored first. This would not be letting anyone profit unduly from the national-defense program, but would be only a reasonable provision to permit the recoupment of losses before imposing a special tax. This would be a fair and reasonable encouragement to investors, who would thereby know that it is not proposed in effect to tax their capital or to prevent its being restored from operations. By permitting the restoration of the capital of such companies to its original amount, it would be possible for their plants and facilities to be operated efficiently, and such a provision would have a strong tendency to restore business confidence and to increase employment. Certainly one who accomplishes no more than to restore his impaired capital to par cannot be said in any reasonable sense of the word, to have received any "excessive" or "excess" profits.

We also note in this connection that under the old excess-profits tax laws, in force in 1917 and later years, the original invested capital, upon which a return of about 8 percent was allowed before the imposition of the excess-profits tax, was not diminished by impairment or losses. In other words, the company and the shareholders were given the benefit of the original investment, in determining a fair rate of return. The same rule was followed in the definition of invested capital in the recent La Follette and Connelly amendments in the Senate. This seems to have been changed, in the recommendation of the subcommittee, in which it is stated, page 5, that the invested capital should be reduced by "the deficit in the earnings and profits account as of the beginning of the taxable year." The corporation and the shareholders will not receive a reasonable return upon their investment, if the permissible return is cut down by subtracting from the capital account losses which have been incurred in prior years. It is to be hoped that this proposed change will not be made, and that the law as enacted will follow the precedent of the 1917–20 law and Treasury regulations in that regard. It is submitted that corporations with impaired capital are equitably entitled to special and additional relief, by being permitted to restore their lost capital out of earnings before the excess-profits tax applies, and that certainly they should not be penalized by having their invested capital reduced by the amount of previous losses.

Respectfully submitted.

WELLES, KELSEY, COBOURN & HARRINGTON.

TOLEDO, OHIO,
*August 16, 1940.*

## Report on the Excess-Profits Tax

By Leonard E. Read, *general manager, Los Angeles Chamber of Commerce*

### Outline

#### FOREWORD

Plan to be judged by effects on national welfare.
Basic principles: (1) A balanced public budget, (2) continuance of private enterprise, (3) private employment to be expanded, and (4) justice in distribution of defense burdens.

#### ARGUMENTS FOR AN "EXCESS PROFITS" TAX

(1) A needed substitute for Vinson-Trammell profit limitations.
(2) Protects the public against profiteering.
(3) Politically necessary accompaniment of conscription.
(4) Secures needed revenues.

#### ARGUMENTS AGAINST AN "EXCESS PROFITS" TAX

(1) The immediate need for liberalizing income tax amortization provisions bears no necessary relation to an excess-profits tax.
(2) The excess-profits tax penalizes efficiency, discourages enterprise and checks needed business expansion.
(3) Its burden is especially heavy on the new, growing, small and medium-sized concerns.
(4) It imposes an "impossible auditing task" on the tax administration, increases bureaucratic control of business and adds to business uncertainties.
(5) Limitations on personal gains from armament building can be better secured through personal income taxes.
(6) Yield of the tax will be relatively small.

#### CONCLUSION

Wanted: Machines.
How Can We Best Get the Machines We Need?
Reinvested Profits—the Growth-Bud of Industry.
Reinvestment of Profits Improves Credit and Preserves Initiative.
Probable Results of the Excess Profits Tax.
Alternative Proposal.

### The "Excess Profits" Tax

#### FOREWORD

The so-called excess-profits tax proposal now before Congress should be considered first and last from the standpoint of its effects on the public welfare. How will it affect the execution and financing of the defense program? How will it affect employment and wage-levels? How will it affect the system of free enterprise and our representative form of government? These are the questions to be answered in discussing legislative policies today.

At the outset, however, there should be noted certain principles which must be accepted as basic for any discussion of increased profits taxation.

(1) The public credit should not be further jeopardized by large-scale borrowings to finance the defense program. Either by economies in other governmental expenditures or by increased taxation, or both, public revenues and expenditures should be speedily brought into balance.

(2) Private enterprise should continue to be our main reliance, at least in the absence of a declared state of war, both because of its proven superior efficiency in production and because it is the only economic basis for democratic institutions whose present continuance we believe is desired by an overwhelming majority of United States citizens.

(3) A marked expansion of employment in private industry is a goal of primary importance for the United States at the present time both for political and economic reasons.

