

# **NONREIMBURSEMENT CERTIFICATES**

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## **HEARING**

BEFORE THE

**COMMITTEE ON FINANCE**

**UNITED STATES SENATE**

**SEVENTY-SEVENTH CONGRESS**

**SECOND SESSION**

ON

## **H. J. Res. 257**

**A JOINT RESOLUTION TO AMEND SECTION 124 OF THE  
INTERNAL REVENUE CODE TO SIMPLIFY THE  
PROCEDURE IN CONNECTION WITH  
AMORTIZATION OF CERTAIN  
FACILITIES**

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**JANUARY 22, 1942**

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Printed for the use of the Committee on Finance



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# NONREIMBURSEMENT CERTIFICATES

THURSDAY, JANUARY 22, 1942

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

The committee met, pursuant to call, at 10:30 a. m. in room 312 Senate Office Building, Washington, D. C., Senator Walter F. George (chairman) presiding.

The CHAIRMAN. The committee will please come to order. We have a quorum, and we have for consideration this morning House Joint Resolution 257 which is entitled "To amend section 124 of the Internal Revenue Code to simplify the procedure in connection with amortization of certain facilities."

It really is a repeal of that section and it appears that the title ought to be amended to make it speak the facts.

(H. J. Res. 257 is as follows):

[H. J. Res. 257, 77th Cong., 2d sess.]

JOINT RESOLUTION To amend section 124 of the Internal Revenue Code to simplify the procedure in connection with amortization of certain facilities

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled, That, effective as of October 8, 1940, section 124 (i), as amended, of the Internal Revenue Code, is hereby repealed.

Passed the House of Representatives January 19, 1942.

Attest:

SOUTH TRIMBLE, Clerk.

The CHAIRMAN. We have here several witnesses from the various departments, I believe, who appeared before the Committee on Ways and Means of the House. We have, first, the Secretary of Commerce, Mr. Jones. We will be very glad to have you make a statement regarding this resolution.

## STATEMENT OF HON. JESSE JONES, SECRETARY OF COMMERCE; ADMINISTRATOR, FEDERAL LOAN AGENCY

Secretary JONES. I think that section of the law that is under consideration should be repealed.

The CHAIRMAN. Section 124 (i) is the section.

Secretary JONES. Yes.

Senator LA FOLLETTE. Will you state your reasons for that, Mr. Secretary, for the benefit of the committee?

Secretary JONES. My reasons are probably somewhat different than those expressed by the War and Navy Departments. We, the R. F. C. and its defense corporations, are required to put in a great many so-called scrambled facilities, particularly in steel mills, and we will have to do more of it in the conversion of plants, if the program to

disseminate defense work to the smaller industries is going to prove successful.

Senator LA FOLLETTE. In other words, will you explain what you mean by "scrambled facilities"?

Secretary JONES. That is where we go into a plant and put additional machinery in with that of the owner, some of which can be moved later and some of which cannot be moved, because a good deal of it would be more expensive to move than it would be worth.

We would like to get the industry to borrow the money, or to furnish the money, take this amortization and own the facilities, which it cannot afford to do if it must amortize over a period of 20 or 15 years. If a man owns the facilities he is more apt to take better care of them.

I do not intend to say that they would not take good care of them if they belonged to the Government, but if we put new facilities into a plant, new equipment, and they belong to the industry, in all probability the older facilities will be discarded and the new ones preserved. That would be of greater value to our whole economy, to the country at large.

If there is any particular advantage—I do not think it could be much, if any—to the industry by reason of this 5-year amortization, it is unimportant. Whatever profit there is, the manufacturer must pay on it later as income tax.

I see no reason why this subsection under discussion should not be repealed, and every reason why it should. I understand Secretaries Patterson and Forrester will give their own testimony, but it gives them a lot of trouble in making contracts. It gives us trouble, too, but we have got to go ahead and do the best we can.

Senator LA FOLLETTE. As I understand, this is advocated in part for the purpose of speeding up the letting of contracts for the building of needed facilities. Is it your opinion that this will speed up the building of needed facilities?

Secretary JONES. I should think so, but of course that is with the War, the Navy, and other Departments. I do not know enough about the operations of those departments to say definitely, but I believe that to be true.

Senator VANDENBERG. Precisely what is it that we are asked to repeal?

The CHAIRMAN. Section 124 (i).

Senator VANDENBERG. What is section 124 (i)?

The CHAIRMAN. Section 124 (i) imposes a requirement for non-reimbursement certificates. In other words, the act which we passed, as you recall, required, first, a certificate of necessity and then a certificate of nonreimbursement before the amortization could be granted for these new facilities or additional facilities. The non-reimbursement certificate is the certificate that has given the greatest difficulty. It is practically impossible, as I have conceded all the while, for anyone to conscientiously give a nonreimbursement certificate under the law, because that certificate contemplates not only that the concern putting in the facility is not being reimbursed on that contract, but it is not being reimbursed under any contract with the Government. That might apply even to future contracts. So it is almost impossible for any conscientious official to speedily do business on that basis, because he could not really issue a nonreimbursement

certificate until after the thing is all over and you have had an opportunity to scrutinize all the contracts made and what had actually been paid the concern in reimbursement for the facility.

Are there any questions that you wish to ask the Secretary?

Senator DANAHER. Mr. Chairman, I have a question.

The CHAIRMAN. Senator Danaher.

Senator DANAHER. How much do you have to do with the issuance of the certificate of necessity, Mr. Secretary?

Secretary JONES. Nothing.

Senator DANAHER. Well, what steps, if any, are taken by your organization to ascertain whether or not a plant that applies for such a certificate has exhausted available facilities without building new ones?

Secretary JONES. He does not come to us for that.

Senator DANAHER. You were saying a few minutes ago, in answer to Senator La Follette, as I understood you, that "If we"—that is the way you put it—"If we could get the individual manufacturer to use his own funds to build it would be better because he would have an interest in the machinery," and so on.

Secretary JONES. I will explain that.

Senator DANAHER. If you please.