(4) The financial and other burdens of the defense program should be equitably distributed. Perfect justice is never attainable, but every precaution must be taken to prevent any class of citizens profiting at the expense of the community. Specifically it is repugnant to every sense of justice that producers behind the lines should grow wealthy while their fellows on the fighting lines risk life and all that makes life worthwhile.

#### ARGUMENTS ON BEHALF OF AN EXCESS PROFITS-TAX

(1) The excess-profits tax is proposed at this time as a substitute for the 7 to 8 percent profits limitations imposed by the Vinson-Trammell Act on Government contracts in connection with the defense program. This act was found to prevent the placing of contracts (a) because existing amortization allowances appeared inadequate, (b) because certain necessary expenses could not be included in costs,

and (c) because unforeseeable expenses and losses were not sufficiently compensated by the 7 to 8 percent maximum profit set by law. The excess-profits tax bill therefore greatly liberalizes the amortization provisions of the income-tax laws for investments certified to be necessary for the defense program and repeals the limitation on the rate of profits.

(2) Some form of limitations on profits from armament making, however, is felt to be necessary to protect the public against profiteering.

(3) Provisions against war profiteering are politically expedient or necessary as an accompaniment to conscription of men. They are a part of the program for maintaining morale.

(4) To finance the defense program increased taxation is necessary. Part of this increased tax burden should fall on corporation profits. This seems especially reasonable in view of the financial benefits accruing to business from the Government's increased expenditures.

ARGUMENTS AGAINST AN EXCESS-PROFITS TAX

(1) The immediate pressing need is for liberalizing amortization provisions of income-tax laws relating to Government contracts. This, however, bears no necessary relation to the Vinson-Trammell limitation on rate of profits or to an excess-profits tax. The new bill proposes that the amortization period on investments necessary for the defense program be made 5 years, or less than 5 years if the President declares the state of emergency ended before that time. That is, in industries essential to the defense program, producers may, for income-tax purposes, set at a higher figure than formerly their annual depreciation charges. This will raise their cost figures and reduce their net earnings subject to corporation income taxes.

Fears have been expressed that, under the new amortization provisions, businessmen may amortize their investments more quickly than the assets lose their economic value. In other words, it is feared that businessmen will charge high prices to cover costs of their investment in a short time, at the same time reducing their tax assessments by artificially high depreciation charges. Then they would have received back from sale of their products the entire amount of their original investment and yet their equipment would still possess considerable earning power. Excess profits, it is assumed, would then be the result. Therefore, according to this view, an excess-profits tax must accompany any provisions to liberalize the amortization provisions of our income-tax laws.

The above view, however, fails to take into account the position of the enterpriser with regard to taxes and negotiation of Government contracts in case he has amortized his investment during a period shorter than the economic life of his assets. If he maintains his prices and volume of business, income-tax assessments will rise by the amount formerly charged for depreciation. The Treasury would then collect from him as much in total taxes as if he had amortized his investment more slowly. Moreover, future rates of taxation are likely to be higher than those existing now. Therefore, the total taxes paid by such an enterpriser would be higher than if he had charged off his investment more slowly.

It is unlikely, however, that he will be able to maintain his prices in view of the Government's power to modify the terms of his contracts. Army and Navy engineers make their own estimates of reasonable costs for the materials ordered from private business. They are not accustomed to favor business with overgenerous estimates of cost. If they find that business has written off the costs of investments, they can and doubtless will reduce the price offered in Government contracts.

Under conditions of liberal amortization privileges, moreover, competition for Government business will be keener and will act as a further influence to prevent profiteering.

It cannot be too strongly emphasized, however, that the enterpriser cannot escape his fair share of taxes or make increased profits by charging off his investment at abnormally high rates. At most he can merely postpone payment and protect himself against taxes on profits he has never earned. Such excessive taxes are now frequently levied to the detriment of both business and the public when actual obsolescence and depreciation occur at a more rapid rate than recognized by the Treasury Department. Liberalizing amortization provisions of the tax laws in this case only protects against losses from taxation of nonexistent profits. It does not permit excess profits or call for an excess-profits tax.

(2) The chief objections to the excess-profits tax, however, are that it penalizes efficiency, discourages enterprise, and checks needed business expansion.

The firm which uses its capital and labor most efficiently, getting highest output at lowest cost, will earn highest profits on a given capital base. The firm which shows most enterprise in reducing costs, increasing service, and extending its markets will show greatest increases in earnings over the base years. Therefore under an excess-profits tax such firms will pay taxes graduated upwards according to their efficiency and enterprise.