Secretary JONES. The R. F. C. and its different subsidiaries, like the Defense Plant Corporation, of which you are talking now—

Senator DANAHER. Yes.

Secretary JONES. Is merely a service agency. We build plants or finance plants at the request of, heretofore, O. P. M., which includes the War and Navy Departments. Say we get a request from the O. P. M. to contract with a certain contractor, a corporation or industry, to build a plant. They give us the estimate of the cost. They say where it has been decided it should be built. Then we get the contractor in, a steel company, for instance, and we undertake to make a trade with that contractor, and in that trade we find, for instance, that maybe we are putting \$50,000,000 worth of scrambled facilities in four or five different plants. Now, they would not buy and own those facilities themselves, they could not afford to do it financially, they could not involve themselves to that extent. It may be putting a facility here, there, or some other place in their plant.

It would be a lot better, however, if we could persuade them to go ahead. We would rather loan them the money on liberal terms and let them own the facilities.

Senator DANAHER. When you say "we" you mean whom?

Secretary JONES. I am talking about the R. F. C., the Defense Plant Corporation. But I am thinking about the over-all picture of the Government. It would be a lot better for the Government if the industry could be persuaded to put those facilities in and let us furnish the money on liberal terms, if necessary, and let them amortize those facilities, depreciate them, over a 5-year period. As it is, we are putting in the facilities, several hundred million dollars in the steel plants alone, and when it is all over we are going to own something here, something there, in each plant.

Senator TAFT. If it is easier to get the certificate, you think you will have many more transactions in which they own the plants, the new machinery and the plants?

Secretary JONES. You cannot get, as I understand it, a definite certificate for amortization, one that would be unquestioned.

Senator DANAHY. Mr. Secretary, if you do not have anything to do with the issuance of the certificate of necessity and hence with the determination of the necessity, in what way does the problem confront you, or the R. F. C.?

Secretary JONES. I am representing the Government, the Congress, in building plants. That is the way it affects me. We work in the closest possible cooperation with the War and Navy Departments and with O. P. M.

Senator DANAHY. Then coming back to my original question, I was trying to find out who decided whether or not a new plant, let us say, should be built, new facilities constructed, before ascertaining whether the existing facilities have, in fact, been exhausted?

Secretary JONES. The O. P. M. does it.

Senator DANAHY. So you rely in that particular on their recommendation?

Secretary JONES. Yes, sir, entirely. We cannot and should not have divided authority.

Senator DANAHY. I agree with that.

Secretary JONES. It is their responsibility. We serve them.

Senator TAFT. Is it not true, Mr. Secretary, even if they get this 5-year amortization and then go on and use the thing for 20 years, of course the amortization stops at the end of 5 years and after that they could not charge any more depreciation?

Secretary JONES. They could not get any more.

Senator TAFT. So the only thing they gain is in having lower taxes during this time when taxes perhaps are higher than they are going to be after the war?

Secretary JONES. We hope.

Senator TAFT. Perhaps they are not higher than they are going to be after the war.

Senator GUFFEY. Thank you for the encouragement.

The CHAIRMAN. Are there any further questions of the Secretary? If not, Mr. Jones, we thank you very much for coming over.

Secretary JONES. Thank you very much.

The CHAIRMAN. Judge Patterson.

#### STATEMENT OF HON. ROBERT P. PATTERSON, UNDER SECRETARY OF WAR

Secretary PATTERSON. Mr. Chairman and gentlemen, this is a proposal to amend section 124 of the Internal Revenue Code, which provides for amortization deductions for income and excess-profits-tax purposes.

This section was enacted in October 1940 to encourage the use of private funds in the rearmament effort then getting under way.

In general, it provides that a taxpayer may, in computing its net income for tax purposes, take annual amortization deductions of 20 percent of the cost of facilities erected or required after June 10, 1940, in lieu of depreciation deductions otherwise allowed by law, if they are certified by the Secretary of War or the Secretary of the Navy as necessary in the interest of national defense. Thus the entire cost is amortized in 5 years instead of over a longer period normally allowed by the Bureau of Internal Revenue.

Subsection (i) of section 124 provides that in case the Government reimburses the taxpayer in whole or in part for the facilities, no



amortization deduction shall be allowed unless there is a certificate issued to the Commissioner of Internal Revenue by the Secretary of War or the Secretary of the Navy to the effect that the interest of the Government in such facilities is adequately protected. If there is any question about reimbursement, a certificate to that effect made by the Secretary of War or Secretary of the Navy is conclusive on the point.

It is proposed by the War and Navy Departments, with the concurrence of all interested agencies in the executive branch, that subsection (i) be repealed, because the subsection has created confusion and uncertainty, with the result that manufacturers refrain from acquiring or constructing new facilities at their own expense; manufacturers delay in the acquisition and construction of such facilities; and valuable time is consumed by military and naval personnel and manufacturers who are engaged in important war work.

It is to be noted that subsection (i) does not prohibit reimbursement for facilities in contracts, nor does it bar amortization in such cases, if the Government's interest in such facilities is adequately protected.

It may likewise be noted that subsection (i) does not apply to cases in which the taxpayer does not have a contract with the United States. Accordingly, a subcontractor can obtain a necessity certificate and is then permitted to amortize the cost of the emergency facilities, regardless of the question of reimbursement. Thus, amortization rights do not depend upon establishment of nonreimbursement.

If the Government pays for facilities, the Government's interest in the future use and disposition of such facilities should be protected. This is true whether the payment is direct, pursuant to a provision in the contract, or indirect, because included in the contract price. It is likewise true whether or not the contractor seeks 60 months' amortization. The protection of the Government's interest is a matter of sound procurement policy, and is quite independent and apart from any tax-amortization question.

By Public, 285, Seventy-seventh Congress, subsection (i) has been amended in certain respects.

The certificate of the Advisory Commission, Council of National Defense is no longer required under the amendment which was passed last summer. These amendments have proven helpful, but the administration of the act still presents serious difficulties.

Now that we are at war it is imperative that these difficulties be promptly removed. The statute makes present determination of the contractor's liability almost impossible of attainment in many cases, because of the difficulty of determining factors relating to the future.

The result has been to retard the flow of private capital into emergency facilities. This in turn results in the expenditure of a larger proportion of Government funds for emergency facilities than was contemplated as necessary.

In order to hold to a minimum the amount of Government funds needed for new facilities, an incentive in the form of amortization was offered by the statute to the manufacturer, to induce him to put his money into new facilities. To obtain amortization a manufacturer must obtain a necessity certificate, and that, of course, is to be continued. But this is merely the first step if the manufacturer has or expects to have a contract with the War or Navy Department.

To fix his future tax situation he must also have a certificate of nonreimbursement. It then becomes necessary for him to establish

that not only his first contract but all subsequent contracts do not include, directly or indirectly, in the price a return of cost of the facility greater than the normal exhaustion, wear, and tear.

Even if he obtains a certificate of nonreimbursement with reference to existing contracts, his tax situation may be jeopardized by a subsequent contract which may later be held to so include such greater return of cost, even in part.

Thus it becomes impossible for the manufacturer to know at the time of his expansion what his future tax situation will be with reference to the facility.

In the case of a small manufacturer who can produce war supplies by adding to or converting his facilities, the problem is an especially difficult one. Such a manufacturer can readily show that his new facilities are needed and his necessity certificate will issue, but if he has or expects to have a direct contract with the War Department or the Navy Department, as mentioned above, he naturally wishes to be assured that such contract or any later contract will not result in the loss of his amortization privilege with reference to those facilities. The possibility that it might be held that there is reimbursement in part for the cost of such facilities in any later contract or contracts, and might defeat the amortization deduction, deters his expenditure of private funds.

Experience has shown that a great deal of time is consumed on the part of contractors in preparing papers and proofs in support of their applications for certificates of nonreimbursement. At best the subject is a difficult and complicated one. A large manufacturer has an ample staff, including attorneys and accountants, who can familiarize themselves with the statutory requirements, but the small or medium-sized manufacturer is not best equipped, and feels uncertain as to his right to amortize newly acquired or constructed emergency facilities.

The administration of subsection (i) likewise requires an inordinate amount of time on the part of military and naval personnel in connection with these applications. The services of these officers are urgently required in procurement work of a pressing nature, which is of direct benefit to the successful prosecution of the war.

A few words as to protection of Government interests. In proposing the outright repeal of subsection (i) the War Department and the Navy Department, as well as the other agencies concerned, are not advocating in the least degree any relaxation of the policy contemplated by Congress in the passage of section 124 of the Internal Revenue Code.

That the rights of the Government should be safeguarded in every case in which it has paid, in whole or in part, for the cost of the facilities is obvious. As indicated already, this is true, whether or not the taxpayer seeks special tax amortization. Such protection should be offered in every case, as a matter of sound procurement policy—and I mean there, of course, on the part of the contracting officer for the War Department or the Navy Department who negotiates with the prospective contractor and arrives at the terms of the contract. It is the duty of contracting officers in all such cases to see that the Government's interests are adequately protected.

In that connection, the procurement officers, the contracting officers for the War Department—and I have no doubt similarly for the Navy Department—are instructed, in taking proposals for con-

tracts, to ascertain what new machinery the contractor needs, to make provision for that in the contract and to see to it that such new machinery is owned in all cases by the Government, and the Government is similarly protected in the use and disposition to be made of that machinery. Adherence to a rigidly uniform rule presents great difficulty in contracting. Some flexibility is necessary in order that the contracting officers may properly fix the terms of the contract to suit the needs of the situation.

This will permit protection of the interests of the Government at the time of negotiating the contract. The contracting officers in the War and Navy Departments have been directed to protect such interests, and these directions are being carried out. The War Department assumes direct responsibility for protecting the interests of the Government in the facilities under all of the War Department's contracts.

Now, Mr. Chairman, that finishes my formal statement and I would be glad to answer any questions.

The CHAIRMAN. Are there any questions, gentlemen?

Senator LA FOLLETTE. I would like to ask a few questions of the Secretary.

As I understood your statement, you said that it is now the procedure and practice of the procurement officers to make certain that there is not, in effect, a reimbursement if they are to secure amortization. Is that correct?

Secretary PATTERSON. Yes, sir.

Senator LA FOLLETTE. I mean in the negotiation of the contract.

Secretary PATTERSON. Yes, sir; that is correct.

Senator LA FOLLETTE. So even if this section is repealed the contracting officers, if they discharge their duties under instructions, will really have to go through the same procedure and in the same detail that is now gone through, will they not?

Secretary PATTERSON. Yes, sir; so far as negotiating the contract is concerned their practices will be the same as now. They will make inquiry, they will go over the plant to see what is needed in the way of new machinery and make proper provision for the protection of the Government in the cost of that machinery, if it is included in the contract price.

We make a great many shell contracts for ammunition. Generally a contractor has a pretty good shop and has some of the tools needed for the production of those shells, but he needs a few tools, sometimes more than a few, to do the machining necessary for the final production of that shell, and it is quite evident that he has got to buy those machines. In all cases reported to us by the contracting officer for the making of the contract with the prospective contractor notation is made as to the cost, estimated cost of the new machinery that will be required, which generally is not a very large part of the final amount involved in the transaction, and a provision for either our ownership of that or some equivalent protection to the Government in the use and availability of that machinery is recommended by the contracting officer and carried out by the terms of the contract.

That will not be varied.

Senator LA FOLLETTE. But if a contractor is to get this amortization, so far as the contracting officers are concerned they will have to make certain, if they are to protect the Government's interest, that the contractor is not being reimbursed in the price of the contract, will they not?

Secretary PATTERSON. Not if the Government owns that machinery.

Senator LA FOLLETTE. Well, if the Government is going to own the machinery then the contractor would not have any amortization, would he? He would not have this accelerated amortization. It is only, as I understand - if I am wrong I want you to correct me - it is only where the contractor wants to own the facility at the end of 5 years and wants to amortize it at the rate of 20 percent a year, in that case the Government would not own the facility.