Said Professor E. R. A. Seligman, outstanding tax authority, concerning the principle of excess-profits tax:

"Something can be said for a graduated tax on income; something can even be said for a graduated tax on capital; but it is difficult to say anything in defense of a tax which is graduated on the varying percentage which income bears to capital. To penalize enterprise and ingenuity in a way that is not accomplished by a tax on either capital or income—this is the unique distinction of the law * * * While it is entirely proper that a share of the profits should go to the community, it is not at all clear that the tax should be graduated according to the degree of inventiveness displayed." (*Political Science Quarterly*, XXXIII, p. 17 ff.)

(3) The burden of the excess-profits tax is especially heavy on new and growing businesses and on small or moderate-sized firms. These are likely to have the highest rate of return on invested capital; they find it most difficult to raise capital unless they can reinvest sizable amounts of earnings, and it is from the growth of such firms that there is most hope of future industrial progress.

Professor Seligman continues on this point:

"Almost all large businesses have grown from humble beginnings, and it is precisely in these humble beginnings that the percentage of the profits to the capital invested is apt to be the greatest. The criterion selected, therefore, is the one best calculated to repress industry, to check enterprise in its inception, and to confer artificial advantages on large and well-established concerns. Nothing could be devised which would more effectively run counter to the long-established policy of the American Government toward the maintenance of competition."

A good case in point is a Los Angeles firm which has shown unusual courage and public spirit in accepting the so-called educational orders of the War Department. This firm accepted contracts and put in new equipment under conditions of great uncertainty. It could not know in advance what its costs were to be on the new products it was to turn out. It had no guaranty that it would ever receive more than the first order. Yet it went ahead, did a high-quality job of production, and put back its earnings year after year in improved equipment and methods. Today that firm is able to produce in volume and at low cost. Its prices to the Government are continually being reduced on successive orders and standards of specifications being raised. It can meet these new terms because it has never paid a dividend but put back every cent of earnings, beyond the owner's modest salary, in raising its ability to produce large volume at low cost. This thrifty and self-sacrificing policy of reinvesting earnings was the only way this firm could have expanded, for at the outset it could not have borrowed the necessary funds, or could only have borrowed by sacrificing the owner's initiative and introducing more conservative methods which would have prevented acceptance of the risky War Department contracts.

This firm is showing the way to other firms in reducing costs and is having a noticeable effect in getting reduced prices to the Government on current armament contracts. Such a firm of proven enterprise and ability should be encouraged to continue its development. It is still a comparatively small firm, but if permitted can become a leader in its field. We need such industrial leaders as never before, but this particular firm would find its growth seriously checked by an excess-profits tax.

The importance of this point at the present time cannot be too strongly emphasized. The greatest advantage which private enterprise possesses over Fascist or Communist forms of economic organization is its ability to make rapid progress. When it is easy for men with new ideas to expand their operations rapidly, industrial progress is rapid. And this rapid expansion of operations by a new firm can take place only insofar as opportunities for good profits exist and insofar as these profits can be put back into development of the business. It is doubtful if private enterprise has any important advantage in competition between nations except this one of superior capacity for progress. If we are to penalize and prevent progress by the new, small, and growing firms, we might as well at once switch over to a Fascist form of society.

(4) Serious administrative difficulties exist in an excess-profits tax which do not exist in the income tax. Added to the difficulty of measuring income is the much greater difficulty of measuring capital worth. Professor William Shultz,

New York tax authority, says this puts "an impossible auditing task" on the tax administration. The situation with respect to the World War excess-profits tax he terms "a hopeless administrative muddle." (*American Public Finance*, 1939, p. 454.) The persistence 20 years later of lawsuits growing out of this tax is supporting evidence of Professor Shultz' opinion.

The difficulty of measuring capital worth puts tremendous power and responsibility in the hands of Treasury officials and adds a most serious factor of uncertainty to every business whether it is making profits or not.

When rates are moderate this uncertainty is not serious and the consequences of arbitrary and unfair decisions are not fatal. But when the rates are set at the levels contemplated in the present proposal and when they are added to taxes which already take over half the profits of the best years and an estimated 65 to 70 percent of profits in a year like 1938, the danger to private business is very great. If business cannot earn enough to build reserves in good years it cannot survive poor years.