The point I am trying to make is if the contracting officers are really going to protect the Government's interest they will have to make certain that in the price which this contract is let for there is not enough of a margin in it of profit so that the contractor is, in fact, being reimbursed for the purchase of the machinery or the construction of facilities. Is not that correct?

Secretary PATTERSON. I think it is. They do not always take title to the machinery. Quite often they have a provision that the contractor shall hold that machinery available, not dispose of it without consent, for a period of time, to be available for further contract for supplies for the War Department.

Now, that is a case where the interest of the Government, in the use and disposition of the machinery, we believe is protected, depending upon the circumstances of the case, of course, and yet the contractor in that case will need his amortization certificate.

Senator LA FOLLETTE. In other words, then, you are going to change the procedure to some extent, or, I mean you are going to change the policy to some extent.

Secretary PATTERSON. Not the procurement policy, no, Senator. Our position on this I think boils down to this, that it is a matter of sound procurement policy, and that the introduction of tax features in determining reimbursement or nonreimbursement is cumbersome and slows down the initiation of production by a contractor on account of the doubtful status that he may be in, and puts a very hard burden on the War Department and Navy Department in deciding what is, in effect, a litigated law case at the inception.

Senator LA FOLLETTE. I am simply trying to get through my head the way this works. I am having trouble doing it. Here is a contractor who comes in and negotiates a contract with some contracting officer or officers in the War Department. Now, it becomes necessary apparently, for this contractor either to buy machinery or to build an addition to his plant if he is going to carry out this contract, if he is going to fulfill the contract. Now, as I understand it, under existing law he first of all gets a certificate from the Secretary of War in this particular case that the facility is necessary to the national war effort. Then the contract is negotiated. But if this man wants to get the benefit of these accelerated amortization provisions there has to be another certificate issued to the effect that in the price of this contract there was not included a reimbursement for these additional facilities over the normal wear and tear on machinery and plant. Is not that correct?

Secretary PATTERSON. That is exactly right, under existing practice.

Senator LA FOLLETTE. Now, what you propose to do, as I understand it, and what will happen under the repeal of subsection (i), it will no longer be necessary for the Secretary of War to certify that the price paid a manufacturer for the product produced under the

contract does not reimburse him for the additional facilities or machinery which he may have purchased or built in order to produce the contract.

Secretary PATTERSON. That is right.

Senator LA FOLLETTE. But, as I understood you to say, even if this is repealed, there is going to be no change in the policy, and that is it is the duty of the contracting officer to make certain that the Government's interests are protected and, as I understood it, that he is not in effect being reimbursed under the contract.

Secretary PATTERSON. Or if he is being reimbursed that the Government get some equivalent commensurate with the reimbursement.

Senator LA FOLLETTE. In other words, you would permit him then to get his accelerated amortization provided he entered into some arrangement with the War Department, so far as the use and disposition of these facilities is concerned, which satisfied you that that was worth the benefit that the Government was getting in relation to the accelerated amortization.

Secretary PATTERSON. Yes.

Senator LA FOLLETTE. Is that correct?

Secretary PATTERSON. Yes, it is.

Senator LA FOLLETTE. In other words, he might be reimbursed for these facilities in the price of the contract under the new policy and he may at the same time get his tax amortization acceleration also, might he not?

Secretary PATTERSON. Yes.

Senator LA FOLLETTE. Provided he agreed, let us say, that he would not sell these facilities for a certain number of years?

Secretary PATTERSON. And would include no further charge for it in any future contract, or something like, or he might buy the machinery and own it. We have had some deals like this, and I think I know the details of them: He will pay for the facilities and we will reimburse him over a period of years for the cost, and at the end of 5 years, or whatever the period may be, we will take the facilities out unless he pays us the value of them at that time, in which case they may be his.

Senator LA FOLLETTE. As I understood it, the intent of this section of the statute was to prevent contractors with the Government for defense or war purposes from receiving both reimbursement for additional machinery or facilities and accelerated amortization at the same time in the same contract. So that if this is repealed it isn't quite accurate to say that the policy will be continued. In other words, the policy is going to be changed.

Secretary PATTERSON. The procurement policy will be the same.

Senator LA FOLLETTE. If section 124 (i) is repealed a contractor will be able to get reimbursement for additional facilities or plant or machinery in the price of the contract and also will be permitted to get his amortization at the rate of 20 percent a year?

Secretary PATTERSON. I do not think there is any change in the procurement policies and practices. He will be able to get the result that you refer to only in cases where the Government is adequately protected.

Senator LA FOLLETTE. As I understood it this amortization acceleration was to be in the nature of an inducement, it was to be something that would be a benefit extended to the taxpayer or to the

contractor in order to get him to go on and expand his facilities. Now, as I understand it, it would be entirely possible for him to get two benefits: One, to get paid back for the money he expends in buying this machinery or building this plant in the form of an increased contract price, and at the same time to get it amortized within 5 years, providing he makes some agreement that he will hold the facility, that he will not sell it, that he will keep it intact or available in case the War Department or the Navy Department, as the case may be, may want some more material produced.

Secretary PATTERSON. That is true. He cannot get his tax amortization in the 5-year period, however, without some quid pro quo for the Government, so far as the use of the facility is concerned. Of course, we have another present incongruity in the law, and that is that subcontractor does not need to worry about this at all. These cases that Mr. Jones was quoting, some of them were on steel, some of them were where the man might have no contract direct with the Government at all, and he does not need to fuss about this non-reimbursement.

Senator LA FOLLETTE. I realize that, but you are proposing to repeal the whole business. We can amend this statute if it were desirable to keep the principle in effect. What I am trying to get clear on the record, and I hope in my own mind, is exactly what is going to happen if we repeal subsection (i) and what change, if any, in policy it envisions.

The CHAIRMAN. Are there any further questions?

Senator DANAHER. Yes, I have a question.

Does it not come down to this, Mr. Secretary, that instead of following whatever standards are set up in subsection (i), the decision as to the effectiveness of the quid pro quo is transferred to the procurement officer who exercises his discretion as to that point when he negotiates the contract?

Secretary PATTERSON. Yes.

Senator DANAHER. Is not that what it comes down to? It is a flexible matter.

Secretary PATTERSON. I think it is.

Senator TAFT. I do not quite understand. Let us say that \$1,000,000 of machinery is put in and the company pays for it—now, when you come to give them a cost-plus contract, supposing it is a cost-plus-a-fixed-fee contract in the form of some sort of percentage, do you count in the cost the depreciation of that machinery? Do you count in the depreciation at its actual depreciation, or do you count it at 20 percent?

Secretary PATTERSON. If it is a cost-plus-a-fixed fee contract, I believe in every case there we own the machinery.

Senator TAFT. The whole purpose of this transaction, from Mr. Jones' standpoint is so you will not own the machinery. Instead of that, you will induce the manufacturer to buy the machinery?

Secretary PATTERSON. I do not think those are cost-plus-a-fixed-fee contracts. I think those are all lump sum contracts.

Senator TAFT. You could give a cost-plus-fixed-fee contract but it must be based on cost, there must be cost. What I do not understand is whether, in figuring this cost, you count depreciation at the actual rate of depreciation, whether you count it at all, or whether you count it at 20 percent. That is an element of cost.

I cannot understand how anybody can understand this section, and that is the reason I would be in favor of repealing it. I do not understand how you can tell whether the price contains a reimbursement for the cost of the facilities.

Secretary PATTERSON. We had embarrassments all along on that, on account of the different views as to the meaning of that section to which you make reference. One school of thought is you have got to wait until the whole contract is performed, and the contract audited to see what the actual return of profit was to the contractor, and then when you think it was too high, why, that means that he must have included in his contract price, no matter what went on in his mind at that time, a return of the cost of facilities.

The other theory is you have got to read the minds of the contracting officer and the contractor at the time they made the contract, and if they made allowances for all of the elements going into the cost of performing the contract and did not allow an undue depreciation for cost of new facilities, then that is a case of nonreimbursement under the statute, no matter how the contract finally shall work out. Under the first view, of course, I do not see how you could issue any certificate for years to come.

Senator TAFT. I do not understand what it means. I think it ought to be repealed, but you might put in some substitute providing in estimating the cost of any properties or any facilities, whether on the basis of cost-plus-a-fixed-fee or any other basis, you should count the actual depreciation, or no depreciation at all.

Secretary PATTERSON. I think we all know what was in the minds generally of the draftsmen of that subsection, but how you would apply it in a particular case is hard to say.

Senator TAFT. Any contract allowing cost to any extent provides for reimbursement for the facilities, because it must include depreciation to pay for the facilities over 20 years anyway. I suppose the life of most machinery is 10 years.

Senator PATTERSON. Surely. I suppose that is what they call exhaustion, wear and tear.

Senator TAFT. Presumably the rule to be followed by the War Department would be to include the cost of actual depreciation under the 20 percent special amortization.

Secretary PATTERSON. On this nonreimbursement provision you can pose questions in cases that I do not know the answer to. Colonel Greenbaum is here. He has handled and been in charge of the tax amortization section of the War Department. If the committee is willing I would be glad to have him answer any questions about the way it works out, and particularly the questions that Senator La Follette asked. I think it is very important that the matter be made as clear as possible.

Senator GERRY. I would like to ask the Secretary a question.

Does it not really come down to this, Mr. Secretary, that you are trying to make it possible for the contractor to know the amount he will have to pay so that he can make his estimates?

Secretary PATTERSON. Yes.

Senator GERRY. That is really the fundamental question, is it not?

Secretary PATTERSON. That is right.

Senator BROWN. May I ask a question?

The CHAIRMAN. Yes, Senator Brown.

Senator BROWN. I am not familiar with what you propose to do here, but I do remember the discussion when we had this matter before us twice before. Am I correct in saying that substantially what you want to do is to avoid the difficulties and uncertainties of ascertaining just how subsection (i) will apply to a particular contract, and in effect provide that we leave the question of the protection of the Government for the procurement agencies rather than require them to follow strictly the provisions in subsection (i)?

Secretary PATTERSON. Yes, sir; that is right.

Senator BROWN. You feel there is not any question but what the Navy and War Departments, and whoever may be concerned, will see to it that the rights of the Government as to future taxation will be adequately protected, but you do not want to be bound by the strict provisions of subsection (i)?

Secretary PATTERSON. Yes; that is right. I am confident the contracting officers will do their best.

The CHAIRMAN. Are there any questions from Colonel Greenbaum? Senator La Follette, do you wish to ask Colonel Greenbaum any questions?

Senator LA FOLLETTE. I do not wish to ask any unless he wishes to make some further amplification on the answers to the questions I asked the Secretary.

#### STATEMENT OF COL. EDWARD S. GREENBAUM, WAR DEPARTMENT

The CHAIRMAN. I think, Colonel, you heard the questions propounded to the Secretary. You may make any statement you desire to make.

Colonel GREENBAUM. I think the Secretary has answered the questions. Senator La Follette's questions presuppose that there might be a change of method merely because of the repeal of the subsection (i). As the Under Secretary has indicated, the procurement methods will be the same, but what we are interested in is relieving the contractor and manufacturer of the uncertainty which now prevails.

Subsection (i) has two provisions in it. One is the provision for determining whether or not there is reimbursement. As Senator Taft indicates, that is a difficult question to answer, because we do not quite understand what the definition is. The other one is if there is such reimbursement there shall be adequate Government protection.

As the Secretary has indicated, we are doing that now, and will continue to do it.

But the other part of subsection (i) provides that in the event that there is such reimbursement there shall be denied to the taxpayer amortization unless the Government's interests are protected. The determination of that question leaves the whole matter in uncertainty in the mind of the taxpayer, and many of the taxpayers will not go on and put in their own money because of that uncertainty. They cannot determine presently whether or not that will be held to be reimbursement. For that reason, as Secretary Jones indicated, that many contractors now go to R. F. C. and otherwise try to get Government money, for the Government to pay for something which was the intent of the Congress, we believe, that the contractor himself should use his own money for.