(5) Personal gains from armament making are likely to be moderate in view of existing income-tax rates. Tax rates on the higher income brackets are now higher than in 1918. As recognized by men like Senator La Follette, noted for support of the ability principle of taxation, taxes on higher incomes are at or near their limit of peacetime productivity. Federal, State, and local taxes on business, furthermore, in 1937, the year of greatest profits since 1929, took 56 percent of corporation net income as against 48 percent in 1918, the year of highest war taxes. Corporation dividend policies are now more liberal and taxes on dividends higher than in 1918. State income taxes moreover have been added to the load borne by personal incomes.

Profits are not personal income but productive capital until paid out as salaries or dividends. They can only be converted into personal income or tax payments by liquidating productive assets or by reducing purchases of productive equipment. Therefore as further control of war gains is needed it should be secured by increased personal income taxes, especially in the middle brackets.

The whole subject of war profits, however, should be reexamined in the light of present conditions. Inflationary policies adopted in the World War caused a rapid rise in price levels and consequent appearance of exceptional profits and wages in certain war industries and losses in other lines. Most of the gains to these war industries, however, were offset by rising taxes and by the deflation which followed the end of the war. In fact, the purchasing power of all persons receiving more than $25,000 a year was decreased by 40 percent or more, according to the figures of Wilford I. King (*The National Income and Its Purchasing Power*, p. 171.), and total net property income and profits in terms of purchasing power actually declined each year from 1917 to 1921, inclusive. (W. I. King, p. 112.)

Today, in the absence of inflationary policies, there is little or no reason for expecting any important increase in profit levels from the defense program. In fact, the opposite is more likely to be the case. Costs will rise and volume of business decline in the nonessential industries as consumers' purchasing power is reduced by taxation and as labor is taken for the Army and war industries. Even in the war industries, high costs of labor and increased taxation will reduce profit opportunities.

It is true that inflation may occur. But is this the reasoning back of the excess-profits tax? The bill is an administration measure. Is the administration willing to come out openly and say that it is necessitated by the danger of inflation resulting from its own financial policies?

One more point should be noted in connection with the possibilities of "excess profits" resulting from the defense program. Profiteering implies the existence of a degree of monopoly. It is true that in nonnegotiated contracts an element of monopoly exists, but in these cases the degree of monopoly is greater on the side of the Government than on the side of the businessman. The Government is the sole buyer, or by all odds the biggest customer, whereas the businessman is not likely to have a complete monopoly of the source of supply. As mentioned above, the Government has its own experts for making cost estimates to check the figures presented by businessmen in their bids to Government contracts. The businessman, once he has made his investment in specialized equipment, is at the mercy of his customer—the Government. This is a further check to profiteering.

In any case where monopoly does exist, moreover, the excess-profits tax would not stop profiteering. It would only return a part of the profits to the Government. The best way, therefore, to guard against profiteering is to prevent it by stimulating competition. And the opportunity for high profits to the exceptionally efficient producer is one of the best means of stimulating competition and reducing prices. An occasional high prize is much more effective in getting a

large number of competitors to enter the lists than a large number of small prizes even when the total amount of the small prizes is greater than the single prize. Accordingly the Government will find it cheaper to permit a few firms to earn good profits, especially if they are largely reinvested in expanding production than in operating on any cost-plus basis or its equivalent through profits limitations or excess-profits taxation. Under competitive conditions most firms make small profits or actually lose money. They are kept going largely by hopes, never to be realized, of gaining the large profits earned by a few leaders. In this way high profits to the most efficient and successful has proven to be the most effective way of getting increased output at low cost. Any firm which is to stay in business, moreover, must make good profits occasionally to compensate for losses.

(6) In any case the yield of the excess-profits tax will not be significant in comparison with the total budget. The Treasury estimates lie between $190,000,000 and $100,000,000. But from this should be deducted losses in income-tax yields since dividend payments will be reduced by the excess-profits tax.

## CONCLUSION

*Wanted: Machines.*—Men can't build guns, tanks, airplanes, and battleships with their bare hands. If they could China would be the world's greatest military power.

Only with the help of machines—thousands of them, big, powerful, and complicated—can we produce the great quantities of munitions and huge weapons needed for our military defenses.

Machines are also needed to create jobs at which workers can earn high wages. In other words, machines are needed to turn out the great quantities of cars, radios, electric refrigerators, as well as low-cost food, shoes, and clothing which go to make up a high standard of living and peacetime prosperity for our people.

Until recently we have been losing sight of these facts. Now, however, we see what men with machines can do in crunching along over the bodies and lands of other people less well equipped. This should remind us that mechanical power is the material basis for national strength, security and prosperity.

*How can we best get the machines we need?*—Whether in Russia, Germany, or the United States, machines can be secured only by self-denial and thrift. They are bought out of someone's savings. What is spent on machinery by way of money or labor cannot for the time being go to buying or producing goods for immediate enjoyment of consumers.

In Soviet Russia and Nazi Germany these savings have been taken from people chiefly by force; that is, by taxes, rationing of consumers, and forced wage reductions. Whereas under private enterprise we have relied mainly on voluntary saving and investment.

The sources of savings on which private enterprise chiefly relied in the past, however, are being dried up by taxes or closed by bureaucratic control. These sources are the savings of the well-to-do and profits reinvested (saved) by business firms.

Taxes on the higher incomes seem to have reached nearly their limit. But taxes on profits are likely to be increased considerably in the near future. What effect will this have in checking the modernizing and expansion of plant and equipment, machinery and tools, so sorely needed by America today? What effect will increased profits taxation have on reducing costs and securing for the taxpayer the most for his money spent on armament building?

Proponents of the excess-profits tax argue that expansion and modernizing of equipment can come out of borrowings. They point to huge excess bank reserves and low interest rates to prove that credit is abundant and cheap.

But can or will business borrow to expand if our tax policies prevent growth from within by reinvestment of earnings?

*Reinvested profits—the growth-bud of industry.*—Reinvestment of profits is a most important factor in industrial growth.

When a firm expands by borrowed funds it must go to the trouble and expense of persuading outsiders that the new investment will be profitable. If it has earnings to reinvest, however, it need persuade only its own management—a much simpler and less expensive task, especially for new firms and for small or medium-sized concerns.

Since 1933, moreover, under the Securities Acts and new banking regulations, the ambitious firm has also been required to persuade various Government officials before it could borrow for expansion. This persuasion has often involved great expense and trouble even when the company's credit and honesty were of the highest order.

True, the income-tax authorities are now looking more and more suspiciously on the firm which puts back earnings into its business. But it has usually been easier and cheaper to persuade the Treasury Department than the Federal Securities Commission.

*Reinvestment of profits improves credit and preserves initiative.*—New investors, especially purchasers of bonds, prefer to invest in companies which are building up surplus out of earnings. This surplus provides additional security to the creditors and therefore reduces interest charges on new funds.

Furthermore, good financial managers themselves want to provide this security to their creditors. Without such a backlog the creditors will take over control more quickly when earnings temporarily decline or disappear—as earnings frequently do for many firms.

In fact all businessmen prefer to finance expansion entirely out of earnings if possible. Borrowing or selling of stock to outsiders always means turning over some of the control to the creditors or new stockholders. It means sacrificing a certain amount of initiative and freedom of action.

Therefore many excellent businessmen refuse to borrow funds unless occasionally for short-term purposes. Henry Ford is a well-known example. And no careful businessmen will expand as far or as rapidly on borrowed funds as on reinvested earnings, if the latter are available.

Reinvestment of profits is, therefore, the growth bud of industry. When this reinvestment is made difficult through declining profits, or through taxation and legal obstacles, business expansion is correspondingly checked.

During the past 10 years business as a whole has paid out in taxes and dividends about $30,000,000,000 more than it has earned. During the first part of the depression this was due to reduced earnings. Since 1936 it has been due to rapidly mounting taxes and political pressure. And the drain still continues!

This may explain why private business does not take up the slack in employment and why investment funds stagnate in our banks.

*Probable results of the proposed excess-profits tax.*—If the expansion of private business at the present juncture is stopped or seriously checked by increased profits taxation Government is likely to attempt to supply the deficiency. Ei the urgency of the defense program or the employment and wages problems, or both, will drive any administration in this direction.

Experience has shown, however, that Government management is in general uneconomic and inefficient. Aside from the political consequences of a further advance toward socialism there would be a reduction in standards of living and a failure to achieve the defense program of which this Nation is capable.

*Alternative proposals.*—Insofar as increased taxes are necessary to balance the Federal Budget, it is our opinion that they should fall on personal incomes—dividends, interest, salaries, and wages—and on luxury goods. It is by this means that maximum fiscal revenue can be obtained with the least discouragement to necessary industries.

Efficient, low-cost firms should be given greater encouragement and opportunity to expand, not further penalized by new and discriminatory taxation. Even in the production of nonessentials, insofar as consumers are to be left enough income to enjoy them, it is important that the efficient, low-cost firms shall replace those which use more labor and capital to turn out a given product. Existing provisions against tax-avoidance through unproductive reinvestment of earnings should be reexamined in the light of the present situation with a view to strengthening them where necessary.