Senator LA FOLLETTE. Colonel, do you not agree, though, that the policy as set forth in subsection (i) was obviously to prevent a contractor, working on defense or war orders, from getting both reimbursement for additional facilities and accelerated tax amortization?

Colonel GREENBAUM. It was intended to do that in a certain number of cases, namely, only those cases in which the taxpayer would apply for the rapid amortization. In other words, knowing that the problem did exist, it sought to try to solve that within the area of cases which the statute was concerned with, namely, those cases, which of course are very small in number, in percentage of all our cases, it carved out of that whole procurement area merely those cases in which a taxpayer might seek rapid amortization. That is quite true. In other words, they tried to put that in a statute for the enforcement of a procurement policy which is applicable to all.

As indicated, the statute does not say if there is such reimbursement, amortization shall be denied. It merely says it shall be denied unless the Government's interest is protected. It does not say, if there is such reimbursement, the amortization shall be denied in every case, but only in those cases in which there is a contract with the Government.

The difficulty we have been up against, gentlemen, is because an effort has been made on the part of the Congress to put into this particular statute a procurement policy that should be, and is properly, enforceable in every contract we make. So here we have a statute where a contractor of a certain class, namely, one who seeks amortization, must get something we have great difficulty in giving, namely, a certificate of nonreimbursement on his particular contract, and that applies to every future contract which he may enter into.

Senator TAFT. May I ask him the same question I asked the Secretary?

How far can you go in estimating the contractor's cost? Do you take actual depreciation?

Colonel GREENBAUM. We interpret the statute to mean, as the Secretary indicated, that it does not go above normal exhaustion, wear and tear.

Senator TAFT. Would you say, if you allowed as part of the cost the amortization of machinery at the rate of 5 percent a year, that is 20 years, that would not be reimbursing the contractor?

Colonel GREENBAUM. No, sir; we do not so interpret it.

Senator TAFT. I see. That is your interpretation of the statute?

Colonel GREENBAUM. Yes.

Senator TAFT. If this is repealed, that will be your guide on the question of whether you are reimbursing him?

Colonel GREENBAUM. That is the way we have been operating under that. As you indicated before, Senator Taft, that is a very difficult question to determine in this particular case, but that is the rule we would follow.

Secretary PATTERSON. Small tools have a life of 2 years, or something like that?

Colonel GREENBAUM. Yes; they gain nothing by amortization. Other facilities may have a 12 years' life, and so forth.

Senator DANAHY. Mr. Chairman, I have a question.

The CHAIRMAN. Yes.

Senator DANAHY. Colonel, assuming that the difficulties that are inherent in subsection (i) as they have been explained here shall be removed on account of the repeal of subsection (i), how do you assure the contractor of greater certainty from then on?

Colonel GREENBAUM. Because he will then know, when he gets his certificate of necessity, that the amortization is assured to him. The Government protection we will take care of through the procuring officers.

Senator TAFT. He gets that amortization even if the Government makes a mistake and gives him too much on the contract?

Colonel GREENBAUM. That is right.

Senator DANAHY. But we will be, as a matter of law, right back to where we were before we passed the statute in 1940.

Colonel GREENBAUM. Before 1940 there was no 5-year amortization.

Senator DANAHY. No; but whatever the rate of amortization, whether it be for buildings, for example, as distinguished from small tools, whatever the rate is that you allow you will be right back there.

Colonel GREENBAUM. This is not the repeal of the amortization law, but merely the repeal of subsection (i). On the repeal of that we will be back then to the Second Revenue Act of 1940 which will allow the 5-year rate, that is correct; yes.

Senator DANAHY. Thank you.

The CHAIRMAN. Thank you very much, Colonel, and thank you very much, Mr. Patterson.

Secretary Forrestal.

#### STATEMENT OF HON. JAMES V. FORRESTAL, UNDER SECRETARY OF THE NAVY

The CHAIRMAN. Mr. Secretary, will you make such statement to the committee as you desire regarding this resolution proposing a repeal of section 124 (i)?

Secretary FORRESTAL. House Joint Resolution No. 257 repeals section 124 (i) of the Internal Revenue Code and I believe such repeal will be of great assistance in our war effort.

Section 124 of the Internal Revenue Code was enacted to induce private capital to invest in what was then called the "defense effort."

Five-year amortization for tax purposes of new facilities (and a facility includes machine tools and equipment as well as buildings) was offered to private contractors.

In order to secure such right of amortization the facility in question had to be certified to be necessary and a certificate of necessity issued. Such right of amortization could, however, be subsequently lost if the contractor sought to be reimbursed for such facility beyond ordinary wear and tear in supply contracts with the United States unless along with such reimbursement some provision was made for recognizing the interest of the Government in the facility.

To evidence the lack of reimbursement in each supply contract a certificate of nonreimbursement had to be issued. If reimbursement existed preservation of the privilege to amortize needed a certificate of Government protection.

Determination of the existence or nonexistence of reimbursements buried in the price of a supply contract is almost an impossible mathe-

mathematical problem. Before the contract is performed it is very difficult to determine where depreciation begins and ends, where reimbursement for more than normal wear and tear blends into profit. Even then calculations made with respect to prices are frequently quite different from calculations made of actual results upon the completion of the contract. The statute refers only to calculations of prices—and not to costs incurred.

Consequently, in spite of several amendments, we have been unable to issue certificates of nonreimbursement in sufficient volume to give the contractors any confidence as to the promised privilege of amortization. As a matter of fact, we have not been able to review and act upon more than 5 percent of the contracts involved. This does not mean that we have rejected the balance of the contracts, but simply that 95 percent of the contracts did not fall into any classifications which either we, the Army, the Advisory Commission (while it was in existence) and the special committee of O. P. M. could be definite about.

The result has been that contractors have been discouraged; have come to the conclusion that certificates of nonreimbursement cannot be issued; and that consequently they can never be sure about the privilege of 5-year amortization.