In any modification of existing taxes on business, however, reinvestment of earnings in plant and equipment for essential industries should be given special encouragement by tax exemptions or reduced rates of taxation. Not only will such a policy increase the ability of private enterprise to produce more goods at less cost, but it will also improve business credit. Not only will it stimulate competition and reduce prices, but it will also stimulate the circulation and expansion of credit and buying power. Not only will it give the public more for its money in building our defenses, but it will also increase personal incomes and taxpaying ability. In short, it will stimulate business, not only to produce more goods but to expand and circulate the purchasing medium necessary for taking the goods off the market.

Such stimulation to private enterprise is needed to expand employment, to rebuild confidence in free enterprise, and to restore mutual trust and cooperation between employers and employees, creditors and debtors, political leaders and citizens. This rebuilding of our morale is a vital part of the program for rebuilding the defenses of our Nation and safeguarding our free institutions. It deserves the courageous support of every citizen and every statesman.

[Telegram]

PEABODY, MASS., *August 17, 1940.*

Hon. JOHN W. MCCORMACK,
*House Office Building, Washington, D. C.:*

Proposed excess-profit tax will be disastrous to tanning industry of Massachusetts. During past 4 years many concerns show net loss. Credit of 4 percent upon invested capital is not proper measure of income in given year in industry with such violent fluctuations. Over a period of years tanners' incomes show more red than black. Sudden demand price rises may inflate income beyond 4 percent to be subsequently offset with losses. Recognizing that tanner's raw materials fluctuate more widely than known in any industry, leather manufacturers should be allowed a 10 percent credit on invested capital against net income before excess-profit tax applied.

JOHN J. GALLAGHER.

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STATEMENT SUBMITTED BY HAROLD A. SCRAGG, OF SCRAGG AND SCRAGG, ATTORNEYS AND COUNSELLORS AT LAW, SCRANTON, PA.

AUGUST 17, 1940

Hon. PATRICK BOLAND,
*Member of Congress,*
*House of Representatives, Washington, D. C.*

(In re: American Stores Co.)

MY DEAR CONGRESSMAN BOLAND: Representing the American Stores Co., with headquarters at Philadelphia, I am writing you in reference to the serious effect upon that company and the National Tea Co. of the proposed limitations and excess-profit bill which is now under consideration. My information as gained from the newspapers and other sources is that the proposed act of Congress contemplates limiting the number of years upon which average earnings may be computed to 3 years or 4 years. In view of the earnings of the above companies, it would be extremely unfair to take the depressed earnings statement of the last 3 or 4 years and strike an average as the base upon which excess earnings would be computed. It seems to us that the limitation is entirely too strict and will work a great hardship upon companies such as the above which have had such bad earning records for the past 3 or 4 years.

I am enclosing herewith a statement of the earnings of the American Stores Co. and of the National Tea Co. covering the years 1930 to 1939. A mere reading of this statement will show how earnings have diminished since 1935 and what low earnings were obtained in 1936, 1937, 1938, and 1939.

Would it be possible for you to bring to the attention of the committee, of which you are a member, cases of this character and, if possible, use your good influence in the drafting of the act so that such a hardship to companies operating in your district and in the State of Pennsylvania might be avoided? I would appreciate very much anything that you might do in behalf of my client in seeing that this is properly laid before and considered by your committee.

With kindest personal regards, I am,

Very truly yours,

HAROLD A. SCRAGG.

HAS:MSW
Encl.

*Yearly earnings, 10 years, 1930–1939, inclusive*

| Year | American Stores Co. | National Tea Co. | Year | American Stores Co. | National Tea Co. |
|---|---|---|---|---|---|
| 1930 | $1,154,000 | $569,000 | 1934 | $3,363,000 | $462,000 |
| 1928 | 676,000 | 982,000 | 1933 | 1,198,000 | 1,180,000 |
| 1937 | 859,000 | 1,365,000 | 1932 | 4,314,000 | 899,000 |
| 1936 | 2,046,000 | 227,000 | 1931 | 3,271,000 | 716,000 |
| | | | 1930 | 3,500,000 | 1,280,000 |
| Total | 4,732,000 | 2,489,000 | | | |
| 4-year average | 1,183,000 | 622,000 | 10-year average | 3,052,400 | 212,700 |
| 1935 | 2,718,000 | 319,000 | | | |