The further result has been that the United States Government has had to put up 100 percent of the cost of many of the facilities. The attempted inducements offered to private capital have not been real, and the Government has had to do the financing. Up to November 30, 1941, private capital had invested \$1,166,000,000 in war facilities and the United States Government, through defense-plant loans, direct grants of E.P.F. contracts, had invested \$5,067,000,000. The possible loss of taxes therefor, through reimbursement free of tax levy must be balanced against the loss to the Government through the possible lack of need for such facilities upon the conclusion of the war. It is difficult at this time to say which will be the greater loss, but certainly the immediate outlay of the Government is now enormous.

Under all of the circumstances, I believe that the requirement of certificates of necessity strictly applied, will constitute the best protection to the Government. We can be very careful to see to it that no unnecessary plants are constructed. That has always been our aim.

So far as reimbursement is concerned, I believe that can be better handled through careful supervision of procurement policy. If the Government is making any reimbursement for plants that reimbursement will be separately stated, and adequate provisions will be taken to protect the interest thus acquired by the Government in each such facility.

Senator BARKLEY. Have you any opinion as to how much more would have been invested by private capital if this war had not been in effect?

Secretary FORRESTAL. That is a very wild guess. I think a substantial amount would have gone in, but I would not mean to infer that the Government would not also have made large investments, because the size of these investments is such now that they could not be handled without the help of the Government. Those figures,

Senator, are subject to constant change, and I will not vouch for their absolute accuracy.

Senator VANDENBERG. You stated that you had only been able to check on 5 percent out of 100 percent of requests for these certificates, is that right?

Secretary FORRESTAL. Yes. As a matter of fact, we have not been able to review and act upon more than 5 percent of the contracts involved. This does not mean we rejected the balance of the contracts, but simply that 95 percent of the contracts did not fall into any classifications which the Army or Navy or the Advisory Commission could be definite about. In other words, as a matter of fact, we were hopeful we would find some more practical way of attacking this problem than to have to make a further reference to some external and extraneous body, because to arrive at a judgment with any precision is very difficult.

Senator VANDENBERG. Those two sets of figures together would prove, at least, that you have collided with a very severe obstacle in your procurement effort in regard to this section.

Secretary FORRESTAL. That is correct. There are two questions, Senator. There is the question of nonreimbursement. If you apply for a nonreimbursement certificate and then want to get some additional benefit, which is what you are talking about, the further recouping of your investment, you have then to guarantee to the Government in some form that the Government shall have the use of that facility after the expiration of the war. In other words, grease it up, isolate it from the rest of the plant, where the Government will have the option to buy it, or whatever the Government may wish to do with it.

Now, I would like to say that of course the benefits of this 20 percent amortization are also uncertain, because they are only benefits if the contractor makes a profit.

Now, I would like to address to Senator Taft one thing that I think may cover the point he had in mind. In a directive that was issued by me on the 17th of January we stated as follows, and this is in relation to cost-plus contracts:

Procurement officers must be sure in making the contract, the fulfillment of which may require the use of a facility covered by an agreement--

that refers to E. P. F. in other words, Government money--

to the effect that no depreciation or amortization of such facility shall be included in the price, that such agreement is unmistakably adhered to and that depreciation and amortization of such facility was definitely excluded from the price.

Senator TAFT. That is, where the Government owned it, of course there should be care exercised in excluding the depreciation and amortization.

Secretary FORRESTAL. Where you are dealing with scrambled plants you require great care.

Senator TAFT. Where you have a limitation on naval contracts, a percentage profit limitation, the question of determining cost becomes material in nearly every contract?

Secretary FORRESTAL. Yes.

Senator TAFT. In those cases you will allow in your procurement what this attempts to permit you to allow only, that is, the actual wear and tear, and that may be 5 percent in the matter of depreciation on machinery?

Secretary FORRESTAL. That is right. I think I can illustrate this by a concrete case. One company, which is the General Electric, was taking a contract for the manufacture of something which we needed very vitally. It was a secret device. They could use a large part of one of their plants to make it with the investment of \$7,500,000, interspersing tools in that plant which we would provide, and under this provision for rapid amortization they were able to do the job. They came to us and said, "We do not want to be confronted with some unclear situation at the end of the war as to where we stand on taxes, because this is going to be a part of our plant, or a scramble in our plant, a big tool here, a boring machine here and a grinder here." The alternative was for them to build a completely separate plant outside of the limits of the present area of their operation with our money, on a cost-plus-fixed basis. The result of that would have been we would have had to spend, I think, about double the amount, about \$15,000,000. The time involved would have been considerably extended, possibly by several months, to construct the new plant and get it into operation, and the cost of the product would be higher.

Senator TAFT. And after the war you might have been stuck with the plant?

Secretary FORRESTAL. After the war we might go through the process of tearing the thing down or letting them buy it at an extremely low figure.

The CHAIRMAN. Are there any other questions? Thank you very much, Mr. Secretary.

Secretary FORRESTAL. Thank you, sir.

The CHAIRMAN. We have here the Acting Secretary of the Treasury.

#### STATEMENT OF HON. JOHN L. SULLIVAN, ACTING SECRETARY OF THE TREASURY

Secretary SULLIVAN. Mr. Chairman and gentlemen, I have no formal statement to make. The Treasury does not recognize that this is a Treasury problem but rather the problem of the service departments. I would like, however, to read into the record the substance of our letter to the Director of the Budget in relation to the bill now pending before you.

At the present time section 124(i) embodies what is essentially a procurement policy, and this Department is strongly of the opinion that such procurement policy should be carried into effect wherever practicable. However, based upon the representations made in the joint letter from the Secretary of War and the Secretary of the Navy to the chairman of the Ways and Means Committee of the House of Representatives, which is dated December 10, 1941, and is attached to your letter, this Department has no objection to the elimination of requirements effectuating this policy now contained in section 124 (i) of the Internal Revenue Code.

I think perhaps I might discuss with you for a moment three things that seemed to be of great interest to the Members of the House Ways and Means Committee. They were, first, very much interested in finding out what loss of revenue, if any, would result from the repeal of this section, and I have to tell you, as I told them, that neither I nor anybody else that I have ever known could give you anything like an accurate estimate on that. In the first place, it is impossible to estimate the degree of reimbursement. In the second place, it depends entirely upon the success, and the continued success

of the particular corporation involved whether or not the acceptance of the special 5-year amortization is to the benefit of that corporation or to its detriment.

You will recall that during the excess-profits tax act, when amortization was first provided for, the Treasury was insistent that there should be written into the amortization provision a clause which would permit a corporation which had once taken special amortization to return to regular depreciation. The reason for our insistence upon that provision was that after corporations had taken special amortization for a year or two and then foreseeing a fairly long period in which taxes would probably be higher, and would certainly not be lower, they might suddenly realize that they had made a serious fiscal mistake and would want to go back on the regular depreciation.

I haven't any figure that would be helpful to you, but I can tell you that many corporations that I know of have left special amortization and gone back to regular depreciation.

Senator TAFT. Mr. Sullivan, does not that depend on whether the machinery, or whatever it is, is something that they think they are going to use after the emergency is over or something that they figure is going to be practically useless?

Secretary SULLIVAN. I think it depends on a lot of factors, Senator Taft. I try not to kid myself in these matters. I feel sure a corporation that has 10 buildings and has 2 new buildings put up for defense purposes, when the war is over is going to keep the 2 new buildings and junk 2 old ones. If that corporation continues in business it will find itself with 2 brand new buildings upon which it has taken all of its depreciation and in 1949 will deeply regret that it used up that type of corporate tax reduction so hurriedly during the period when the rates are no higher than they may well be in 1949.

Senator TAFT. It is like the rubber plants. Somebody has got a rubber plant and he will figure synthetic rubber costs twice as much and will want to amortize it in 5 years.

Secretary SULLIVAN. You are correct. The concern that does not want to stay in business except during the emergency period, or the concern that goes into bankruptcy or greatly curtails its activity, it will profit by having taken special amortization.

The other two matters that were discussed in the hearings before the House were these: One, the facility of definitely establishing that there is no reimbursement. I am not a cost accountant, but I am sure I can take some contracts and determine, just as you gentlemen could, that in that particular contract there is reimbursement, and neither you nor I would have any hesitancy in certifying that there is reimbursement in that particular contract, but I want you to contrast that situation with what they are asked to do under this particular section. They are asked to make an affirmative finding that there is no reimbursement in that particular contract.

Now, as I say, this is not a Treasury problem, but the reason I am somewhat familiar with it is that soon after this provision went into effect the advisory commission OPM borrowed from the Treasury Mr. Eichholz of Mr. Tarleau's office for the work that was involved in the Defense Commission, and I kept myself familiar with the subject in that way.

The only case in which you can be sure that there has not been reimbursement is in the case of the company that has failed, that has

lost on the contract and has gone into bankruptcy. The degree of reimbursement, where there has been reimbursement, in my opinion, is a matter which the best cost accountant in the world cannot determine until not only after the contract is consummated but also until after the emergency has expired. It is a terribly difficult thing to do it.

One matter was mentioned briefly here this morning, but I do not think was fully explained, and that was the fact that a contractor who puts \$1,000,000 into his facilities and receives a certificate of necessity is not insured and guaranteed the use of special amortization, merely because there is no reimbursement in his contract. Suppose I put \$1,000,000 into a new plant and on the first contract I receive a certificate of nonreimbursement, and on the second contract and third contract, maybe 10 contracts, running into millions of dollars, and then along comes a little contract of \$20,000 in the third year and the certifying officer says, "Now, this is a new type of article, we do not know what the cost is going to be here, it is a difficult thing, we never made this before, it is a new invention and I cannot conscientiously certify you are not getting some reimbursement in the price we are going to pay you," my amortization stops right at that minute. You must remember that amortization continues only so long as there is a new certificate of nonreimbursement for every contract that is being executed with the particular facilities which are being amortized.

Those were the three points that were brought up in the House and that I thought I should just mention to you. I would be very happy to answer any questions.

The CHAIRMAN. Are there any questions from any member of the committee?

Senator VANDENBERG. Who was the author of this interesting scheme?

Secretary SULLIVAN. Would you mind if I merely stated the Treasury was not?

The CHAIRMAN. I would like to ask you, Mr. Sullivan, a practical question here of legislation. It has been suggested that the title of this resolution is not quite clear, that it ought to be changed. Obviously, if the Senate passes the resolution we would rather not send it back to the House to concur in something that is not vital. The title is now "To amend section 124 of the Internal Revenue Code to simplify the procedure in connection with amortization of certain facilities."

Actually, of course, it is a repeal of section 124 (i).

Secretary SULLIVAN. I think it says "To amend section 124," does it not? It does not say to amend section 124 (i).

The CHAIRMAN. That is right. I beg your pardon. If it is clear enough I would rather not bother with it. I am sure the committee would rather not send it back to the House. It would seem to make no difference.

Secretary SULLIVAN. I think if we would start again we might make it more explicit, but I would not consider it of sufficient importance to send it back.

The CHAIRMAN. No. Are there any other witnesses to be heard? Colonel Foster is here. Does any member of the committee desire to ask Colonel Foster any questions regarding this section?

**STATEMENT OF COL. GEORGE H. FOSTER, OFFICE OF THE  
UNDER SECRETARY OF WAR**

Colonel FOSTER. I have nothing to add. I just happen to be the one who has been, up until very recently, under Colonel Greenbaum trying to administer this law in the War Department. Having been, a tax lawyer in civilian life, I thought probably that accounted for my being there. I understand the tax question, but I do not think I can add anything now, because my study of the case has been more or less in the nature of how the Treasury is going to operate in these cases when they are all over.

The CHAIRMAN. Are there any questions? If there are no other witnesses the committee will go into executive session.

Thank you, gentlemen, for your courtesy.

(Thereupon, at 11:45 a. m. the committee retired into executive session.)

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